TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 21 June 2016

Inflation Developments

1. In May, consumer prices rose by 0.58 percent, and annual inflation remained flat with 6.58 percent. Food inflation increased somewhat due to the base effect, yet maintained its low course and continued to limit consumer inflation. In this period, annual inflation in core indicators registered a decline, while improvement in the underlying trend proved more evident.

2. Annual inflation in the food and non-alcoholic beverages group rose by 1.09 points to 2.47 percent in May. The low course of food inflation was mainly driven by unprocessed food prices, the annual inflation of which was -4.22 percent. In this group, prices of fresh fruits and vegetables remained below the previous year's levels due to increased supply of products, whereas red meat prices exhibited a mild outlook amid the measures in effect. On the other hand, processed food inflation sustained its high course due to prices of items other than meat and dairy products. Although leading indicators on June indicate that unprocessed food prices may be subject to a partial correction and the group's annual inflation may soar, food prices are expected to support the low course in inflation across the year. On the energy front, prices rose by 1.10 percent in line with the international oil prices and depreciating Turkish lira, while annual inflation sustained the favorable outlook with 1.65 percent.

3. Prices of services increased by 0.76 percent, and the annual services inflation stood close to the previous month's level with 8.74 percent in May. Being the culprit of high figures in services inflation, the deceleration in restaurants-hotels and other services groups in the last couple of months continued in May excluding package tour prices. The mild course in food prices reflected favorably on prices in the restaurants-hotels group, and the attenuated cumulative effects of the exchange rate underpins the slowdown in inflation in other services. On the other hand, it is assessed that the surge in unit labor costs in the first quarter is also responsible for the high course in services inflation. Moreover, it is notable that rents soared in May as they did in April. All in all, the underlying trend of services prices remained high in May.

4. Annual core goods inflation decreased by 1.29 points to 8.82 percent in May. Annual inflation recorded a decline in all sub-groups, and the clothing and durable goods groups stood out. Prices of durable goods registered a favorable outlook on account of the fall in white goods and flat course of automobile prices in addition to declining furniture prices following an uptrend in the first four months of the year. The underlying trend of core goods improved further, and when clothing is excluded, the improvement is still remarkable. Amid the decelerating cumulative exchange rate effects, annual core goods inflation is projected to slow in the second half of the year.

5. In sum, inflation has recently recorded a notable decline driven mainly by the unprocessed food prices. Core inflation indicators also recorded favorable figures, yet remained high in May. Meanwhile, the improvement in the underlying core inflation trend proved more remarkable in this period. Accordingly, annual inflation in core indicators is projected to fall further in the upcoming period. However, the high inflation trend in the services group coupled with the unit labor cost developments limit disinflation.

Factors Affecting Inflation

6. According to TurkStat data for the first quarter of 2016, GDP grew by 4.8 percent year-on-year. On the production side, industries and services made the greatest contribution to the first quarter's annual growth. Adjusted for seasonal and calendar effects, GDP increased by 0.8 percent from the previous quarter. On the spending side, consumption and exports were the main drivers of quarterly growth. In this period, private consumption accelerated amid wage hikes, employment growth and improving financial conditions. Exports were buoyed by the strengthening EU recovery. Nonetheless, with imports gaining remarkably in the first quarter due to increased consumption, net exports contributed negatively to quarterly growth. In short, growth was driven largely by consumption and supported somewhat by exports in the first quarter, yet capital accumulation remained moderate.

7. Data for the second quarter of 2016 indicate no additional acceleration for economic activity. Industrial production dropped by 1.1 percent month-on-month in April on the back of mining, vehicle, furniture and computer industries. May's PMI indicators and BTS indicators for orders over the last three months performed slightly better than in April, suggesting some correction in industrial production for May. Given favorable calendar effects and May's strike-driven low base effect from automotive manufacturing in last year, industrial production is expected to post a stronger year-on-year increase in May than in April.

8. Data on the spending front point to a slowing consumer demand and mildly recovering investments for the second quarter. The production and imports of consumer goods declined in April. Sales of home appliances fell marginally during April-May, whereas sales of automobiles remained on the rise. Among indicators for investments, imports of non-vehicle capital goods and machinery-equipment were up from the previous quarter's average, while their production dropped. Sales of light

and heavy commercial vehicles increased in the April-May period. The waning uncertainty and improved financial conditions are believed to help investments recover.

9. Favorable developments in the terms of trade accompanied by the moderate course of consumer loans support the recovery in the current account balance. The growing EU demand continues to support exports. High market-shifting flexibility of exports limits downside risks caused by geopolitical developments. Yet, the falling number of foreign visitors weighs on revenues from services, posing a downside risk to the current account balance.

10. Seasonally-adjusted unemployment rates were down in March for the second consecutive month. The strengthening non-farm employment growth pulled unemployment rates down despite the increased labor force participation. Industrial employment saw a moderate gain, while construction and services employment expanded significantly. Failing to spread across all sectors, the employment growth in services was driven mostly by public administration and community services. In view of production and survey indicators, employment is expected to remain on a modest track in the short term. Yet, the SSI data indicate that the stagnant tourism industry has started to affect employment. Thus, the unemployment rate continues to face upside risks for the period ahead.

11. In sum, current indicators suggest that the economy continues to grow at a moderate and steady pace. Income channel supports domestic demand through wage increases. Although geopolitical developments continue to pose downside risks, the growing EU demand continues to support exports, and thus production.

Monetary Policy and Risks

12. Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Risk weight arrangements and wage developments are expected to boost loan growth further in the upcoming period via loan supply and household income channels. Thus, annual loan growth rates are likely to remain at reasonable levels. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This composition not only limits medium-term inflationary pressures but also supports the improvement in the current account balance.

13. Economic activity remains on a moderate and steady growth track. In the first quarter, GDP expanded on the back of domestic demand. Consumer spending spurred domestic demand while investments remained weak. Despite the negative implications of geopolitical developments in external demand, exports to the EU remained on the rise. Accordingly, exports made a positive contribution to growth in the first quarter. Domestic demand is expected to continue to support growth in the upcoming period. Employment remains on a moderate upward path. Given wage developments, employment growth is likely to support domestic demand further

through the income channel. On the external demand side, geopolitical tensions and the weakening global growth continued to pose risks, while risks to the tourism industry became prevalent. However, the robust increase in Turkey's exports to the EU and the market-shifting flexibility of exports alleviate the downside risks to external balance. Moreover, the favorable impact of the cumulative fall in commodity prices on the terms of trade and the moderate course of consumer loans contribute to the improvement in the current account balance.

14. Global financial markets remain volatile amid ongoing concerns over global growth, developments regarding UK's exit from the EU and continued uncertainty about global monetary policies. Accordingly, emerging-market portfolio flows slowed while risk premiums and exchange rate volatilities recorded increases. The Committee assesses that the tight monetary policy stance, the cautious macroprudential policies and the effective use of the policy instruments laid out in the road map published in August 2015 enhance the resilience of the economy against shocks. In fact, the Turkish lira has followed a relatively less volatile path than other emerging market currencies since September 2015. Against this backdrop, the Committee decided to take a measured step towards simplification by lowering the marginal funding rate. Moreover, within the context of the road map, related departments made presentations about the arrangements that would increase the predictability of liquidity policy and make liquidity management of banks more efficient.

15. The sharp decline in food inflation since the beginning of the year helped to bring consumer inflation markedly down. The recent improvement in the core inflation indicators also contributed to this disinflation. Low imported-input costs and the continued weakening of the lagged effects of cumulative exchange rate movements support the improvement in the underlying core inflation trend. On the other hand, the underlying services inflation trend remains elevated. High levels of inflation expectations and unit labor cost developments restrain the improvement in the underlying trend of inflation. To this end, the Committee stated that the current tight liquidity stance should be maintained in order to ensure that the recently observed disinflation becomes permanent.

16. In the upcoming period, the monetary policy stance will be conditional on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, the tight monetary policy stance will be maintained. Moreover, global and domestic volatilities will be monitored closely and necessary measures will be taken for the foreign exchange and Turkish lira markets. In sum, the policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of financial stability.

17. Developments in the fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices. A revision of the monetary

policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

18. Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. Any measure that would ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.