TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 26 October 2017

Inflation Developments

1. In September, consumer prices were up 0.65 percent and annual inflation rose by 0.52 points to 11.20 percent. Annual inflation recorded a decline in the energy group due to the base effect, but increased in other subgroups. Food inflation increased due to the negative base effect in the unprocessed food group coupled with the spike in the processed food prices. Core goods and services groups witnessed overall price hikes, while the rise in the clothing group is mainly attributed to the methodological change in the weighting system. These developments pushed both the annual inflation and the underlying trend of core indicators higher.

2. Annual inflation in food and nonalcoholic beverages increased by 0.53 points to 12.50 percent in September. Both unprocessed and processed food prices recorded higher annual inflation rates. While this outlook on unprocessed food inflation was triggered by the base effect, the red meat prices are decreasing amid the measures in effect and seasonally-adjusted unprocessed food prices have been on the decline for the last three months. Leading indicators for October hint at a sustained downtrend in unprocessed food prices. On the energy front, prices jumped in September amid price developments in oil and other inputs, and this trend continued in October.

3. Prices of services rose by 1.04 percent and the annual services inflation reached 9.55 percent in September. Price hikes spread across subgroups, and particularly striking were those in accommodation services and rent. Largely indexed to headline inflation, prices of educational services increased at a high rate in September as in August. Climbing inflation in services was driven both by increased costs and indexation to past inflation besides the robust course of economic activity.

4. Annual core goods inflation increased by 1.62 points to 12.70 percent in September. All subgroups, chiefly the clothing group saw higher annual inflation in this period. The recent upward course of core goods inflation was led by the lagged effects of the exchange rate, the strong course of economic activity and the clothing-driven

methodological effects. The change in the weighting structure in clothing was mostly manifested itself in this period and accounted for nearly half of the rise in annual inflation in core indicators. Among durable goods, price hikes were more prevalent in automobiles and home appliances, and monthly price increases in core goods excluding clothing and durable goods gained momentum. Indicators for October hint at an ongoing uptrend in core goods inflation. The termination of the temporary tax reductions in white goods and furniture sector will also have a role in this uptrend. In addition, the weight update for clothing prices may still put upward pressure in October, albeit to a lesser degree.

5. In sum, current elevated levels of inflation and the developments on core inflation outlook continue to pose risks on the pricing behavior.

Factors Affecting Inflation

6. Recently released data indicate a strong economic activity. July-August data on industrial production and September's survey indicators suggest that industrial activity remains strong yet somewhat slower than in the second quarter. As growth becomes more widespread across sectors, indicators for services and trade have also recorded substantial gains; the recovery in the tourism sector helped boost the economic activity, as well.

7. A similar outlook is also evident in demand indicators. Private consumption props up growth, while machinery and equipment investments have been increasingly displaying signs of recovery following a long spell of weak growth. Domestic demand is expected to provide added support to growth in the third quarter. The Committee reiterated that annual growth will be much faster in the third quarter owing to strengthening economic activity as well as calendar and base effects.

8. The improving growth outlook across the globe, particularly for the EU, and Turkey's flexibility to shift markets abroad continue to stimulate exports. Despite that a slight deterioration in the current account deficit is expected in the next few months due to the recovery in domestic demand and base effects, the strong recovery in tourism and the uptrend in exports of goods is envisaged to contribute further to the current account balance.

9. The labor market improvement halted in July. In this period, construction employment increased whereas employment in industry and service sectors dropped compared to the previous period. Thus, despite the strong economy-wide growth, the labor market displayed only a partial recovery. Survey data suggest that the weak July outlook was only temporary. Still, the Committee noted that employment gains failed to fully pass through to unemployment rates due to the strong upward trend in the labor force participation rate.

10. In short, economic activity was robust in the third quarter. Domestic demand conditions keep improving and the improving external demand, primarily from European Union economies, continues to contribute positively to exports. The

Committee assesses that the implementation of structural reforms would contribute to potential growth significantly.

Monetary Policy and Risks

11. The global economic upturn is expected to continue in the rest of 2017 and throughout 2018. Although financial market volatility slightly increased in the third quarter, global financial conditions remain accommodative as the risk appetite is still strong. Despite the third quarter's higher crude oil prices driven by the benign global growth outlook, the OPEC output cut and the hurricanes that hit the US oil production, demand and supply-side factors specific to the oil market are containing the upward pressures on energy prices. On the other hand, risks related to other commodity prices are on the upside due to the global growth outlook.

12. The primary downside risk to the global economic outlook is the uncertainty surrounding monetary policy normalization across advanced economies. The communication after the September meeting reinforced financial market expectations that the Fed will stick to its previously announced path of normalization. The Fed started reducing the size of its balance sheet in October. If the impending balance sheet downsizing of the Fed and other major central banks is introduced faster than expected, the high risk appetite and low volatility cycle in financial markets may be reversed. In addition to these uncertainties regarding global economic policies, the lack of a clear-cut Brexit strategy, the tendency towards more inward-oriented policies in European economies and the ongoing geopolitical turmoil in Asia and the Middle East stand out as other upcoming downside risks to financial markets and global growth. The fact that the size of private sector debt has reached high levels across some emerging economies, with China in the lead, might aggravate the impact of the risks related to financial markets.

13. The favorable global economic outlook and trade volume as well as the ongoing global risk appetite prompted an upturn in portfolio flows toward emerging economies recently, but heightened geopolitical risks caused portfolio investments to lose momentum in Turkey. Turkey's portfolio inflows have been more concentrated in government bonds since September whereas flows to the stock market remained volatile and weak. The volatility in the foreign exchange market triggered a rise in long-term inflation compensation. Despite these developments, financial conditions remained mostly accommodative in the third quarter. Loan growth balanced at historical levels in the third quarter, as the loans guaranteed by the Credit Guarantee Fund almost reached the pre-determined upper limit. The strong acceleration of credit growth in the first half of the year and its phase-out in the second half are monitored closely with regard to their impact on aggregate demand and economic activity.

14. The third quarter's economic activity and aggregate demand were mostly in line with the predictions of the previous Report. After the third quarter, domestic

demand might see some slowdown due to the reduced support of the additional credit boost to growth and the termination of tax incentives for durable goods, and the economy is expected to move towards its underlying trend. Both the subsiding effect of the accommodative policies of 2017 and the fiscal measures announced in the recent Medium Term Program (MTP) are monitored closely with respect to their effect on economic activity. The continued recovery in tourism, the improving global growth outlook and the favorable course of the real exchange rate are expected to contribute further to growth and the current account balance in the coming months through the export channel. The improving perceptions regarding uncertainty will continue to bolster investment in the next quarter, as in the third quarter. As the recovery becomes widespread, it is expected that favorable tendency will take place in employment and investment, upholding economic growth. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments remain key to economic activity. Exchange rate volatility that may arise from such factors poses a downside risk to the timing and strength of the support that financial conditions could provide to the economic activity.

15. The Committee evaluated the medium-term projections to be presented in the final Inflation Report of the year. Accordingly, year-end inflation forecast was revised upwards by 1.1 points for 2017, and 0.6 points for 2018, compared to the 2017 July Inflation Report. Given a tight policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to be 9.8 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 7 percent by the end of 2018.

16. Following the July Inflation Report, the rise in commodity prices, particularly for oil and metals, and exchange rate changes drove inflation higher through the cost channel, causing core inflation indicators to exceed forecasts. Inflation is expected to remain high in October and November before coming down markedly to a still elevated level in December amid base effects. Base effects from food prices, the termination of temporary tax cuts for home appliances and furniture in October and the methodology change for clothing are the factors that will cause inflation to fluctuate in the short term and core inflation to rise briefly. The inflation outlook is expected to improve gradually from December onwards.

17. The current elevated levels of inflation and developments in core inflation indicators continue to pose risks to the pricing behavior. These risks and the high levels of inflation expectations might dampen the expected improvement in the inflation outlook from December through the first months of 2018. The fact that inflation expectations and the pricing behavior show no sign of improvement jeopardizes the inflation outlook. All these developments necessitate the maintaining of the tight monetary policy stance.

18. Against this background, the Committee decided to maintain the tight monetary policy stance in its October meeting and kept the Late Liquidity Window lending rate constant at 12.25 percent. The Committee strengthened gradually the caution level of its monetary stance with the communication conducted in September and October.

19. The tight stance in monetary policy will be maintained until the inflation outlook displays a significant improvement and becomes consistent with the targets. Accordingly, the monetary policy will aim to bring inflation down to 7 percent at end-2018 before gradually falling to 5 percent. Consequently, with the current reading of the data, this stance requires that the tight monetary policy be preserved until a convincing fall in the trend of inflation is reached. The CBRT formulates monetary policy by taking the medium-term inflation into account, thus focusing on the developments in underlying inflation rather than the anticipated fluctuations driven by the base effects during the course of the year. Inflation expectations, pricing behaviors and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered if needed. The Committee will continue to use all available instruments in pursuit of the price stability objective.

20. Developments in 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 and taxes. 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.

21. In recent years, sustaining fiscal discipline has been one of the key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of an expansionary fiscal policy. Structural measures to provide room for counter-cyclical fiscal policies will enhance the coordination of monetary and fiscal policy, and improve macroeconomic stability.