Summary of the Monetary Policy Committee Meeting

31 July 2019, No: 2019-31

Meeting Date: 25 July 2019

Inflation Developments

1. In June, consumer prices remained almost unchanged with a minimal rise of 0.03% and annual inflation decreased by 2.99 points to 15.72%. In this period, annual inflation decreased across all subgroups, chiefly in the food group. Annual food inflation declined on the back of the falling unprocessed food prices in tandem with the prospects for the vegetable products. Energy prices decreased, contributing positively to consumer inflation. Domestic demand developments and the effects of monetary tightening as well as the waning impacts of the cumulative depreciation supported the deceleration in annual inflation of core inflation indicators.
2. In the food and non-alcoholic beverages group, annual inflation fell by 9.24 points to 19.20% in June. Annual unprocessed food inflation declined to 15.31% due to vegetable prices and became the main driver of the slowdown in consumer inflation. Processed food prices, on the other hand, posted a significant month-on-month increase also in June in response to the lagged effects of increases in costs on prices and annual inflation increased in this group.
3. In June, energy prices decreased by 1.04% due to the fall in municipal water tariffs and exchange rate developments, as well as fuel prices which declined amid falling oil prices. In July, annual energy inflation is expected to rise depending on the adjustment in electricity prices.
4. In June, annual core goods inflation decreased by 1.80 points to 14.79%, underpinned by declines across all subgroups. Despite the increase in automobile prices, the durable goods group registered a moderate price increase due to the effects of remaining subgroups, while the change in clothing prices continued to remain below seasonal averages. The high base effect from the previous year coupled with the recent exchange rate developments and the sluggish domestic demand support the fall in core goods inflation. On the other hand, annual core goods inflation is expected to rise temporarily in July due to the expiry of the provisional tax cuts in the furniture, white goods and automobile sectors.
5. Prices of services rose by 1.65% in June and the group's annual inflation inched down by 0.23 points to 14.92%. Annual inflation receded in the communication and other services groups, but increased in other subgroups. In this period, the restaurants-hotels group saw price hikes both in catering and accommodation services on account of the vibrant tourism sector. The uptick in the transport group inflation was led by intercity passenger transport prices. Meanwhile, the underlying trend of services inflation displayed some increase on account of

the robust tourism demand. In this period, the downward impact of the weak domestic demand on services inflation is believed to be restrained by the brisk tourism demand, cumulative cost increase in some items, real unit labor costs and the backward indexation behavior.

Factors Affecting Inflation

6. Recently-released data indicate a moderate recovery in the economic activity. Industrial production recorded a month-on-month increase in May, and maintained the trend of recovery in the April-May period with an uptick by 1.7%. This outlook is preserved even when other transport vehicles that stimulate industrial production are excluded. The unfavorable outlook in the survey data of April-May was replaced by recovery in June. Thus, survey indicators such as the manufacturing industry capacity utilization ratio and the PMI-production recorded an increase in the second quarter. On the other hand, the services sector also exhibits improvements, while the construction sector still remains sluggish.

7. Goods and services exports continue to display an upward trend despite the weakening in the global economic outlook, due to improved competitiveness. In particular, strong tourism sector supports economic activity through direct and indirect channels. Despite recent signs of a partial global slowdown, particularly for the European Union (EU), external demand maintains its relative strength. Notwithstanding the somewhat slowing exports to the EU in April-May, the seasonally-adjusted non-gold export quantity index continued to rise quarter-on-quarter amid strong exports to other regions. In the same period, the number of foreign visitors and travel and transport revenues remained on a firm uptrend while exports of services continued to boost growth. Economy-wide spillovers from the robust tourism industry through sectors such as nondurable goods production, clothing in particular, and transport services help offset part of the weak domestic demand caused by the dim labor and credit markets outlook.

8. The composition of growth is having a positive impact on the external balance. Firms' orientation towards external markets due to subdued domestic demand, and their flexibility in market diversification stimulate exports of goods; the lagged effects of exchange rates and the modest outlook for loans and economic activity restrain import demand, and external balance continues to improve at an accelerated pace thanks to the upbeat in tourism activity. Thus, the current account balance is expected to maintain its improving trend.

9. Labor market data is relatively weak. According to April 2019 data, nonfarm employment remains flat while nonfarm unemployment rate came to a halt. Across sectors, industrial employment increased while services employment edged down and construction lost more jobs, compared to the previous period.

10. In sum, looking forward, net exports are expected to contribute to economic growth and the gradual recovery is likely to continue with the help of the disinflation trend and the partial improvement in financial conditions. Against this background, aggregate demand conditions are estimated to make a further contribution to disinflation.

Monetary Policy and Risks

11. Besides geopolitical developments, ongoing uncertainties over global economic activity pose a downside risk to growth via capital flows and foreign trade channels. The persistent trade tension between the US and China, political uncertainties regarding the Brexit, and Middle East-based geopolitical developments cause the uncertainty over global economic policies to

remain elevated and the vulnerabilities in global financial markets to continue. All these factors keep the downside risks to global economic activity alive.

12. The downside risks to future crude oil prices have intensified. Despite OPEC's decision in July to extend the production cuts, ongoing geopolitical problems across the world, and the slowing US shale oil production, the downside risks to crude oil prices have strengthened due to the high level of uncertainty over global trade and the unfavorable global economic outlook. In addition, in spite of higher wages due to tight job markets in advanced economies, inflation remains moderate. All in all, the global economic outlook appears to have fed into the downside risks to global inflation.

13. Recently, weaker global economic activity and heightened downside risks to inflation have strengthened the possibility of advanced economy central banks to take expansionary monetary policy steps. These developments support the demand for emerging market assets and the risk appetite, increasing the upward risks on portfolio flows to emerging markets. On the other hand, rising protectionism and the uncertainty regarding global economic policies pose downside risks to these portfolio flows. These factors are closely monitored in terms of their potential impacts on domestic economic activity and financial markets through both capital flows and international trade.

14. In the second quarter of the year, Turkey's risk premium negatively diverged from other emerging market economies due to domestic uncertainties and geopolitical factors. However, it has rapidly declined since mid-June owing to reduced uncertainties, the improvement in the outlook for global financial conditions as well as in macroeconomic indicators, and the tight monetary policy stance, while the volatility in financial markets has decreased. On the other hand, the persistence of high levels of country risk premium and exchange rate volatility as well as the lingering global uncertainties and geopolitical risks keep the upside risks to the medium-term inflation outlook alive.

15. In the second quarter of 2019, banks' domestic funding conditions tightened, causing them to reflect the increased Turkish lira funding costs in loan rates. Due to these developments and the expectations for the overall economic outlook, loan growth rates lost pace in this period. A decrease in the degree of monetary policy tightness and the introduction of accommodative credit packages are deemed to be the factors that will support the normalization in credit conditions and credit demand in the upcoming period. The speed, scope and sustainability of the normalization in credit conditions will be important for the economic activity outlook.

16. Despite the restrictive impact of domestic demand conditions on inflation, elevated levels of inflation continue to pose an upside risk to the inflation outlook in the upcoming period. Anchoring inflation and exchange rate expectations is crucial for the effectiveness of monetary policy in the current period.

17. The course of food prices constitutes one of the risk factors that may affect the short-term inflation outlook. While accumulated cost pressures keep the upside risks to processed food prices alive, they may also exert an additional pressure on catering services prices through periodic factors. On the other hand, projections for unprocessed food inflation may be revised downwards depending on the future course of the correction in this group's inflation driven by the increased supply of vegetables due to favorable weather conditions. Against this background, the risks that the course of food prices may pose to the short-term inflation outlook are considered to be balanced.

18. The inflation outlook continued to improve. In the second quarter, inflation displayed a significant fall with the contribution from a deceleration in unprocessed food and energy prices. Domestic demand conditions and the tight monetary policy continue to support disinflation. Underlying trend indicators, supply side factors, and import prices lead to an improvement in the inflation outlook. In light of these developments, recent end-year inflation forecasts are slightly below the projections of the April Inflation Report. Accordingly, considering all the factors affecting the inflation outlook, the Committee decided to reduce the policy rate by 425 basis points.

19. The Committee assesses that maintaining a sustained disinflation process is the key for achieving lower country risk premium, lower long-term interest rates, and stronger economic recovery. Keeping the disinflation process on track with the targeted path requires the continuation of a cautious monetary stance. In this respect, the extent of the monetary tightness will be determined by considering the indicators of the underlying inflation trend to ensure the continuation of the disinflation process. The Central Bank will continue to use all available instruments in pursuit of the price stability and financial stability objectives.

20. The Committee maintains its assessment that the recent gradual improvement in the country risk premium will also continue in the upcoming period. The Central Bank will continue to use all available instruments in pursuit of price and financial stability objectives, taking into account all macroeconomic indicators including inflation and economic activity in particular. In order to support the effectiveness of monetary policy and minimize a likely inflation-growth trade-off, it will be crucial that macro-financial policies are determined with a focus on reducing financial volatility and risk premium, and that the predictability of fiscal policy continues to be reinforced.

21. The fiscal policy outlook that the monetary policy is based on incorporates a policy stance that focuses on price stability and macroeconomic rebalancing and that is coordinated with the monetary policy. Accordingly, the monetary policy stance assumes that administered price and tax adjustments are formulated in a way that will help reduce the backward indexation behavior. If the fiscal policy significantly deviates from this framework leading to an adverse impact on the medium-term inflation outlook, the monetary policy stance may be revised.

22. Collective efforts to turn the recently enhanced coordination between monetary and fiscal policies into a sustained and systematic structure are expected to support the achievement of price stability. Moreover, continued structural steps focusing on reducing rigidity and volatility in inflation will contribute to price stability and therefore social welfare.