Summary of the Monetary Policy Committee Meeting

20 December 2018, No: 2018-49

Meeting Date: 13 December 2018

Inflation Developments

1. In November, consumer prices dropped by 1.44% and annual inflation decreased by 3.62 points to 21.62%. Annual inflation registered a decline across all subcategories. The fall in core goods inflation was mainly led by temporary tax cuts applied to durable goods. In this period, energy prices dropped due to the fall in oil prices and the appreciation in the Turkish lira. Against this background, annual inflation and the underlying trend in core indicators both decelerated. In sum, consumer prices in November reflect tax cuts, the appreciation in the Turkish lira, and falling oil prices as well as demand-side effects led by weaker economic activity.
2. Annual inflation in food and nonalcoholic beverages went down by 3.60 points to 25.66% in November. This decline was mostly driven by the fall in unprocessed food prices led by fresh fruits and vegetables. On the processed food front, after following a high course for a while, price increases lost pace in this period.
3. Energy prices were down by 0.71% and annual inflation in this group fell by 4.08 points to 25.35%. This is attributed to falling international oil prices and the appreciation in Turkish lira. Leading indicators for December indicate that the support from fuel prices to consumer inflation continues at a strong pace.
4. Annual core goods inflation fell by 7.46 points to 26.89% in November owing mainly to the prices of durable goods that dropped on the back of temporary tax cuts and the high reflections of these discounts on prices in past months. The rate of increase in clothing prices remained significantly below periodic price increases of past years. Meanwhile, lagged effects of the exchange rate on other core goods persisted, albeit in a weaker manner. All in all, the decline in core goods inflation in November is largely attributed to temporary tax cuts, while appreciation in the Turkish lira and weaker domestic demand emerged as other factors to support the slowdown in inflation.
5. The annual services inflation fell by 0.09 points to 14.67%. Annual inflation declined in rents and transport services, but remained almost flat in communication, restaurants-hotels and other services groups. Cost-side factors led by food and fuel prices had a positive effect on the catering and transportation services inflation. Meanwhile, weakening domestic demand supported the overall slowdown in services inflation.

Factors Affecting Inflation

6. In the third quarter, Turkey's Gross Domestic Product (GDP) contracted by 1.1% quarter-on-quarter but grew by 1.6% at an annual basis. The economic slowdown was driven by domestic demand, with both consumption and investment expenditures down from the previous quarter. Public consumption was another drag on quarterly growth. As a result of the domestic demand-led sharp drop in imports coupled with robust exports of goods and strong tourism demand, net exports made an increased contribution to quarterly and annual growth and prevented the economy from contracting further.

7. Recently released data show that the rebalancing trend in the economy has become more noticeable. Economic activity continues to slow amid weaker domestic demand. In addition, with the rapid rise in inflation, real incomes fall and weigh on domestic demand. The outlook for export and tourism-related activities remains relatively stable, but employment and investment weaken across sectors.

8. Despite recent signs of some slowdown in global growth, external demand maintains its strength. Firms' orientation towards external markets amid sluggish domestic demand and their flexibility in market diversification stimulate exports of goods; and external balances continue to improve rapidly on brisk tourism demand. On the other hand, imports remain on a downward slide, largely due to consumption and investment goods, which led to historically high current account surplus in August – October period. The rapid improvement in current account balance is expected to continue in the period ahead. Accordingly, net exports are expected to contribute further to growth in the fourth quarter and limit the economic slowdown to some extent. The Committee noted that exports of goods and services will continue to spur growth in the coming months and the falling import demand reflecting weak domestic demand will continue to have a positive effect on the current account balance.

9. Labor market data confirm that the economy continues to slow on the back of domestic demand. In the third quarter, construction employment declined while the public sector and business activities across services and industrial sectors with relatively stronger external trade links continued to make a positive contribution to employment.

Monetary Policy and Risks

10. Global economic activity remained positive from the perspective of external demand, yet decelerated slightly. Increasing protectionist trends in foreign trade increased the uncertainty over global economic policies and highlighted downside risks to the global growth outlook for the upcoming period. The slowdown in the global economic activity was mostly driven by advanced economies, led by the euro area. Forecasts for 2019 also point that the global growth outlook weakened slightly compared to the previous period, mainly due to the weak foreign trade. Additionally, developments related to the Brexit keep uncertainties over both the economic activity and financial markets in the euro area alive.

11. Despite the weakening global economic activity, global inflation has risen due to both advanced and emerging economies. This rise is mainly attributable to energy prices led by oil prices, which generally hovered at high levels throughout the first three quarters of 2018. In the recent period, oil prices have decreased notably driven by both supply and demand factors. This decline is expected to exert downward pressure on the inflation of both advanced and emerging economies. On the wages front, the unemployment rates, which are

at historically low levels in some advanced economies, remain to be a wages driven upside risk factor for global inflation.

12. The normalization expectations regarding the monetary policy of advanced economies is more moderate compared to the previous period, mainly due to the relative weakening of global growth outlook and the decline in oil prices. Although this outlook implies more favorable conditions in terms of portfolio flows to emerging economies, increased uncertainties over global economic policies may affect risk appetite adversely, thereby posing downside risks to portfolio flows.

13. While developments in import prices and domestic demand conditions have led to some improvement in the inflation outlook, risks to price stability continue to prevail. Elevated levels of inflation and inflation expectations, and uncertainties over the course of cost factors continue to pose risks to the pricing behavior in the coming period. Accordingly, the Committee has decided to maintain the tight monetary policy stance until the inflation outlook displays a significant improvement and kept the policy rate (one week repo auction rate) constant at 24%.

14. The Central Bank will continue to use all available instruments in pursuit of the price stability objective. Inflation expectations, pricing behavior, lagged impact of recent monetary policy decisions, contribution of fiscal policy to the rebalancing process, and other factors affecting inflation will be closely monitored and if needed, further monetary tightening will be delivered.

15. 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, tax and wage adjustments are formulated in a way that will help reducing 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.

16. 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.