Summary of the Monetary Policy Committee Meeting

19 December 2019, No. 2019-50

Meeting Date: 12 December 2019

Inflation Developments

1. In November, consumer prices increased by 0.38% while annual inflation rose by 2.01 points to 10.56%. The rise in annual inflation was largely driven by the base effect recorded in the core goods group due to the temporary tax cuts in the same period of the previous year. In this period, annual inflation increased in core goods, food, and energy groups while it remained relatively flat in the services group. Although annual inflation in core indicators was up due to the base effect, the B and C indices maintained their mild trend thanks to the stable course of the Turkish lira, the improvement in inflation expectations, and the developments in domestic demand conditions and producer prices.

2. Annual inflation in the food and non-alcoholic beverages group rose by 1.04 points to 8.89% in November. This rise was primarily driven by the unprocessed food group. Unprocessed food prices displayed a favorable outlook in this period but annual inflation in this group increased due to the low base effect from last year. Meanwhile, the monthly rate of increase in processed food prices somewhat accelerated. This acceleration is also expected to continue in December, led by dairy products in line with the developments in purchasing prices of raw milk.

3. In November, energy prices were up by 0.55% while annual energy inflation increased by 1.34 points to 7.34%. This increase was mainly due to the hikes in bottled gas and fuel prices driven by the rise in oil prices. It should be noted that annual inflation in the energy group will be in an upward trend in the next two months due to the low base effects.

4. Annual core goods inflation surged by 4.65 points to 6.57% in this period due to the effect of the durable goods group in particular. Although durable goods prices remained flat in November on the back of both the stable outlook in the Turkish lira and the moderate course of domestic demand conditions, annual inflation in this group posted a significant increase due to the low base effect stemming from the temporary tax cuts in the same period of the previous year. While annual inflation in the clothing and footwear group remained almost flat at a low level, it slightly receded in the other core goods group. The stable course of the Turkish lira and the current trend in producer prices favorably affect the short-term inflation outlook in the core goods group.

5. Services prices increased by 0.16% in November, and annual services inflation rose by 0.15 points to 12.16%. While annual inflation remained flat in rents, it declined in the restaurants-hotels group and slightly increased in transport, communication and other services. Monthly price hikes in catering services in the restaurants-hotels group significantly slowed down in line with the moderate course of food prices. In this period, despite the curbing effects

driven by domestic demand and Turkish lira, services inflation remained elevated due to the backward-indexation behavior, real unit labor costs, and the lagged price hikes in the sub-items of administered transport services.

6. The improvement in inflation expectations continues. The downtrend in 12-month ahead inflation expectations persists while the distribution of expectations implies an increased consensus among survey participants in December, which indicates that uncertainties regarding the medium-term inflation outlook has significantly decreased.

Factors Affecting Inflation

7. Recent data indicate that moderate recovery in economic activity continues. Gross Domestic Product (GDP) rose by 0.9% in the third quarter of 2019, while the data adjusted for seasonal and calendar effects edged up by 0.4%. Main driver of quarterly growth proved to be consumption expenditures. Due to the robust increase in machinery-equipment investments, the downtrend in total investments came to a halt. Although the uptrend in exports of goods and services remained intact, the contribution of net exports to annual and quarterly growth was negative due to the rebound in imports.

8. As risk premium, exchange rate volatility and uncertainties have declined, improved financial conditions and accelerated loans have supported domestic demand in the last quarter of the year. Despite the weakness in the labor market, private consumption has been increasing on the back of postponed demand. In addition, public expenditures continue to boost growth through the consumption channel.

9. Sectoral diffusion of economic activity continues to improve. Indicators such as the CBRT Business Tendency Survey, PMI and sectoral confidence indices hint at an ongoing improvement in the manufacturing industry and services activities. Although investment remains weak, survey indicators show that in addition to large firms in the manufacturing industry which have higher investment appetite, investment tendency in small and medium-sized firms have also started to recover after bottoming out. The Committee emphasized the importance of stable growth and demand for a sustainable improvement in investment and employment.

10. While favorable effects of improved competitiveness prevail, weakening global economic outlook tempers external demand. In addition to the EU, MENA countries also signaled for a partial slowdown in this period. While flexibility in market diversification and strong course in tourism support exports of goods and services, the recovery in domestic demand stimulates imports. Against this background, in the last quarter of the year, it is expected that the contribution of net exports to economic growth will decline, and the current account balance, which has recently recorded significant improvement, will maintain a moderate course with the contribution of supportive policy measures.

11. Labor market data is relatively weak. Despite the rise in nonfarm employment in the third quarter, nonfarm unemployment rate continued to rise. Compared to the second quarter, industrial employment remained flat in the third quarter, and services employment increased, while the downtrend in the construction employment continued, although to a lesser extent. Leading indicators signal for a partial recovery in the labor market in the last quarter of the year.

12. In sum, in the upcoming period, as the contribution of net exports to economic growth declines, economic recovery is expected to be sustained with the help of the ongoing disinflation process and improvement in financial conditions.

Monetary Policy and Risks

13. Global economic activity continued to slow down in the third quarter of the year. Leading indicators for the next quarter indicate that the ongoing global slowdown in the manufacturing industry might have also fed into the services sector. These developments keep the downside risks to global economic activity alive. The resulting likely effects on domestic growth are monitored closely.

14. Weak global economic activity depresses commodity prices and leads to a mild course in crude oil prices despite supply-side hurdles arising from geopolitical developments. Accordingly, global inflation rates remain flat.

15. Weakness in global economic activity and low levels of global inflation strengthen expectations regarding the continuation of expansionary monetary policies in advanced economies. The expectation that recently adopted accommodative stance of monetary policies in advanced economies, the US in particular, is likely to be maintained over a medium term horizon under current circumstances, and its implications for global financial conditions support the demand for emerging market assets and the risk appetite. Accordingly, amid recent positive expectations regarding a likely settlement of the trade tension between the US and China, global risk appetite has increased slightly compared to the previous meeting period and portfolio flows towards emerging economies have presented a more favorable outlook. Meanwhile, rising protectionism and uncertainty regarding global economic policies are closely monitored in terms of their impact on both capital flows and international trade.

16. Turkey's risk premium continued to decline owing to a cautious monetary policy stance and improved macroeconomic indicators as well as the accommodative monetary policy outlook in advanced economies. The decline in the short-term exchange rate volatility has also become more pronounced following the previous meeting period. However, possible upside effects of global and geopolitical uncertainties on the medium-term inflation outlook through country risk premium and exchange rate volatility channels will continue to be monitored closely.

17. The strong rate cuts since July and expectations of further rate cuts thereafter helped bring loan and deposit rates further down. Thus, TL-denominated commercial and consumer loan rates dropped significantly due also to the improvement in inflation expectations, while improved financing conditions and growing domestic demand helped total loans, consumer loans in particular, accelerate. Consumer loans have seen an upswing since early August while corporate loan growth gained pace with a lag. This can be attributed to supply-side effects caused by expectations for the overall economic outlook as well as postponed loan demand.

18. The more flexible and effective use of required reserves as a countercyclical macroprudential tool in this period supports credit growth and financial stability. In this context, firstly on 19 August 2019, Turkish lira reserve requirement ratios and the remuneration rate on Turkish lira denominated required reserves were linked to annual growth rates of Turkish lira cash credits. Moreover, on 9 December 2019, considering the level of rebalancing in the economy, a new reserve requirement practice was introduced to channel credit supply towards production-oriented sectors rather than consumption. Thus, long-term commercial loans that have a strong relation with production and investment and long-term mortgage loans that have a weak relation with imports will be encouraged. In the upcoming period, with the improvement in liquidity and capital adequacy ratios of the banking sector, the fall

in interest rates and adjustments in required reserves are expected to further support credit growth. In addition, NPLs and Stage 2 loans are monitored closely for any impact they might have on banks' loan supply in the short term. Employment and income developments will determine if the recent rate cut-driven rebound in loan demand will persist. The pace, scope and sustainability of the normalization in credit conditions will be important for the outlook for economic activity.

19. Inflation outlook continued to improve while inflation expectations displayed a wide-spread decline. Thanks to the stable course of the Turkish lira as well as the developments in domestic demand conditions and producer prices, core inflation indicators have displayed a mild trend. The improvement in macroeconomic indicators, inflation in particular, supports the fall in country risk premium and contributes to a benign outlook in cost factors. Underlying trend indicators, supply side factors and import prices lead to an improvement in the inflation outlook. In light of these developments, recent forecasts suggest that inflation is likely to materialize close to the lower bound of the October Inflation Report projections for the end of the year, with risks around the disinflation path for 2020 being balanced. Accordingly, considering all the factors affecting inflation outlook, the Committee decided to reduce the policy rate by 200 basis points. At this point, the current monetary policy stance is considered to be consistent with the projected disinflation path.

20. The Committee assesses that maintaining a sustained disinflation process is the key for achieving lower sovereign risk, lower long-term interest rates, and stronger economic recovery. Keeping the disinflation process in 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.

21. The Committee emphasized the importance of sustaining the improvement in the country risk premium for the price and financial stability objectives. In this context, in order to support the effectiveness of the 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 the fiscal policy continues to be reinforced.

22. 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.

23. Collective efforts to turn the recently enhanced coordination between monetary and fiscal policies into a sustained and systematic framework 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.

24. It should be emphasized that any new data or information may lead the Committee to revise its stance.