Summary of the Monetary Policy Committee Meeting

14 March 2018, No:2018-06

Meeting Date: 7 March 2018

Inflation Developments

1. In February, consumer prices rose by 0.73 percent and annual inflation receded by 0.09 points to 10.26 percent. Annual inflation was down in energy and core goods, but up in food and services. Energy inflation was pulled down by falling oil prices as well as relatively stable exchange rates. Annual core goods inflation slowed slightly while food inflation was driven higher by both processed and unprocessed food prices. Thus, the annual inflation of core indicators recorded a small decrease while their underlying trend remained high.
2. Annual inflation in food and nonalcoholic beverages was up by 1.51 points to 10.27 percent in February. Annual unprocessed food inflation accelerated to 6.71 percent, due to rising prices of fresh fruits and vegetables as well as higher milk and red meat prices. On this account, being adversely affected, annual processed food inflation hit a nine-year high of 13.76 percent. In this category, prices of cheese and other dairy goods, fats and processed meat recorded sharp gains. In addition, bread prices that went up due to the adjustment in the Bread Regulation and prices of nonalcoholic beverages that were driven higher by the new Special Consumption Tax (SCT) applied to some beverages put upward pressure on annual processed food inflation.
3. Energy prices fell by 0.58 percent in February amid sliding international oil prices and moderating exchange rates, and annual inflation dropped to 6.92 percent in this category.
4. Annual services inflation increased by 0.14 points to 9.37 percent in February, largely due to the subcategory of other services, the inflation of which was pushed up by rising prices of package tours and health services. Meanwhile, annual inflation was relatively flat in rents, restaurants-hotels and telecommunications, but continued to decline in transport services.
5. Annual core goods inflation fell by 0.65 points to 14.93 percent in February. Annual inflation was down across all subcategories yet remained high. The rise in annual clothing inflation was prompted by cumulative cost developments and robust aggregate demand conditions. Prices of durable goods posted a month-on-month increase due to furniture and automobile prices. Other core goods, on the other hand, saw a lower annual inflation rate thanks to base effects but their prices were up due to home maintenance-repair and medicines. It should be noted that the remaining impact of the mid-February increase of 15 percent in medicine prices caused by the reference exchange rate will also be felt in March.
6. In sum, current elevated levels of inflation and inflation expectations continue to pose risks to the pricing behavior. Underlying trend indicators display inertia and core inflation remains elevated.

Factors Affecting Inflation

7. Recently released data indicate that economic activity maintains its strength. Industrial production continued to grow in the fourth quarter, albeit at a slower rate. However, this deceleration stems from the slack in sectors subject to tax incentives, particularly furniture, whereas other sectors see no loss of momentum. Survey indicators hint at strong industrial output across subsectors for January and February. Indicators for services and trade remain moderate while the tourism rebound bolsters economic growth.
8. Domestic demand continues to expand. Private consumption growth is expected to lose some pace over the fourth quarter following the expired tax incentives for home appliances and furniture. On the other hand, current indicators show that machinery-equipment investments have been improving since the third quarter.
9. The upbeat growth outlook across the globe, particularly in the European Union (EU), rising external demand and Turkey's flexibility in diversifying export markets continue to stimulate exports. Notwithstanding the recovering import demand aided by the buoyant economy, gains in exports of goods helped slow down the deterioration of the core current-account-deficit indicators. The uptrend in exports of goods, coupled with the ongoing tourism rebound, will likely contribute further to the current account balance over the upcoming period. The Committee noted that the contribution of net exports to quarterly GDP growth will increase in the fourth quarter owing to brisk exports accompanied by slowing gold imports.
10. The second and third-quarter recovery in the labor market continued into the fourth quarter, confirming that economic activity remains strong. Employment surged in services and construction sectors in this period, but remained constant in the industrial sector compared to the previous period. Survey data hints at further employment gains and lower unemployment rates for the upcoming period. The Committee highlighted that employment gains failed to fully pass through to unemployment rates due to the upswing in labor force participation. Thus, unemployment rates are expected to decline gradually in the period ahead.
11. In short, recently released data indicate that economic activity maintains its strength. Domestic demand continues to expand and external demand contributes positively to exports.

Monetary Policy and Risks

12. Fourth-quarter data of the previous year on global growth signal continued simultaneous recovery in both advanced and emerging economies. PMI indicators pointing to growth for both markets and the upgraded growth forecasts, particularly for the EU, confirm the steady economic rebound across the globe.
13. The primary downside risks to the global economic outlook for the upcoming period are the geopolitical tensions in the Middle East and the heightened protectionism clouding international trade negotiations. In fact, the recent US plan to impose extra customs tariffs on imported steel and aluminum might spark more protectionism in foreign trade across the world. Moreover, the newly passed US tax reform has provided a growth boost to the US and its trading partners, which is considered an upside risk factor for the world economy.
14. Global inflation may fluctuate amid changes in commodity and oil prices, yet remains low, while global core inflation follows a flat course. Upside risks to global inflation reside for the

period ahead. Oil prices stand out as a main factor to distort the steady course of global inflation rates. A second risk factor to stimulate global inflation is the possibility of an upsurge in wages following the fall in unemployment rates in advanced economies. In fact, following the announcment of the US labor market data in early February, acceleration in inflation proved more likely.

15. With the Federal Reserve (Fed) and the European Central Bank (ECB) in the lead, major central banks continue to normalize monetary policy. However, risks to monetary tightening are more on the upside due to the possibility of accelerating inflation. In fact, higher volatility emerged in global financial markets and, particularly in the US, a decline was witnessed in the stock exchange amid concerns over the possibility of accelerating inflation and faster-than-projected monetary tightening by the Fed following the labor market data in the US. The stronger growth outlook also for the European Union is likely to cause a sooner-than-expected tightening in the ECB's monetary policy. Unless upside surprises occur in inflation in the period ahead, it is considered that the Fed's and the ECB's steps towards normalization will be in line with expectations.

16. The favorable global economic outlook and trade volume as well as the ongoing global risk appetite drive strong portfolio flows into emerging economies. The recent sharp movements in the US stock market had more limited impacts on the stock markets of emerging economies with sounder macroeconomic fundamentals compared to the past. It is estimated that portfolio inflows will continue in the case of sustained economic recovery in emerging economies and a moderate course in monetary policy normalization of advanced economies in 2018 as well.

17. With the diminishing effect of the macroprudential incentives and the CGF support granted last year in Turkey, credit growth reverted to historical averages. Meanwhile, underpinned also by the robust domestic demand, loan rates trended upwards. In 2018, the release of the new CGF-backed tranches is expected to accelerate the extension of credits, particularly for investment purposes. Financing the new credits, to be extended by banks, through core liabilities and long-term resources is significant. Effects of growth and composition of credits on aggregate demand and economic activity are monitored closely.

18. The reduced support of the additional credit boost to growth and the expiry of tax incentives on durable goods have led domestic demand to lose pace and economic growth to move towards its underlying trend as of the fourth quarter of 2017. In 2018, in addition to the fading effect accommodative policies of 2017, the tight monetary stance and the fiscal measures under the MTP are likely to appear as the main drivers of loan growth and a normalized economic activity. Meanwhile, the continued support from the CGF, albeit limited, will stand as a factor to stimulate domestic demand in 2018. The steady 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. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments remain a key element of 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 economic activity.

19. Current elevated levels of inflation and inflation expectations continue to pose risks to the pricing behavior. The hikes in processed food prices in the last couple of months disclose persisting risks to food inflation. Producer-driven cost pressures remain brisk. Costs in energy, particularly electricity, exhibit an uptick. The upbeat economic activity also acts in the

appearance of cost pressures on inflation. All these developments maintain brisk risks to the core inflation outlook, particularly to the core goods inflation.

20. Accordingly, the Committee decided to maintain the tight monetary policy stance and kept the Late Liquidity Window (LON) lending rate at 12.75 percent. The CBRT will continue to use all available instruments in pursuit of the price stability objective. The tight stance in monetary policy will be maintained decisively until the inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets. The Committee 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, the pricing behavior and other factors affecting inflation will be closely monitored, and, if needed, further monetary tightening will be delivered.

21. 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.

22. 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. Moreover, continuation of structural steps to reduce inertia and volatility in inflation will contribute positively to the price stability and social welfare.