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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 27 July 2017

Inflation Developments

1. In June, consumer prices were down 0.27 percent and annual inflation decreased by 0.82 points to 10.90 percent. Food inflation dropped on the back of fresh fruits and vegetables while annual energy inflation continued to decelerate. The lagged effects of the cumulative Turkish lira depreciation continued to weigh upon core goods whereas annual core goods inflation declined due to prices of durable goods. There is an improvement in underlying inflation in this period, even after adjusting for the transient effects of the methodology change in the clothing price index.
2. Annual inflation in food and nonalcoholic beverages fell by 2.57 points to 14.34 percent in June due to the reduction in annual fresh fruits and vegetables inflation coming from the base effect. On the other hand, annual inflation remained on the rise across food excluding fresh fruits and vegetables, with red meat prices recording large increases. Leading indicators for July signal that annual food inflation will continue to decrease owing to the base effect from unprocessed food. Annual energy inflation fell further in June amid a more favorable exchange rate and oil price outlook. Yet, recent developments may lead to a slight pickup in July's energy inflation.
3. Prices of services rose by 0.53 percent while annual services inflation inched up by 0.12 points to 9.18 percent in June amid factors such as rising transport prices driven by the lagged effects of increased fuel prices, and higher catering prices due to the indirect effects of increased food inflation, particularly in red meat. In addition to cost increases driven by exchange rates, fuel prices and food prices, factors affecting services inflation also include indexation to headline inflation.
4. Annual core goods inflation dropped by 0.51 points to 9.20 percent in June on the back of durable goods prices due to recent outlook in Turkish lira. Meanwhile, annual clothing inflation remained relatively flat in this period. Across core goods excluding clothing and durables, monthly price hikes have abated yet annual inflation remained high because of the lagged spillovers of the cumulative Turkish lira depreciation.

5. In sum, inflation edged down but still remains high. Despite the disinflationary impact of recent cost developments and a likely partial correction in food prices, the high inflation remains a risk to the pricing behavior.

Factors Affecting Inflation

6. Recently released data indicate an ongoing recovery in the economic activity. An evaluation of April and May industrial production figures jointly suggests a stronger quarter-on-quarter increase in the second quarter. Survey indicators of June show that this outlook will be maintained. Not only the manufacturing industry, but also services, retail trade and construction saw strengthening activity recently. Accordingly, economic recovery appears to be more widespread across sectors.
7. A similar outlook is also visible in demand indicators. Both consumer confidence and investment tendency have improved recently. The consumer demand for categories subject to incentives remains strong while investments signal some pickup after the subdued course in the first quarter. Domestic demand is likely to make more contribution to growth in the second quarter.
8. Domestic demand keeps recovering while net external demand spurs growth amid increases in exports of goods that spill over into a wide range of sectors. The improving growth outlook across the globe, particularly for the EU, the course of the real exchange rate and Turkey’s flexibility to shift markets abroad continue to stimulate exports. Increases in exports of goods slow down the deterioration of the current account deficit and help improve core current account deficit indicators. In addition to the expected partial recovery in tourism, the uptrend in exports of goods is envisaged to contribute further to the current account balance.
9. The uptick in the labor market, which started in February and March, grew more apparent in April period. Supported by rising employment in non-farm sectors, unemployment rate records a decline. Leading indicators hint at a further decrease in unemployment rate amid the economic recovery.
10. In sum, recent data indicate that the economic activity will maintain its strength due to the supportive measures and incentives provided recently. Domestic demand conditions have improved and demand from the European Union economies continues to contribute positively to exports. The rebound in economic activity will bear favorable effects on the labor market in the upcoming period as well.

Monetary Policy and Risks

11. The mild recovery in global economic activity became more pronounced particularly due to advanced economies in the first quarter of 2017. The considerable fall in volatility in global financial markets and the increased the risk appetite reinforces the support of global financial conditions on economic activity. Moreover, the optimistic outlook in the consumer and the real sector confidence indices and the favorable course of some commodity prices, chiefly oil, also improve expectations regarding global economic activity. The favorable global growth outlook and the

resulting fall in unemployment notwithstanding, the normalization process in monetary policies of advanced economies is believed to prove mild due to the absence of an apparent inflationist pressure related to wage increases. These factors keep portfolio inflows to emerging economies brisk including Turkey.

12. Despite the current favorable outlook in global economic activity, downside risks to global economy reside as well. In particular, should the normalization process of the Fed's policy-rate increase and the balance sheet downsizing prove faster than expected, the high risk appetite and low volatility cycle in financial markets may reverse. That may generate fluctuations in prices of securities in advanced economies and weaken the growth trend. Moreover, fading risk appetite may cause fluctuations in portfolio flows to emerging economies as well. In addition to these, the course of Brexit talks and effects of the blurred global economic policies like foreign trade protectionism that is on the agenda of many countries, particularly the US, are monitored closely.

13. In line with the positive course of the global financial markets, domestic financial conditions also proved more supportive of economic activity in the second quarter. This was driven by macroprudential policies, public measures and incentives and acceleration of the credits secured by the Credit Guarantee Fund (CGF), for which the limits were raised and terms of use were facilitated as of March. On the other hand, owing to strong capital inflows to especially the GDDS markets as of March, the share of foreign investors within the GDDS stock increased, and the Treasury increased foreign borrowing due to bulky foreign demand, which offered domestic banks a considerable room on the supply side. As the upper limit defined in credits secured by the CGF is near and as the supply-side effects have recently stepped in the banking sector, credit growth which lost pace starting from June is expected to be balanced at milder levels as of the second half of the year. The improvement in credits in the first half of the year is monitored closely with regard to the extent of their impact on the aggregate demand and economic activity.

14. Recently-released indicators confirm the previous view that downside risks to economic activity have abated and the economic recovery will prove more robust as of the second quarter of the year. Signals for a wider sectoral spillover of the pickup in economic activity led by exporting sectors compared to the previous periods are important to a stable recovery in growth. The gradual improvement in tourism revenues, the strengthened confidence channel, the positive effect of the cumulative depreciation on net exports and the normalization of commercial relations with Russia support growth. Moreover, the measures and incentive packages to boost consumption and investment expenditures, reduced uncertainty and improved financial conditions will continue to spur growth. The improvement in employment and the fall in unemployment rate on the back of the ongoing recovery constitute a ground for the maintenance of this trend and increased contribution of domestic demand to growth. Investment is envisaged to exhibit a gradual improvement as uncertainties wane and the climate of confidence grows stronger.

On the other hand, the pace of recovery in tourism revenues, uncertainties regarding monetary policies of advanced economies, the course of capital flows and geopolitical developments constitute a downside risk to growth also in 2017, as they have recently.

15. The favorable effects of the monetary tightening on inflation have become visible. Consumer inflation receded following on the back of falling oil prices and the recent stable course of the Turkish lira and remained broadly consistent with the forecasts in the April Inflation Report. The medium-term inflation outlook seems to have improved since the previous Reporting period, and the recovery in underlying inflation is expected to continue gradually. However, considering that the rigidity in expectations and the pricing behavior resides to a great extent, the improvement in the core inflation outlook, which is not yet deemed satisfactory, requires a tight monetary policy stance.
16. The Committee evaluated medium-term projections to be presented in the July Inflation Report in the meeting. Accordingly, year-end inflation forecast was revised upwards by 0.2 points for 2017, while it was kept unchanged for 2018 compared to the 2017 April 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 8.7 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 6.4 percent in 2018.
17. Although the highest inflation levels of the year are left behind, inflation is likely to follow a fluctuating course in the second half. The correction in food prices is yet to be at a favored level, which necessitates a cautious evaluation of how permanent the recent decline in the group’s inflation due to the base effects will be. Furthermore, temporary tax reductions in white goods and the furniture sector to be taken back in October as well as the effects driven by methodological changes stand out as factors that will lead to fluctuations in inflation in the short term and temporary increases in core inflation. The inflation outlook is projected to recover starting from the last month of the year, and become more evident in the early months of 2018.
18. Against this background, the Committee decided to maintain the tight monetary policy stance in its July meeting and kept the Late Liquidity Window lending rate constant at 12.25 percent. The CBRT will continue to use all available instruments in pursuit of the price stability objective. Tight stance in monetary policy will be maintained until inflation outlook displays a significant improvement. 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 behavior and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered if needed.

19. Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance for the upcoming period 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.

20. In recent years, sustained fiscal discipline has been one of key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of 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.