Summary of the Monetary Policy Committee Meeting

31 July 2018, No: 2018-29

Meeting Date: 24 July 2018

Inflation Developments

1. In June, consumer prices rose by 2.61 percent and annual inflation increased by 3.24 points to 15.39 percent. The rise in annual inflation was widespread across subcategories, with the most significant contribution coming from unprocessed food. Cost pressures from recent exchange rate developments drove prices higher in many related items. Producer prices exerted even stronger upward pressure on consumer prices compared to a month earlier. Thus, core indicators saw a notable increase in both their annual inflation rates and underlying trends.
2. Annual inflation in food and non-alcoholic beverages rose by 7.89 points to 18.89 percent in June. This increase was driven by the unprocessed food inflation that soared due to vegetables prices. In this period, there was significant divergence between the producer prices for PPI for agriculture and the consumer prices for food. The widening gap between producer and consumer price levels for some vegetables signaled market problems associated with the distribution channel. Meanwhile, processed food prices recorded increases across all subcategories, pushing annual processed food inflation up to 14.47 percent. In the upcoming period, bread and raw milk reference purchase prices might put upward pressure on processed food prices.
3. Energy prices increased by 1.01 percent in June and annual energy inflation rose by 1.82 points to 16.99 percent. Solid fuel, bottled gas and administered municipal water prices were up, whereas fuel prices remained flat due to the new sliding-scale tariff system. In the period ahead, administered energy prices will likely reflect the cumulative cost pressures from exchange rates and oil prices.
4. In June, annual services inflation increased by 1.44 points to 10.96 percent. The rise in services inflation was widespread across subcategories. Communication services inflation went up on the back of internet tariffs, while transport services inflation was driven higher by cumulative cost pressures and the buoyant domestic and international tourism industry. The tourism upsurge was the main driver of price hikes in related subcategories, such as catering, accommodation and package tours. In summary, prices of services reflected not only cost

pressures from exchange rates, oil prices and food prices but also demand-side effects of the favorable tourism outlook.

5. Annual core goods inflation rose by 2.57 points to 18.55 percent in June, largely due to recent exchange rate developments. Thus, prices of durable goods and other core goods posted sharp widespread increases. Clothing inflation, however, remained flat in this period. The exchange rate-driven rise in costs is likely to put further inflationary pressure on prices of core goods in coming months.

Factors Affecting Inflation

6. Economic activity proved a little stronger than projected in the first quarter of 2018. Gross Domestic Product (GDP) increased by 2.0 percent on a quarterly basis and 7.4 percent on an annual basis. Main driver of quarterly growth was domestic demand, particularly private consumption in the first quarter. Investment offered rather limited support to growth due to the muted course of machinery-equipment investments. Net exports contributed positively to quarterly growth owing both to the contraction in imports coupled with the rebound in tourism.

7. Recently released data indicate a more significant rebalancing trend in economic activity. Data for the second quarter reveal that external demand maintains its strength. Amid favorable global growth outlook, rising external demand and flexibility in diversifying export markets continue to stimulate exports. The Committee noted that the rebound in revenues from tourism and other services is rather brisk, and under these circumstances, net exports will provide positive contribution to quarterly growth in the second quarter as well. In the upcoming period, exports of goods and services are expected to boost growth further and the slowdown in import demand resulting from the subdued domestic demand is likely to have further positive repercussions on the current account balance.

8. In the second quarter, signs of deceleration in domestic demand became more visible. In this period, the depreciation in the Turkish lira accompanied by the increased financial volatility, perceptions of uncertainty and financing costs decelerated domestic demand both through the consumption and investment expenditures channels. The slowdown in domestically-oriented sectors, particularly sectors affiliated to construction, confirms this outlook. Meanwhile, accommodative stance of the public sector conducted through expenditures and fiscal measures are projected to moderate the slowdown in domestic demand to some extent. Survey indicators point that the rebalancing process in economic activity may continue in the third quarter.

9. The ongoing improvement in the labor market came to halt in the second quarter, as the economic activity started to lose pace and converge to its underlying trend. Employment in the services and industrial sectors posted mild increases in April, while the evident fall in construction employment led to a quarterly decline in non-farm employment.

10. In sum, data for the second quarter indicate that economic activity has assumed a rebalancing process both in terms of growth rate and composition. However, the downside

risks to the magnitude and duration of the slowdown in economic activity are kept alive by the high level of financial volatility and perceptions of uncertainty.

Monetary Policy and Risks

11. The Committee evaluated the medium-term inflation forecasts for the July Inflation Report as well. Accordingly, year-end consumer inflation forecasts for 2018 and 2019 were revised upwards by 5 points and 2.8 points, respectively compared to the April forecast. With a tight policy stance that focuses on bringing inflation down with enhanced policy coordination, inflation is projected to converge gradually to the target. Accordingly, inflation is projected to be 13.4 percent at the end of 2018 and then fall to 9.3 percent at the end of 2019, 6.7 percent at the end of 2020, stabilizing around 5 percent over the medium term. Forecasts are based on a monetary policy framework that envisaged that the tight monetary policy stance will be maintained for an extended period.
12. Cost factors and volatility in food prices have been the main drivers of the recent upsurge in inflation. On the other hand, price increases have shown a generalized pattern across subsectors. Despite the milder impact of demand conditions on inflation, elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior. Accordingly, the Committee assessed that it might be necessary to maintain a tight monetary stance for an extended period.
13. The Central Bank will continue to use all available instruments in pursuit of the price stability objective. Tight stance in monetary policy will be maintained decisively until inflation outlook displays a significant improvement. Inflation expectations, pricing behavior, lagged impact of recent monetary policy decisions, contribution of fiscal policy to rebalancing process, and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered.
14. The outlook that the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions. Nevertheless, various risks to these factors may affect the inflation outlook and necessitate changes in the monetary policy stance envisaged in the baseline scenario. The Committee evaluated that risks to the medium-term inflation outlook are mostly on the upside.
15. The pricing behavior, developments in global risk appetite, the contribution of fiscal policy to the rebalancing, and the lagged effects of the monetary policy will be monitored closely in the coming period. Should these factors deviate from the baseline scenario, the monetary policy stance will be reviewed depending on the change in the inflation outlook.