TÜRKİYE CUMHURİYET MERKEZ BANKASI

No: 2017-15

PRESS RELEASE

23 March 2017

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 16 March 2017

Inflation Developments

1. In February, consumer prices were up 0.81 percent and annual inflation increased by 0.91 points to 10.13 percent. Annual food inflation continued to climb while exchange rate changes seemed to be passed through to all items, especially to core goods and energy. Notwithstanding temporary tax reductions, the cumulative TL depreciation caused the core goods inflation to soar, driving the annual inflation and underlying trend of core indicators higher.
2. Annual inflation in food and non-alcoholic beverages rose by 0.95 points in February to 8.72 percent, largely due to higher prices of fresh fruits and other unprocessed food. On the processed food front, the monthly price increase gained momentum while the annual inflation rose to 7.06 percent. Leading indicators for March signal a sharp upswing in annual food price inflation mainly on the back of the base effect from unprocessed food. Energy prices remained on an uptrend, which spread across all subcategories. Thus, annual energy inflation soared by 2.34 points in February to 13.94 percent. Annual energy inflation is expected to edge down in March amid on back of international oil prices.
3. Prices of services rose by 0.68 percent while annual services inflation edged up by 0.10 points to 8.37 percent in February. Annual inflation increased in transport and communication but remained relatively flat in other subcategories. Transport services were largely affected by the cumulative increase in fuel prices. Rent inflation remained elevated at 9.4 percent.
4. Annual core goods inflation increased by 1.65 points to 8.83 percent in February. All subcategories were influenced by the spillovers from the depreciating Turkish lira. February discounts lagged well behind historical averages in the clothing industry despite weaker output and external demand, whereas temporary tax cuts put a lid on price hikes in durable goods. Prices were also significantly higher across core goods other than clothing and durables due to the exchange rate pass-through as well as the increased customs duty on cosmetics. The cumulative depreciation of

the Turkish lira may continue to put upward pressure on core goods inflation in March.

5. In short, cost push pressures and the volatility in food prices in recent months have led to a sharp increase in inflation. The significant rise in inflation is expected to continue in the short term due to lagged pass-through and the base effect in unprocessed food prices.

Factors Affecting Inflation

6. Recently released data indicate a gradual recovery in the economic activity. Industrial production posted a quarterly growth in the fourth quarter of 2016. However, subtracting the offset work day losses of the third quarter, the output growth is a moderate one that fails to spread across all sectors. Auto and home sales were robust in the fourth quarter thanks to demand being brought forward, yet only a number of sectors saw a recovering domestic demand. Moreover, although public investments provided an added boost to the economy, the recovery in investment demand was much slower than in consumption.

7. With the supportive measures and incentives provided recently, the recovery in the economic activity is expected to continue at a moderate pace. First-quarter data suggest that the economic recovery is moderate and not quite widespread yet. Despite a strong industrial production in January, the sectoral growth is uneven and the underlying trend is weaker. Although the production in industrial sectors subject to incentives, such as furniture and construction, showed signs of recovery, the gloomy outlook in sectors of services, particularly retail, suggested that there is no strong recovery in domestic demand. In fact, domestic demand seems to be slowing due to demand being brought forward in the fourth quarter of 2016 as well as the recent TL plunge and the weakening confidence. However, the extension of housing tax reductions and recent employment incentives are likely to buoy up domestic demand and growth in the coming months.

8. Despite a relatively sluggish domestic demand, the growing EU demand continues to stimulate total exports, the auto industry in particular. Turkey's flexibility in diversifying markets continues to cushion exports against the negative effects of geopolitical tensions on external demand. Furthermore, the restoring relations with neighboring countries translated into a boost for exports. The sluggish outlook in tourism sector continues to have a negative impact on the current account balance, which, however, is alleviated by the recent developments in real exchange rates and the moderate course of loans.

9. The deterioration in the labor market that began in May continued through December. In this period, industrial and construction employment fell whereas services employment remained flat. Meanwhile, leading indicators, such as new job vacancies, the PMI employment index and the expected number of employees in

services and construction, suggest that employment is subdued and unemployment rates will remain high.

10. In sum, economic activity exhibited a gradual recovery in the last quarter and a moderate growth is expected for 2016. Economic activity is projected to display a slow gradual and slow rebound in 2017. However, the course of capital flows in line with uncertainties regarding global economic policies, geopolitical developments, the subsided course of the labor market and the lingering volatility in exchange rates may stand out as factors to limit the pace of growth in 2017.

Monetary Policy and Risks

11. Leading indicators and expectations regarding global economic activity have recently been favorable. Both the electoral climate in Europe and news on how the US trade and fiscal policies will be shaped weigh on the volatility in financial markets, while diminished uncertainties over global monetary policies support the global risk appetite. Backed also by positive growth prospects, portfolio inflows are observed in emerging economies. Meanwhile, following a marked increase in 2016, global energy prices displayed a steady outlook in the last couple of months owing to favorable supply conditions in the energy market.

12. Parallel to a tighter stance in January 2017, Turkey's financial indicators have recorded an improvement. Recent losses in all indicators were mostly redeemed, which led to a positive divergence between Turkey and other emerging economies. Moreover, loan rates remain mild despite the rise in the CBRT funding rate; and the revival in loan growth continues due to the partial recovery in growth outlook, macroprudential arrangements and public incentives. In fact, consumer loans and TL-denominated commercial loan growth caught up with past averages.

13. Domestic demand registered a recovery in the last quarter of 2016, yet sectoral diffusion of this recovery proved limited and the underlying trend of the economy exhibited a mild growth. Recent indicators show that the TL depreciation and the confidence channel have led to a deceleration in domestic demand. Nevertheless, owing both to waning uncertainties and volatility in the financial markets and the incentives supporting the economy, a mild economic growth is expected in the upcoming period. On the other hand, the pace of recovery in tourism revenues, the global economic outlook, uncertain global economic policies and geopolitical developments pose a downside risk to economic activity. Meanwhile, possible lagged effects of recent incentives and measures are considered to be upside risks.

14. The mild trend in economic activity notwithstanding, cost pressures arising out of the cumulative effects of the depreciation in the TL led to a significant rise in inflation. Exchange rate volatility pose an upside risk to inflation through the cost channel as well as the expectations and the pricing behavior channel. In the coming period, not only the lagged effects of the exchange rate developments but also the

base effect from unprocessed food prices is projected to push inflation further upwards in the short term.

15. Against this background, the Committee decided to strengthen the monetary tightening in order to contain the deterioration in the inflation outlook. At the March meeting, the late liquidity window lending rate was raised from 11 percent to 11.75 percent, while the other CBRT rates were kept unchanged. 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. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered.

16. 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. Accordingly, the gradual elimination of the effect of 2016 tax increases on annual inflation may support the disinflation process. 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.

17. In recent years, sustaining fiscal discipline has become one of the major factors in reducing the sensitivity of the Turkish economy against external shocks. Moreover, the room provided by the fiscal discipline facilitates the countercyclical implementation of the fiscal policy in periods of slowing economic activity without a permanent deterioration in budget balances, as in 2016. Designing public spending and tax policies under a holistic approach that takes into account the subsequent effects on other macroeconomic variables such as growth, domestic savings and inflation, as well as the budget balance will contribute to furthering the coordination of monetary policy and fiscal policy, and enhance macroeconomic stability and price stability as well.