TÜRKİYE CUMHURİYET MERKEZ BANKASI

Summary of the Monetary Policy Committee Meeting

25 January 2018, No: 2018-02
Meeting Date: 18 January 2018

Inflation Developments

1. In December, consumer prices rose by 0.69 percent, and annual inflation dropped by 1.06 points to 11.92 percent. Annual inflation recorded a decline in food and energy groups, but increased in the core goods group. The fall in food inflation was led by the unprocessed group, while core goods group was largely affected by the cumulative depreciation in the Turkish lira. Against these developments, annual inflation in core indicators increased slightly and their underlying trend remained high.

2. In December, annual inflation in food and nonalcoholic beverages receded by 1.99 points to 13.79 percent. This fall was largely driven by unprocessed food prices due to the base effect accompanied by the sustained decline in red meat prices. Meanwhile, having soared lately, processed food prices rose moderately in December. The surge in prices of cheese and other dairy products in recent months turned flat due to the muted rise in raw milk prices. In line with red meat prices, processed meat products recorded a decline. Owing to the change in the basis weight in the Bread Communique, processed food prices entail the risk of an upsurge in January. Nevertheless, leading indicators for January hint at a downtrend in the annual food inflation to be led by the unprocessed food group.

3. The uptrend in international oil prices weigh on energy prices. Accordingly, energy prices registered an increase in December, yet the group's annual inflation declined due to the base effect. Despite the increase in electricity prices, leading indicators hint at a similar decline in energy inflation due to the base effect in January as well.

4. Prices of services inched up by 0.43 percent in December and the annual services inflation remained almost unchanged at 9.47 percent. In this period annual inflation increased in transport services; remained relatively flat in the restaurants-hotels and communications group, but decreased in other groups. Fuel prices, which surged amid the depreciated Turkish lira coupled with the rise in oil prices, aggravate inflation in transport services. Meanwhile, the robust course of demand conditions in certain groups and the headline-inflation indexation stiffens the elevated levels in services inflation.

5. Annual core goods inflation crept up by 0.40 points and reached 15.45 percent in December. This was led by the prices of durable goods that increased parallel to the soaring prices of automobiles and white goods. Thus, inflation in durable goods reached 18 percent. Price increases in other core goods accelerated in tandem with the cumulative exchange rate effects in products with high import component. The effect of the methodological change in the clothing group continued with a weaker pace. The rebound in manufacturing in the

clothing sector coupled with the improvement in tourism fueled the rise in group's inflation across the year.

6. In sum, current elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior.

Factors Affecting Inflation

7. Recently-released data indicate that economic activity maintains its strength. A joint analysis of October and November data suggests sustained growth in industrial production with some deceleration in the fourth quarter. However, this deceleration stems from the slowing activity in sectors subject to tax incentives, particularly furniture, and other sectors do not register a loss of momentum. Survey indicators show that this trend is maintained in December as well. Indicators for services and trade stand moderate, while the recovery in the tourism sector spurs economic activity further.

8. Domestic demand continues to expand. In the fourth quarter, private consumption growth is expected to lose some pace following the withdrawal of tax reductions in white goods and furniture. On the other hand, current indicators show that the third-quarter improvement in machinery-equipment investments continues.

9. The improving growth outlook across the globe, particularly in the EU, rising external demand and Turkey's flexibility to shift markets abroad continue to stimulate exports. The improvement in the import demand in tandem with the course of economic activity notwithstanding, the rise in exports of goods slows the deterioration in the core current account deficit indicators. In addition to the ongoing recovery in tourism, the uptrend in exports of goods is envisaged to contribute further to the current account balance. The Committee noted that the contribution of net exports to quarterly GDP growth will continue in the fourth quarter owing to the strong course of exports accompanied by the slowing gold imports.

10. The second and third-quarter recovery in the labor market continued in the October period, confirming that economic activity remains robust. Employment increased in services and industry, but receded in the construction sector compared to the previous period. Survey data suggest the rise in employment coupled with the fall in unemployment rates will continue. The Committee highlighted that employment gains failed to fully pass through to unemployment rates due to the strong uptrend in the labor force participation rate. Against this background, the unemployment rate is anticipated to decline gradually in the period ahead.

11. In sum, 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. Data on global growth hint at 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 euro area, confirm the steady economic rebound across the globe. Global inflation has been volatile amid changing commodity and oil prices yet remains low, whereas global core inflation remains stable.

13. The primary downside risks to the global economic outlook over the upcoming period are the geopolitical tensions in the Middle East and the Korean peninsula and the heightened

protectionism clouding international trade negotiations. Moreover, the US tax reform is considered a positive risk factor for the world economy.

14. With the Federal Reserve and the ECB in the lead, major central banks continue to normalize monetary policy. As the steps towards normalization have been in line with expectations, the market reaction is currently mild. However, risks to monetary policy tightening are more on the upside. With the ongoing economic recovery in the US, the Fed demonstrated its commitment to policy normalization. The strengthening euro area economy increases the possibility of an earlier-than-anticipated tightening of the ECB monetary policy. Despite the favorable course of the labor market in advanced countries, the limited increase in wages, while limiting price increases, poses an upward risk in terms of inflation in the upcoming period. Another key factor that might deteriorate the stable global inflation is the recent movements in oil prices.

15. The favorable global economic outlook and trade volume as well as the ongoing global risk appetite drive strong portfolio flows into emerging economies. In 2018, it is estimated that portfolio inflows will continue in the case of sustained economic recovery and a moderate course in monetary policy normalization of advanced economies. Meanwhile, portfolio investments to Turkey may at times be volatile amid geopolitical risks.

16. Both global and domestic financial conditions have generally been supportive of economic activity. Since the December MPC meeting, financial indicators such as exchange rate volatility, market interest rates and risk premium have alleviated thanks to the CBRT policies and the interruption in the negative news flow. Due to the CBRT's tighter monetary stance, the downward slope of the yield curve has become more pronounced. The loan growth that hovers around historical averages as the loans guaranteed by the Credit Guarantee Fund hit the pre-determined upper limit in mid-2017 is monitored closely with regard to its impact on aggregate demand and economic activity.

17. Domestic demand has slowed slightly due to the reduced support of the additional credit boost to growth and the withdrawal of tax incentives for durable goods, and economic growth has started to move towards its underlying trend as of the fourth quarter of 2017. The accommodative policies of 2017 will have less of an effect in 2018 while the fiscal measures to be introduced within the context of the Medium Term Program and the tight monetary stance are expected to be the main drivers of loan growth and a normalized economic activity. Moreover, the smaller yet ongoing Credit Guarantee Fund support will support 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 key to 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.

18. Current elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior. Having pulled annual consumer inflation down in December largely on the back of base effects and weather conditions, food and energy prices might shape consumer prices over the first quarter of 2018, particularly due to upward and downward volatility in unprocessed food prices. In addition, changes in oil prices put upward pressure on domestic energy prices. Meanwhile, core goods inflation remains on the rise amid cumulative exchange rate effects, and aggregate demand conditions support this uptrend. Given also the

elevated services inflation, the Committee assesses that there is no significant improvement in the core inflation outlook.

19. 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.

20. 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.

21. 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 process and social welfare.