No: 2017-21

PRESS RELEASE

28 April 2017

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 26 April 2017

Inflation Developments

1. In March, consumer prices were up 1.02 percent and annual inflation increased by 1.16 points to 11.29 percent. As stated in the summary of the MPC meeting in March, annual food inflation was the key driver of the rising consumer inflation in this period due, among others, to the low base effect from a year earlier. On the other hand, energy prices inched down amid lower international oil prices. Services inflation remained high while core goods saw widespread price hikes due to the lagged effect of the cumulative Turkish lira depreciation. Thus, core inflation indicators remained on the rise.
2. Prices of food and nonalcoholic beverages increased by 1.93 percent in March, bringing annual inflation up by 3.81 points to 12.53 percent in this subcategory. This upsurge was mostly attributed to higher unprocessed food prices, particularly for fresh fruits, and the low base effect. On the processed food front, prices continued to rise rapidly month-on-month due to exchange rates, causing annual processed food inflation to hit 7.28 percent. Leading indicators for April signal that annual food inflation will increase sharply on the back of the base effect from unprocessed food. Energy prices edged down by 0.95 percent amid lower international oil prices in March. Accordingly, after having surged since June 2016, annual energy inflation declined to 12.19 percent in this period.
3. Prices of services rose by 0.63 percent while annual services inflation inched up by 0.27 points to 8.64 percent in March. Annual inflation was up in transport and other services but remained flat in other subcategories. Prices of transport services were driven higher by the lagged effects of rising fuel prices. Across other services, both exchange rates and the high level of headline inflation pushed inflation higher in subcategories such as maintenance and repair, healthcare and education. Rent inflation remained elevated.
4. Annual core goods inflation increased by 1.63 points to 10.46 percent in March. The lagged spillovers of the depreciating Turkish lira continued to weigh on all

subcategories. Clothing and footwear prices soared much faster than historical averages in March. Prices of durable goods were up mainly because of the exchange rate-stricken auto industry. In this period, prices of core goods excluding clothing and durables increased dramatically due to the exchange rate pass-through.

5. In summary, cost-push pressures and the volatility in food prices in recent months have led to a sharp increase in inflation. Although the recent improvement in the risk appetite contains some of the upside pressures from cost factors, current elevated levels of inflation pose risks on the pricing behavior.

Factors Affecting Inflation

6. Data for the fourth quarter of 2016 confirmed the conjecture that the third-quarter economic slowdown was transitory. In this period, the Gross Domestic Product (GDP) expanded by 3.8 percent quarter-on-quarter and 3.5 percent year-on-year. Excluding the offset work day losses of the third quarter, the fourth quarter was marked by a moderate growth. The TURKSTAT's upward revisions to the first three quarters of 2016 showed that the level of economic activity was much higher than anticipated. Hence, the economy grew by 2.9 percent in 2016, a rate much lower than past years' averages.

7. Annual growth was driven by domestic demand in the last quarter of 2016. Private spending was up both annually and quarterly thanks to the demand brought forward by automobile tax adjustments, eased macroprudential measures and better financial conditions. Investments, particularly machinery and equipment investments, were relatively weak in this period. With exports accelerating in the last quarter, net external demand provided considerably higher contribution to quarterly growth and a slightly better contribution to annual growth compared to the first nine months of 2016.

8. The first-quarter data for 2017 hint at diminishing recovery in economic activity in the first quarter. Following a robust increase in January, industrial production contracted in February. Rapid depreciation of the Turkish lira at the start of the quarter, uncertainties led by volatile financial markets and the leap in inflation are projected to dampen consumption and investment spending. Although tax incentives stimulate the demand for houses, furniture and home appliances, the recovery in domestic demand fails to spread across all sectors. Indicators for March and April signal for a stronger economic activity and labor market. In brief, the mild recovery in the underlying trend of economic activity continues, which is enhanced by supportive incentives and measures.

9. Despite a partial recovery in domestic demand, net external demand spurs growth with robust increases in exports of goods that spill over into all sectors. The growing demand from the European Union economies, normalizing relations with neighboring countries, the course of the real exchange rate, and Turkey's market-shifting flexibility abroad continues to stimulate exports. Increases in exports of goods translate into a decelerated deterioration in the current account deficit and

improvement in core current account deficit indicators. In addition to the expected partial recovery in tourism, the robust course of exports of goods is expected to contribute positively to the current account.

10. The worsening trend in the labor market that began in May 2016 came to a halt in January 2017. In this period, non-farm employment recorded an uptick particularly with the contribution from the services sector. Meanwhile, leading indicators, such as new job vacancies, the PMI employment index and the expectations for the number of employees in services and construction for March and April suggest a recovery in the employment outlook. Amid the mild rebound in economic activity and the announced employment incentive packages, the partial improvement in unemployment rates is expected to continue.

11. In sum, the recently released data indicate a gradual recovery in the economic activity. Domestic demand conditions display a moderate improvement and demand from the European Union economies continues to contribute positively to exports. With the supportive measures and incentives provided recently, the economic activity is expected to gain further pace in the forthcoming period. 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

12. Financial market impact of expectations about post-election US economic policies has started to wane since early 2017. Compared to the previous reporting period, indicators of economic activity point at a stronger global growth in 2017, owing especially to advanced economies. However, uncertainties over the Brexit process and blurred prospects for post-electoral economic policies in the US keep downside risks to global growth brisk. As of the first quarter of 2017, the upward trend in advanced economies' long-term bond yields which started in November came to a halt, and portfolio flows to bond and stock markets of emerging economies resumed thanks to abated uncertainties over the Fed policy accompanied by optimistic expectations in financial markets. Although there is a slight recovery in recent global financial conditions, the pace of the Fed's monetary tightening cycle will be the determining factor on the direction and volume of portfolio flows to emerging economies.

13. Despite the relative improvement in global financial conditions, domestic financial conditions tightened slightly in the first quarter of 2017 due to the partly persistent volatility in the exchange rate market and the tightening in monetary policy. On the other hand, the Turkish lira has recently diverged positively from other emerging economy currencies and offset past losses to some extent. Moreover, macroprudential policies supporting the financial system, public incentives and public credit guarantees allowed credit conditions to continue to recover. The

recovery in consumer loans and Turkish lira denominated commercial loans observed in the first quarter of 2017 is monitored closely with regard to its effects on aggregate demand and economic activity.

14. Downside risks to economic activity have recently abated. The growth outlook for 2017 is expected to be more favorable compared to 2016 which was subject to numerous concurrent adverse shocks. The relative stability in tourism revenues, the strengthened confidence channel, the favorable effect of the cumulative exchange rate depreciation on net exports, and the normalization of commercial relations with Russia will all contribute to growth. Moreover, measures and incentives to stimulate consumption and investment expenditures, fading perceptions of uncertainty and the improvement in the tightness of financial conditions will also enhance growth. Accordingly, economic activity is expected to strengthen as of the second quarter of the year. 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 downside risks to growth in 2017 as well as it has recently.

15. Consumer inflation has surged since November 2016 and rose above the upper band of January forecasts. The upward trend in inflation was largely driven by the depreciation in the Turkish lira and the rise in import prices in addition to the increase in food prices. The rapid depreciation in the Turkish lira spread across the consumer price index, particularly to energy and durable goods items.

16. The Committee evaluated medium-term projections to be presented in the April Inflation Report in the meeting. Year-end inflation forecasts for 2017 and 2018 were revised upwards by 0.5 and 0.4 points, respectively, compared to the 2017 January 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 8.5 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 6.4 percent in 2018. As also indicated in the previous Report, due to the base effects stemming from the prices of unprocessed food, tobacco and clothing as well as temporary tax reductions, consumer inflation will fluctuate throughout 2017. Inflation is expected to reach the highest levels in April-May particularly due to the base effect from unprocessed food and the lagged effects of the exchange rate, and then to fall thereafter as the impact of last year's price increases in energy, alcohol-tobacco products and food gradually diminishes. The tight monetary stance will support the disinflation process.

17. Aggregate demand conditions on which medium-term inflation forecasts are based, continue to have a disinflationary effect albeit at a more limited extent in comparison with the January Report. The upward revision in last year's national income data and the acceleration in credit indicate that the recovery in economic activity might be stronger than expected. However high levels of unemployment rates suggest that the demand-side risks on inflation are balanced. The effects on

aggregate demand conditions, of production and employment incentives and measures to boost the credit market, will be closely monitored in the upcoming period.

18. Risks to food inflation – another major determinant of inflation forecasts – are considered to be on the upside. Due to the recovery in the exports of food products and the impact of the exchange rate developments, food inflation might exceed current projections, which are based on the assumption that measures taken by the Food Committee will considerably balance the upside risks to food prices.

19. Although the recent improvement in the risk appetite contains some of the upside pressures from cost factors, current elevated levels of inflation pose risks on the pricing behavior. Accordingly, the Committee decided to strengthen the monetary tightening in order to contain the deterioration in the inflation outlook, and raised the Late Liquidity Window lending rate from 11.75 percent to 12.25 percent in its April meeting. Tight stance in monetary policy will be maintained until inflation outlook displays a significant improvement. The CBRT formulates monetary policy in consideration of the medium-term inflation outlook, thus, focuses on the developments in the underlying trend of inflation rather than the anticipated fluctuations in inflation 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, 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 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. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework and have an adverse effect on the medium-term inflation outlook.

21. In recent years, sustained fiscal discipline has been one of key factors in lowering the sensitivity of the Turkish economy against external shocks. Countercyclical fiscal policy has been implemented recently, thanks to the space provided by fiscal discipline. Structural measures, which would improve the potential to implement countercyclical fiscal policy, will contribute to the coordination of monetary and fiscal policy, and thus support macroeconomic stability.