TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 14 December 2017

Inflation Developments

1. In November, consumer prices rose by 1.49 percent and annual inflation increased by 1.08 points to 12.98 percent. Annual inflation recorded some decline in the services group, but increased in other subgroups. Food inflation increased due to the unprocessed food group, while the core goods and energy groups witnessed the adverse effects of exchange rate developments. Against these developments, annual inflation in core indicators increased due to the core goods group, and the underlying trend remained high.
2. In November, annual inflation in food and nonalcoholic beverages increased by 3.04 points to 15.78 percent in November. The rise in annual inflation was largely driven by unprocessed food prices, while processed food prices also continued to rise at higher rates. Unlike the decline in meat prices, the negative outlook in the vegetables group drove notably upwards the seasonally adjusted unprocessed food prices. Meanwhile, the processed food group saw sustained price increases in cheese and other dairy products. Leading indicators for December hint at a downtrend in the annual food inflation to be led by unprocessed food prices. On the energy front, prices soared further in November amid exchange rate developments coupled with the prices of oil and other inputs.
3. Prices of services inched up by 0.11 percent in November and the annual services inflation has declined for the first time since the start of the year to 9.42 percent. Monthly price increases accelerated to some extent in rent, and remained mild in other subgroups. This period was particularly marked by falling prices in transport services as well as package tours under other services.
4. Annual core goods inflation increased by 0.74 points and reached 15.05 percent in November. Annual inflation followed a flat course in the clothing group but increased in other subgroups. Durable goods saw further monthly price hikes, chiefly in automobiles, white goods and other electrical appliances. Meanwhile, monthly price increases in core goods excluding clothing and durable goods gained momentum. The recent hike in core goods inflation was mostly driven by exchange

rate developments and was also stimulated by the robust course of demand conditions.

5. In sum, current elevated levels of inflation and the recent cost developments continue to pose risks on expectations and the pricing behavior.

Factors Affecting Inflation

6. The GDP expanded by 11.1 percent in the third quarter of 2017 in annual terms, and the quarterly growth became 1.2 percent. In addition to the course of economic activity, this tremendous expansion in annual growth is also attributed to calendar and base effects. The main driver of annual and quarterly growth proved to be domestic demand led by machinery-equipment investments and private consumption in the third quarter. The rebound in tourism and the robust course of exports of goods notwithstanding, the sharp increase in gold imports limited the contribution of net exports to annual growth in this period.

7. Recently released data indicate a strong economic activity. Industrial production in October recorded an increase compared both to the previous month and the average of the third quarter. Activity in sectors subject to tax incentives, chiefly the furniture sector, displayed a slowdown, yet other sectors did not record a loss of momentum. In fact, survey indicators hint at a sustained uptrend in industrial production in the fourth quarter, albeit with some deceleration. Indicators for services and trade stood moderate, while the recovery in the tourism sector spurs economic activity further.

8. Domestic demand conditions keep improving. 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 for the EU, and Turkey's flexibility to shift markets abroad continue to stimulate exports. The rise in exports of goods slows the deterioration in the current account deficit and improves the core current account deficit indicators. In addition to the expected recovery in tourism, the uptrend in exports of goods is envisaged to contribute further to the balance. The Committee noted that the contribution of net exports to growth will continue in the fourth quarter amid the strong course of exports.

10. The recovery in the labor market continued in the September period. Employment increased in services, but receded in industry and construction compared to the previous period. Survey data suggest that the labor market will improve further in the last quarter. 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, economic activity recorded a robust growth in the third quarter. Recently released data indicate that economic activity maintains its strength. Domestic demand conditions keep improving and external demand continues to contribute positively to exports.

Monetary Policy and Risks

12. Third-quarter 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 for 2017 and 2018 compared to the start of 2017 confirm the steady economic rebound across the globe. Global inflation remains stable.

13. The primary downside risk to the global economic outlook over the upcoming period is the geopolitical tensions in the Middle East and the Korean peninsula and the heightened protectionism clouding international trade negotiations. Moreover, the imminent passing of the US tax reform bill is considered a positive risk factor for the world economy. Although oil prices that gained following the OPEC's recent extension of the output cut decision seem to be the main threat to the steady global inflation, this upward tendency has been contained by the oil production increase in the US.

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 the US interest rates are on the upside. The imminent tax reform fuels upbeat prospects for the US stock market, yet if this bill leads to a bigger budget deficit, the US Treasury bond rates might increase faster than expected.

15. The favorable global economic outlook and trade volume as well as the ongoing global risk appetite drive strong portfolio flows into emerging economies. Having lost some momentum after mid-September, portfolio investments to Turkey have been picking up again recently amid reduced geopolitical risks. As the loans guaranteed by the Credit Guarantee Fund hit the pre-determined upper limit, the loan growth hovers around historical averages. The strong acceleration of loan growth in the first half of the year and its phase-out in the second half are monitored closely with regard to their impact on aggregate demand and economic activity.

16. The third quarter's economic activity and aggregate demand were mostly in line with predictions. In the fourth quarter, domestic demand might see some slowdown due to the reduced support of the additional credit boost to growth and the withdrawal of tax incentives for durable goods, and economic growth is expected to move towards its underlying trend. The continued 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.

17. 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. In this regard, the contractionary pressure of the recent Turkish lira depreciation on domestic demand might be partly offset by the export channel.

18. The rise in commodity prices, particularly for oil and metals, and exchange rate changes have recently driven inflation higher through the cost channel. Amid robust economic activity, cost pressures had a much larger effect on inflation. Consumer inflation is expected to come down markedly due to base effects but remain high in December.

19. The current elevated levels of inflation and developments in core inflation indicators continue to pose risks to the pricing behavior. These risks and the high levels of inflation expectations might dampen the expected improvement in the inflation outlook from December through the first months of 2018. The fact that inflation expectations and the pricing behavior show no sign of improvement jeopardizes the inflation outlook.

20. Accordingly, the Committee decided to tighten the monetary policy stance. First of all, as of 22 November 2017, all CBRT funding have been made through the Late Liquidity Window (LON) and the weighted average funding cost is raised by about 25 basis points to 12.25 percent. Moreover, at its December meeting, the Committee decided to increase the LON lending rate from 12.25 to 12.75 percent.

21. 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 and becomes consistent with the targets. 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, if needed, further monetary tightening will be delivered.

22. 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.

23. 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.