Summary of the Monetary Policy Committee Meeting

30 April 2018, Number 2018-12

Meeting Date: 25 April 2018

Inflation Developments

1. In March, consumer prices rose by 0.99 percent and annual inflation edged down by 0.03 points to 10.23 percent. Annual inflation came down in core goods and services, went up in food and energy. Producer-price-driven cost pressures became stronger relative to February. The annual inflation and the underlying trend of core indicators recorded a small decrease, yet remained high.
2. Annual inflation in food and nonalcoholic beverages was up 0.10 points to 10.37 percent in March. Moderating amid mild weather, fresh fruits and vegetables inflation pulled unprocessed food inflation down, while milk and red meat prices soared. These price increases were reflected on processed food prices, as the prices of cheese, other dairy goods, fats and processed meat climbed. Prices remained on the rise for nonalcoholic beverages that were subject to the adjustment in special consumption tax in January. Thus, prices across the processed food category continued to post strong month-on-month increases while the annual processed food inflation reached 14.42 percent. Leading indicators for April point to some deceleration in annual food inflation.
3. Energy prices increased by 0.32 percent in March and annual energy inflation rose to 8.29 percent, largely due to base effects. Energy inflation is expected to register a significant surge in April driven by rising electricity tariffs and also fuel prices due to the weakening Turkish lira and higher oil prices. Given the low base effect from the second quarter of 2017, energy inflation is likely to remain on the rise in the short term.
4. Annual services inflation dropped by 0.11 points to 9.26 percent in March, mostly due to the subcategories of transport and other services. Transport inflation decreased on account of intercity passenger transport by road, while other services inflation decreased on account of repair of household appliances and base effects due to package tours. The current levels of inflation and inflation expectations, price increases across exchange-rate-sensitive items, the food inflation outlook and the robust economic activity lead services inflation to remain high. Moreover, real unit labor costs driven higher by wage adjustments hinder more positive inflation outlook for the services sector due to its labor-intensive nature.
5. Annual core goods inflation fell by 1.00 point to 13.93 percent. Annual inflation was down across all subcategories yet remained high. Prices of durable goods posted a month-on-month increase due to prices of automobiles and white goods. In the other core goods category, prices saw large monthly increases due to the lagged exchange rate pass-through effects and the spillovers of the February increase in medicine prices caused by the updated

reference exchange rate. The recent Turkish lira deprecation worsens the outlook for core goods inflation.

6. In sum, the current elevated levels of inflation and inflation expectations continue to pose risks on pricing behavior. Upside movements in import prices, particularly for oil, have increased such risks.

Factors Affecting Inflation

7. GDP data confirmed our previous assessments that economic activity would remain strong in the fourth quarter of 2017. The GDP expanded at a quarterly rate of 1.8 percent and an annual rate of 7.3 percent in the fourth quarter. Accordingly, the economy grew by 7.4 percent in 2017.

8. Domestic demand was the driver of both quarterly and annual growth in the fourth quarter of 2017. Despite expired tax reductions, private spending rose substantially in the fourth quarter, while public spending provided an accelerated boost to growth. Despite having contributed to annual growth, investment restrained quarterly growth. On the other hand, net exports contributed negatively to both quarterly and annual growth, as total imports registered a sharp increase due to strong domestic demand and historically high gold imports even though exports remained solid.

9. Recently released data indicate that economic activity maintains its strength. Survey indicators for the first quarter of 2018 and industrial production data for the January-February period suggest that industrial activity continued to grow, albeit at a slower rate than in the previous quarter. The acceleration in sectors supplying intermediate inputs for construction activity was particularly notable. The robust activity in industries closely associated with tourism, such as textiles and clothing, supported the manufacturing industry output. Survey indicators show some moderation in services and trade activity.

10. Domestic demand continues to expand. Indicators point to some moderation in the quarterly growth of private consumption demand. Meanwhile, indicators for investment demand signal a rise in both machinery-equipment and construction investment for the first quarter. The jump in public investment spending and the increased public spending on goods and services were of particular significance in this period.

11. The rising external demand led by the favorable global growth outlook and Turkey's flexibility in diversifying export markets continue to stimulate exports. According to February data, the rebound in tourism is strengthening while the number of tourists from regions whose per capita spending is relatively higher, such as Europe, is increasing. On the other hand, transport and shuttle trading remain strong. Due to the quarterly moderation in private consumption demand, imports of goods and services slowed slightly in the first quarter. The Committee noted that net exports is likely to contribute positively to quarterly growth under these circumstances. Amid the cumulative depreciation of the real exchange rate, the recovering tourism and the strengthening global growth, exports of goods and services are expected to provide further strong stimulus to growth and affect favorably the current account balance. However, the rise in energy prices hinders the improvement in the current account balance.

12. The robust economic activity supports the labor market. Nonfarm employment rose month-on-month in January owing to construction and industrial sectors, whereas services employment fell slightly. Leading indicators signal a continued fall in unemployment rates for the first quarter.

13. In short, recently released data indicate that economic activity maintains its strength. Domestic demand continues to expand and growing external demand contributes positively to exports.

Monetary Policy and Risks

14. Current data on global economy point to stable and strong growth across both advanced and emerging economies. Global growth is estimated to have accelerated in the first quarter, leading to upward revisions to forecasts for 2018. Despite rising commodity and energy prices amid solid growth outlook, consumer and core inflation rates are moderate across the globe.

15. The risks to the global economic outlook are tilted to the downside for the upcoming period. The primary downside risks to the global growth outlook are the geopolitical tensions and the growing protectionist agenda in international trade. The newly passed US tax reform is poised to provide a growth boost to the US and its trading partners, which is considered as an upside risk factor for the world economy.

16. The US government's announcement in March to impose additional customs tariffs on imported steel and aluminum might spark more protectionism in international trade across the world. The extent to which such policies will affect global growth will depend on how other trading partners will respond.

17. An analysis of risks to global inflation reveals that geopolitical developments coupled with uncertainties regarding trade policies are likely to pose upside risks to commodity prices, particularly to energy and metal prices. Moreover, in line with the falling unemployment rates in advanced economies, the possibility of wages to increase more rapidly than the current trends is among the major risk factors to push inflation up.

18. Unless notable upside surprises occur in global inflation under the mentioned risk factors, it is considered that major central banks, the Fed and the ECB in particular, will continue to normalize monetary policy in line with expectations, and the impact on financial markets will remain limited. However, the possibility of accelerated inflation amid strong demand conditions accompanied by surging commodity prices in advanced economies may trigger a faster-than-projected tightening in these countries. In such a case, global financial markets may witness fluctuations as in early February, and emerging economies may face higher volatility in exchange rates and weakening portfolio flows.

19. Further ahead, the baseline outlook envisages a sustained support from the favorable global economic outlook to Turkey's external demand, an increase in portfolio flows, and a decline in commodity prices as implied by the futures markets. Under a potential scenario of waning global growth and rising commodity prices, the Turkish economy may face cost-push inflationary pressures and widened current account deficit. In such a case, the CBRT will formulate the monetary policy response assessing the disinflationary impact of weaker demand conditions in tandem with the second-round effects of cost pressures on inflation. Should this scenario be accompanied by portfolio outflows, the extent of the pass-through from exchange rate depreciation to consumer prices and the potential impact on overall financial stability will shape the monetary policy response as well.

20. The volatility in global financial markets in February coupled with geopolitical developments had reflections on domestic financial conditions as well. Accordingly, the risk premium increased slightly, portfolio flows declined, the Turkish lira depreciated with a rise in volatility, and interest rates in financial markets as well as loan rates increased. The credit

market reveals that the accelerating effect of the Credit Guarantee Fund (CGF) support of 2017 have dissipated to a great extent. In addition to the developments in commercial loans, the consequences of the deceleration in consumer loans on economic activity are monitored closely. All in all, the domestic financial conditions are expected to remain on the current trajectory, should the rising trend of external interest rates continues as per expectations.

21. The fiscal measures and incentives to support the economic activity as well as the CGF-backed credit expansion produced a strong recovery in domestic demand in 2017, thereby weakening the disinflationary transmission of monetary policy. The expansionary effect of these policies, also taking into account the lagged effects, are estimated to have peaked in the first quarter of 2018, and the economic activity is expected to start to revert to its main trend from the second quarter on, which will gradually lessen the effect of aggregate demand conditions on inflation. Turkey's flexibility in diversifying export markets and the cumulative real exchange rate depreciation, as well as the favorable global growth outlook for 2018 are expected to continue supporting exports and growth. A relatively moderate outlook for domestic demand is expected as a result of the waning effect of the supportive policies. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments continue to pose downside risks to growth. 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.

22. In the first quarter of 2018, cost pressures played a significant role in shaping not only producer prices but also consumer prices led also by the robust demand conditions. High levels of inflation and the rise in inflation expectations keep the risks to the pricing behavior alive. For instance, the fact that the producer price inflation improved only slightly in the first quarter despite the relatively mild course of input costs indicates that firms can raise prices more easily in the high inflation environment. Indeed, the diffusion indices show evidence that the economic agents' tendency to raise prices rose to quite high levels in the first quarter.

23. In addition, wage increases hinder the improvement in services inflation because of the sector's labor-intensive structure. As a result of the significant backward indexation behavior in the service sector, inflation inertia is strong in this sector. Productivity gains are imperative to contain the adverse effect of rigidities arising from wage and price setting behaviors on price stability.

24. The risks are on the upside for food inflation, another significant factor underlying the inflation forecasts. Despite a decline in the second half of 2017 due to the import measures, the red meat prices surged in the first quarter of 2018. Given the supply conditions in the sector, the red meat prices constitute an upside risk factor to food prices in the remainder of the year. The projections for food inflation are based on the assumption that measures taken by the Food Committee will balance considerably the upside risks to food prices.

25. The Committee evaluated the medium-term projections to be presented in the April Inflation Report. Accordingly, the inflation forecast for end-2018 was revised upwards by 0.5 points, while that for 2019 was kept intact. Given a tight policy stance that focuses on bringing inflation down, inflation is projected to converge gradually to the 5-percent target, falling to 8.4 percent at the end of 2018, 6.5 percent at the end of 2019, and stabilizing around 5 percent over the medium term.

26. The Committee judges that the rigidity in the underlying inflation indicators and the high levels of core inflation in the first quarter continue to pose risks to the pricing behavior, and

in addition, that the recent rise in import prices also weighs on these risks. Accordingly, the Committee decided to implement a measured monetary tightening in April to support price stability.

27. The Committee also assessed the technical presentations on finalizing the simplification process of the monetary policy's operational framework and enhancing the predictability of monetary policy.

28. 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. Inflation expectations, the pricing behavior and other factors affecting inflation will be closely monitored, and, if needed, further monetary tightening will be delivered.

29. Public finance has been providing more support to disinflation, which confirms the stronger coordination between monetary and fiscal policies. There was no significant inflationary impact arising from tax increases throughout 2017. The joint efforts to transform policy coordination into a continuous and systematic framework will contribute to disinflation in 2018 as well.

30. 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.

31. 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, sustaining structural steps to reduce inertia and volatility in inflation will contribute positively to the price stability and social welfare.