TÜRKİYE CUMHURİYET MERKEZ BANKASI

Summary of the Monetary Policy Committee Meeting

30 September 2021, No: 2021-44

Meeting Date: 23 September 2021

Inflation Developments

1. Consumer prices rose by 1.12% in August, and annual inflation increased by 0.30 points to 19.25%. While the rise in food prices was determinant in this development, annual inflation slowed in core indices. The Turkish lira followed a relatively stable course in August, and items that are highly sensitive to exchange rates performed better. In the same period, international oil prices fell whereas prices for agricultural products and industrial metals increased. Accordingly, annual inflation went down in B and C indices but the recent trends of these core indicators remained high.

2. In August, prices of food and non-alcoholic beverages rose by 3.18%, and their annual inflation soared by 4.08 points to 29%. The upsurge in food prices was mostly driven by prices of fresh fruits and vegetables, while droughts in Turkey and across the world have negative implications for consumer food prices. Annual inflation surged by 6.72 points to 32.45% in unprocessed food, and by 1.69 points to 25.82% in processed food. In seasonally adjusted terms, prices of fresh fruits and vegetables continued to rise significantly in August amid weather conditions, driving unprocessed food prices higher. Among other unprocessed food items, increase in egg prices was notable, and the outlook for prices of pulses remained bleak. On the processed food front, the subcategories that saw price hikes were bread and cereals as well as cheese and other dairy products, the latter of which reflect the rise in raw milk prices.

3. In August, energy prices increased by 0.63%, while the group's annual inflation decreased by 0.79 points to 20.72%. The sliding scale system continued to curb annual inflation in the energy group, meanwhile, fuel prices slightly increased in August mainly due to the rise in LPG prices for which the SCT was formerly reduced to zero. Bottled gas prices increased in tandem with the rise in LPG prices. In addition to the uptrend in electricity market clearing prices due to weather conditions, international natural gas and coal prices are on the rise as well.

4. In August, annual core goods inflation decreased by 0.94 points to 20.28%. While annual inflation declined in durable goods and clothing-footwear groups, it increased in other core goods. Prices of durable goods dropped by 1.02%, while annual inflation of the group decreased by 2.97 points to 24.21%. While prices of furniture and white goods posted moderate increases, prices of automobiles decreased owing to the SCT tax base adjustment for automobiles. In clothing and footwear, annual inflation slowed down due to more significant end-of-season sales compared to previous years. Overall, in August, the relatively stable course of the Turkish lira suppressed pressures led by international commodity developments and annual inflation in core goods decreased underpinned by the SCT tax base adjustment.

5. In August, services prices increased by 1.25%, while annual group inflation edged up by 0.13 points to 13.88%. While annual inflation rose in restaurants-hotels, communication services and rent, it remained flat in transport services, and declined in other services. High increases in the restaurants-hotels group in line with re-opening continued in August albeit with some deceleration. The monthly increase in rents gained some pace in August. The decline in annual inflation in other services was led by services items with high sensitivity to the exchange rate following the relatively stable course of the Turkish lira.

6. The September results of the Survey of Market Participants indicated that inflation expectations were revised upwards. Accordingly, the current year-end inflation expectation rose by 0.44 points to 16.74%, and the 12-month ahead inflation expectation increased by 0.46 points to 12.94%. Currently, the 24-month ahead inflation expectation is 10.71%.

Factors Affecting Inflation and Risks

7. The worldwide speeding up of vaccination rollout, especially in developed countries, supports the global economic recovery. Leading indicators suggest that the strong recovery in the global economy continues, albeit at a somewhat decelerated pace. Economies advancing in their vaccination programs exhibit a stronger performance in economic activity by easing the restrictions. Nonetheless, despite the increase in the vaccination rate, new variants keep the downside risks to global economic activity alive.

8. Strong recovery in global demand, high course of commodity prices, supply constraints in some sectors, and the rise in transportation costs have led to producer and consumer price increases internationally. Unfavorable effects of weather conditions in major agricultural commodity exporting countries are observed on global food prices. While the effects of high global inflation on inflation expectations and international financial markets are closely monitored, central banks in advanced economies assess that the rise in inflation will prove to be mostly temporary with the normalization in demand composition, easing of supply constraints, and waning base effects. Accordingly, central banks in advanced economies continue their supportive monetary stances and asset purchase programs.

9. In this MPC Meeting period, equity and bond markets of emerging economies have attracted portfolio inflows to a limited extent. The volatility in long-term bond rates in advanced economies and the course of global financial conditions keep the risks to portfolio flows to emerging economies alive. The impact of such risks through portfolio flows channel towards Turkey are judged to prove to be relatively limited, considering the current levels of non-residents' portfolio positions.

10. Producer inflation continued to rise in August due to international commodity prices, the lingering problems in supply chains, and energy prices. According to main industrial groups, the increases in energy and intermediate goods groups stood out in August. Agricultural drought that has become evident in some regions leads to a change in the composition of electricity production, having an upward effect on industrial electricity costs. The increase in intermediate goods prices was driven by metals-related products, items such as wood and cork products that provide input to the furniture sector, and the construction sector-related non-metallic mineral products.

11. Although economic activity lost some momentum in the second quarter due to pandemic restrictions and the tightening in financial conditions, it remained above its long-term trend. In the second quarter of 2021, GDP increased by 21.7% in annual terms and by 0.9% in quarterly terms. On the production side, industrial and services sectors were the main drivers of annual and quarterly growth whereas construction and agricultural sectors limited the quarterly growth. On the expenditures side, private consumption and net exports had

the largest contribution to quarterly growth while public expenditures and investments remained mild.

12. Leading indicators show that domestic economic activity remains strong in the third quarter, with the help of robust external demand. In July, the industrial production index decreased by 4.2% month-on-month and by 2.3% year-on-year. The sector-wide decrease of production in this period is attributed to the loss of working days (bridging day effect) driven by the bridging the official holiday of 15 July (Thursday) with the Feast of Sacrifice (Eid al-Adha) holiday (17-25 July), which was extended to 9 days. Excluding this effect, the underlying trend of industrial production remained strong. Survey indicators and export data for August hint that the decline in industrial production will be compensated in August. Meanwhile, the services and construction turnover indices, along with retail sales posted monthly and quarterly increases in July.

13. High–frequency data indicate a rapid recovery in the services items most affected by the pandemic due to increased mobility in the third quarter. In fact, the weekly credit card expenditures data suggest that services sectors and retail trade items, which were affected more by the restrictions, registered higher rates of increases. The acceleration of domestic vaccination rollout facilitates the recovery in services, tourism and related sectors, which have been adversely affected by the pandemic, and leads to a more balanced composition in economic activity.

14. While employment continued to grow in July led by the services sector, the total and non-farm unemployment rates increased by 1.4 points and 1.6 points month-on-month to 12.0% and 13.9%, respectively, due to the rise in the labor force participation rate. Survey indicators and high-frequency data suggest that the improvement in the employment outlook and the positive course in the labor market continue thanks to the reopening and the course of economic activity.

15. Favorable external demand conditions and current tight monetary policy impact the current account balance positively. According to the provisional foreign trade data for August, seasonally adjusted exports and imports excluding gold, have posted high increases over the previous month, most visibly in exports. The recovery trend in tourism revenues has also become more evident. The current account is expected to post a surplus in the rest of the year due to the strong upward trend in exports, and the strong progress in the vaccination program stimulating tourism activities. The improvement in the current account balance is important for the price stability objective. The Committee once again underlined its emphasis on the importance of the course of the current account balance for the sustainability of recovery in economic activity and financial stability.

Monetary Policy

16. The monetary policy stance will be set by taking into account the evaluations on the source and permanence of risks, along with the extent to which they can be contained by monetary policy, and with a focus on bringing inflation down permanently in a cautious manner and achieving the price stability target. Accordingly, the policy stance will continue to be determined by taking into account inflation developments, inflation expectations, as well as the temporary factors projected to bear effect on these in the short term, and at a degree of tightness that will restore the disinflation process as soon as possible and ensure its sustainability until the medium-term targets are achieved.

17. Recent increase in inflation has been driven by supply side factors such as rise in food and import prices and supply constraints, increase in administered prices and demand developments due to the reopening. It is assessed that these effects are due to transitory

factors. On the other hand, the decelerating impact of the monetary tightening on credit and domestic demand is being observed. The tightness in monetary stance has started to have a higher than envisaged contractionary effect on commercial loans. While the nominal commercial loan growth remains well below previous year averages, the strong course in personal loans has largely remained in place. In addition, the macroprudential policy framework has been strengthened to curb personal loan growth. Accordingly, the impact of the Banking Regulation and Supervision Agency's related decisions will be monitored. The Committee also maintained its assessment that a milder growth in personal loans is critical to curb risks to the inflation outlook and external balance. Accordingly, the course and composition of loans are closely monitored for macroeconomic stability. The Committee evaluated the analyses to decompose the impact of demand factors that monetary policy can have an effect, core inflation developments and supply shocks. Accordingly it is judged that a revision in monetary policy stance is needed and the policy rate was decided to be reduced by 100 basis points.

18. Inflation is expected to follow a volatile course in the short term due to various supply and demand side factors, with commodity prices and administered prices in the lead. However, sufficiently tight monetary stance to ensure the return of inflation to its downward trend once temporary effects disappear, will serve as a significant buffer against external and temporary volatilities in the context of inflation expectations, the pricing behavior and financial market developments.

19. The CBRT will continue to use decisively all available instruments until strong indicators point to a permanent fall in inflation and the medium-term 5 percent target is achieved in pursuit of the primary objective of price stability.

20. Stability in the general price level will foster macroeconomic stability and financial stability through the fall in the country risk premium, continuation of the reversal in currency substitution and the upward trend in foreign exchange reserves, and durable decline in financing costs. This would create a viable foundation for investment, production and employment to continue growing in a healthy and sustainable way.

21. Demand and cost-side effects remain significant for inflation given credit market and economic activity indicators as well as exchange rate volatility and developments in import prices. The outlook for monetary policies in advanced economies and the global risk appetite heighten the risks to the portfolio flows towards emerging economies. In formulating the monetary policy towards the target of price stability, the Committee will continue to follow an approach that also addresses the risks to financial stability.

22. The Committee reiterated that in order to achieve price stability, strong policy coordination and a holistic macro policy mix involving all stakeholders are required.

23. The Committee will continue to take its decisions in a transparent, predictable and data-driven framework.