TÜRKİYE CUMHURİYET MERKEZ BANKASI

No: 2017-25

PRESS RELEASE

22 June 2017

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 15 June 2017

Inflation Developments

1. In May, consumer prices were up 0.45 percent and annual inflation fell 0.15 points to 11.72 percent. Food inflation remained on the rise while energy inflation continued to slow. The lagged effects of the cumulative Turkish lira depreciation continued to weigh upon core goods whereas annual core goods inflation declined due to the methodology change to clothing prices. Adjusted for these transient effects, the improvement in underlying inflation remained limited in this period.

2. Annual inflation in food and nonalcoholic beverages increased by 1.28 points to 16.91 percent in May largely due to the annual fresh fruits and vegetables inflation that hit 48 percent. Price hikes were also common across food excluding fresh fruits and vegetables, notably in red meat. Leading indicators for June signal that annual food inflation will decrease on the back of the base effect from unprocessed food. Annual energy inflation fell further in May due to exchange rates and lower oil prices, to 8.72 percent. Leading indicators suggest that annual energy inflation has continued to slow in June.

3. Prices of services rose by 0.93 percent while annual services inflation edged up by 0.19 points to 9.06 percent in May. Factors affecting services inflation included cost increases driven by exchange rates and food prices and indexation to headline inflation.

4. Annual core goods inflation dropped by 0.31 points to 9.71 percent in May, mainly due to the temporary impact of the methodology change to weight system of the clothing category. In non-clothing categories, annual inflation continued to climb because of the lagged spillovers of the cumulative Turkish lira depreciation. More specifically, prices soared at a much faster rate than historical averages across core goods excluding clothing and durables.

5. All in all, inflation remains high. Despite recent cost developments and the expected partial improvement in food prices, risks to the pricing behavior still prevail.

Factors Affecting Inflation

6. In the first quarter, the Gross Domestic Product (GDP) expanded by 5.0 percent year-on-year and 1.4 percent quarter-on-quarter, thus indicating economic activity picked up further. Key drivers of quarterly growth were, in sequence, exports, construction investments and public consumption. Machinery and equipment investments remained sluggish, while private consumption slowed due to demand being brought forward. The high contribution from net exports to quarterly growth translates into a growth composition buoying up the current account balance.

7. Leading indicators hint at a strengthening economic recovery in the second quarter. April's industrial production and May PMI data signaled a more robust increase for the second quarter than in the previous one. Not only the manufacturing industry, but also services, retail trade and construction saw strengthening activity recently. Accordingly, economic recovery appears to be more widespread across sectors.

8. A similar outlook is also visible in demand indicators. Both consumer confidence and investment tendency have improved recently. The consumer demand for categories subject to incentives remains strong while investments signal some pickup after the subdued course in the first quarter. Domestic demand is likely to make more contribution to growth in the second quarter.

9. Domestic demand keeps recovering while net external demand spurs growth amid robust increases in exports of goods that spill over into a wide range of sectors and destinations. The improving growth outlook across the globe, particularly for the EU, and Turkey's flexibility to shift markets abroad continue to stimulate exports. Increases in exports of goods slow down the deterioration of the current account deficit and help improve core current account deficit indicators. Strong course of exports of goods are expected to continue to contribute positively to the current account.

10. The labor market picked up in March for the second month in a row. In this period, non-farm employment recorded an uptick, particularly in construction and industrial sectors. Although economic recovery has yet to fully seep through to the labor market in the first quarter, March data and leading indicators show a more upbeat picture for the second quarter. With a more solid economic rebound, employment gains will likely be more notable in the upcoming period while unemployment rates may decline further.

11. In sum, recent data indicate a strengthening recovery in economic activity. Domestic demand has improved and the growing EU demand continues to contribute positively to exports. Economic activity is expected to strengthen further amid supportive incentives and measures. The Committee assesses that implementing structural reforms would augment potential growth significantly.

Monetary Policy and Risks

12. Global economic activity continues to improve. This improvement, which appears simultaneously in advanced and emerging economies, accompany the upward revision in global growth forecasts, and they both underpin the optimism in global markets. Inflation still hovers low despite the favorable growth outlook, which leads advanced economies to sustain the accommodative monetary policy stance. In addition, due to the perceptions for a milder monetary tightening by the Fed, global risk appetite hit historically high levels, and emerging economies saw accelerated portfolio inflows as of March 2017.

13. Despite the recovery in global economic activity, energy prices, which have recently been on the decline, lend the inflation prospects and current account balance a helping hand. The recent favorable outlook notwithstanding, downside risks to global economy still reside. Blurred process of the Fed's balance sheet downsizing, the political climate in Europe, the course of Brexit talks and geopolitical developments are the factors that may alter the risk sentiment in a short time.

14. Thanks also to the tight monetary policy stance, Turkey still diverges positively from other emerging economies in the exchange rate and risk premium indicators. Backed by macroprudential policies and credit guarantee support, retail loans and TL-denominated business loans has grown considerably since the start of the year. In the banking sector, as the supply-side effects step in, the fast loan growth is expected to be soon replaced by a milder outlook. The improvement in credits is monitored closely with regard to the extent of their impact on the aggregate demand and economic activity.

15. Recently-released indicators confirm that downside risks to economic activity have abated and the economic rebound will prove more robust as of the second quarter of the year. Thus, growth prospects for 2017 recorded a progress. Tourism revenues stabilized relatively, the cumulative depreciation affected net exports positively and trade relations with Russia started to normalize, which all underpin growth. What is more, the measures and incentive packages to boost consumption and investment expenditures, reduced uncertainty and improved financial conditions contribute to growth. 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 a downside risk to growth also in 2017, as it has recently.

16. The recent stable course of the Turkish lira and the falling commodity prices notwithstanding, cumulative effects of cost factors on inflation lingers. The correction in food prices has not reached desired levels yet, thus requires a cautious stance regarding the permanence of the sizeable decreases expected in June and July to result from the base effect in the group's inflation. Moreover, temporary tax reductions in white goods and furniture sectors to be taken back in October accompanied by the effects of the methodological changes in the clothing group are

also noted as the developments envisaged to cause fluctuations in inflation in the short term. Additionally, the Committee evaluated that as the improvement in economic activity gets stronger, demand conditions will offer less support to the disinflation process.

17. In short, although recent improvements in cost factors and expected partial correction in food prices will contribute to disinflation, current elevated levels of inflation pose risks to the pricing behavior. Accordingly, the Committee decided to maintain the tight stance of monetary policy at the June Meeting, and kept the lending rate at 12.25 percent under the Late Liquidity Window. 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 until inflation outlook displays a significant improvement. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered.

18. 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 and taxes. 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.

19. In recent years, sustained fiscal discipline has been one of key factors in lowering the sensitivity of the Turkish economy against external shocks. Thanks to the room for maneuver provided by fiscal discipline, stabilizing fiscal policy could have been implemented recently. 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.