Summary of the Monetary Policy Committee Meeting

31 October 2018, No: 2018-46

Meeting Date: 25 October 2018

Inflation Developments

1. In September, consumer prices rose by 6.30 percent and annual inflation increased by 6.62 points to 24.52 percent. Price increases spread across subcategories in this period. Effects of exchange rate developments were apparent in many items, particularly on core goods, while items with relatively low exchange rate pass-through also recorded noticeable price hikes. Elevated exchange rate volatility weighed on inflation uncertainty, while backward-indexation in inflation trended upwards and exchange rate pass-through to consumer inflation remained strong, which resulted in a notable deterioration in the pricing behavior. Although aggregate demand conditions started to support disinflation, the course of consumer inflation was mostly shaped by the elevated producer inflation-driven cost pressures. Against this background, both the annual inflation and the underlying trend of core indicators recorded a sharp increase.
2. Annual inflation in food and non-alcoholic beverages rose by 7.95 points to 27.70 percent in September. This period was marked by accelerated tendency for price hikes both in processed and unprocessed food items, and all subcategories witnessed price increases. Leading indicators for October point out that food inflation is yet to increase.
3. In September, energy prices increased by 6.05 percent and annual inflation in this group rose by 5.69 points to 27.03 percent. This rise was mainly driven by price adjustments in electricity and natural gas as well as increased fuel oil prices due to the lingering effect of Special Consumption Tax (SCT) arrangements in August. Oil prices trended upwards in this period, but the continued sliding-scale tariff restricted the possible upside risks to inflation. The rise in energy inflation is likely to move further upwards in October due to the price adjustments in electricity and natural gas.
4. Annual core goods inflation rose by 11.94 points to 35.12 percent in September. This rise was led by the sharp depreciation in the Turkish lira, and prices increased across all subcategories. Considerable price increases were seen particularly in durable goods with high imported content (12.93 percent) and other core goods (11.22 percent). Moreover, the clothing group registered price hikes above seasonal norms. Core goods inflation is expected to follow a favorable course in October particularly due to durable goods supported by the recent appreciation in the Turkish lira coupled with the SCT base arrangement in automobiles. In addition the All-Out War on Inflation Program is also considered to underpin the downtrend in inflation in the short term.
5. Annual services inflation increased by 2.13 points to 13.97 percent month-on-month. The rise in the restaurants-hotels and transportation services inflation went up due to the cost-

side factors led by food and fuel oil prices as well as the brisk outlook in tourism. Meanwhile, the uptrend in other services inflation is attributed to the reverberations of exchange rate developments accompanied by the price hikes in education services driven by the high levels of headline inflation.

Factors Affecting Inflation

6. Recently released data show that the rebalancing trend in the economy has become more noticeable. Composite indicators of domestic demand signal a notable deceleration both in private consumption and investment expenditures, while the central government budget data show that the public expenditures' direct support to growth recorded a decline compared to the previous period. External demand maintains its strength in contrast to slowing domestic demand. Amid a stable global growth outlook, rising external demand and flexibility in diversifying export markets continue to stimulate exports. The Committee noted that the brisk course of revenues from tourism and other services notably boosted the contribution of net exports to quarterly growth in the third quarter. In the upcoming period, exports of goods and services are expected to boost growth further and the slowdown in import demand resulting from the subdued domestic demand is likely to maintain its positive effect on the current account balance.

7. The slowdown in economic activity continues, partly due to tighter financial conditions. Survey indicators for the last quarter show that the downtrend in the capacity utilization rate of the manufacturing industry continues across all subcategories. The deceleration in the indicators for production and orders of domestic market-oriented sectors, particularly sectors affiliated to construction, confirms this outlook. Prospects for exports and tourism-linked activities seem relatively better, yet the stance for employment and investment has recorded an overall worsening.

8. The labor market data confirmed the evaluations that the economy lost pace in the third quarter due to the domestic demand. Sectors affiliated to foreign trade and government offered positive contributions to the services employment. However, the fall in construction employment continued and the industrial employment registered a decline compared to the previous period. Leading indicators signal a sustained increase in unemployment rates.

9. Credit conditions have remained to be tight in the third quarter. In addition, the propensity to save in public expenditures coupled with the rise in unemployment rates hint at a further deceleration in domestic demand. Net exports are likely to boost growth further in the last quarter and curb the slowdown in economic activity to some extent.

10. In sum, recently released data for the third quarter and the leading indicators for the last quarter point that the real adjustment in the economy continues with full speed and the rebalancing trend has become more pronounced. Lingering tight financial conditions maintain the downside risks to the magnitude and duration of the slowdown in economic activity.

Monetary Policy and Risks

11. The Committee evaluated the medium-term inflation forecasts for the October Inflation Report as well. Accordingly, compared to the July forecast, year-end consumer inflation forecasts for 2018 and 2019 have been revised upwards by 10.1 points and 5.9 points, respectively. Under a tight policy stance focusing on bringing inflation down accompanied by reinforced policy coordination, inflation is projected to converge gradually to the targets. In this respect, inflation is projected to be 23.5 percent at end-2018, and then fall to 15.2

percent at end-2019 and 9.3 percent at end-2020 before stabilizing around 5 percent in the medium term. Forecasts are based on a monetary policy framework that envisages that the tight monetary policy stance will be maintained for an extended period.

12. Recent developments regarding the inflation outlook point to significant risks to price stability. Price increases have shown a generalized pattern across subsectors, reflecting the movements in exchange rates. Although weaker domestic demand conditions will partially mitigate the deterioration in the inflation outlook, upside risks to the pricing behavior continue to prevail. The significant increase in producer prices-driven cost-side pressures, and the elevated levels of inflation and inflation expectations continue to pose risks to the inflation outlook in the coming period. Accordingly, the Committee has decided to maintain the tight monetary policy stance and keep the policy rate (one week repo auction rate) constant at 24 percent.

13. The Central Bank 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. Inflation expectations, pricing behavior, lagged impact of recent monetary policy decisions, contribution of fiscal policy to the rebalancing process, and other factors affecting inflation will be closely monitored and if needed, further monetary tightening will be delivered.

14. The outlook that the medium-term projections presented in the Inflation Report are based on is shaped by the Monetary Policy Committee's judgments and assumptions. Nevertheless, various risks to these factors may affect the inflation outlook and necessitate changes in the monetary policy stance envisaged in the baseline scenario. The Committee noted that risks to the medium-term inflation outlook are mostly on the upside.

15. The primary risk to inflation outlook in the upcoming period would be a further deterioration in pricing behavior. In recent months, the exchange rate pass-through to the consumer inflation has firmed, backward indexation has become more widespread, and pricing behavior has deteriorated considerably. Although it is believed that exchange rate-related inflationary pressures will remain relatively subdued under current circumstances, risks to the inflation outlook remain solid amid highly volatile exchange rates. In case of a failure in implementing the macroeconomic rebalancing process rapidly and effectively enough to bring inflation down amid high inflation rates and risk premium levels, inflation and exchange rate expectations may feed each other and undermine the disinflation process. In such a case, any further deterioration in pricing behavior may necessitate a tighter-than-envisaged monetary policy stance for a longer time in order to lower inflation.

16. Crude oil prices and domestic food prices are also considered to constitute upside risks to inflation in the upcoming period. Although problems in the US regarding the supply of shale oil have been largely settled in the recent period, the supply shortage due to geopolitical developments in Iran and Venezuela continues to be the major upside risk to crude oil prices. On the other hand, increased protectionism in global trade stands out as a downward risk factor for commodity prices due to its likely adverse effect on global growth. Risks related to domestic food prices are projected to be on the upside because of cumulative cost-side pressures, particularly in the short term. In this framework, the monetary policy response will be determined in such a way to curb a possible deterioration in inflation expectations and pricing behavior, taking into account the direct and secondary effects of respective risks on inflation.

17. The deteriorated pricing behavior, tight financial conditions and the financial state of the corporate sector have recently caused inflation dynamics to change and the uncertainty over

inflation and forecasts to rise. The cumulative cost pressures on firms and the decrease in their profitability, coupled with increased working capital costs and the backward indexation behaviour in wages, may cause the disinflationary impact of the demand channel to be more limited compared to the implications of the historical data. In the short-run, monetary policy decisions will be more sensitive to incoming data and the monetary policy stance will be revised upon detection of changes in the inflation outlook.

18. In the third quarter of the year, credit conditions recorded a significantly higher tightening than historical averages due to incresing risk premiums. The rate and extent of the normalization to be observed in credit conditions in the upcoming period are important in terms of the outlook of economic activity. As cash flows and balance sheets of firms have been adversely affected by the increase in exchange rates and loan rates as well as by the slowdown in economic activity, conducting the necessary assessments and analyses related to the asset quality of firms will have a decisive role in the credit market. Therefore, establishing a coordination between the financial sector policies that restrict the balance sheet effects of the corporate sector and the monetary policy that focuses on inflation has become crucial for preventing the financial conditions from falling into an unproductive tightening cycle.

19. There are also risks stemming from global monetary policies and risk appetite developments that may lead to a decline in capital flows towards emerging economies and feed into exchange rate volatility. The sustained monetary tightening trend and the increase in bond yields in advanced economies, heightened protectionism in global trade, Brexit developments, concerns over the budget deficit and sovereign debt of Italy, and imminent sanctions on Iran may cause the risk appetite for emerging economies to display a fluctuating pattern in the upcoming period. This, in turn, may pose a downside risk to portfolio flows to emerging economies. In case of excessive market volatility due to fluctuations in global liquidity conditions and in perceptions of risk, the CBRT may use liquidity measures intended for providing the market with the needed FX liquidity in a timely, controlled and effective manner. In addition, it may introduce additional tightening in monetary policy to curb the impact of these risks on inflation and inflation expectations.

20. The coordination between the monetary policy and the fiscal policy is very crucial with respect to disinflation and macroeconomic rebalancing. The fiscal policy outlook that the medium-term projections in the Inflation Report are based on incorporates a policy stance that focuses on disinflation and macroeconomic rebalancing and that is coordinated with the monetary policy, which is in line with the New Economy Program announced in September. Accordingly, the projections rest on an outlook where the fiscal policy introduces a tight fiscal discipline, as envisaged in the New Economy Program. Moreover, it is assumed that administered prices, tax and wage adjustments will be formulated in a way that will help reduce the backward-indexation behavior. If the fiscal policy significantly deviates from this framework leading to an adverse impact on the medium-term inflation outlook, the monetary policy stance may be revised.

21. Collective efforts to turn the recently enhanced coordination between monetary and fiscal policies into a sustained and systematic structure are expected to support the fight against inflation. Moreover, continued structural steps focusing on reducing rigidity and volatility in inflation will contribute to price stability and social welfare.