Summary of the Monetary Policy Committee Meeting

25 February 2021, No. 2021-11

Meeting Date: 18 February 2021

Inflation Developments

1. In January, consumer prices were up by 1.68% and annual inflation rose by 0.37 points to 14.97%. The rise in inflation was mainly driven by core goods and energy groups. While annual inflation in services slightly decreased, the fall in food annual inflation was led by fresh fruits and vegetables. Against this background, annual inflation rates and trends of B and C indices increased.

2. Although prices of food and non-alcoholic beverages increased by 2.48% in January, annual inflation in the group decreased by 2.50 points to 18.11%. While processed food inflation increased by 2.59 points to 18.11%, unprocessed food inflation decreased by 8.26% to 18.08% also due to the base effect. The significant drop in seasonally adjusted vegetable prices became the key driver of the marked fall in unprocessed food prices. Unlike the favorable outlook in fresh fruits and vegetables prices, the rapid rise in other unprocessed food prices continued. Following the adjustment in the reference raw milk price, milk prices significantly increased (14.52%), while the rise in meat prices was another prominent development. Processed food prices increased by 3.75% in January, led by cheese, other dairy products and fats and oils. The rise in the reference raw milk price widely affected related food products and leading indicators point that this trend, although slowing down, continues in February. Despite the appreciation in the Turkish lira, developments in international commodity prices continued to affect processed food prices adversely, particularly those of fats and oils. As a result, annual food inflation excluding fresh fruits and vegetables rose to 19.89%.

3. In January, energy prices increased by 3.24% and annual inflation in the energy group reached 7.86%, driven by adjustments in administered prices. The rise was led by price increases in electricity (6.18%), municipal water (7.15%) and natural gas (1.09%) prices. Despite the rise in international crude oil prices, the rise in fuel oil prices remained limited (0.65%) thanks to the appreciation in the Turkish lira and the sliding scale system. The Committee noted that annual inflation in the energy group, which significantly decreased in February-April period last year, would continue to increase in the upcoming months due to the base effect, despite the limiting effect of the sliding scale system.

4. In January, core goods prices was up 0.47% and annual inflation in the core goods group increased by 2.94 points to 20.18%. The cumulative exchange rate effects and demand conditions as well as the minimum wage developments, international commodity prices and supply constraints continued to affect durable goods inflation. In this period, while price increases in automobiles and electrical and non-electrical equipment decelerated, furniture prices posted a high increase of 6.31%. Other core goods prices, which are affected by the lagged effects of exchange rate developments, increased by 2.03%. Seasonal sales in clothing and footwear, groups limiting consumer inflation, remained more limited compared

to the previous year and annual inflation in the group increased. Leading indicators suggest that a partial decline has started in cumulative exchange rate effects on the core goods inflation trend. Yet, the Committee highlighted the upside risks to clothing inflation that was contained by pandemic-led weak demand conditions.

5. In January, services prices rose by 1.87%, while annual services inflation decreased by 0.14 points to 11.52%. Annual inflation increased in rents, restaurants-hotels and communication groups, while posting a more significant rise in the transport group, and decreased in other services. The rise in transport services was mainly driven by the adjustments in intra-city transportation fees. The rise in annual inflation in restaurants-hotels was mainly driven by catering services, and the increases in food prices and the minimum wage were influential in this development. Excluding communication, the trend of the services inflation remained high. The Committee has reiterated that pandemic-led dynamics have contained the services inflation, particularly inflation in accommodation, package tours, education, transport, recreational and cultural services, and underlined the upside risks associated with the normalization process. Moreover, it was noted that the special communication tax, which was raised from 7.5% to 10%, had an upside effect on services inflation, as confirmed by leading indicators.

6. Inflation expectations decreased in January and also in February, however remained at elevated levels. In CBRT Survey of Expectations the 12-month-ahead inflation expectation decreased by 0.17 points to 10.36% and 24 month-ahead inflation expectation decreased by 0.11 points to 9.03%.

7. The Committee evaluated the impact of the change in the weights in consumer prices index on the forecast path presented in the January Inflation Report. It was noted that the rise in the weights of groups with high annual inflation would make an upside impact on annual inflation until mid-2021. The impact of the weight on annual inflation was projected to reach 0.5 points by April, then post a gradual decline in the rest of the year and die out towards the end of the year.

Factors Affecting Inflation and Risks

8. Global economic activity data indicate that the partial recovery since the third quarter continues, albeit with some deceleration. However, despite ongoing vaccination efforts, risks to the global economic activity prevail due to uncertainties pertaining to the vaccination process and the course of the pandemic. The effects of pandemic-related restrictions in European countries are more prevalent on the services sector, while manufacturing industry remains strong.

9. Advanced and emerging economies maintain their expansionary monetary and fiscal stances. Despite the recent rise, long-term interest rates in advanced economies are still at historically low levels. Even though central banks announce in their statements that inflation is likely to increase temporarily in the post-pandemic normalization process, the forward guidance delivered and market expectations point that the low interest environment would continue for an extended period in advanced economies. The effectiveness of these policies on financial markets, growth and employment will depend on the course of the pandemic and the available policy room in each country.

10. Similar to the previous MPC meeting period, emerging economy portfolio markets continued to attract large volume of inflows due to improved risk sentiment. In this period, the trend of inflows to bond markets of emerging economies remained the same as the previous MPC meeting, while inflows to equity markets continued increasingly.

11. Crude oil prices have been rapidly increasing since the last MPC meeting. In addition, the ongoing rise in commodity prices excluding energy, specifically agricultural commodities and industrial metals, have an adverse effect on both producer and consumer inflation. Inflation is quite high in paper products and basic metals sectors, which are main input providers for the manufacturing industry. Supply constraints have become more pronounced as delivery times lengthened in those and related sectors. Other items driving producer inflation higher include vegetable oils, animal feed, processed steel products, vehicles and electronic products. These items affect consumer inflation through food and durable goods. The Committee stated that in the upcoming months, consumer inflation would increase consistent with the past projections due to the base effect of import prices and the rise would be mainly driven by the energy group. The Committee noted the important role of commodity prices in continuing inflationary pressures despite the appreciation in the Turkish lira, and reiterated the upside risks for the upcoming months.

12. Economic activity is on a strong course. In December, the industrial production index increased by 1.3% month-on-month and 12.1% year-on-year. Thus, production gained strength, having grown by 4.8% in the fourth quarter from the third quarter. While turnover and retail trade volume indices also strengthened compared to the third quarter, economic activity was considerably buoyant in services excluding tourism-related sectors as well as in trade. Hence, pre-pandemic levels were exceeded widely across sectors excluding industrial and services sector groups that were adversely affected by the pandemic.

13. The strong course of economic activity is also reflected onto the labor market.. In November period, seasonally adjusted nonfarm employment increased by 0.2% from the previous period, while total and nonfarm unemployment rates were 12.9% and 14.9%, respectively. During this period, employment was up in the industrial sector amid supported by upward trend in exports, but edged down in construction and services. The fall in services employment was driven by the sectors that have been hit hardest by the pandemic.

14. While the downward effects of the pandemic-related restrictions on the economy have been limited, the slowdown in activity in services and related sectors and uncertainties surrounding the short-run outlook of these sectors prevail. Survey indicators for February indicated that manufacturing industry activity remains strong, particularly in intermediate and durable goods sectors. While there is no additional slowdown in domestic demand, there is some weakening in external demand mainly due to lockdown restrictions in Europe. Domestic demand faces upside risks associated with the timing of lifting pandemic-related restrictions. The Committee assessed that the inflationary effects of the sectoral divergences that emerged due to pandemic dynamics and the macro policy mix, along with the risks they imply for the period ahead should be monitored.

15. Evaluating the output gap indicators related to the cyclical state of the economy, the Committee concluded that economic activity started converging to its underlying trend due to some slowdown in the first quarter, but demand-side inflationary effects continue to exist throughout the quarter. Business and household surveys indicate that the demand for durable goods has been strong. Some members of the Committee underlined that personal loan demand is still brisk due to high inflation expectations, and reiterated that the effects of the monetary policy tightening are yet to be felt. To this end, developments in credit growth and its composition will be monitored closely.

16. The strengthening domestic demand, due to the cumulative effects of high credit growth during the pandemic, continues to have an adverse effect on the current account balance. In addition, rising international prices for oil and other commodities also affect the external balance. Gold imports have declined to their historical averages since mid-January. The

Committee assessed that terms of trade-related risks to the current account balance may be limited if that trend in gold imports hints at a permanent improvement.

17. Credit growth has started to slow down amid tighter financial conditions. The limiting effect of the slowdown in loans on domestic demand and imports is expected to be more pronounced in the upcoming period. The Committee underscored once again the importance of the course of the current account balance in terms of a lasting recovery in economic activity and financial stability.

Monetary Policy

18. The Committee re-emphasized that monetary policy decisions will be taken within the framework of inflation targeting regime and with the priority of price stability. The monetary policy stance will be set taking into account the upside risks to the inflation outlook and with a focus on bringing inflation down permanently in a cautious manner and achieving price stability target.

19. Domestic demand conditions, cumulative cost effects, in particular the exchange rate effects, increasing international food and other commodity prices and high levels of inflation expectations continue to affect the pricing behavior and inflation outlook adversely. The decelerating impact of the strong monetary tightening on credit and domestic demand is expected to become more significant; hence the effects of demand and cost factors on inflation are envisaged to wane gradually.

20. On the other hand, the ongoing upward trend in international commodity prices, supply constraints intensifying in some sectors, and the adjustments in wage and administered prices maintain their importance for the medium-term inflation outlook. The tight monetary stance will serve as a significant buffer against external and temporary volatilities in the context of inflation expectations, pricing behavior and financial market developments.

21. Accordingly, the tight monetary policy stance will be maintained decisively, taking into account the end-2021 forecast target, for an extended period until strong indicators point to a permanent fall in inflation and price stability. In regard to the indicators pointing to a permanent fall in inflation and price stability, indicators for the underlying trend of inflation and pricing behavior, diffusion indices, demand and cost factors, and inflation expectations are monitored closely for their compatibility with the targets in the forecast horizon. The interaction of risks posed by soaring commodity prices to the inflation outlook with the pricing behavior and inflation expectations will be closely monitored. In addition, there has been recently an acceleration in consumer loans. Additional monetary tightening will be delivered if needed.

22. The balance between the monetary policy rate and actual/expected inflation will be sustained decisively to maintain a strong disinflationary effect until permanent price stability and the 5% target are reached. Sustaining the tight monetary policy stance in such a manner, besides attaining permanent price stability, will foster macroeconomic and financial stability positively by facilitating the fall in country risk premium, the reversal in currency substitution, the accumulation of foreign exchange reserves and the perpetual decline in financing costs.

23. The effects of the monetary policy stance on money markets have been examined. There has been some decline in loan and deposit rates, recently. The Committee stated that Turkish lira reserve requirements need to be increased in order to enhance the effectiveness of the monetary transmission mechanism. For the same purpose, the Committee discussed whether to lower the rates within the Reserve Options Mechanism, which allows a certain ratio of Turkish lira required reserves to be maintained in foreign currency and gold. The

Committee emphasized that the policy rate is the sole instrument to determine the monetary policy stance, while the required reserve ratio is a tool that affects the transmission of the monetary stance determined by the policy rate to deposit, loan and other money markets.

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

25. In its decision-making process, the CBRT adopts a framework with a medium term perspective, based on analyzing all factors affecting inflation and the interaction between these factors.

26. It should be emphasized that any new data or information may lead the Committee to revise its stance.