TÜRKİYE CUMHURİYET MERKEZ BANKASI

Summary of the Monetary Policy Committee Meeting

25 March 2021, No: 2021-14

Meeting Date: 18 March 2021

Inflation Developments

1. In February, consumer prices increased by 0.91% and annual inflation rose by 0.64 points to 15.61%. While the increase in annual inflation was spread across all sub-groups, the most significant contribution came from core goods and energy groups. Under this outlook, while annual inflation rates of B and C indices continued to increase, their trends declined somewhat.

2. Prices of food and non-alcoholic beverages increased by 2.57% in February, and the group's annual inflation increased by 0.29 points to 18.40%. While this rise was mainly driven by the 19.72% increase in processed food prices, unprocessed food inflation decreased by 1.07 points to 17.01%. In this period, inflation in fresh fruits and vegetables decreased slightly, while in other unprocessed food group, meat prices continued to increase and the lagged impact of the adjustment in the reference raw milk price continued to be observed in milk prices. When leading indicators for March are taken into account, it is observed that the rise in the reference raw milk price in January had a significant impact on consumer inflation throughout the first quarter. Processed food prices maintained their rapid uptrend and increased by 2.27% month-on-month. In tandem with the related items in the unprocessed food group, prices of processed meat products, cheese and other dairy products increased as well. Meanwhile, with the impact of developments in international markets, the high rate of increases in fats and oils continued. With these developments, the annual food inflation excluding fresh fruits and vegetables reached 20.75%. Leading indicators signal that annual food inflation may slow down led by unprocessed food prices.

3. In February, energy prices increased by 0.25% and annual inflation in the energy group was 8.82%. During this period, natural gas and municipal water prices increased by 0.80% and 0.59%, respectively. Despite the rise in international crude oil prices, the rise in fuel oil prices remained limited at 0.16% due to the appreciation in the Turkish lira and the active use of the sliding scale system. The uptrend in oil prices continued in March, however, the sliding scale system curbed the effects coming through this channel. As per the EPDK decision of 17 March 2021, a price cap practice was introduced for every province for a period of 2 months and fuel oil prices decreased thereafter. Despite the curbing effect of the sliding scale system, the Committee has noted that the annual energy group inflation will significantly increase in the next two months due to the low base in the previous year.

4. In February, core goods prices decreased by 0.12% and the group's annual inflation in the increased by 1.52 points to 21.70%. While annual inflation increased in clothing, footwear and durables goods, it remained flat in other core goods. Annual inflation in the clothing and footwear group rose significantly as seasonal discount rates in the clothing and footwear prices were low this year. Annual inflation in durable goods had been hovering high due to

the rise in the international commodity prices, supply constraints and strong domestic demand; nevertheless, durable goods inflation decelerated on the back of easing cumulative exchange rate effects. While prices in other core goods decreased by 0.19%, annual inflation remained flat. Medicine prices, which increased by 6.09% on a monthly basis due to the reference price practice, prevented a more favorable outlook in this group. It is anticipated that the portion of the increase in medicine prices that were extended to March will be higher and will continue to affect other core goods inflation adversely. The Committee maintained its emphasis on the upside risks to clothing inflation that was curbed by weak demand conditions due to the pandemic.

5. Services prices were up 1.04% in February and the group's annual inflation increased by 0.22 points to 11.74%. Annual inflation increased in communication services and restaurants-hotels; remained flat in rents and other services, and decreased in transport services. While the regulation in the special communication tax was the determining factor in the increase in annual inflation in communication services, it is observed that its impact continued in March as well. While the catering services item stood out in the increase in the annual restaurants-hotels inflation, the rise in food prices and the minimum wage is considered to be effective in this development. Meanwhile, other services group prices continued to display different trends across its sub-items. Annual inflation in health and repair-maintenance items remained high, while that in package tours, recreational and cultural services and education activities, adversely affected by the pandemic, maintained its moderate course. However, the Committee drew attention to the upward impact of the controlled normalization process on some service prices in the light of leading indicators. The Committee also noted that the accumulated costs during pandemic lockdowns as well as capacity-limiting measures may lead to unit cost-driven inflationary effects in certain sectors, particularly in the restaurants-hotels groups.

6. Inflation expectations increased in March. The 12-month-ahead inflation expectation increased by 0.11 points to 10.47% and 24 month-ahead inflation expectation increased by 0.15 points to 9.18%. In this period, inflation compensations derived from bond yields increased as well. The Committee underlined that this course of inflation expectations increased the risks to pricing behavior and the medium-term inflation outlook.

Factors Affecting Inflation and Risks

7. Global growth outlook has improved and international commodity prices have risen on the back of expansionary monetary and fiscal policies as well as positive developments in the vaccination process. 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.

8. In tandem with the recovery in expectations of growth in advanced economies, rising global inflation expectations and long-term bond rates lead to uncertainties about advanced economy monetary policies, and volatility in global financial markets. 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 points that the low interest environment would continue for an extended period in advanced economies. Nevertheless, the Committee noted that global inflationary pressures might cause an earlier-than-projected tightening in monetary policies; it is assessed that a period marked by increased data-sensitivity and related volatilities in global financial markets is entered.

9. Since the last MPC meeting, portfolio flows to emerging economies continued, albeit at a slower rate. In this period, bond markets of emerging economies saw outflows, while inflows

to equity markets accelerated. Portfolio flows to emerging economies may be adversely affected if the uptrend in long-term bond rates in advanced economies continues.

10. Crude oil and industrial metal prices continue to rise. The sliding scale system limits the negative effects of crude oil prices. Although agricultural commodity prices are somewhat more moderate, prices of certain products, oils in particular, remain on the rise. High producer inflation and ongoing problems in supply chains are additional pressure factors. Despite the partial appreciation in the Turkish lira in February, producer prices continued to soar in input supplying industries such as petroleum, chemical products, food, wood and cork, non-metallic minerals and paper. The Committee assessed that upside risks to the year-end forecast target announced in the January Inflation Report rose significantly due to an increased credit impulse, especially since the end of January, and rising import costs.

11. Economic activity is on a strong course. In the last quarter of 2020, GDP grew by 5.9% year-on-year and 1.7% quarter-on-quarter. While private consumption demand maintained its strong course spreading across all goods and services, public consumption continued to support domestic demand. Despite the sharp increase in machinery and equipment investments, investment expenditures weighed on growth as construction investments fell markedly. The Committee noted that, excluding construction, domestic demand exhibited a quite strong momentum, as envisaged, and maintained its assessment that aggregate demand conditions were at inflationary levels in the last quarter of 2020.

12. Economic activity displays a strong quarterly momentum in the first quarter as well and being higher than projected, remains above its long-term trend. In January, the industrial production index increased by 1.0% month-on-month and 2.3% quarter-on-quarter. Intermediate and durable consumer goods continued to be the drivers of the increase in industrial production. Turnovers increased in trade and construction in January, but remained almost flat in services due to the weak course in sectors that are directly affected by the pandemic. As the pandemic-related restrictions are being eased, economic activity is expected to pick up in services and related sectors. In fact, high-frequency data indicate that economic activity has gained strength amid credit developments and controlled normalization. Nevertheless, risks for economic activity remain significant depending on possible developments regarding the course of the pandemic.

13. The strong course of economic activity is also reflected onto the labor market. In January, seasonally adjusted nonfarm employment increased by 2.1% from the previous month, while total and nonfarm unemployment rates were 12.2% and 14.2%, respectively. During this period, employment increased in the services sector, but remained almost flat in industry and construction sectors.

14. The data released for the first quarter point to a stronger course compared to the outlook presented in the January Inflation Report regarding economic activity and the cyclical state of the economy. The Committee assessed that the underlying trend in economic activity is quite strong, considering the limiting effect of the pandemic-related restrictions. Business and household surveys indicate that the demand for durable goods is still higher than long-term averages. Some members of the Committee reiterated that personal loan demand is still brisk due to high inflation expectations.

15. Strong domestic demand due to the cumulative effects of high credit growth during the pandemic and the rise in import prices continue to adversely affect the current account balance. High-frequency data point to an increase in exports and imports, while the developments in terms of trade have a more pronounced impact on the foreign trade deficit. Meanwhile, 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.

16. Credit growth, which has slowed down amid tighter financial conditions, has recently trended upwards. Despite this uptick in personal and commercial loans, the limiting effect of the slowdown in loans on domestic demand and imports is expected to be more pronounced in the upcoming period with the additional monetary tightening. 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

17. 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.

18. 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. On the other hand, supply constraints intensifying in some sectors and the adjustments in wages and administered prices maintain their importance for the medium-term inflation outlook. While the expectation that the decelerating impact of the monetary tightening on credit and domestic demand to become more significant is maintained, the projected gradual waning in demand and cost factors is being delayed by the recent upward trend in credit growth and increase in import costs.

19. As a result of pandemic-driven expansionary policies, inflation expectations have been increasing recently in the United States, causing long-term bond yields to rise, and thus the global risk appetite to follow a volatile course and emerging market currencies to depreciate. 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.

20. Considering the upside risks to inflation expectations, pricing behavior and the medium-term inflation outlook associated with these developments, the MPC has decided to implement a front-loaded and strong additional monetary tightening.

21. 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 will continue to be monitored closely for their compatibility with the targets in the forecast horizon. The interaction of the risks on the inflation outlook caused by the recent acceleration in loans, the increasing volatility in financial markets due to rising global inflation expectations, and the increase in international commodity prices with the pricing behavior and inflation expectations will be closely monitored. 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 percent 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. 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 domestic demand, international prices and global risk appetite heightens the risks arising from external financing needs to the balance of payments. 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.

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.