Summary of the Monetary Policy Committee Meeting

27 July 2023, No: 2023-29

Meeting Date: 20 July 2023

Global Economy

1. While global inflation has been declining, it remains above the long-term averages and targets of central banks. Consumer inflation in advanced and emerging economies decreased from 5.59% and 5.82% in the previous MPC meeting period to 4.91% and 5.41%, respectively. In the last ten years, the average inflation was 2.2% in advanced economies and 5.6% in emerging economies. Inflation continues to hover significantly above the average target rate of 2% in advanced economies and 3.5% in emerging economies. The average annual inflation expectation for the last quarter of 2023 for advanced and emerging economies are 3.1% and 5.9%, respectively. Although the downward trend in commodity prices that started in the middle of last year continues, the current level of the Commodity Price Index is 26.2% above the average of the last ten years. The index decreased by 28.7% compared to the highest level reached last year. Similarly, the Agricultural Commodity Price Index, which declined by 11.2% compared to the peak it reached last year, is 16.2% above the average of the last ten years. This still has an impact on inflation due to the high share of food in the consumer basket. Compared to the previous MPC meeting period, core inflation posted a limited decline from 5.12% to 5.02% in advanced economies and from 6.20% to 6.03% in emerging economies. The average annual inflation expectation for the last quarter of 2023 is 3.2% in the USA and 3.0% in the euro area, while core inflation expectations are 3.7% and 4.0%, respectively.
2. High levels of core inflation and inflation expectations imply that global inflation will continue to remain above the targets of central banks for a while. As a result, many central banks continue the monetary tightening process. The central banks of 12 advanced countries held a total of 130 meetings in the last 17 months, and policy rates were increased in 93 of these meetings. During the same period, 15 emerging countries' central banks held a total of 190 meetings, and policy rates were increased in 97 of these meetings.[1] The results of the implemented monetary policy have begun affecting financial conditions, and central banks' emphasis on tightening financing and credit conditions has strengthened.
3. Despite the flat global growth outlook, relatively strong demand and tight labor markets persist. The global growth index, which is weighted with export shares of Türkiye's foreign trade partners, has posted a very limited increase compared to the previous MPC meeting period. The index is projected to grow by 1.7% in 2023, which is approximately 0.4 points higher than the trough in January. However, when the 3.5% growth of the index in 2022 is considered, a notable slowdown in foreign demand, on an annual basis, in 2023 is evident.

[1] Developed Countries: Australia, Canada, Czech Republic, Denmark, Eurozone, Japan, New Zealand, Norway, South Korea, Sweden, United Kingdom, United States of America.
Developing Countries: Brazil, Chile, China, Colombia, Hungary, India, Indonesia, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, Thailand.

Global PMI indices indicate that the services sector activity remains robust, while the manufacturing industry continues to follow a flat course just below the threshold value since the last quarter of last year. The global services PMI rose by 2.6 points quarter-on-quarter to 54.9 in the second quarter of the year, while the manufacturing PMI decreased by 0.2 points to 49.3. The composite PMI index was 52.7 in June with a decline of 1.7 points compared to the level in May at the global level, dropped by 1.5 points to 52.2 in advanced economies, and decreased by 2 points to 53.6 in emerging economies. While the composite PMI indicator in China fell by 3.1 points to 52.5 in June compared to May, the index was above the 50-threshold level in both the manufacturing and services sectors. Expectations for a slowdown in economic activity in advanced economies due to financial conditions continue. In the euro area, one of Türkiye's major trading partners, the manufacturing PMI fell to 43.4 in June, the lowest level since the pandemic.

4. Portfolio flows to emerging markets continued in June on the back of improving risk sentiment. While there was an inflow of approximately USD 46.4 billion to equity markets from the beginning of the year until the end of May, there was an outflow of around USD 4.3 billion in bond markets. From the beginning of June until July 7, the portfolio inflows amounted to USD 7.6 billion in total, USD 4.9 billion of which were inflows to equity markets.

Inflation Developments

5. Although annual inflation in Türkiye has decreased by 47.3 points compared to the peak in October 2022, it still remains high. Consumer prices rose by 3.92% in June, while annual inflation fell by 1.38 points to 38.21%. Recent indicators point to continuation of the increase in the underlying trend of inflation. The strong course of domestic demand, cost pressures stemming from wages and exchange rates, the stickiness of services inflation and tax adjustments have been the main drivers.

6. Contributions of subgroups to annual inflation rose from 10.17 points to 10.49 points in the core goods group (0.32 points of increase) and from 1.50 points to 1.81 points in the total of alcohol, tobacco and gold groups (0.31 points of increase) but dropped from 13.64 points to 13.56 points in the food and non-alcoholic beverages group (0.08 points of decrease), from 15.17 points to 15.00 points in the services group (0.17 points of decrease) and from -0.88 points to -2.64 points in the energy group (1.76 points of decrease).

7. Prices of food and non-alcoholic beverages increased by 3.02% in June, and annual inflation rose by 1.40 points to 53.92%. The seasonally adjusted monthly rate of increase in food prices accelerated compared to the previous month, driven by prices of fresh fruits and vegetables, mainly vegetables. In the other unprocessed food group, the rise in red meat prices gained pace compared to the previous month. Processed food prices went up by 1.85% on a monthly basis mainly due to tea prices that were driven up by fresh tea purchase prices. Monthly inflation of bread and cereals increased somewhat in this period, reaching 1.41%.

8. Energy prices rose by 4.23% in June, and the group’s annual inflation dropped by 9.55 points to -16.52% due to the base effect. Fuel prices, which increased (11.32%) in tandem with the outlook of the Turkish lira despite the relatively flat course of international crude oil prices, were the leading driver of the monthly increase in energy prices.

9. In June, prices of services rose by 3.66%, and the group’s annual inflation edged down by 0.50 points to 59.45%. Price hikes spread across subgroups, while rents and restaurants-hotels continued to be the subgroups standing out with their price increases of 5.80% and 4.32%, respectively. Communication prices remained on the rise led by internet fees, while increases in prices of the maintenance and repair of personal transport vehicles as well as recreation

and sports services were notable in the other services subgroup. Meanwhile, the outlook for transport services was mainly shaped by the ongoing price hikes in air passenger transport.

10. Prices of core goods were up by 4.03% in June, and annual inflation increased by 1.62 points to 36.69%. In June, annual inflation increased in durable goods (excluding gold) as well as in clothing and footwear, but decreased in other core goods. The monthly increase in durable goods (excluding gold) grew stronger with 6.64% over the previous month, mainly driven again by automobiles in June. Automobile prices surged by 10.28% due to brisk domestic sales as well as exchange rate developments. Thus, the rise in automobile prices amounted to 34.01% in the first six months of 2023. Meanwhile, prices of white goods posted an increase of 3.78% in June.

11. Prices in the alcoholic beverages and tobacco products group soared by 11.13%, and annual inflation in this group rose by 10.80 points to 40.90%. This was mainly driven by producer-driven price hikes in tobacco products (12.29%). The price increase in the alcoholic beverages and tobacco group will also continue in July due to the specific SCT rise that is automatically updated based on the D-PPI as well as VAT arrangement at the beginning of the month.

12. The underlying trend of inflation remains elevated, despite having slowed in the post-2022 period. Seasonally adjusted monthly increases in the B and C indices gained pace compared to the previous month, which is also confirmed by alternative core inflation indicators. The three-month average increases in the seasonally adjusted B and C indices, which peaked at 8.8% and 8.4%, respectively, in February 2022, declined to 2.8% and 3.3% as of June 2023. In June, the seasonally adjusted rates of monthly increase in the B and C indices were 3.1% and 3.7%, respectively (2.9% and 3.6% in the previous month). Alternative core indicators such as median inflation and SATRIM also posted increases compared to the previous month.

13. Leading indicators for July point to a significant monthly price increase through the channels of demand, wages, exchange rates, taxes and deteriorating pricing behavior. Accordingly, it is estimated that annual inflation will also increase significantly.

Demand and Production

14. Data for the second quarter of the year confirm that economic activity remained robust, particularly driven by domestic demand. In May, the retail sales volume index maintained its uptrend, increasing by 33.1% year-on-year. The quarterly rate of increase as of May was 4.6%. The uptrend in card expenditures continued in the second quarter, and seasonally adjusted card expenditures posted a strong increase of 24.3% compared to the first quarter. An analysis of manufacturing firms' registered orders in the second quarter reveals that orders from the domestic market displayed a significant rise at 2.6 points on an annual basis. Leading indicators and field interviews suggest that the strong course of domestic market orders continued in July.

15. Recent data show that economic activity in the earthquake zone continued to recover faster than expected, thereby largely compensating for the disaster-driven contraction. As of May, seasonally adjusted employment reached 31.7 million, which was 26,000 people above its pre-disaster level in January. In this period, seasonally adjusted employment increased quarterly by 0.9%, and labor force participation rate by 0.3 points. Meanwhile, the unemployment rate decreased by 0.5 points in May from its 10% level in the previous month, hitting its lowest level since March 2014.

16. In May, the annualized current account deficit increased by USD 37.3 billion to USD 60 billion, from its May 2022 level of USD 22.6 billion, despite the decline in energy imports due to energy prices. This increase was driven by the rise in foreign trade deficit despite the strong course of the services balance. As of May, the annualized balance of payments-defined

foreign trade deficit increased by USD 49.9 billion year-on-year to USD 101.9 billion. In the same period, the annualized services surplus increased by USD 12.1 billion to USD 51.5 billion. Gold imports play an important role in the widening of the current account deficit due to monetary conditions and expectations. In the first five months of the year, total gold imports increased by USD 10.7 billion year-on-year to USD 14.6 billion. Provisional foreign trade data for June suggest that despite hovering below the May level, gold imports remain high. The strong course of domestic demand has an increasing effect on the current account deficit through imports of consumption goods. Provisional foreign trade data for June and high-frequency data for July indicate that imports remained high despite the relatively flat course of exports in seasonally adjusted terms, excluding religious holiday-related working day effects.

17. Tourism revenues are expected to make a strong contribution to the current account balance in the second half of the year, thanks to their performance beyond expectations throughout the year. Travel revenues increased by USD 2.5 billion in the first five months of the year compared to the first five months of the previous year, and reached USD 14.1 billion. Similarly, the number of foreign visitors increased by 26.1% year-on-year to 13.6 million in the first five months of the year. With the increasing contribution of tourism revenues, the current account is projected to follow a more balanced course in the second half of the year. It is anticipated that the strong course of tourism revenues, considered along with the normalization in energy imports, will contribute to healthy price formation and stability due to supply in the foreign exchange market. However, increased tourism activity poses a risk to consumer inflation by boosting demand in the short term.

18. In May, the seasonally and calendar-adjusted industrial production index increased by 1.1% month-on-month. While monthly increases became widespread across sectors, they were stronger in sectors with high export shares and in those that typically exhibit high volatility. Industrial production increased by 1.4% quarter-on quarter, pointing to the continuation of the post-earthquake recovery trend. Similarly, the manufacturing industry capacity utilization rate increased by 0.9 points quarter-on-quarter to 76.2% in the second quarter, and compensated for the earthquake-induced loss in capacity utilization.

Cost Conditions

19. Global commodity prices that have been on the decline since the second half of 2022, have supported the fall in consumer inflation through input prices channel. On the other hand, due to exchange rates and rising labor costs, pressure on producer prices has been increasing.

20. The monthly increase of domestic producer prices at 6.50% was significantly stronger compared to recent months, while annual producer inflation decreased by 0.34 points to 40.42% due to the base effect. In June, international commodity prices declined slightly (-0.76%), while exchange rate developments were the main driver of the rise in producer prices. Price increases were broad-based across subgroups, with energy production posting the most notable rise (12.67%). Thus, the outlook for energy costs, which had been supporting the inflation outlook for a long time, reversed in this month. In this period, other subgroups that stood out with high monthly price increases were capital goods (8.02%) and intermediate goods (6.59%).

21. In July, indicators for global supply chain pressures and international transportation costs remained low. The Global Supply Chain Pressure Index remained about one standard deviation below its historical average in June. Global commodity prices did not display a noticeable change in July. In sum, current global supply conditions remain favorable for inflation.

22. Adjustment in the minimum wage in July 2023, accompanied by wage adjustments for civil servants and public sector workers, and wage hikes becoming broad-based are expected to feed upward pressures, particularly cost-driven impacts, on inflation in the second half of the year.
23. The depreciation in the Turkish lira, widespread wage increases and tax adjustments are expected to place additional cost-side pressure on inflation in the near term. The pass-through from these factors to consumer prices is particularly rapid in times of strong demand conditions. In fact, leading indicators suggest that cost developments led to widespread price hikes in July.

Stickiness of Services Inflation

24. Price increases in the services sector remain high, and inflation in this group displays inertia compared to goods. Monthly price increases in the services sector, where the domestic demand effect is more obvious, are still high compared to 2022. The average of seasonally-adjusted consumer price increases in the last three months is 2.8% in the B index, while it is 3.5% in services. Additionally, the diffusion index for the services sector is hovering above its historical average, indicating that the increases showed a generalized pattern across the sector.
25. Monthly increases in the restaurants and hotels subgroup, which is significantly affected by food, wage and tourism developments, display a persistent outlook. The sector, which is highly sensitive to minimum wage developments, is expected to maintain its uptrend in the following months.
26. Certain services items, particularly rents, education, health, recreation and culture, exhibit pricing behavior indexed to past consumer inflation, prompting inflationary effects to spread over a long period of time. Given the expected outlook for consumer inflation in the near term, there is a risk that inflation will remain high for an extended period in groups in which backward-indexation is prevalent.
27. Fuel prices are capable of having a significant impact on consumer prices, particularly on transport services, through both production inputs and transportation costs. The recent significant increase in fuel prices driven by exchange rates, crude oil prices and tax hikes is likely to have a significant impact on transport services prices in the upcoming period.

Tax Adjustments

28. The Committee anticipates that tax regulations will put further pressure on inflation in the short run. However, it is assessed that the impact of tax hikes will be temporary and will be offset to some extent by favorable effects on demand and fiscal discipline.
29. VAT rates were raised by 2 points in July. Additionally, the VAT rate on some cleaning products was raised to 20% from 8%. The higher fiscal multiplier due to the VAT increase in tobacco products led to high price increases.
30. The lump-sum SCT amounts on fuel were increased. The lump-sum SCT increase of TRY 5 for gasoline and diesel, and TRY 4 for LPG will have a negative impact on consumer inflation both directly and indirectly.

Inflation Expectations

31. The current course of inflation expectations and the deterioration in pricing behavior keep upside risks to the inflation outlook alive. The headline inflation diffusion index was about two standard deviations above its historical average in June.

32. According to the July results of the Survey of Market Participants, the 12-month-ahead inflation expectation increased by 2.56 points from 30.65% to 33.21%, the 24-month-ahead inflation expectation rose by 0.92 points from 18.12% to 19.04%, and the five-year-ahead inflation expectation was revised upwards by 0.79 points from 8.07% to 8.86%.

33. Consumer inflation is projected to rise somewhat in 2023, and then decline as the cumulative effects of interest rate increases and quantative tightening kick in, gradually converging first to historical averages and then to the medium-term target.

Monetary and Financial Conditions

34. Credit growth poses a risk to inflation by increasing domestic demand. As of 14 July 2023, the retail loan balance increased by 81.1% in credit cards, 68.7% in vehicle loans, 30.6% in personal loans, and 22.1% in housing loans compared to end-2022, amounting to an increase of 44.6% in total. Meanwhile, since the last MPC meeting period, personal loan growth has lost further momentum, increasing by 2.9% from 16 June. This was driven by the expansion of the scope of the loan growth-based securities maintenance practice. On the other hand, growth remains robust in credit cards with an annual growth rate rising from 175.4% to 186.6%. TL commercial loans remained relatively flat with a decline in annual growth rates from 73.8% to 69.1%.

35. Average personal loan rates (excluding ODA), which increased by 749 basis points to 41.7% in the previous MPC meeting period compared to the pre-regulation times, rose by 644 basis points to 48.1% in the last MPC meeting period. Housing and vehicle loan rates increased from 21.8% and 34% to 32.6% and 41.3%, respectively in the same period. Meanwhile, Turkish lira commercial loan rates increased by 1,054 basis points to 25.2% due to the policy rate hike.

36. TL deposit rates, which rose to 32.9% on June 23, declined despite the 650 basis points increase in the policy rate and stood at 27.8% on 14 July. The spread between the policy rate and TL deposit rates narrowed notably. This was mainly driven by the regulation on securities maintenance practice, which is the first step of the simplification process in the micro and macroprudential framework.

37. Foreign direct investment, notable improvement in external financing conditions, continued increase in foreign exchange reserves and improvement in current account balance driven by rising tourism revenues will contribute significantly to price stability.

38. With the recently-signed agreements, foreign direct investments that will focus on improving technology investments and production capacity will support external financing in the upcoming period.

39. Türkiye's 5-year CDS premium, which peaked this year with 703 basis points on 22 May 2023 amid domestic uncertainties, declined to 493 basis points in the previous MPC meeting period and to 457 basis points on 19 July 2023. Similarly, 1-month and 12-month exchange rate volatilities of the Turkish lira, which were 25.2 and 33.8 points in the previous MPC meeting period declined to 23.6 and 30.3 points, respectively. Falling figures in the risk premium and exchange rate volatilities were accompanied by net portfolio inflows totaling USD 1.42 billion since June, USD 0.09 billion of which went to the GDDS market and USD 1.33 billion to the equity market.

40. International reserves of the CBRT have assumed a strong upward trend since June. Having declined from USD 128.8 billion at the end of 2022 to USD 98.5 billion at the end of May, gross international reserves of the CBRT rose to USD 113.1 billion as of 14 July.

Monetary Policy

41. The policy rate will be determined in a way that will create monetary and financial conditions necessary to ensure a decline in the underlying trend of inflation and to reach the 5% inflation target in the medium term. The Committee assessed that the capacity of the monetary policy framework to achieve the 5% inflation target should be enhanced in view of the inflation outlook and upside risks. The Committee drew attention to the risks that a deterioration in price stability may pose to macroeconomic stability and financial stability, in particular. Accordingly, the Committee decided to continue the monetary tightening process, the steps of which are strengthened as much as needed in a timely and gradual manner. The monetary tightening process is envisaged to be further strengthened until a significant improvement in the inflation outlook is achieved.

42. The Committee decided to continue the monetary tightening process initiated in order to establish the disinflation course as soon as possible, to anchor inflation expectations, and to control the deterioration in pricing behavior. In this context, the policy rate (the one-week repo auction rate) was increased from 15% to 17.5%.

43. It is assessed that the inflation outlook necessitates a sustained monetary tightening. The Committee reviewed analyses on the effects of monetary tightening on macroeconomic and financial conditions. The effects of rate hike scenarios on key macroeconomic variables such as inflation, loan growth, loan and market rates, economic activity and expectations were assessed from a holistic perspective.

44. In addition, the Committee reiterated that the current micro- and macroprudential framework should be improved to foster macrofinancial stability and increase the functionality of market mechanisms. Accordingly, the simplification policy in this framework has been maintained. The existing micro- and macroprudential framework will be simplified to increase the functionality of market mechanisms and strengthen macrofinancial stability. The simplification policy will continue to be gradual. In the simplification process, the pace and sequence of the steps depend on impact analyses. Impact analyses of the CBRT's regulations are conducted from a holistic perspective for all components of the framework, including its impacts on inflation, interest rates, exchange rates, reserves, expectations, securities and financial stability.

45. In this context, in addition to the increase in the policy rate, the Committee has made decisions on quantitative tightening and selective credit tightening to support the monetary policy stance. While policy rates, the main policy instrument, affect monetary and financial conditions and expectations, these decisions aim to stabilize excess Turkish lira liquidity and consumption demand and increase the effectiveness of monetary policy.

46. The categories of personal credits, credit cards and vehicle loans have been increasing by 9.8% and 9.1% on a monthly average since early 2023. With this acceleration in retail loans, it is assessed that domestic demand deteriorates price stability both directly and through the current account balance. Selective credit tightening decisions are projected to support the rebalancing process in domestic demand.

47. The Turkish lira liquidity inflows to the financial system stemming from the foreign exchange difference payments of FX-protected deposit accounts due to the exchange rate developments are closely monitored. Due actions will be taken based on the impact analyses in view of the current market conditions and liquidity projections for the upcoming period. According to the quantitative tightening decision, the CBRT planned to sterilize the excess liquidity in the market by raising the Turkish lira reserve requirement ratios for FX-protected deposit accounts.

48. Indicators of inflation and the underlying inflation trend will be closely monitored and the CBRT will continue to decisively use all the tools at its disposal in line with its main objective of price stability.
49. The Committee will continue to take its decisions in a predictable, data-driven and transparent framework.