TÜRKİYE CUMHURİYET MERKEZ BANKASI

Summary of the Monetary Policy Committee Meeting

28 January 2021, No: 2021-05

Meeting Date: 21 January 2021

Inflation Developments

1. In December, consumer prices were up by 1.25% and annual inflation rose by 0.57 points, ending the year 2020 at 14.60%. The rise in inflation was mainly driven by the core goods group. While energy inflation increased due to international oil prices, the rise in services inflation remained limited. The strong upward trend in seasonally-adjusted food prices persisted whereas annual food inflation somewhat declined due to the base effect. Against this background, annual inflation rates and trends of B and C indices increased significantly.
2. Prices of food and non-alcoholic beverages rose by 2.53% in December but annual inflation in this group dropped by 0.47 points to 20.61% due to the base effect. Annual inflation in processed and unprocessed food stood at 15.52% and 26.34%, respectively. Seasonally-adjusted prices of fresh fruits and vegetables increased by approximately 10% cumulatively in November and December. Sharp increases in international prices and cumulative exchange rate effects were determinant in the food group excluding fresh fruits and vegetables. The strong upward trend continued in prices of eggs, white meat, rice and pulses that are among the main food items. In the processed food group, prices of bread and cereals remained on the rise while fats and oils also continued to post high increases. The last four months' cumulative increase in prices of fats and oils exceeded 20%. High-frequency data indicate that the rise in the reference price of raw milk is reflected in a wide range of the related food items.
3. In December, energy prices were up by 1.47% and annual energy inflation rose to 5.64%. This rise was mainly driven by fuel prices that increased by 3.5% due to the rise in international oil prices. It is expected that even though there is an appreciation in the Turkish lira, crude oil prices will increase at a higher rate in January and group inflation will continue to climb due to hikes in administered prices.
4. Prices of core goods went up by 1.42% in December while annual core goods inflation rose by 1.92 points to 17.24%. Cost pressures arising from the lagged effects of exchange rates, the increasing trend in international metal prices and aggregate demand conditions reinforce the strong upward trend in durable goods prices. The rapid increases in durable goods prices spread across subcategories while annual inflation in this group reached 30.40%. The gradual rise continued in other core goods inflation in which the exchange rate pass-through is observed with a lag. In the clothing and footwear group, prices dropped below its previous year level due to the weak course of demand. The Committee assessed the inflationary effects of the pandemic-led divergences in sectoral demand conditions and highlighted the tourism-driven upside risks to the clothing group in the upcoming period.
5. In December, services prices increased by 0.59% and annual services inflation rose by 0.24 points to 11.66%. While annual inflation remained almost flat in restaurants-hotels and transport services, it increased in other subcategories. Despite the rise in food inflation,

annual inflation in restaurants-hotels remained relatively flat due to pandemic-related restrictions. On the other hand, the extension of VAT cuts on some items of the services sector affected the inflation outlook favorably. The Committee assessed that pandemic-led dynamics have contained the services inflation. The Committee also underlined the normalization-related upside risks during the year due to the relatively low course of inflation in accommodation, education, transport, recreational and cultural services items. In addition, some Committee members considered that minimum wage increase, which is higher compared to inflation targets, would adversely affect the inflation outlook through the channel of service prices and increasing inflation rigidity.

6. Inflation expectations remain high. The Committee agreed that the tight monetary policy stance should be maintained decisively for the year-end inflation expectation of 11.15% in CBRT Survey of Expectations, to converge to the end-2021 forecast target. The information value of survey-based and market pricing-based expectations in terms of the pricing behavior was also discussed. Twelve-month-ahead inflation expectations decreased by 0.31 points to 10.53% while 24-month-ahead inflation expectations were down 0.10 points to 9.14%. Some Committee members associated the improved medium-term expectations with the tight monetary policy stance despite news on minimum wage and administered prices, which are expected to weigh on the inflation outlook, and stated that the commitment to fight inflation would play a critical role in anchoring expectations.

Factors Affecting Inflation and Risks

7. Global economic activity data indicate that partial recovery since the third quarter continues. However, despite ongoing vaccination efforts, uncertainties surrounding the global economic activity prevail due to the recent increase in Covid-19 cases. Pandemic-related restrictions in European countries mostly affect the services sector, while manufacturing industry activities remain buoyant. Strong exports to the region confirm this outlook.

8. Advanced and emerging economies maintain their expansionary monetary and fiscal stances. While long-term interest rates remain at historic lows across advanced economies, both central bank statements and market expectations suggest that the low interest rate environment is likely to continue for a long period. 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.

9. Emerging economy portfolio markets continued to attract large volume of inflows since the previous MPC meeting due to improved risk sentiment. In January, bond markets saw an increase in inflows across emerging economies, while inflows to equity markets were slightly down.

10. Crude oil prices soared after the previous MPC meeting. In addition, the ongoing rise in commodity prices excluding energy, specifically agricultural commodities and industrial metals have an adverse affect 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, vehicles and electronic products. These items affect consumer inflation through food and durable goods. The Committee noted the important role of commodity prices in continuing inflationary pressures despite the appreciation in the Turkish lira, and drew attention to the upside risks for the coming months.

11. Economic activity is on a strong course. In November, industrial production index increased by 1.3% month-on-month and 8.7% year-on-year. Thus, in the October-November period,

production strengthened on the back of a 4.2% increase compared to 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. Survey indicators for January suggested that the increase in the manufacturing industry capacity utilization rate continues with a more pronounced trend in intermediate goods and durable goods sectors. In particular, the strong course of both domestic and foreign demand in the production of electrical equipment that also includes white goods sector, along with its effects on inflation are noteworthy. Employment developments also confirm the strong outlook in the industrial sector.

12. Although the downward effects of the pandemic-related restrictions on the economy are more confined compared to the second quarter of last year, the slowdown in activity in services and related sectors and uncertainties surrounding the short-run outlook of these sectors prevail. Restrictions imposed since early November due to the increasing number of cases have reduced the country-wide mobility significantly. Travel, catering and recreation were the sectors hardest hit by the pandemic, as was the case in earlier phases of the pandemic. 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.

13. Evaluating the output gap indicators related to the cyclical state of the economy, the Committee concluded that despite the constraining effect of unemployment and tourism, aggregate demand conditions remained inflationary in the last quarter due to the cumulative effects of the strong credit impulse and external demand. It was judged that economic activity reached its cyclical peak in the last quarter and started to converge towards its trend owing to the deceleration in the first quarter. Some members of the Committee indicated that the deceleration in the first quarter was largely driven by the sectors adversely affected by the pandemic restrictions and that the effects of the monetary policy tightening are yet to be felt. Accordingly, demand-side inflationary effects continue to exist in the first quarter although they will subside gradually in the upcoming period.

14. 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. Although economic activity has decelerated in European countries due to the recent increase in cases, the fact that pandemic restrictions do not cover the manufacturing industry activity supports the outlook for exports. While a partial deceleration is observed in the import demand, gold imports are still above their historical averages. While evaluating the implications of the residents’ dollarization trend on external balance, the Committee discussed the dynamics of gold trade.

15. Credit growth has started to slow down amid tighter financial conditions. Attaching a particular importance to the composition of loans in terms of its effects on external balance and inflation, the Committee, in view of the four-week trends, evaluated the slowdown in personal loans positively. 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.

16. Pandemic-related restrictions affect the labor market. In the October period, total and non-farm unemployment rates in seasonally-adjusted terms rose by 0.1 points each and realized as 12.9% and 14.9%, respectively. Non-farm employment remained flat, while the effects of the pandemic differ across sectors. Employment in services sectors that are affected more

adversely by the restrictions such as accommodation and food services decreased, whereas sectors with continuing activity such as information-communication and transport-storage registered higher employment figures. Backed by the uptrend in exports, employment in the industrial sector also diverges positively in this period.

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. The decelerating impact of the strong monetary tightening implemented in November and December MPC meetings 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.
19. On the other hand, the developments in international commodity prices, supply constraints intensifying in some sectors, and the adjustments in wage and administered prices remain important to the medium-term inflation outlook. As the lagged effects of the credit slowdown are expected to become apparent in the upcoming period, inflation may increase further in the coming few months due to supply-side inflationary factors that are significant in the short run. The additional inflation rigidity to be driven by the minimum wage through the services prices channel in particular, necessitates an extended period of a tight monetary policy stance compared to past projections. 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. Accordingly, the MPC, taking into account the end-2021 forecast target, has decided to maintain the tight monetary policy stance decisively for an extended period until strong indicators point to a permanent fall in inflation and price stability. As regards 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 be monitored closely for their compatibility with the targets in the forecast horizon. Additional monetary tightening will be delivered if needed. Besides the current information set, if any new information arrives pointing at the risk of inflation expectations and pricing behavior diverging from the medium-term target path, additional front-loaded tightening will be implemented.
21. The tight monetary policy stance, 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.
22. 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.
23. 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.

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