

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 22 May 2014

Inflation Developments

1. In April, consumer prices rose by 1.34 percent month-on-month, and annual inflation increased by 1 percentage points to 9.38 percent. This uptick in annual inflation was particularly driven by food prices. Meanwhile, the lagged effects of the depreciation in the Turkish lira continued to affect core inflation indicators adversely through the core goods channel.
2. Annual food group inflation climbed to 13.15 percent amid soaring prices of fruits in April, contrary to their moderate course in the first quarter. The rise in the annual processed food inflation remained comparatively limited.
3. Prices of services edged up by 0.55 percent month-on-month, and the group's annual inflation remained flat at 8.61 percent. The persisting rise in the prices of catering services (restaurants-hotels) due to the developments in the food group excluding fruits and vegetables lost pace compared to the first quarter. Annual inflation in rents, transport and communication services exhibited a relatively mild course in this period, while other services (particularly health and education) posted rising figures. The seasonally adjusted data point to persisting high levels in the underlying trend of services inflation in this period without any further acceleration.
4. Annual core goods inflation rose by 1.06 percentage points to 11.10 percent in April. With the effect of accumulated depreciation in the Turkish lira, the annual inflation in durable consumer goods reached 15.87 percent. In this group, price increases in automobiles and white goods decelerated in contrast to the upsurge in furniture prices. Meanwhile, clothing prices rose above seasonal averages in April and the group's annual inflation reached 7.61 percent. April developments indicate that the effects of the exchange rate waned in some groups, yet spread across the core goods group. Accordingly, core goods became the main driver of the rise in the underlying trend of the core inflation.

Factors Affecting Inflation

5. Data for the first quarter of 2014 point to a moderate increase in economic activity. On the production side, following the rise in January, the industrial production index posted a slight fall in February and March. Thus, production maintained a steady trend of quarterly increase by exceeding the average of the previous quarter by 1.4 percent in the first quarter. The upcoming period is expected to witness an ongoing rise in production with the support of exports and modest course in the domestic demand.
6. Data on expenditure side show that private demand weakened in the first quarter due to developments in the consumption of durable goods and the investment of private machinery-equipment. On the other hand, data on the consumption of nondurable goods and construction investments remain favorable. Among subcategories of imports of consumption goods, imports of automobiles plunged, while imports of durable and semi-durable goods fell moderately and imports of non-durable goods continued to rise in the first quarter. In this period, the production of durable goods was down from the previous quarter, whereas the production of nondurable goods remained on the rise. Among the indicators of machinery-equipment investments, the production and imports of investment goods excluding transport declined. Moreover, the data regarding construction investments show that the increase in construction investments continued.
7. With the support of recovery in consumption demand thanks to reduced perceptions of uncertainty, improved confidence indices, and appreciation in Turkish lira, the domestic demand is expected to settle on a track of gradual increase starting from second quarter. Nevertheless, second-quarter CBRT Business Tendency Survey (BTS), PMI, loans and imports data suggest that this recovery will be moderate.
8. Recent data show that exports continued to grow in the first quarter of 2014. The export volume index excluding gold rose again in March and hovered above its average in the previous quarter. With the support of the global recovery signaled by recent survey indicators, and the pickup in international trade, exports are envisaged to follow a favorable path in the upcoming period. PMI and BTS export indicators also support this outlook.
9. In seasonally adjusted terms, total and non-farm unemployment rates declined in February 2014. This drop in unemployment rates was driven by the upsurge in non-farm employment. Furthermore, seasonally adjusted data regarding total employment expectations, a BTS indicator, maintain its trend of favorable outlook.

10. In sum, recent data releases indicate that the private final domestic demand will follow a modest course, and with the help of the recovery in foreign demand, net exports will contribute positively to growth. It is expected that the current outlook in demand components will curb inflationist pressures and support the improvement in the current account deficit.

Monetary Policy and Risks

11. Owing to the significant decline in uncertainties about the Fed's asset purchases recently coupled with the recovery in global growth, the risk sentiment improved across global financial markets. Along with these developments, emerging economies saw limited amounts of portfolio inflows after a long while. Risk indicators, which deteriorated in times of elevated country-specific risks in Turkey, recovered due to the waning domestic and external uncertainties. With the recent decline in uncertainties and improvement in the risk premium indicators, market interest rates declined across all maturities. In this regard, the Committee decided on a measured decrease in the one-week funding rate. It is stated that, with a flat yield curve even after this decision, the monetary policy stance will continue to be tight.

12. The Committee closely monitors inflation expectations and the pricing behavior. The slowdown in consumer loans and the weak private demand are expected to restrict the effect of the cost-push shocks on inflation in the coming period. Moreover, thanks to the strong and front-loaded monetary tightening delivered in January and the recently-waned uncertainties, a considerable portion of the depreciation in the Turkish lira during the first quarter is reversed. This development in the exchange rates is assessed to contribute favorably to the inflation outlook. However, lagged effects of the exchange rate movements and the unfavorable course of food prices are likely to cause inflation to remain above the target for some time. In the meantime, the Committee will closely monitor inflation expectations, the pricing behavior and other factors that affect inflation and maintain the tight monetary policy stance by keeping the yield curve flat until there is a significant improvement in the inflation outlook.

13. The Committee stated that loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. Across subcategories, growth rates of consumer loans and credit cards exhibit a notable slowdown, while growth of commercial loans expand at a rate close to past years. The Committee assessed that this positive development in loan growth composition will contribute to financial stability, the rebalancing process and the decrease in inflation. In line with these developments, recent data

indicate a modest course in the private final domestic demand. Meanwhile, net exports are expected to contribute positively to economic growth thanks to the recovery in external demand, particularly from European countries, and real exchange rate developments. The Committee expects that such a demand composition will support disinflation and will lead to a significant improvement in the current account deficit in 2014.

14. Although having faded to a great extent, the uncertainty about global monetary policies is yet to disappear. Expectations about the timing and pace of the Fed's rate hike are important to the pricing in financial markets. However, the transmission mechanism of the interest rate channel is better known than the quantitative easing and the monetary policy dependence on high-frequency data has decreased. As a result, it is assessed that the uncertainty effect of an interest rate hike on financial markets might be more limited than that of the exit from the quantitative easing program. Moreover, the ECB's possible quantitative easing might be another supporting factor for capital flows. Hence, capital may start flowing back to emerging economies. If this scenario materializes, the Central Bank might take steps to accumulate foreign exchange reserves.
15. The Committee closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. The baseline monetary stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes on administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.
16. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the MTP remains to be of utmost importance.