Press Release on Summary of the Monetary Policy Committee Meeting

19 September 2019, No: 2019-37

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Inflation Developments

1. In August, consumer prices rose by 0.86%, while annual inflation decreased by 1.64 points to 15.01%. The fall in inflation was mainly driven by the core goods and energy groups, while the downtrend in annual food inflation continued. In addition to the stable course of the Turkish lira, improved inflation expectations, commodity prices, and domestic demand conditions supported the decline in the annual inflation of core indicators. Against this background, core indicators maintained their mild course. Inflation will register a significant fall in September due also to the high base from the previous year.
2. In the food and non-alcoholic beverages group, annual inflation fell by 0.99 points to 17.22% in August. In this period, annual inflation lost pace both in unprocessed and processed food groups. Monthly increases in processed food prices, which has surged since May due to the lagged cost effects, lost pace in August. Leading indicators show that the slowdown in annual food inflation continues in September.
3. In August, energy prices rose by 0.34%. In this period, the mild course of the Turkish lira and the decline in oil prices pulled fuel prices down, curbing the effect of the rise in natural gas prices. Despite the upside impact of the adjustments in natural gas prices in September, annual energy inflation is projected to decline further due to the base effect. Prices of tobacco products soared by 20.84%, adding 0.99 points to the group's contribution to annual inflation.
4. In August, annual core goods inflation decreased by 4.79 points to 13.02%, mainly due to durables and other core goods, while annual inflation in the clothing group posted a limited rise. Despite price increases in white goods, prices of durable goods registered a decline due to falling automobile prices. Prices of other core goods have recorded a month-on-month decline, albeit limited, for the first time since June 2010. The high base effect from the previous year accompanied by the recent exchange rate developments and the mild course of economic activity supports the fall in core goods inflation.
5. Services prices rose by 1.12% in August while annual services inflation inched down by 0.38 points to 14.19%. Annual inflation declined in restaurants-hotels and communication groups whereas it remained flat in rents and transport groups and increased in the other services group. The catering services-driven slowdown in the restaurants-hotels group is also attributed to the moderate course of food prices. The other services group posted a large monthly increase that was mainly triggered by the rise in private university tuition fees. Against this background, the underlying trend of services inflation displayed a modest deceleration. In this period, the downward impact of domestic demand conditions on

services inflation is believed to have been restrained by cumulative cost increases in some items, real unit labor costs and the backward indexation behavior. It is projected that there will be price increases in transport services in September due to urban transport fares.

Factors Affecting Inflation

6. Recently released data indicate that moderate recovery in economic activity continues. In July, industrial production increased month-on-month by 4.3% in seasonally and calendar-adjusted terms, showing that the decline observed in June due to the impact of the extended religious holiday was a temporary one. This outlook is preserved even when the other transport vehicles sector, which has recently stimulated industrial production, is excluded. Leading indicators point to a continued moderate recovery trend in the third quarter and to a partial improvement in the sectoral diffusion of economic activity.
7. Goods and services exports continue to display an upward trend despite the weakening in the global economic outlook, indicating improved competitiveness. In particular, strong tourism revenues support the economic activity through direct and indirect channels. Despite recent signs of a partial global slowdown, particularly for the European Union (EU), external demand maintains its relative strength. Notwithstanding the somewhat slowing exports to the EU, the seasonally-adjusted non-gold export quantity index continued to rise amid strong exports to other regions. In the same period, the number of foreign visitors and travel and transport revenues remained on a firm uptrend while exports of services continued to boost growth. Economy-wide spillovers from the robust course of tourism to sectors such as nondurable goods production, clothing in particular, and transport services help offset part of the weak domestic demand.
8. The composition of growth is having a positive impact on the external balance. Firms' orientation towards external markets due to the domestic demand outlook, and their flexibility in market diversification stimulate exports of goods. The lagged effects of exchange rates and the modest outlook for loans and economic activity restrain import demand, and external balance continues to improve at an accelerated pace thanks to the upbeat in tourism activity. Thus, the current account balance is expected to maintain its improving trend.
9. Labor market data is relatively weak. According to May 2019 data, nonfarm employment declined while nonfarm unemployment rate rose compared to April figures. Across sectors, industrial employment remained almost flat while employment in the services and construction sectors fell compared to the previous period.
10. In sum, looking forward, net exports are expected to contribute to economic growth and the improvement in risk premium and financial conditions with the help of the disinflation trend is likely to support the gradual recovery. Against this background, aggregate demand conditions are estimated to make a further contribution to disinflation.

Monetary Policy and Risks

11. Global economic activity lost further pace due to the deceleration in the euro area and China in particular, and leading indicators, primarily the manufacturing sector-related data, posted a decline, signaling that the deceleration will continue. The persistent trade tensions between the US and China coupled with the possibility of protectionist measures spreading across other countries, a more apparent slowdown in the euro area, lingering uncertainties regarding the Brexit and other geopolitical developments cause the uncertainty over global

economic policies to remain elevated and the vulnerabilities in global financial markets to continue. All these factors keep the downside risks to global economic activity alive.

12. Commodity prices maintain their demand-driven decline due to the deceleration of global economic activity, supporting the disinflation in advanced and emerging economies. Besides the slowdown in global economic activity, the increased excess supply in crude oil points to a moderate course in crude oil prices in the period ahead, yet geopolitical risks remain significant.

13. Recently, advanced economy central banks have started to adopt more expansionary policies as global economic activity weakened and downside risks to inflation heightened. While these developments support the demand for emerging market assets and the risk appetite, rising protectionism and uncertainty regarding global economic policies pose downside risks to these portfolio flows towards emerging markets. These factors are closely monitored in terms of their potential impacts on financial markets and domestic economic activity through both capital flows and international trade.

14. Although Turkey's risk premium dropped in the second half of June amid a cautious monetary stance, improved macroeconomic indicators and major central banks' move to quantitative easing, it has been volatile since then. The persistence of high levels of country risk premium and exchange rate volatility as well as ongoing global uncertainties and geopolitical risks keep the upside risks to the medium-term inflation outlook alive.

15. July's rate cut and expectations of further rate cuts thereafter helped bring loan and deposit rates markedly down from the previous MPC period. Notwithstanding lower deposit rates, the stable Turkish lira and improved inflation expectations drove Turkish lira deposits higher. Consumer loans have been on the rise amid accommodative credit packages and seasonal needs whereas commercial loan growth has been flat due to supply-side effects caused by expectations for the overall economic outlook as well as delayed loan demand and weak investments. Improvement in the liquidity and capital adequacy ratios of banking sector and lower interest rates are likely to provide a boost to loan growth in the upcoming period. The outlook for economic activity will largely depend on the pace, scope and sustainability of the normalization in credit conditions.

16. Despite the restrictive impact of domestic demand conditions on inflation, the current levels of inflation expectations continue to pose an upside risk to the medium-term inflation outlook. Anchoring inflation expectations is crucial for a more effective monetary policy and a reduced inflation-growth tradeoff.

17. The course of food prices constitutes one of the risk factors that may affect the short-term inflation outlook. The accumulated cost effect on processed food prices have mostly terminated and prices in this group have posted a limited rise in August. The unprocessed food inflation remains favorable. In this framework, the risks that the course of food prices may pose to the short-term inflation outlook are lower than the July Inflation Report forecasts.

18. The inflation outlook continued to improve. Domestic demand conditions and the level of monetary tightness continue to support disinflation. Underlying trend indicators, supply side factors, and import prices lead to an improvement in the inflation outlook. In light of these developments, recent forecast revisions suggest that inflation is likely to materialize slightly below the projections of the July Inflation Report by the end of the year. Accordingly, considering all the factors affecting the inflation outlook, the Committee decided to reduce

the policy rate by 325 basis points. At this point, the current monetary policy stance, to a large part, is considered to be consistent with the projected disinflation path.

19. The Committee assesses that maintaining a sustained disinflation process is the key for achieving lower sovereign risk, lower long-term interest rates, and stronger economic recovery. Keeping the disinflation process in track with the targeted path requires the continuation of a cautious monetary stance. In this respect, the extent of the monetary tightness will be determined by considering the indicators of the underlying inflation trend to ensure the continuation of the disinflation process. The Central Bank will continue to use all available instruments in pursuit of the price stability and financial stability objectives.

20. The Committee emphasized the importance of sustaining the recent improvement in the country risk premium for the price and financial stability objectives. In this context, in order to support the effectiveness of monetary policy and minimize a likely inflation-growth trade-off, it will be crucial that macro-financial policies are determined with a focus on reducing financial volatility and risk premium, and that the predictability of fiscal policy continues to be reinforced.

21. The fiscal policy outlook that the monetary policy is based on incorporates a policy stance that focuses on price stability and macroeconomic rebalancing and that is coordinated with the monetary policy. Accordingly, the monetary policy stance assumes that administered price and tax adjustments are formulated in a way that will help reduce the backward indexation behavior. If the fiscal policy significantly deviates from this framework leading to an adverse impact on the medium-term inflation outlook, the monetary policy stance may be revised.

22. Collective efforts to turn the recently enhanced coordination between monetary and fiscal policies into a sustained and systematic structure are expected to support the achievement of price stability. Moreover, continued structural steps focusing on reducing rigidity and volatility in inflation will contribute to price stability and therefore social welfare.

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