Summary of the Monetary Policy Committee Meeting

14 June 2018, Sayı: 2018-24

Meeting Date: 7 June 2018

Inflation Developments

1. In May, consumer prices rose by 1.62 percent and annual inflation increased by 1.30 points to 12.15 percent. The uptick in inflation spread across subgroups in this period. Persisting producer-price-driven cost pressures proved stronger relative to April. All in all, core indicators witnessed an increase in annual inflation, and their underlying trend maintained a high course.
2. Annual inflation in food and nonalcoholic beverages went up by 2.19 points to 11.00 percent in May. The uptick in the annual food inflation was led by the unprocessed food group, while the annual processed food inflation remained on a downward track. Seasonally adjusted unprocessed food prices recorded a notable increase, with items such as vegetables, potato, white and red meat and eggs in the lead. Price increases in processed food, which proved high across the first quarter, decelerated further in May as in April, and the group’s annual inflation receded to 13.42 percent.
3. Energy prices increased by 1.74 percent in May and annual energy inflation rose by 3.18 points to 15.17 percent, largely due to the low base effect accompanied by exchange rate developments and the course of oil prices. Owing to the tax arrangement in fuel products (re-arrangement of lump-sum special consumption tax amounts according to the changes in domestic refinery outlet prices due to the international oil prices or the exchange rate), it is expected that price increases in the energy group will lose pace, but the group’s annual inflation will remain on the rise in June.
4. In May, prices of services rose by 1.17 percent and annual services inflation inched up by 0.25 points to 9.52 percent, mostly due the to transport and restaurants-hotels groups. Inflation in transport services was pushed up by highway passenger transport, while the restaurants-hotels group saw rising prices in catering and accommodation services. These groups also reflected cost pressures led by the exchange rate as well as oil and food prices in addition to demand-side effects driven by the upbeat performance in tourism.
5. Annual core goods inflation rose by 0.52 points to 15.98 percent. Annual inflation declined somewhat in the clothing group, but picked up in other subgroups. The persisting upsurge in prices of durable goods continued in May, which was led by the prices of automobiles and white goods. In the other core goods group, prices posted increases due to the items with large import content such as housing maintenance and repair equipment and domestic cleaning products. In sum, cumulative deprecation in the Turkish lira stood out as the main driver of the rise in the core goods inflation in May.

6. The base effect and cost factors are likely to continue to exert upward pressure on annual inflation in June. Moreover, leading indicators signal that some subcategories of the unprocessed food group may register price hikes well above seasonal averages. Considered mostly temporary, this movement is monitored closely.

7. As a result, cost factors are the main driver of the upsurge in inflation. On the other hand, price increases marked a generalized pattern across subsectors. Despite the mild outlook for demand conditions, elevated levels of inflation and inflation expectations continue to pose risks to the pricing behavior.

Factors Affecting Inflation

8. Data for the first quarter of 2018 suggest a maintained strength in economic activity. Although industrial production lost momentum in quarterly growth compared to previous quarters, its annual growth proved strong with 9.8 percent. In this period, sectors providing inetermediate inputs to the construction activity and sectors strongly affiliated to tourism supported industrial production. The data reveal a mild course in sectoral activities other than industry as well.

9. Domestic demand stood out as the main driver of quarterly growth in the first quarter. Private consumption remained on the rise, while investments, also supported by the public sector, were mainly contsruction oriented in the first quarter. Despite the sustained increase in gold imports, with the robust course in exports of goods excluding gold besides tourism revenues, net exports are expected to boost quarterly growth.

10. Recently released data indicate a rebalancing trend in the economic activity. Data for the second quarter indicate that external demand maintains its strength. Amid the favorable global growth outlook, rising external demand and flexibility in diversifying export markets continue to stimulate exports. The Committee noted that the rebound in tourism and transportation revenues remains rather brisk, and under these circumstances, net exports will provide positive contribution to quarterly growth in the second quarter as well. In the upcoming period, exports of goods and services are expected to boost growth further and the balancing in the domestic demand is likely to halt the upward trend in the current account deficit. However, soaring energy prices and gold imports hinder the improvement in the current account balance.

11. Domestic demand displays a more moderate course in the second quarter. Survey indicators point to a weaker consumer confidence as well as the trends of orders in firms especially producing for the domestic market. The current outlook signals for a domestic demand-driven slowdown, which is consistent with past projections that economic activity would converge to the uynderlying trend. In the close future, rising volatility in financial markets and perceptions of uncertainty, the depreciation in the Turkish lira and mounting financing costs may restrain domestic demand through investments. Meanwhile, accommodative fiscal measures are projected to moderate the slowdown in domestic demand.

12. In the first quarter, the maintained strength of economic activity supported the increase in employment and the decline in unemployment. Leading indicators signal that the balancing in economic activity in the period ahead may result in some deceleration in the labor market improvement.

13. In sum, recently released data indicate that economic activity remains strong in the first quarter, while it is converging to its underlying trend in the second quarter amid the balancing in domestic demand.

Monetary Policy and Risks

14. Current data on global economy point to stable and strong growth both in advanced and emerging economies. Data for the first quarter hint at an accelerated global growth compared to the previous quarter, and the prospects for the year end remain positive. Despite rising commodity and energy prices amid the solid growth outlook, consumer and core inflation rates are moderate across the globe.

15. Risks to the global growth outlook are more on the downside for the upcoming period. Major risks that can pose a drag on global growth include geopolitical tensions and the rising protectionist sentiment in international trade. Both the US government's decision not to exempt EU member states from the additional customs tariffs on imported steel and aluminum and political uncertainty add to the downside risks to EU growth that slowed down in the first quarter of the year. The newly passed US tax reform is poised to provide a growth boost to the US and its trading partners, which is considered a major upside risk to global growth.

16. After the March announcement on imposing additional customs tariffs on imported steel and aluminum, the US government lifted certain country exemptions from tariffs in early June, sparking possibly more protectionism in international trade across the world. In fact, impacted trading partners are poised to impose retaliatory tariffs that would spark more trade protectionism. The potential negative spillovers of such policies on global growth will depend on the size and form of the response of other trading partners.

17. An analysis of risks to global inflation reveals that geopolitical developments coupled with uncertainties regarding trade policies are likely to pose upside risks to commodity prices, especially to energy and metal prices. Moreover, in line with the falling unemployment rates in advanced economies, the possibility of wages to increase more rapidly than current trends is among major risk factors to push up inflation.

18. Financial conditions have recently tightened in advanced economies. The probability of an accelerated inflation due to brisk demand conditions and rising commodity prices constitutes a risk of triggering a faster-than-projected tightening in monetary policies across these countries. US bond returns have been on the rise since mid-April as the Federal Reserve (the Fed) hints at three policy rate hikes in the remainder of 2018. Amid the appreciation of the US dollar, global financial markets have recently witnessed fluctuations, the risk sentiment towards emerging economies has deteriorated, exchange rates saw depreciation and increased volatility and portfolio flows lost momentum.

19. Fluctuating global financial markets have a tightening effect on domestic financial conditions, which led to a higher risk premium, slower portfolio flows, a weaker and more volatile Turkish lira and higher market and loan rates. Geopolitical developments and the outlook for macro indicators such as inflation and the current account deficit made Turkey more sensitive to global fluctuations. Due to higher risk premium and reduced portfolio flows, the Turkish lira faced more depreciation and volatility compared to other emerging market currencies. On the credit market front, the loan boost created by the CGF support of 2017 has largely subsided and in addition to commercial loans, there has been a balancing in consumer loans, especially in housing loans. Hence, both external and domestic developments suggest that financial conditions will remain tight over the upcoming period.

20. After a robust first quarter, economic activity started to converge to its underlying trend in the second quarter. The uncertainty over monetary policies across advanced economies and geopolitical tensions feed into downside risks to economic activity. The recent financial

market volatility and the mounting uncertainty pose downside risks to domestic demand and the growth outlook, particularly via investment spending. The tighter monetary policy stance is likely to decrease financial volatility and contain downside risks to growth. On the other hand, the strong tourism rebound, the upbeat global growth outlook and accommodative real exchange rates are expected to provide further positive contribution to the growth composition and the current account balance. The Committee emphasized that the steps toward tighter monetary policy should be accompanied by an enhanced macro policy coordination to ensure a modest rebalancing of the economy.

21. High inflation and rising inflation expectations keep risks to pricing behavior alive. Although aggregate demand conditions are likely to have a steadily waning effect on inflation, the significant cost pressures from the recent Turkish lira depreciation and their potential second-round effects weigh on the inflation outlook. According to diffusion indices, economic agents are much more inclined to raise prices. The inertia in the indicators for underlying inflation trends and the high levels of core inflation continue to pose risks to pricing behavior. In addition, the recent increases in import prices, particularly for oil, add to these risks.

22. Thus, considering the effects of unhealthy pricing and excessive volatilities across markets on the inflation outlook, the Central Bank introduced some adjustments for the foreign exchange market since the interim meeting on 23 May. These adjustments aim at controlled and efficient provision of the liquidity required by the market in times of excessive volatility. Accordingly, on 24 May 2018, the Bank announced an update to the calendar for Turkish lira-settled forward foreign exchange sale auctions to be held in the second quarter of 2018, thus raising the amount of forward foreign exchange sale position from 7.1 billion USD to 8 billion USD. Moreover, the upper limit for the total amount of forward foreign exchange sale position was determined to be USD 10 billion until end-2018. Additionally, on 25 May 2018, the Bank decided to allow repayments of rediscount credits for export and foreign exchange earning services to be made in Turkish liras at a fixed exchange rate.

23. Furthermore, on 28 May 2018, the Committee announced its decision to complete the simplification process regarding the operational framework of monetary policy. Accordingly, the one-week repo rate will be the main policy rate of the Central Bank. This rate is set equal to the late liquidity window lending rate in effect on the date of meeting. In addition, the Central Bank overnight borrowing and lending rates are determined at 150 basis points below/above the one-week repo rate. Thus, the overnight borrowing and lending rates will form a symmetrical corridor around the one-week repo auction rate, keeping market rates from deviating significantly from the weekly repo auction rate. The new operational framework that took effect on 1 June 2018 is expected to enhance the predictability of monetary policy and strengthen the transmission mechanism.

24. With the strong policy response at the interim meeting on 23 May 2018 and the simplified operational framework, the Committee has partially restrained the domestic financial market volatility. Nevertheless, the current elevated levels of inflation and inflation expectations continue to pose risks on pricing behavior. Accordingly, the Committee decided to further strengthen the monetary tightening in June to support price stability and raised the policy rate (one week repo auction rate) from 16.5 percent to 17.75 percent.

25. The Central Bank will continue to use all available instruments in pursuit of the price stability objective. Tight stance in monetary policy will be maintained decisively until inflation outlook displays a significant improvement. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and, if needed, further monetary tightening will be delivered.

26. Public finance has been providing more support to disinflation, which confirms the stronger coordination between monetary and fiscal policies. The joint efforts to transform policy coordination into a continuous and systematic framework will contribute to disinflation in 2018 as well.
27. Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices and taxes. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.
28. In recent years, sustaining fiscal discipline has been one of the key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of an expansionary fiscal policy. Structural measures to provide room for counter-cyclical fiscal policies will enhance the coordination of monetary and fiscal policy, and improve macroeconomic stability. Moreover, sustaining structural steps to reduce inertia and volatility in inflation will contribute positively to the price stability and social welfare.