TÜRKİYE CUMHURİYET MERKEZ BANKASI

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 20 November 2014

Inflation Developments

1. In October, consumer prices increased by 1.90 percent and annual inflation edged up by 0.10 points to 8.96 percent. The rise in annual inflation was mainly driven by the energy group due to the electricity and natural gas prices, and the contribution of food to annual inflation remained high. The relatively favorable course of underlying core goods inflation continued, whereas the services category remained on the rise.
2. Annual food inflation fell by 1.4 percentage points to 12.56 percent. This fall was mainly led by the unprocessed food group, particularly fresh fruits and vegetables, whereas annual processed food inflation increased. The seasonally-adjusted data pointed to a correction in September and October in unprocessed food prices, albeit limited, and the group's annual inflation remained elevated. Indicators for November signal for a possible increase in the annual food inflation due to fruits and vegetables.
3. Owing to the adjustment in the electricity and natural gas tariffs, annual energy inflation rose by 3 points to 4.43 percent in October. However, the declining oil prices poses a downside pressure on the group's inflation, particularly through the fuel and bottled gas prices. In fact, indicators for November suggest a notable fall in the annual energy inflation and sustained favorable contribution of the group to the consumer inflation.
4. Annual core goods inflation dropped by 0.5 points to 8.95 percent in October. Annual inflation, which has been on the decline in durable goods since May, recorded a decrease also in core goods excluding durables and clothing after a long time, indicating that the exchange rate effects have been quite alleviated. On the other hand, prices of services rose by 0.61 percent in October and annual services inflation edged up by 0.2 points to 9.17 percent. Annual inflation remained elevated in restaurants and hotels, and maintained the upward trend in transport services and rent groups.

5. The seasonally-adjusted data point to a sustained improvement in the underlying trend of core inflation indicators. A noticeable improvement was witnessed in core goods inflation following the first quarter, while the underlying trend of services inflation remained high.

Factors Affecting Inflation

6. Data for the third-quarter of 2014 show a more benign economic outlook than in the second quarter. Industrial production grew by 1.7 percent in September on a seasonally adjusted basis. Thus, industrial production rose by 1.5 percent quarter-on-quarter. This recovery in production is expected to continue with the support of domestic demand.
7. Data on the expenditure side point to a moderate recovery in domestic private demand for the third quarter after the first-half decline. In this period, the production of consumer goods rose on the back of durable goods, while the fall in the imports of consumer goods ended. The sales of automobiles and home appliances recovered markedly thanks to more favorable financial conditions. However, indicators for private investment demand display a weaker outlook. The production of capital goods picked up from the second quarter whereas imports of capital goods went down. An indicator for construction investments, the production of minerals continued to decline, albeit more modestly, while construction employment remained weak. As a consequence, private construction investments are expected to slow slightly in the third quarter. Overall, private consumer spending is expected to rebound in this period whereas private investment demand may remain on a more moderate path.
8. Survey indicators for the fourth quarter suggest that the recovery may continue into the fourth quarter. The PMI and the Business Tendency Survey, both leading indicators for production, gave positive signals for the fourth-quarter industrial production. The domestic sales of automobiles increased in October, nearing the level in the final quarter of 2013. As an indicator for investments, the firms' expectation for fixed-capital investments has been associated with positive signals for the past two months. Yet, it is too early to declare that this development hints at a permanent recovery for investments in the upcoming period. Meanwhile, the weak consumer confidence in October added to the downside risks on consumption.
9. The rise in total and nonfarm unemployment stopped in August in seasonally adjusted terms. After falling in previous periods, nonfarm employment rose in August, while labor force participation continued to increase. Construction and industrial employment began to rise again in line with the recent economic recovery. Meanwhile, services employment continues to grow steadily. Leading indicators for the final quarter signal a modest growth in nonfarm employment and a flattening in the unemployment rate. The low levels of investment tendency and the weak external demand suggest that the recovery in the labor market may take some time.

10. To sum up, domestic demand is expected to make more contribution to growth while economic activity is likely to recover moderately in the second half of the year. However, the uncertainty surrounding global monetary policies, the slowing yet continued financial volatility and the weak consumer confidence put downside pressure on economic activity. Against this background, demand conditions are expected to continue to limit the upside pressures on inflation.

Monetary Policy and Risks

11. The Committee indicated that the recent fall in market rates and risk premiums had an expansionary effect on financial conditions. However, the tight monetary stance and the macroprudential measures kept loan growth rates at reasonable levels. The composition of loans also continues to move in the desired direction. While the annual growth rate of consumer loans hovers around low levels, commercial loans remain relatively more robust. This loan outlook and the composition not only limit medium-term inflationary pressures but also support the improvement in the current account balance.
12. Global demand remains weak, while the contribution of domestic demand to growth is increasing. The second half of the year saw some recovery in private consumption and private machinery-equipment demand. In this period, contribution of exports to annual growth rate has moderated, largely due to the global economic slowdown. Despite this change in growth composition, the moderate course of consumer loans and the favorable changes in the terms of trade may contribute to the improvement in the current account balance.
13. The macroprudential measures adopted in early 2014 and the tight monetary stance continue to have a positive impact on the core inflation trend. Although elevated food prices delay the improvement in inflation, underlying inflation has displayed a marked decrease in core goods during recent months. Falling commodity prices, in particular declining oil prices, are expected to support the disinflation process foreseen for the next year.
14. On the other hand, the current elevated levels of services inflation and the medium-term expectations suggest that risks related to pricing behavior are still prevalent. The Committee will closely monitor inflation expectations, pricing behavior and other factors that affect inflation, and maintain a tight monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook. The Committee anticipates that, under the current monetary policy stance, inflation will decline throughout 2015 in line with the forecast presented in the Inflation Report.
15. The meeting also involved a discussion of the importance of prudent borrowing against global risks. It was stated that capital flows to emerging markets may continue to be volatile in 2015. The ongoing uncertainty about the normalization of global monetary policies cause the global risk appetite and capital flows to be data-sensitive. The Committee emphasized that the CBRT has a rich set of policy tools to

use against an earlier-than-expected policy rate hike by the Fed. Yet, Europe and Japan have announced new monetary expansion packages recently, and the economic slowdown might postpone the normalization of global monetary policies. Thus, a scenario in which global interest rates remain low for a long time while uncertainties over global economy persist gains prominence. As materialization of such a scenario would cause a surge in over-borrowing, it is crucial to support prudential borrowing to limit the accumulation of macrofinancial risks in the upcoming period. In this respect, the staff briefed the Committee about the possible measures that would encourage the extension of maturities for non-core liabilities.

16. Developments on the 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 on administered prices. 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.
17. The Committee welcomed the development that the new Medium Term Program incorporates the fight against inflation as one of the main objectives. Moreover, it was indicated that Turkey’s growth potential would increase gradually with the implementation of the recently announced structural transformation program. Any measure to ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.