Summary of the Monetary Policy Committee Meeting

3 July 2023, No: 2023-24

Meeting Date: 22 June 2023

Global Economy

1. While global inflation has decreased, it is still above the long-term averages. In the last ten years, the average inflation was 2.2% in advanced economies and 5.6% in emerging economies. In 2023, inflation is expected to be 3.3% in advanced economies and 8.1% in emerging economies. Although the downward trend in commodity prices that started in the middle of last year continues, the current level of the Commodity Price Index is 23.2% above the average of the last ten years. The index decreased by 29.4% compared to the highest level reached in June last year. Similarly, the Agricultural Commodity Price Index, which declined by 22.0% compared to the peak it reached in April last year, is 14.3% above the average of the last ten years. This still has an impact on inflation due to the high share of food in the consumer basket. In 2023, year-end inflation expectations in the USA and the Euro area are 3.0% and 3.8%, respectively; while core inflation expectations are 4.3% and 5.1%, respectively.
2. High levels of core inflation and inflation expectations imply that global inflation will continue to remain above the targets of central banks for a while. For this reason, central banks all over the world take measures to reduce inflation. The central banks of 12 advanced countries held a total of 123 meetings in the last 16 months, and policy rates were increased in 89 of these meetings. During the same period, 15 emerging countries' central banks held a total of 182 meetings, and policy rates were increased in 97 of these meetings. The results of the implemented monetary policy have begun affecting financial conditions, and central banks' emphasis on tightening financing and credit conditions has strengthened.
3. Despite the flat global growth outlook, relatively strong demand and tight labor markets persist. The global growth index, which is weighted with export shares of Türkiye’s foreign trade partners, has continued its flat course compared to the previous MPC meeting period. The index is projected to grow by 1.6% in 2023, which is approximately 0.3 points higher than the trough in January. However, when the 3.5% growth of the index in 2022 is considered, a notable slowdown in foreign demand, on an annual basis, in 2023 is evident. Global PMI indices indicate that the services sector activity remains robust, while the manufacturing industry continues to follow a flat course just below the threshold value. As of May, the global services PMI rose by 3.1 points quarter-on-quarter to 55.4 in the second quarter of the year, while the manufacturing PMI increased by 0.1 points to 49.6. The composite PMI index was 54.4 in May with an increase of 0.2 points compared to the level in April at the global level, remained flat at 53.7 in advanced economies, and rose to 55.6 with an increase of 0.7 points in emerging economies. While the composite PMI indicator in China was 55.6 with an increase of 2 points compared to April, the index was above the 50-threshold level in both the manufacturing and services sectors in May. Besides, it was observed that the recovery in services was more pronounced after the relaxation of pandemic measures. On the other hand, expectations for a slowdown in economic activity in advanced economies due to

financial conditions continue. In the euro area, one of Türkiye's major trading partners, the manufacturing PMI fell to 44.8 in May, the lowest level since the pandemic.

4. Portfolio flows to emerging markets continued in June on the back of improving risk sentiment. While there is an inflow of approximately 46.4 billion dollars to equity markets from the beginnig of the year until May, there is an outflow of around 4.3 billion dollars in bond markets. In June capital flows amounted to 9.2 billion dollars in total of which 8.3 billion dollars were inflows to equity markets.

Inflation Developments

5. Although consumer inflation decreased by 45.92 points compared to the peak reached in October 2022, it still maintains its high level. Consumer prices inched up by 0.04% in May, and annual inflation decreased by 4.09 points from 43.68% to 39.59%. Recent indicators point to an increase in the underlying trend of inflation. The strong course of domestic demand, exchange rate developments and the stickiness of services inflation have been the main drivers.

6. Contributions of subgroups to annual inflation rose from 14.62 points to 15.17 points in the services group (0.55 points of increase); rose from 9.80 points to 10.17 points in the core goods group (0.37 points of increase); dropped from 1.81 points to 1.50 points in the total of alcohol, tobacco and gold groups (0.31 points of decrease); dropped from 14.22 points to 13.64 points in the food and non-alcoholic beverages group (0.58 points of decrease); dropped from 3.24 points to -0.88 points in the energy group (4.12 points of decrease).

7. Food prices edged up by 0.71% in May, while annual inflation fell by 1.40 points from 53.92% to 52.52%. The seasonally adjusted monthly rate of increase in food prices decreased compared to the previous month. While the rise in red meat prices decelerated in this period, seasonally adjusted data pointed to an increase in the prices of fresh fruits and vegetables in May, being more pronounced in vegetables. Volatilities in the prices of fresh fruits and vegetables keep the domestic food prices-driven risks alive. Processed food prices registered an uptick by 1.08% in monthly terms. Excluding processed meat products, price movements were moderate across the group, while the deceleration of the price increase in bread and cereals continued in May.

8. Energy prices fell significantly by 21.00% in May, and annual inflation in this group declined by 28.16 points from 21.19% to -6.97%. The impact of free natural gas use on the group’s prices was the main driver of this development. While prices receded across the group on account of the favorable outlook for international energy prices, fuel prices were another item that stood out with a noticeable decline.

9. Services prices rose by 4.60% in May, pushing the group’s annual inflation up by 1.33 points from 58.62% to 59.95%. In this period, annual inflation decreased in transport, while it increased in other subgroups. Restaurants-hotels and rents were the leading subgroups driving the monthly price hike in this group, with their price increases of 7.10% and 5.15%, respectively. The rise in the prices of the other services subgroup was mainly driven by the maintenance and repair of transport vehicles, which is sensitive to exchange rate developments, as well as items with a strong backward indexation tendency such as education and health services.

10. Prices of core goods were up by 3.90% in May, and annual inflation increased by 0.91 points from 34.16% to 35.07%. In May, annual inflation increased in the durable goods and clothing-footwear subgroups, while it decreased in other core goods. Durable goods prices (excluding gold) increased by 3.48% month-on-month, with automobiles coming to the fore with a price increase of 6.37%. Automobile prices display a strong uptrend amid the outlook for the

Turkish lira and brisk domestic sales. Prices in the clothing and footwear subgroup rose above historical May averages at 9.96%, which is attributed to the shift in the month of entry into the index from April to May for summer products due to a change in the methodology.

11. The underlying trend of inflation remains elevated, despite having slowed in the post-2022 period. Seasonally adjusted monthly increases in the B and C indices gained pace compared to the previous month, which is also confirmed by alternative core inflation indicators. The three-month average rates of increase in the seasonally adjusted B and C indices, which peaked at 8.8% and 8.4%, respectively, in February 2022, declined to 2.5% and 2.8% as of May. As of May, the seasonally adjusted rates of increase in the B and C indices were 2.9% and 3.6%, respectively (2.3% and 2.6% in the previous month). Alternative core indicators such as median inflation and SATRIM also posted increases compared to the previous month.

Demand and Production

12. Data for the second quarter of the year confirm that economic activity remained robust, particularly driven by domestic demand. Despite the earthquake-related effects, the retail sales volume index rose by 28.7% year-on-year in the first quarter. In April, the index maintained its uptrend and increased by 23.7% year-on-year. The quarterly rate of increase was 3.3% in April. The uptrend in credit card expenditures continued in the second quarter. An analysis of manufacturing firms' registered orders in the second quarter reveals that orders from the domestic market displayed a significant rise at 2.6 points on an annual basis.

13. Recent data show that economic activity in the earthquake zone continued to recover faster than expected, thereby largely compensating for the disaster-driven contraction. While employment growth across the country slowed in the first quarter due to the disaster, seasonally adjusted employment stood at 31.6 million in April, considerably close to its pre-disaster level of 31.7 million in January. The seasonally adjusted labor force participation rate stood at 53.9%, reaching its pre-disaster level.

14. In April, the annualized current account deficit increased by USD 38.1 billion to USD 57.8 billion, from its April 2022 level of USD 19.7 billion, despite the decline in energy imports due to energy prices. This increase was driven by the rise in foreign trade deficit despite the strong course of the services balance. As of April, the annualized balance of payments-defined foreign trade deficit increased by USD 54.0 billion year-on-year to USD 100.2 billion. In the same period, the annualized services surplus increased by USD 14.9 billion to USD 51.6 billion. Gold imports play an important role in the widening of the current account deficit due to monetary conditions and expectations. In the first four months of the year, total gold imports increased by USD 9.2 billion year-on-year to USD 11.8 billion. Provisional foreign trade data for May indicated the continuation of the upward momentum in gold imports. The strong course of domestic demand has an increasing effect on the current account deficit through imports of consumption goods. Provisional foreign trade data for May and high-frequency data for June indicate that despite the relatively flat course of exports in seasonally adjusted terms, imports displayed an uptrend due to the above-mentioned groups.

15. Tourism revenues are expected to make a strong contribution to the current account balance in the second half of the year, thanks to their performance beyond expectations throughout the year. Travel revenues increased by USD 2.1 billion in the first four months of the year compared to the first four months of the previous year, and reached USD 10.3 billion. Similarly, the number of foreign visitors increased by 29.2% year-on-year to 9.5 million in the first four months of the year. With the increasing contribution of tourism revenues, the current account is projected to follow a more balanced course in the second half of the year. It is anticipated that the strong course of tourism revenues, considered along with the normalization in energy imports, will contribute to healthy price formation and stability due

to supply in the foreign exchange market. However, increased tourism activity poses a risk to consumer inflation by boosting demand in the short term.

16. Despite the earthquake-related effects, annual growth of Gross Domestic Product increased to 4%, up from 3.5% in the previous quarter. In seasonally and calendar-adjusted terms, quarterly growth stood at 0.3%. Contributions to annual growth were -2.8 points from net exports, 1.2 points from investments, and 5.6 points from the rest of the consumption sector. Domestic demand made the largest contribution to annual growth, while the weak external demand and the earthquake-driven temporary production loss limited the contribution of the industrial sector to growth. Annual growth in private consumption was 16.2%, while final domestic demand growth, which includes private and public sector consumption and investment expenditures, was 12.1%. In this period, machinery-equipment investments grew by 8% on an annual basis, extending their uptrend into the fourteenth quarter.

17. In April, the seasonally and calendar-adjusted industrial production index decreased by 0.9% month-on-month, but increased by 0.8% quarter-on-quarter, pointing to the continuation of the post-earthquake recovery trend.

Cost Conditions

18. Global commodity prices, which started to decrease as of the second half of 2022, supported the fall in consumer inflation via the input prices channel. Meanwhile, the pressure on producer prices increases due to higher exchange rates and labor costs.

19. The domestic producer prices index posted a mild increase by 0.65% in May due to the decrease in the energy production group, and annual producer inflation declined by 11.35 points from 52.11% to 40.76%. After a widespread decline in May, international commodity prices follow an almost flat course in June. Indicators for pressures in the global supply chain and international transportation costs remain low. With the decline in global commodity prices, current global supply conditions continue to be favorable for inflation. Meanwhile, exchange rate developments are expected to exert pressure on energy and other imported input prices in the upcoming period.

20. The decision to provide household natural gas free of charge for full use in May and for use of 25 cubic meters for the following 11 months led to a significant slowdown in the rate of increase in consumer prices in May, decreasing inflation by 2.4 points. In the absence of additional supports, this downward effect will reverse into an upward effect on inflation in the last quarter of the year, as cold weather and consumption of energy for heating purposes come into effect.

21. Despite the favorable course of energy prices, the outlook for sub-indices for capital goods, durable and non-durable consumption goods diverged from headline producer prices. In addition to this outlook, the depreciation in the Turkish lira, the increasing volatility in exchange rates, and the widespread rise in wages are projected to exert additional cost pressures on inflation in the short run. The pass-through from these factors to consumer prices is rapid particularly amid strong demand conditions. According to leading indicators, the exchange rate-led increases in many items in the inflation basket, durable consumption goods in particular, have started to be reflected on consumer inflation.

Stickiness of Services Inflation

22. Price increases in the services sector remain high, and inflation in this group is stickier than in goods. The monthly price increases in the services sector, where the impact of domestic demand is stronger, remain higher than 2022. The last three month average of the seasonally adjusted consumer price increases was 2.5% in the B index and 3.7% in services. In addition,

the diffusion index for the services sector hovers above its historical average, indicating that the increases spread across the sector.

23. In addition to soaring house prices and the backward-indexation behavior, imbalances between supply and demand in the real estate market affect consumer inflation negatively by pushing rent increases upwards.

24. In the restaurants and hotels subgroup, which is significantly affected by developments in food, wages and tourism, monthly price increases display a steady outlook.

25. A backward-looking pricing behavior prevails in certain services items led by rents, education, health, recreation and culture, which causes inflationary effects to spread over a long period of time.

Inflation Expectations

26. Inflation is projected to increase somewhat in 2023, and then decline as the cumulative effects of monetary tightening kick in, gradually converging first to historical averages and then to the medium-term target. Credit expansion, cost pressures and exchange rate developments indicate that pressures on inflation might increase. The current course of inflation expectations and the deterioration in pricing behavior keep the upside risks to the inflation outlook alive.

27. According to the June results of the Survey of Market Participants: The 12-month-ahead inflation expectation increased by 0.81 points from 29.84% to 30.65%; the 24-month-ahead inflation expectation went up by 0.38 points from 17.74% to 18.12%; the five-year-ahead inflation expectation was revised downwards by 0.15 points from 8.22% to 8.07%.

Monetary and Financial Conditions

28. Along with the monetary policy decision, the Committee made assessments regarding loan growth and lending and deposit rates. From the perspective of financial stability, sensitivity analyses were conducted and it was evaluated that banks are resilient under potential policy rate hike scenarios considered and that these potential scenarios do not threaten the safety and soundness of the banking system.

29. Credit growth poses a risk to inflation by increasing domestic demand. As of 16 June 2023, the retail loan balance increased by 65.7% in credit cards, 63.1% in vehicle loans, 27% in personal loans, 21.3% in housing loans compared to end-2022, amounting to an increase of 38.1% in total. Meanwhile, since the last MPC meeting period, loan growth has declined. In this development, the expansion of the scope of the loan growth-based securities maintenance practice and the increase in deposit rates due to the existing regulations have been effective.

30. The difference between loan and deposit rates and policy rates widened in the previous MPC period. As of 16 June 2023, average personal loan (excluding overdraft accounts) rates in the sector have risen by 749 basis points to 41.7% compared to the period before the regulation. Turkish lira commercial loan rates have remained flat at 14.7%. The Turkish lira deposit rate has increased by 674 basis points to 30.3% since the previous MPC meeting period. The upward impact of the removal of the interest rate cap on FX-Protected Deposit accounts continues.

31. Accordingly, the Committee evaluated the necessity of increasing the functionality of market mechanisms through the simplification process of the current micro and macro-prudential framework along with monetary tightening.

Monetary Policy

32. The Committee will determine the policy rate in a way that will create monetary and financial conditions necessary to ensure a decline in the underlying trend of inflation and to reach the 5% inflation target in the medium term. Considering the inflation outlook and the upside risks, the Committee assessed that the current monetary policy was far from achieving the inflation target of 5%. The Committee underlined that deterioration in price stability was threatening macroeconomic stability and, in particular, financial stability. Accordingly, the Committee decided to implement a monetary tightening process, the steps of which will be strengthened as much as needed in a timely and gradual manner. The monetary tightening process will continue until a significant improvement in the inflation outlook is achieved.
33. The policy rate (the one-week repo auction rate) has been increased from 8.5% to 15%. The Committee sees this decision as the first step of the monetary tightening process that was initiated to establish the disinflation course as soon as possible, to anchor inflation expectations, and to control the deterioration in pricing behavior.
34. The Committee has evaluated analyses on the impact of the monetary tightening process on macroeconomic and financial conditions. The impact of rate hike scenarios on key macroeconomic variables such as inflation, credit growth, credit and market rates, economic activity and expectations as well as on stress tests on banks have been evaluated. The inflation outlook necessitates taking new steps to achieve the goals.
35. Indicators of inflation and the underlying inflation trend will be closely monitored and the CBRT will continue to decisively use all the tools at its disposal in line with its main objective of price stability.
36. The Committee concluded that inflation, which has drifted away from the target, calls for the effective use of the monetary policy. The monetary tightening process will increase the effectiveness of monetary policy.
37. In addition, the Committee evaluated that the current micro and macro-prudential framework fell short of supporting the macro-financial stability and distorts the functionality of market mechanisms. Therefore, a simplification policy has been adopted. The existing micro- and macro-prudential framework will be simplified to increase the functionality of market mechanisms and strengthen macro-financial stability. For a smooth transition period, it was decided to implement a gradual simplification policy. The pace and sequence of transition in the simplification process will depend on impact analysis. Impact analyses of the CBRT's regulations will be conducted for all components of the framework by assessing their impact on inflation, interest rates, exchange rates, reserves, expectations, securities and financial stability.
38. In addition, in order to be able to sustain price stability in the long-term, the CBRT will continue to support strategic investments that will improve the current account balance.
39. The Committee will continue to take its decisions in a predictable, data-driven and transparent framework.