

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: 17 July 2014

Inflation Developments

1. In June, consumer prices increased by 0.31 percent and annual inflation declined to 9.16 percent. This decrease in annual inflation was driven primarily by food prices, but also by energy and services prices. In this period, the cumulative effects of the Turkish lira depreciation continued to weaken and the uptrend that started in the annual core goods inflation in early January stopped. Thus, the annual inflation in core indicators followed a relatively flat course.
2. Annual food group inflation fell by 1.6 points to 12.47 percent, mainly on the back of the unprocessed food group whose annual inflation decreased by 4.4 points due to base effects, while the introduction of new fresh fruits to the index limited the decline in the group's inflation. On the processed food front, rapid increases prevailed across all subcategories, particularly in bread and cereals, and annual inflation rose to 12.2 percent. The elevated food prices have been the main factor limiting the pace of decline in inflation. In fact, excluding the food group, the underlying consumer inflation trend has been slowing. On the other hand, the energy group continued to contribute favorably to consumer inflation with an annual increase of 4.25 percent.
3. Prices of services rose by 0.88 percent in June, and the group's annual inflation edged down by 0.34 points to 8.18 percent. Annual inflation in restaurants-hotels, rents and transport were up in this period, while the decline in inflation was mainly driven by the base effect from driving school fees. Seasonally adjusted data point to a slowing yet still high underlying services inflation trend for June.
4. Annual core goods inflation remained flat at 11.4 percent in June. Following the appreciation of the Turkish lira during April-May, prices of durable goods dropped for the second consecutive month, and the group's annual inflation continued to decrease. Meanwhile, prices of core goods excluding durable goods, which witness the effects of the exchange rate with a further lag, remained on the rise. Accordingly, the exchange rate-driven inflationary pressures on the core goods group continued to subside. In fact, June's seasonally adjusted data suggest a notable improvement in the underlying core goods inflation.

Factors Affecting Inflation

5. Data for the second quarter of 2014 point to a moderate increase in economic activity. On the production side, the industrial production index declined by 1 percent in May after the 0.9 percent increase in April. The drop in May's production was largely due to the sharp month-on-month fall in the production of capital goods. In May, the production of durable goods decreased slightly, whereas the production of nondurable goods rose, and the production of intermediate goods was flat. Thus, production remained unchanged during April-May. The upcoming period is expected to witness an ongoing modest rise in production with the support of exports and a rebound in domestic demand.
6. Among the indicators of nondurable consumption demand, the production of nondurable goods increased quarter-on-quarter during April-May, whereas the imports of nondurable goods were down quarter-on-quarter. The production and imports of durable goods were up quarterly during April-May. Among indicators of durable goods demand, sales of automobiles were flat in the second quarter following the first-quarter plunge, while sales of home appliances registered an increase during April-May after a two-quarter slowdown. Thus, it is considered that the uptrend in the demand for nondurable goods continued in the second quarter and that the fall in the demand for durable goods may have halted. Indicators for machinery-equipment suggest that investments remain weak. Indicators for construction investments show that the increase in construction investments continued at a decelerating pace in the second quarter.
7. With the decrease in uncertainty, the improved confidence indices and the declining volatility in the Turkish lira, consumption demand is expected to help domestic demand recover in the second half of 2014. This recovery is projected to be gradual and mild due to the tight monetary stance and macroprudential measures.
8. Exports continued to expand in the second quarter amid recovering external demand and contributed favorably to growth. Having increased slightly month-on-month in May, the non-gold export volume index surpassed the average of the previous quarter during April-May. Due to the modest global recovery signaled by recent survey indicators and the improving world trade, exports are envisaged to support growth further in the upcoming period. Yet, the geopolitical tensions in Iraq may pose downside risks on economic activity and the current account balance.

9. The ongoing upsurge in employment since November 2013 lost pace during March-April and seasonally adjusted unemployment rates followed a flat course. Construction employment fell in this period, while industrial employment remained unchanged and non-farm employment rose on the back of the services sector. Leading indicators for the second quarter point to a mild increase in employment.

Monetary Policy and Risks

10. The Committee assessed the medium-term forecasts to be included in the July Inflation Report. In the second quarter of 2014, the inflation excluding food was consistent with the April forecasts. Yet, the continued upsurge in food prices due to negative supply-side developments caused annual consumer inflation to remain above the forecast. The Committee stated that no major update was made to the assumptions underlying inflation forecasts and external conditions. Under the assumption that the upside risks to food prices are contained, the end-2014 inflation forecast of the April Inflation Report was left unchanged.
11. Due to tight monetary policy stance and the macroprudential measures, loan growth rates remain at reasonable levels. In the first half of the year, consumer loan growth fell well below its average of recent years, while commercial loan growth was relatively more robust. The Committee concluded that this favorable growth composition of loans both contribute to the disinflation and supported the rebalancing by curbing private final demand.
12. In line with these developments, domestic private final demand displays a modest outlook. Meanwhile, with the help of the recovery in foreign demand, exports contribute positively to economic growth. The Committee expects that such a demand composition will support disinflation and will lead to a significant improvement in the current account balance in 2014. Recent geopolitical developments, on the other hand, may pose downside risks to growth and balancing process directly due to the trade channel as well as the oil price channel. In addition, rise in oil prices may bear adverse effects on inflation.
13. The adverse impact of exchange rate developments since mid-2013 on annual inflation is gradually tapering off. Indeed, the underlying trend of core inflation indicators has recently displayed a decline amid the alleviation of inflationary pressures led by the exchange rate particularly on durable goods. However, the high course of food prices due to supply-side developments in recent times limited the pace of decline in inflation. The committee stated that given the

falling prices in international agricultural products in the second quarter, an active foreign trade policy for these products might curb upside risks to food prices.

14. Recently, the Fed has stated that accommodative policies would be maintained for a long time and lowered the long-term interest rate expectations, which had a positive effect on the markets. In addition, the ECB reduced the policy rates and announced a new quantitative easing program, boosting the global risk appetite. These developments led to expansionary effects on global liquidity conditions, and capital inflows towards emerging economies saw a recovery. The Committee decided to deliver a measured cut in the one-week repo rate amid the fall in underlying inflation trend excluding food and improvement in global liquidity conditions. Inflation expectations, pricing behavior and other factors that affect inflation will be closely monitored and the tight monetary policy stance will be maintained, by keeping a flat yield curve, until there is a significant improvement in the inflation outlook.
15. Emerging economies, including Turkey, saw an increase in portfolio inflows in recent months, reversing the outflows occurring since mid-2013. The mild global growth outlook and the favorable conditions for risk appetite are expected to further support capital flows to emerging economies in the upcoming period. Accordingly, should capital inflows accelerate; steps may be taken to strengthen foreign exchange reserves. Committee was also informed about the need for a technical change in the exchange rate composition of the Reserve Option Mechanism.
16. 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.
17. 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 Medium Term Program remains to be of utmost importance.