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# SUMMARY OF THE MONETARY POLICY MEETING

## Meeting Date: 27 August 2014

### *Inflation Developments*

**1.** In July, consumer prices were up 0.45 percent and annual inflation increased by 0.16 points to 9.32 percent. This increase in annual inflation was driven primarily by prices of services, alcoholic beverages and tobacco, while the high course of food prices continued in this period. The underlying trend of services inflation remained elevated, whereas the trend in core goods continued to improve on the back of the fading cumulative effects of the Turkish lira depreciation.

**2.** Food inflation edged up to 12.56 percent year-on-year. In July, annual inflation declined to 12.1 percent in unprocessed food and reached 13 percent in processed food. Although the headline food inflation was relatively flat in this period, the annual rate of increase in food prices excluding fresh fruits and vegetables rose to 15.2 percent. This was mostly attributed to drought-related supply issues.

**3.** Down to 3.74 percent, the annual increase of energy prices continued to contribute favorably to consumer inflation. Alcoholic beverages and tobacco products added 0.12 points to annual consumer inflation due to increased prices of some cigarette brands.

**4.** Prices of services surged by 1.20 percent month-on-month, bringing annual services inflation up by 0.44 points to 8.62 percent. In this period, annual inflation was up across all subcategories of services. In particular, the annual inflation in restaurants and hotels continued to rise in line with food inflation. Therefore, the underlying trend of services inflation soared, curbing the improvement in core indices.

**5.** Annual core goods inflation fell to 11 percent in July. After declining in May and June, prices of durable goods remained flat in July, driving annual durable goods inflation further down. However, annual inflation continued to rise in core goods excluding durables that respond with a lag to the exchange rate pass-through. On a seasonally adjusted basis, the underlying trend in core goods inflation continued to improve in this period.

*Factors Affecting Inflation*

**6.** Second-quarter data point to a continued moderate growth in economic activity. On the production side, the industrial production index recovered its April rise in May and increased modestly in June. Thus, production remained flat during the second quarter.

**7.** On the spending front, domestic private final demand displays a moderate course. The production of consumer goods was higher quarter-on-quarter, whereas the imports of consumer goods were down from the previous quarter. A similar divergence was noted in the consumption demand for durable and nondurable goods. Automobile sales, an indicator for the durable goods demand, picked up moderately in the second quarter after the first-quarter plunge, and posted a rapid increase in July. Sales of home appliances, on the other hand, increased in the second quarter after a two-quarter slowdown. Thus, it is anticipated that the demand for nondurable goods registered a mild increase in the second quarter and the fall in the demand for durable goods may have halted. Meanwhile, indicators for machinery and equipment investments suggest that investments remain weak. Moreover, indicators for construction investments do not show any recovery at this point.

**8.** Recent data suggest that the contribution of exports to growth may decrease in the upcoming period. The non-gold export volume index posted a monthly decline in June for the first time in a long while due to the geopolitical tensions in Iraq, Turkey's second largest export destination, as well as due to the slowing economic activity in the euro area. These factors are likely to continue to put downside pressure on external demand for some time. In fact, leading indicators signal some slowdown in exports for the third quarter of the year.

**9.** In seasonally adjusted terms, total and nonfarm unemployment rates were higher in May 2014 than in the previous period. The rise in unemployment rates was largely due to the slowing nonfarm employment. In this period, industrial employment remained unchanged from the previous month, while construction employment declined. Moreover, the rate of increase in services employment slowed. Leading indicators for the third quarter signal no significant recovery for employment. The low levels of investment tendency suggest that a recovery in the labor market may take some time.

**10.** In sum, domestic demand remains moderate while external demand loses momentum. Thus, economic activity is expected to have flattened in the second quarter after the robust quarterly growth in the first quarter. Survey indicators suggest that economic activity will remain moderate in the third quarter as well. Therefore, demand developments are not expected to put pressure on inflation in the upcoming period. Meanwhile, the improvement in the current account deficit may decelerate to some extent due to the slowdown in external demand growth.

***Monetary Policy and Risks***

**11.** The Committee assessed that the recent growth rate and the composition of loans evolve in the desired direction, owing to the tight monetary policy stance and macroprudential measures. Annual rate of growth in consumer loans continue to decrease, while commercial loan growth is relatively more robust. The current pace and composition of loans not only contain medium-term inflation pressures but also support the improvement in the current account balance. The Committee stated that the partial easing in financial conditions besides the decline in domestic uncertainties may affect the credit market positively in the upcoming period. Meanwhile, food prices surging amid drought coupled with the ongoing geopolitical risks may limit the increase in the consumer confidence and the credit demand in the short term.

**12.** The adverse impact of cumulative exchange rate developments since mid-2013 on annual inflation is gradually tapering off. Having exceeded 3 percentage points in April, these effects are estimated to ease to around 2.5 percentage points as of July. The Committee highlighted that there is a considerable room for decline in inflation through this channel in 2015. However, it was also underlined that second round effects of the exchange rate pass-through should be closely monitored.

**13.** The high course of food prices delays the improvement in the inflation outlook. In this respect, the Committee also evaluated the possible impact of the drought and the geopolitical risks on the inflation outlook. The Committee underlined that domestic food prices had recently decoupled from those abroad in a negative way. The food group has seen marked price increases since the start of the year, and no apparent correction is expected in the short term, partly due to the geopolitical risks. Given that the current elevated levels of inflation affect the medium-term expectations adversely and add on the risks to the pricing behavior, all relevant institutions' involvement with the fight against inflation is deemed crucial for macroeconomic stability. In this scope, it was mentioned that an active foreign trade policy might be helpful in containing risks to food prices.

**14.** In line with these assessments, the Committee decided to maintain the current stance regarding short-term interest rates. 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. Accordingly, the Committee reminded that the liquidity policy may be used actively when needed.

**15.** The Committee highlighted that long-term interest rates had recently become less volatile amid the alleviation of uncertainties regarding global monetary policies. Coupled with unwinding domestic uncertainties, this has partially eased the need for a wide interest rate corridor. Accordingly, the Committee decided to reduce the overnight lending rate to render the interest rate corridor more symmetric.

**16.** The Committee closely monitors developments on the 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.