No: 2011 – 08 **30 March 2011**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: March 23, 2011

Inflation Developments

1. In February, consumer prices increased by 0.73 percent, while annual inflation fell to 4.16 percent, mainly due to base effects from unprocessed food prices. The annual rate of increase was up in prices of core goods but slightly down in prices of services. As anticipated in the Summary of the February Monetary Policy Committee (the Committee) meeting, the annual rate of increase in core inflation measures continued to rise.

2. In the unprocessed food group, prices increased by 4.32 percent in February, while inflation dropped to 2.89 percent year-on-year owing to base effects. In the processed food group, prices continued to accelerate on soaring prices for bread and cereals as well as oils and fats. Although annual processed food inflation is expected to increase gradually in coming months amid higher international food prices, the temporary lifting of customs duties on wheat imports may help to reduce this upward pressure.

3. Developments in international oil prices and exchange rates continued to push fuel prices up in February, while annual energy inflation eased to 6.23 percent on base effects.

4. Annual services inflation edged down to 4.22 percent in February. Annual inflation was down in restaurants and hotels, reflecting lower food inflation, while accelerating fuel prices put further upward pressure on transport services. Annual inflation in services excluding catering and transport was as low as 2.34 percent in February, while the annual rate of increase in rents remained stable at 4 percent.

5. Annual core goods inflation (excluding food, energy, alcoholic beverages, tobacco and gold) rose by 1.31 percentage points to 3.31 percent on higher import prices and the depreciation of the Turkish lira. Specifically, the increase in durable goods inflation was significant in February.

6. Noting the recent run-up in seasonally adjusted core price measures driven by rapid increases in import prices, the Committee expects annual core inflation to continue to rise for a while.

Factors Affecting Inflation

7. Recent releases on economic activity have been largely consistent with the outlook presented in the January Inflation Report. After increasing sharply in December, seasonally adjusted industrial production decelerated in January, but was still significantly higher than the fourth-quarter average. Leading indicators for February and March have shown that the pace of economic activity slowed quarter-on-quarter, yet remained strong.

8. Economic activity continues to strengthen amid increasing domestic demand. The production and imports of consumer goods were significantly higher in January than the fourth-quarter averages. The ongoing surge in consumer confidence and credit use does not point to a marked slowdown in the first quarter's private consumption spending. Similarly, the January rise in the production and imports of capital goods and the robust sales of commercial vehicles during January-February suggest that the rapid recovery in private investments continued in the first quarter.

9. Imports continue to increase with strong domestic demand. The Committee has noted that rising oil prices may mask the slowdown in the main trend of imports, and thus non-energy imports would be a more informative variable in assessing the impact of the recent policy measures. That said, the Committee has reiterated that the restrictive effects of these policy measures on loans and imports would be observed with a lag.

10. Foreign demand remains relatively weak despite the recent pick-up. January's export (excluding gold) quantity index was higher than the fourth-quarter average, while leading indicators for February and March confirm the gradual recovery in exports. The flat course of 3-month-ahead expectations for new orders indicates that foreign demand is unlikely to recover strongly over the short term. Moreover, both the political tension in North Africa and the massive earthquake in Japan pose downside risks to the foreign demand outlook.

11. Employment conditions continue to improve, yet, unemployment rates remain at high levels. While the recovery in the non-farm employment continues, both recent production data and survey indicators for investment and employment indicate that this trend would be maintained over the coming months. Nevertheless, the Committee has reiterated that unemployment rates would remain higher than pre-crisis levels for a while, containing the unit labor costs.

Monetary Policy and Risks

12. In light of these developments, the Committee concluded that aggregate demand conditions are in line with the outlook presented in the Inflation Report. Both the unemployment and capacity utilization rates suggest that the

output gap has not closed. In fact, unit labor costs and services prices do not display a noticeable acceleration. However, oil and other commodity prices hover above the Inflation Report assumptions, exerting upward pressure on core goods prices. Accordingly, the Committee expects that core goods inflation would continue to increase for some time, while services inflation would display a more benign path.

13. Although the measures taken by the Central Bank of Turkey (CBT) since November are expected to have an impact on credit volume and domestic demand starting with the second quarter, some additional increase in reserve requirement is deemed necessary for macroprudential purposes. The measures aim at containing the macro financial risks by inducing a more balanced composition of the aggregate demand. Recently, domestic and export orders show a more balanced pattern, suggesting that policy measures have started to become effective to some extent. However, given the strength of the credit growth and other domestic demand indicators, the Committee indicated that additional monetary tightening would be necessary for containing macro financial risks. According to the Committee members, implementing the monetary tightening through reserve requirements, rather than using the policy rates, would be more effective under current conditions. In this respect, the CBT decided to deliver a notable hike in the weighted average of reserve requirements on short term liabilities.

14. In this respect, the Committee noted that the decision on reserve requirements would also provide the monetary tightening required for containing the potential second round effects of the recent increases in oil and other commodity prices. The Committee members indicated that this decision reflects the policy reaction implied through the "persistent increases in commodity prices" scenario in the January Inflation Report.

15. In light of these assessments, in order to contain the risks towards price stability and financial stability, the Committee has decided to monitor the tightening impact of the implemented policy mix—a low policy rate, a wide interest corridor and high reserve requirement ratios—and take additional measures along the same lines, if needed.

16. The Committee members have indicated that reserve requirement is only one of the tools for containing credit growth and domestic demand, and emphasized the importance of the supplementary macroprudential measures by other related institutions. In this respect, it was stated that the direct measures targeting credit supply would enhance the effectiveness and efficiency of the policy implemented by the CBT.

17. The Committee monitors the fiscal policy developments closely. Budget figures regarding the first two months of the year suggest that revenues are increasing

at a faster pace than envisaged in the Medium Term Program (MTP), owing to the stronger-than-expected economic activity. The Committee underscored that saving this fiscal space would not only help to balance the domestic and external demand, but also reduce the need for the CBT to take additional measures.

18. Monetary policy will continue to focus on price stability in the period ahead. To this end, the impact of the macroprudential measures taken by the Central Bank and other related institutions on the inflation outlook will be considered carefully. Strengthening the commitment to fiscal discipline and the structural reform agenda would support the improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. Sustaining the fiscal discipline will also provide more flexibility for monetary policy and support the social welfare by keeping interest rates permanently at low levels. In this respect, timely implementation of the structural reforms envisaged by the MTP and the European Union accession process remains to be of utmost importance.