No: 2010 – 10

30 March 2010

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: March 18, 2010

Inflation Developments

1. Consumer prices increased by 1.45 percent in February, pushing annual inflation up by 1.94 percentage points to 10.13 percent. As noted in February's Monetary Policy Committee (the Committee) Meeting Summary, the recent rise in annual inflation was driven by temporary factors such as soaring unprocessed food prices, lagged impacts of tax adjustments, and base effects. In fact, core inflation indicators have continued to hover at low levels, notwithstanding the rise in annual inflation.

2. The steep increase in vegetable prices due to adverse weather conditions and the ongoing surge in meat prices pushed annual unprocessed food inflation up by about 10 percentage points in February. Nonetheless, there may be a correction in vegetable prices during March.

3. Besides the developments in unprocessed food items, price hikes in energy and tobacco also put upward pressure on inflation. Energy prices continued to increase in February on the back of higher bottled gas and auto LPG prices. Annual energy inflation is expected to rise further in coming months owing to base effects. Meanwhile, tobacco inflation continued to accelerate due to the spillover of January's tax changes.

4. By contrast, weak aggregate demand has dampened the pass-through of price hikes in food, energy and tobacco into overall pricing trends. The end-February annual inflation across core goods (excluding food, energy, alcoholic beverages, tobacco and gold) was a modest 2.17 percent. The low level of inflation in core goods was particularly driven by durable good items.

5. The impact of higher food and energy prices on catering and transport services became more significant, while prices of other services continued to rise at a slower pace. The Committee noted that, although seasonally adjusted services inflation has been rising modestly for a while, underlying services inflation is consistent with the medium-term targets. Nevertheless, Committee members emphasized that overall pricing behavior needs to be closely monitored.

Factors Affecting Inflation

6. Recent data releases suggest that a moderate recovery in economic activity is ongoing. Industrial production grew by 12.1 percent year-on-year in January, which is equivalent to 16.1 percent in calendar adjusted terms. The seasonally adjusted industrial production index was up 0.3 percent month-on-month, pointing to ongoing yet slower growth. Leading indicators suggest that industrial production has continued to recover in February and March.

7. Domestic demand is following a gradual growth trend. The recent growth in labor compensation and favorable developments across credit markets are supporting the recovery in private consumption. Production and imports data indicate that private consumption demand increased moderately during the final quarter of 2009. Moreover, releases on consumer goods production in January signal an ongoing recovery in private consumption demand. In addition, new order indices in the PMI show that the recovery in private consumption demand continued into the first quarter, albeit at a slower pace, which is also supported by the flattening of consumer confidence indices.

8. Production and imports data for capital goods suggest that the recovery in private investment demand has yet to gain momentum. Indicators of resource utilization, such as capacity utilization in the manufacturing industry and hours worked per capita, remain weak, while manufacturing firms continue to view their production capacity as “more than sufficient”, considering their current order books and demand expectations. Investment demand is expected to continue to grow moderately in the upcoming period. Yet, insufficient and uncertain aggregate demand is likely to restrain new investments in the manufacturing industry, given the weak global growth outlook. Accordingly, the Committee expects investment demand to remain below pre-crisis levels for a while.

9. Uncertainty regarding foreign demand remains. The Committee emphasized that the outlook for existing export markets, particularly the euro area, remains weak, and reiterated that the recovery in exports would be gradual, which is demonstrated by the recent trends in leading indicators for exports. Thus, it will take a while before industrial capacity utilization rates return to pre-crisis levels.

10. Although employment conditions continue to improve, unemployment rates remain at high levels. Seasonally adjusted data for December indicate that non-farm employment continues to recover. Weak foreign demand continued to restrain industrial employment, while the recovery in construction and services sectors helped non-farm employment return to pre-crisis levels.

11. Overall, recent data releases suggest that the economic recovery is ongoing. The lagged effects of monetary policy actions on domestic demand have become more pronounced, while the weak outlook for global growth continues to dampen resource utilization in tradable sectors. Overall, the Committee continues to expect the economic recovery to be gradual.

Monetary Policy and Risks

12. Monetary policy decisions are based on the medium-term outlook for inflation, rather than temporary price developments. However, the Committee members indicated that, for the purpose of managing expectations, it might be useful to inform economic agents about the likely path of inflation in the short term, given that inflation currently hovers significantly above the target.

13. With the partial correction in unprocessed food prices, the Committee members expect inflation to drop to single digit levels in March. However, the Committee indicated that inflation would display fluctuations in 2010 owing to the base effects driven by the temporary tax cuts and volatile unprocessed food prices during 2009. Temporary tax cuts implemented in March 2009, which were withdrawn partly in June and fully in October, would lead to rising inflation rates during March and April, and a decrease in inflation rates during June and October of 2010. Moreover, unprocessed food inflation registered a historically high print in the last quarter of 2009, following a historical low during the third quarter. These strong base effects would likely lead to fluctuations in headline inflation throughout 2010, therefore making it difficult to assess underlying trend inflation. In this respect, the Committee underscored that economic agents should closely monitor the Central Bank's reports and statements regarding inflation developments.

14. The Committee stated that the impact of the sharp increases in unprocessed food prices during the last quarter of 2009 would ease in the final quarter of 2010. Likewise, the 1.9 percentage point impact of the recent tax hikes on inflation would dissipate during the January-February period of 2011. Accordingly, inflation would continue to hover significantly above target for some time, however, it would then revert to a downward trend as the temporary factors taper off starting in the last quarter of the year, and decline to levels consistent with inflation targets by early 2011.

15. Core inflation indicators would increase in the short term as well, especially during March and April, owing to the base effects driven by the temporary tax cuts of the previous year. However, in line with the modest recovery in aggregate demand conditions, core inflation indicators would continue to remain below the target.

16. Increasing headline inflation is having an adverse impact on inflation expectations. The current state of aggregate demand conditions is expected to dampen the pass-through of the rise in unprocessed food and administered prices on overall prices. Still, the Committee members underscored the importance of closely monitoring price setting behavior, given that Turkey has had to cope with high levels of inflation in the past.

17. Credit markets have continued to improve in response to the monetary easing. Committee members noted that easing financial conditions have been strengthening the expansionary impact of monetary policy. Commercial loans have recovered significantly in the first two months of the year, while the recovery in consumer loans has been relatively more moderate. The Committee indicated that lagged impacts of the monetary easing would continue to support the credit markets, yet high levels of unemployment rates and relatively tight external financing conditions would restrain credit growth.

18. The global economy continues to recover. However, the high levels of budget deficits on a global scale and ongoing problems in credit and real estate markets continue to pose downside risks on global activity, particularly in developed economies.

19. Overall, despite recent improvements, there are still lingering problems across the global economy. Accordingly, the Committee has reiterated that it would be necessary to keep policy rates at low levels for a long period of time. However, the CBT will not hesitate to tighten monetary policy sooner than envisaged in the baseline scenario of the Inflation Report, should the recent increase in inflation expectations lead to a deterioration in price setting behavior.

20. Increasing budget deficits on a worldwide scale, particularly across developed economies, continue to pose risks on inflation expectations and thus on longer-term global interest rates. In fact, recently, long-term interest rates across developed economies have been displaying significant increases. Countries with relatively sounder banking systems and prudent fiscal policies would be more resilient against such risks. In this respect, the Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. Should the goals set out in the Medium Term Program be implemented through institutional and structural improvements, rather than tax and administered price hikes, it would be possible to keep policy rates at single digit levels over the medium term.

21. Since the last quarter of 2008, the CBT, without prejudice to its primary objective of price stability, has focused on containing the adverse effects of the global crisis on the domestic economy—which has been achieved to a large extent. Monetary policy will continue to focus on price stability in the period

ahead. 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. In this respect, timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union accession process remains to be of utmost importance.