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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: November 11, 2010

Inflation Developments

1. In October, consumer prices were up 1.83 percent, while annual inflation was down 0.62 percentage points to 8.62 percent due to base effects. Although unprocessed food prices continued to soar dramatically, inflation remained broadly subdued across all other subcategories. Annual services inflation continued to decrease steadily, and core inflation indicators remained consistent with medium-term targets.

2. Annual inflation in food and nonalcoholic beverages increased by 1.75 percentage points to 17.08 percent in October. Thus, food prices added 4.67 percentage points to annual inflation. Having soared in August and September on escalating vegetable prices, unprocessed food prices continued to rise sharply in October. Specifically, tomato prices increased sharply by 112 percent due to the supply shortage during the shift from field crops to greenhouse crops, driving inflation up by 0.85 percentage points in October. Meanwhile, unprocessed red meat prices continued to rise, albeit more slowly. Accordingly, annual unprocessed food inflation climbed to an all-time high of 31.28 percent.

3. Bread and grains prices in the processed food group have recently been affected by higher wheat prices. Moreover, prices for other processed food products, especially processed meat products, have increased rapidly over the past two months. The cumulative increase in both red meat and wheat prices continues to put cost pressure on processed food prices.

4. Inflation in core goods and services remains contained. Although rising food prices continues to weigh on catering services, prices for services other than catering and transport remain flat for the third consecutive month. The base effects from the 2009 tax incentives on durable goods faded out in October. Thus, the annual rate of increase in prices of core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) slowed to a record 1.25 percent. As a result, annual inflation captured by core price measures declined to around 2.5 to 3 percent year-on-year.

5. Against this backdrop, the Committee expects the annual change of unprocessed food prices to fall significantly in coming months. At the same time, inflation is expected to decrease markedly as the influence of tobacco price base effects diminishes during the beginning of 2011. Core inflation might rise modestly in the forthcoming period, but is expected to remain around levels consistent with the medium-term targets.

Factors Affecting Inflation

6. Recent data releases suggest that economic activity continues to recover with the support of domestic demand. Industrial production grew by a seasonally adjusted 1.2 percent quarter-on-quarter in the third quarter, recording a more moderate recovery than in the first half of the year. Yet, in view of the rapid recovery in domestic demand leading indicators, the Committee has stated that the economy is set to regain momentum in the last quarter.

7. Confidence indices and new order indicators suggest that domestic demand continues to recover. Three-month ahead expectations for total new orders were more upbeat during September and October due to strong domestic market conditions. Moreover, the Committee has noted that consumer confidence continues to improve, while investment appetite has grown further and stabilized at higher levels, and emphasized that domestic demand continues to grow at a faster pace than foreign demand in the final quarter.

8. Uncertainties regarding external demand persist. Exports remained subdued in October, while indicators for export orders showed no sign of a strong recovery in the short term. Furthermore, there remain downside risks to the pace of recovery in the global economy. Therefore, the Committee expects that it would take a long time before industrial capacity utilization rates return to their pre-crisis levels, due to the weak external demand outlook.

9. Although employment conditions continue to improve, unemployment rates remain at high levels. Non-farm employment growth paused in the third quarter, owing to the slowdown in the services sector. Committee members have noted that labor market developments are consistent with the third-quarter slowdown in production, and expect that employment growth will resume in line with the end-year economic recovery. Nevertheless, the Committee has reiterated that unemployment rates would remain higher than pre-crisis levels for some time, containing unit labor costs.

Monetary Policy and Risks

10. The Committee expects the weakening in the economic activity and employment indicators in the third quarter to be temporary. According to the

Committee members, especially credit volume and domestic demand follow a strong trend, nevertheless aggregate demand conditions do not exert upside pressures on inflation yet due to weak external demand. Moreover, the Committee has indicated that 5 percentage points of inflation, which was at 8.62 percent as of October, can be attributed to the direct effects of the unprocessed food and tobacco prices, which are both expected to decelerate in the forthcoming period. Therefore, it is expected that inflation would be on a declining path in the forthcoming period, while core inflation indicators would remain consistent with the medium-term targets. In light of these assessments, the Committee has reiterated that it would be necessary to maintain the policy rate at current levels for some time, and to keep it at low levels for a long period.

11. Although aggregate demand conditions support the stance of keeping policy rates at low levels for a long period of time, the developments in the composition of the demand necessitates the active use of other policy tools. The weakness in global economic outlook not only delays the recovery in the external demand but also leads to further expansionary policies across developed economies, which in turn fuels domestic demand through the acceleration in capital inflows to emerging markets. The surge in capital inflows exacerbates the divergence between the growth rates of domestic and external demand, widening the current account deficit through rapid credit growth and increasing import demand, thereby highlighting the risks regarding financial stability. The Committee once again underscored that, to limit such risks, other policy instruments such as reserve requirement ratios and liquidity management facilities may be used more effectively as macroprudential tools.

12. In order to encourage the lengthening of the maturities in Turkish lira money market transactions, the Committee has decided to allow overnight interest rates to diverge from the policy rate temporarily, when needed. To this end, the Committee has decided to widen the gap between lending and borrowing rates by reducing the borrowing rates by 400 basis points. Moreover, observing the favorable developments in credit conditions, the Committee has indicated that it would be appropriate to proceed with the remaining measures outlined in the exit strategy.

13. Commodity prices continue to pose risks regarding the inflation outlook. The Committee members have highlighted the sharp increases in agricultural commodity prices such as cotton and wheat. The existing output gap and the strength of the Turkish lira have been limiting the pass-through from agricultural commodity prices to the prices of core goods and services. However, the Committee stated that the impact of the commodity prices on the general price setting behavior should be closely monitored.

14. The CBT continues to monitor fiscal policy developments closely while formulating monetary policy. Increasing government savings—and therefore maintaining fiscal discipline—under the present circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. The Committee members see the Medium Term Program (MTP) as an important step toward this direction. Accordingly, inflation forecasts presented in the latest inflation report take the projections of the fiscal variables in the MTP as given, which envisages that, after a temporary acceleration in the final quarter of the year, the ratio of government expenditures to GDP would decline gradually starting from 2011. The Committee stated that, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on the inflation outlook, a revision in the monetary policy stance may be considered.

15. 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 MTP and the European Union accession process remains to be of utmost importance.