No: 2010 – 14

26 April 2010

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: April 13, 2010

Inflation Developments

1. Consumer prices increased by 0.58 percent in March. Annual inflation was down 0.57 percentage points yielding a rate of 9.56 percent. The decline in annual inflation was largely driven by the correction in vegetable prices, as envisaged in the Summary of the Monetary Policy Committee (the Committee) Meeting held in March.

2. Developments in energy and food prices lead to fluctuations in inflation. After a sharp increase in February driven by adverse weather conditions, vegetable prices displayed a partial correction in March. On the other hand, meat prices continued to rise, albeit at a slower pace, and remained the main driver of higher food prices. In fact, the cumulative price hike for unprocessed and processed meat products amounted to 9.85 and 8.86 percent, respectively, during the first quarter. Meanwhile, annual energy inflation continued to rise in March to 10.26 percent on the back of the low base effect from 2009 as well as higher fuel and water prices. Therefore, food and energy items account for 4.62 percentage points of annual inflation as of the end of the first quarter. Food and energy prices are expected to remain volatile over the upcoming period.

3. Core inflation indicators rose markedly in March. The year-on-year increase in core goods prices (goods excluding food, energy, alcoholic beverages, tobacco and gold) was largely attributable to the base effect resulting from the tax cuts on durable goods in 2009, and partly to developments in clothing prices. On the other hand, inflation in other goods continued on a downtrend.

4. Similarly, the annual rate of change in prices of services increased significantly in March. While higher energy prices put further pressure on transport services, rising meat prices continued to weigh on catering services. Moreover, landline call rates soared, accounting for about one-fourth of the increase in annual core inflation measured by the H index.

5. The Committee expects that core inflation indicators would increase in April as well, owing to the temporary tax cuts of the previous year, but would continue to remain at levels below the target.

Factors Affecting Inflation

6. Recent data releases suggest that the recovery in economic activity is ongoing. Gross Domestic Product (GDP) expanded by 6.0 percent year-on-year during the fourth quarter of 2009, and by 2.3 percent quarter-on-quarter in seasonally adjusted terms, indicating that economic activity has continued to recover, albeit more modestly.

7. On the spending side, public consumption grew rapidly to bolster quarterly GDP growth, whereas private demand remained more moderate. The run-up in public spending on goods and services was due to advance payment of the health care expenditures for 2010 amid the improved budget revenue performance. In this respect, the Committee emphasized that the marked increase in public spending is largely transitory.

8. First-quarter data suggest that economic activity continued to recover in 2010. In February, the seasonally adjusted industrial production index increased by 1.6 percent month-on-month. Industrial production is expected to grow at a slightly faster pace during March. The Committee noted that industrial production grew by 17.2 percent year-on-year during January-February in calendar adjusted terms, and emphasized that annual growth would reach double digits in the first quarter owing to the low base effect from a year earlier. Nevertheless, the Committee reiterated that growth rates in seasonally adjusted terms are more informative for assessing the underlying trend in economic activity.

9. Domestic demand is following a gradual growth trend. The effects of the policy rate cuts and increased public spending are having a more noticeable effect on domestic demand, with sectors more sensitive to domestic demand experiencing relatively stronger growth performances. The recent pick-up in industrial production indicates that sectors with strong linkages to non-durable goods manufacturing and construction have been on the rebound. Commercial loan and employment data verify that the recovery is more pronounced in the services sector, which is more sensitive to domestic demand, compared to the industrial sector.

10. Both the increase in labor compensation driven by employment growth and the favorable developments across credit markets are supporting the recovery in private consumption. Production and imports data indicate that private consumption demand continued to rise moderately during the first quarter. The PMI new order index suggests that the recovery continued into the first quarter, albeit at a slower pace, which is also confirmed by the consumer confidence indices.

11. Production and imports data for capital goods suggest that the recovery in private investment demand has yet to gain momentum. The global growth outlook continues to dampen economic activity, particularly in sectors that are relatively more sensitive to foreign demand, such as export-oriented industrial sectors and related services sectors. Following the recent crisis, manufacturing firms that mostly serve external markets are operating at lower capacity than local market-oriented firms. Accordingly, indicators of resource utilization, such as capacity utilization in the manufacturing industry and hours worked per capita, remain weak. Investment demand is expected to continue to grow moderately in the upcoming period. Yet, given the weak global growth outlook, insufficient and uncertain aggregate demand is likely to restrain new investments in the manufacturing industry. Therefore, the Committee expects investment demand to remain below pre-crisis levels for a while.

12. Uncertainty regarding foreign demand remains. The export quantity index was down 8.6 percent year-on-year during January-February; yet, excluding gold, the index remained flat quarter-on-quarter. The Committee emphasized that the growth outlook for export markets, particularly the euro area, remains weak, and reiterated that the recovery in exports would be gradual, which is also confirmed by the recent trends in leading indicators for exports. Thus, it would take a while before industrial capacity utilization rates return to pre-crisis levels.

13. Although employment conditions continue to improve, unemployment rates still remain at high levels. Seasonally adjusted data indicate that non-farm employment continues to recover. Weak foreign demand continued to restrain industrial employment, while non-farm employment returned to pre-crisis levels owing to the recovery in construction and services sectors. Nevertheless, the Committee expects unemployment to remain well above pre-crisis levels for a long period, and therefore unit labor costs are not expected to face any significant upside pressures.

Risks and Monetary Policy

14. In light of above assessments, the Committee has indicated that the economic recovery is ongoing. The lagged effects of monetary easing on domestic demand have become more pronounced, while the weak outlook for global growth has continued to dampen resource utilization in the tradable sector. On balance, the Committee continues to expect the economic recovery to be gradual.

15. The Committee indicated that inflation would hover significantly above the target for sometime 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 an increase in headline and core inflation rates during March and April, and a decrease during June, July and October of 2010.

16. Inflation is expected to drop significantly in the last quarter of 2010 and the first quarter of 2011. The fall in the last quarter of 2010 reflects the base effect driven by the indirect tax hikes and the sharp increase in food prices in the last quarter of 2009. Similarly, the impact of the tax hikes, which added around 1.9 percentage points to headline inflation in the first two months of 2010, would disappear during the first quarter of 2011. Accordingly, the Committee stated that inflation would revert back to a downward trend as the temporary factors taper off starting in the last quarter of the year, and converge to levels consistent with the targets by early 2011.

17. The Committee has underscored that elevated levels of inflation, albeit temporary, warrants close monitoring of price setting behavior. Several adverse factors (such as unprocessed food and oil price increases, base effects and administered price hikes) have led to a significant increase in inflation since the last quarter of 2009. Although these factors are temporary, they cause headline inflation to stay at elevated levels for sometime, leading to an adverse impact on inflation expectations. Currently the pricing behavior, excluding items that are directly affected by cost push effects, does not reveal a deterioration that might endanger the achievement of medium term targets. However, the Committee underscored that the CBT will not hesitate to take the necessary measures, should inflation expectations continue to rise and lead to a deterioration in general price setting behavior.

18. Although downside risks on global economic activity have been decreasing, they have not disappeared completely. Rising budget deficits and ongoing problems in credit, real estate and labor markets across developed economies continue to pose downside risks for the recovery in global activity. The Committee stated that, should the global conditions deteriorate again, and consequently delay the domestic recovery, the policy rates would be kept constant for an extended period.

19. The Committee indicated that uncertainties regarding the lagged effects of the strong monetary stimulus have been leading to upside risks on both domestic and global economic activity. According to the Committee members, the recovery in domestic demand has been relatively robust. Therefore, a faster-than-envisaged recovery in external demand would lead to a rapid narrowing in the resource utilization gap, which, coupled with cost push pressures, could delay the attainment of medium term inflation targets. In this respect, it was stated that necessary measures would be taken to ensure the alignment of

medium term inflation with the targets, should the recovery in economic activity turn out to be faster than expected.

20. Prospects regarding the pace of growth in developing economies, especially in China and India, have been posing upside risks regarding commodity prices. Increasing share of these economies in total world demand has been creating additional pressures on commodity prices. If commodity prices rise faster than expected in the forthcoming period and delay the disinflation, then the Committee will implement the policies required to eliminate the risks related to price setting behavior.

21. The Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. Since the second half of 2009, economic activity has been stronger than envisaged in the Medium Term Program (MTP), leading to a better than expected performance in budget revenues. Using this fiscal space mostly to reduce the government debt, as implied by the fiscal rule, would facilitate the demand management and ease the need for indirect tax hikes, therefore providing more room to conduct countercyclical monetary policy. In this respect, the Committee believes that, should the goals set out in the Medium Term Program be implemented through institutional and structural progress, such as enacting and establishing the fiscal rule, it would be possible to keep policy rates at single digit levels over the medium term.

22. In light of these assessments, and considering the normalization in the money and credit markets, the Committee has decided to gradually remove the liquidity measures implemented during the crisis. In this context, the Committee members fully agreed that publishing a comprehensive technical note regarding the exit strategy, the day after the meeting, would enhance predictability of the monetary policy. However, despite recent improvements, lingering problems across the global economy are not resolved completely. Accordingly, the Committee has stated that it may be necessary to maintain policy rates at current levels for sometime, and to keep them at low levels for a long period.

23. 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.