No: 2010 – 42

28 December 2010

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: December 16, 2010

Inflation Developments

1. In November, consumer prices were up 0.03 percent, while annual inflation was down 1.33 percentage points to 7.29 percent largely owing to the downward correction in unprocessed food prices, as stated in the summary of the November Monetary Policy Committee (the Committee) Meeting. Meanwhile, prices of core goods and services remained favorable.

2. Annual inflation in food and nonalcoholic beverages decreased by 4.7 percentage points to 12.39 percent in November. Thus, the contribution of food prices to annual inflation slowed to 3.41 percentage points. After soaring dramatically over the past three months, unprocessed food prices slumped in November amid falling vegetable prices. Leading indicators suggest that this downtrend would continue into December.

3. Processed food prices continued to rise in November. Processed meat prices rose further due to the lagged effects of previous increases in unprocessed meat prices. Prices of bread and cereals remained on an upward trend amid rising wheat prices. Prices of other processed food items, especially solid and liquid fats, were also on the rise in November.

4. Fuel prices continue to rise amid higher international oil prices. Yet, the annual rate of increase in energy prices continued to fall in November on the back of base effects. Prices of alcoholic beverages increased by 16.2 percent due to the special consumption tax hike, but this increase made only a limited contribution to consumer inflation.

5. Core goods and services inflation remained muted, as expected. Annual services inflation increased slightly due to higher prices of transport services, while the annual rate of increase in services other than catering and transport continued to hover around all-time lows. Annual inflation in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) slowed further to 1.04 percent. Accordingly, despite a slight increase, core inflation indicators remained on track with medium-term targets.

6. With the additional support of falling unprocessed food prices, the Committee expects inflation to decline in the forthcoming period. Meanwhile, core inflation indicators are expected to increase slightly, but remain below medium-term targets.

Factors Affecting Inflation

7. Recent releases regarding economic activity have been consistent with the outlook presented in the October Inflation Report. Gross Domestic Product (GDP) grew by 5.5 percent year-on-year in the third quarter. The pace of economic recovery slowed in the third quarter due to the lagged effects of the distress in European economies ongoing since May, and consequently, GDP increased by 1.1 percent quarter-on-quarter. This slowdown was largely driven by the negative contribution of exports of goods and services to quarterly GDP growth, while domestic demand continued to grow rapidly.

8. Economic activity continues to recover amid strong domestic demand. Industrial production grew by a dramatic 3.1 percent month-on-month in October in seasonally adjusted terms and remained significantly above the average of the previous quarter. November's capacity utilization rate and expectations for new orders suggest that production has recovered at a faster pace than in the third quarter. This outlook is recently supported by both the sharp increases in domestic sales of automobiles and commercial vehicles and the improvement in investment and consumer confidence indices. These developments confirm the Committee's expectation of a renewed acceleration in economic activity for the final quarter of 2010.

9. Foreign demand remains weak. Although exports of goods were higher than the third-quarter average during October and November, indicators for new orders show no sign of a strong recovery in the short term. Weak foreign demand continues to suppress particularly industrial production. Therefore, the Committee expects that it would take a long time before industrial capacity utilization rates return to their pre-crisis levels.

10. Employment conditions continue to improve, yet unemployment rates remain at high levels. Committee members have noted that labor market developments are in line with the temporary slowdown in production during the third quarter, and expect that employment growth would resume by the end of the year amid the ongoing economic recovery. In fact, after the third-quarter drop, non-farm employment was back on the rise in September, albeit modestly. 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

11. The primary objective of the Central Bank of Turkey (CBT) is to achieve and maintain price stability. At the same time, financial stability is one of the fundamental duties of the CBT. However, unlike other regulatory and supervisory institutions, the CBT approaches financial stability from a macroeconomic perspective.

12. From a macro perspective, financial stability risks under the current conditions are most evident as the rapidly increasing current account deficit fueled by short-term capital inflows. The divergence between domestic and foreign demand growth coupled with a rapid credit expansion is increasing the current account deficit, thereby raising financial stability concerns. Moreover, the recent developments and related policy decisions in the European and US economies have been exacerbating these risks, necessitating a revision in the domestic policy mix.

13. The contribution of credit expansion to the current account deficit deserves particular attention in an environment of weak external demand. Therefore, the Committee members have underscored that one of the goals of the current policy mix should be reducing the pace of credit growth. To this end, it was stated that reserve requirement ratios should be used as an active monetary policy tool. At the same time, the rapid pace of credit expansion also brings attention to the maturity mismatches between the assets and liabilities of the banking system. Accordingly, gearing the policy mix towards extending the maturities of the banking system liabilities would also help with regard to macroprudential risks. In this respect, the Committee has suggested that it would be useful to differentiate reserve requirement ratios for different TL deposit maturities in order to encourage longer-term funding, to raise reserve requirement ratios especially for short-term liabilities, and to widen the scope of reserve requirements.

14. Another issue which should be taken account while formulating current policy mix is fostering the maturity extension of capital inflows. This is important for improving the quality of the capital account and avoiding exchange rate movements detached from economic fundamentals. Against this backdrop, the Committee has come to the conclusion that it would be an appropriate policy mix to lower the policy rate and to widen the corridor between overnight borrowing and lending rates so as to allow fluctuations in the short-term interest rates, when needed.

15. The Committee underscored that price stability should be the overriding concern while designing the policy measures against the current account

deficit. Although inflation is expected to be close to the end-2010 target, the Committee members have highlighted that the sharp increases in agricultural commodity prices such as cotton and wheat pose risks for the inflation outlook. The existing output gap has been limiting the pass-through from agricultural commodity prices to the prices of core goods and services. However, the Committee, highlighting the rapid pace of domestic demand, has stated that the impact of commodity prices on general price setting behavior should be closely monitored. Accordingly, the Committee members have agreed that the net impact of the macroprudential policy package implemented—and to be implemented—both by the CBT and other institutions should be on the tightening side.

16. In light of these assessments, as an outcome of the meeting, the Committee has stated that a lower policy rate, a wider interest rate corridor, combined with higher required reserve ratios would serve as a more effective policy mix, both for price stability and financial stability.

17. The Committee assessed that the net impact of these measures on the monetary conditions would not be expansionary. In particular, higher effective required reserve ratios are anticipated to curb the credit growth through the cost and liquidity channels starting from January 2011. The effects of today's decisions on both price and financial stability will be monitored closely and additional measures will be implemented if necessary. The composition and the direction of the policy instruments in the forthcoming period may vary depending on the factors affecting price stability and financial stability.

18. The policies implemented by the CBT should be assessed as an entire package. The monetary policy stance is not only determined by the level of the policy rates, but as a mixture of all the policy instruments mentioned above. Therefore, the net impact of the combination of the policy measures should be taken into account while assessing the inflation outlook.

19. The measures implemented by the CBT are necessary but not alone sufficient to safeguard financial stability under current conditions. Coordination across all institutions responsible for regulation, supervision and counterbalancing is therefore crucial. The support of other institutions especially regarding the tightening of credit supply and encouraging maturity extensions would increase the flexibility and effectiveness of monetary policy.

20. Increasing government savings—and therefore maintaining fiscal discipline—-is also essential for containing the risks regarding current account deficit. Controlling the budget expenditures during 2010 as envisaged in the Medium Term Program (MTP) is a major step towards this direction. Maintaining the fiscal discipline in the period ahead would enhance the impact of the measures taken for both price and financial stability.

21. Monetary policy will continue to focus on price stability in the period ahead. To this end, the impact of the measures taken by the CBT and other 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. 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.