

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: January 20, 2011

Inflation Developments

1. In December, consumer prices decreased by 0.30 percent, and annual inflation fell to 6.40 percent. Thus, the annual inflation rate was quite close to the end-2010 target of 6.5 percent. Unprocessed food prices continued to fall, while the inflation in services and core goods rose slightly, yet remained in line with medium-term targets. Headline inflation would continue to decelerate in coming months, mainly due to base effects, whereas the annual rate of increase in core indicators is expected to increase, albeit modestly.
2. Unprocessed food prices continued to fall with a December outturn of 5.79 percent. Prices of fresh fruits and vegetables as well as red meat decreased. As stated in the October Inflation Report, fruit and vegetable production forecasts for 2010 suggested that fruit and vegetable prices were rising only temporarily and would see a correction in the final quarter. Indeed, increases in fruit and vegetable prices were followed by larger-than-expected decreases during the fourth quarter, bringing the annual unprocessed food inflation down from 31.28 percent in October to 8.52 percent at year-end.
3. Regarding processed food, processed meat prices declined while prices of bread and cereals and solid and liquid fats increased on rising international food prices. Thus, after soaring at an unprecedented rate amid higher unprocessed food prices during the third quarter, the annual inflation in food and nonalcoholic beverages slowed to 7.02 percent, bringing the group's contribution to annual inflation down to 1.94 percentage points at year-end from as high as 4.67 percentage points over 2010.
4. Energy prices rose by 2.73 percent in December amid higher fuel and bottled gas prices driven by rising international oil prices and exchange rate developments. Moreover, water tariffs went up in a number of cities. Therefore, after slowing in the second half of 2010, the annual energy inflation increased to 9.96 percent in December.
5. The services inflation rate registered an all-time year-end low of 4.24 percent. Although services inflation rose slightly in December due to higher

communication prices, inflation was down in rents, hotels, restaurants and transport services. The annual inflation in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) rose to 1.70 percent owing to December's lower-than-average seasonal discounts on clothing and footwear. Overall, the annual rate of increase in core inflation indicators was slightly faster in December but remained in line with medium-term targets.

Factors Affecting Inflation

6. Recent releases have been consistent with the outlook presented in the October Inflation Report. Despite falling month-on-month in November, industrial production was significantly higher than the third-quarter average during October-November owing to sharp increases in October. Leading indicators suggest that November's production loss would be offset in December. In fact, the fourth-quarter capacity utilization rates and expectations for new orders point to a faster production growth than in the third quarter. These developments confirm the Committee's expectation of a renewed acceleration in economic activity for the final quarter of 2010.
7. Economic activity continues to recover amid strong domestic demand. The production and imports of consumer goods were higher during October-November than the third-quarter average. The fourth-quarter improvement in survey indicators, sales data and consumer confidence points to an ongoing recovery in private consumption demand. Yet, the Committee expects the recent policy measures to restrain the pace of recovery in loans and domestic demand over the upcoming period.
8. The production and imports of investment goods, particularly those related to motor vehicles, increased significantly during October-November compared to the third-quarter average. Indicators for the last quarter suggest that private investments would accelerate quarter-on-quarter and continue to rise sharply year-on-year. The Committee expects the robust growth in investments to continue into coming months amid supportive monetary conditions and reduced demand uncertainty. Indeed, both the gradual rise in capacity utilization rates and the manufacturing industry investments recently hitting a four-year high support this observation. However, Committee members have noted that foreign demand uncertainties would continue to slow the pace of recovery in investments, particularly in the manufacturing industry.
9. Uncertainties remain about foreign demand. Although the export quantity index excluding gold increased quarter-on-quarter during October-November after declining in the third quarter, leading indicators for exports and new orders show no sign of a strong recovery in the short term. In fact, exports

have grown at quite a weaker and more volatile pace than domestic demand during the recovery. Having noted that industrial capacity utilization rates remain below their pre-crisis levels due to weak foreign demand, the Committee expects this slowdown to continue for a while in view of the prospects of a weak global economic recovery.

10. Although employment conditions continue to improve, unemployment rates remain at high levels. Non-farm employment increased during September-November in seasonally adjusted terms. Leading indicators point to an acceleration in December's non-farm employment growth, confirming the Committee's expectation that the third-quarter pause was temporary and employment growth would resume by the end of the year. Nevertheless, the Committee has reiterated that unemployment rates would remain higher than pre-crisis levels for some time, containing unit labor costs.
11. Against this backdrop, the Committee has stated that aggregate demand conditions do not exert upside pressures on inflation.

Monetary Policy and Risks

12. According to the Committee members, the impact of the measures taken in December to contain credit supply will be seen in the forthcoming days. It was indicated that additional restrictive measures on credit expansion, to be taken until the next meeting, would provide more room for monetary policy. In this respect, the Committee stated that additional hikes in required reserve ratios for short term liabilities would be necessary.
13. Since the launch of inflation targeting in 2006, the Committee has announced its medium-term inflation forecasts and provided a qualitative perspective regarding the outlook for policy rates. The current economic climate requires the monetary policy to consider financial stability along with price stability, requiring the Committee to utilize a broader set of monetary policy instruments including policy rates, reserve requirement ratios, and liquidity management facilities. Therefore, the Committee has indicated that lower policy rate coupled with higher reserve requirement ratios is the optimal policy mix under current conditions, in terms of upholding both financial stability and price stability. In this respect, it was decided that the policy rate would be reduced by 25 basis points.
14. Given the mounting uncertainties concerning the global economic outlook, flexibility regarding each instrument within the policy mix would be needed. Therefore, the Committee agreed that the Inflation Report will provide forecasts for the net effect of the policy mix rather than the direction of each policy instrument, and will not outline an explicit path regarding the individual elements of the policy mix.

15. The Committee evaluated the forecasts to be presented in the January Inflation Report. Inflation is expected to decline significantly in January and remain below the end-year target of 5.5 percent in the first quarter, before displaying a volatile path starting with the second quarter. Assuming that a limited monetary tightening brings credit growth rate down to 20-25 percent in 2011, the revised forecasts indicate that inflation would be close to the target by the end of 2011. The Committee noted that the envisaged monetary tightening in 2011 may be executed through various combinations of different policy tools. It was underscored that the monetary tightening could be implemented by either required reserve ratios or policy rates, or a combination of both. Moreover, it was stated that during the tightening process, both instruments could move in either the same or in opposite directions. On the other hand, the Committee also emphasized that the net impact of the measures taken—and to be taken in the future—within the new policy framework, will be restrictive.
16. The baseline scenario of the January Inflation Report envisages a gradual tightening by changing the mix of the policy rate and reserve requirement ratios. Such a tightening should not only aim at slowing down credit growth and domestic demand, but also reduce macroprudential concerns. The impact of the monetary tightening on the credit growth is expected to be apparent over the near term. However, the time lag and the extent of the impact of the policy measures may vary depending on the developments beyond the control of monetary policy. Therefore, the Committee will closely monitor the effects of the policy measures and take further actions should the credit growth rate or the inflation rate deviate from the desired levels.
17. Developments regarding the global economy remain central for the domestic inflation and monetary policy outlook. Under current conditions, the Committee is utilizing several instruments in order to preserve both price stability and financial stability. Therefore, global developments would not only affect the direction of the policy instruments, but also their mix. Accordingly, global developments will be assessed against their effects on the aggregate demand as well as its composition.
18. Although there has been some improvement regarding the expectations on the US economy, uncertainties driven by debt sustainability problems across euro area peripheral economies still persist. Ongoing problems in credit, real estate, and labor markets across developed economies and the uncertainties regarding the impact of fiscal consolidations continue to pose downside risks regarding the pace of global growth. The possibility of a longer-than-anticipated period of anemic global growth and a long period of quantitative easing by developed economies not only creates downside risks regarding external demand but also suggests that capital inflows may continue at a

faster pace. Should such a scenario materialize, a policy mix of low policy rate and high reserve requirement ratios may be implemented for a long period, both for balancing the domestic and external demand and for macroprudential purposes. Moreover, an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity may require an easing in all policy instruments.

19. Although downside risks are important, there are also upside risks regarding global economy, particularly driven by the lagged impacts of the exceptionally loose monetary policies implemented by the developed economies during the past two years. If the global economy faces a faster-than-expected recovery, global inflation may increase and thus trigger a tightening in the monetary policies of developed economies. Materialization of such a scenario would mean higher global interest rates and demand-driven domestic inflation, and thus necessitate a tightening by using both policy rates and reserve requirements.

20. Oil and other commodity prices have displayed rapid increases in the recent period. The increases in commodity prices, if they persist, exert risks regarding general pricing behavior, given the strong pace of domestic demand. Should such a risk materialize and hamper the attainment of the medium-term inflation targets, there may be stronger tightening than envisaged in the baseline scenario. However, the policy mix may vary depending on the developments regarding external demand, capital flows, and the outlook for credit growth.

21. The Committee continues to monitor fiscal policy developments closely while formulating monetary policy. Increasing government saving under current circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. Our inflation forecasts take the fiscal projections of the Medium Term Program (MTP) as given. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on inflation outlook.

22. 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 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.