

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: April 21, 2011

Inflation Developments

1. In March, consumer prices increased by 0.42 percent, while annual inflation fell to 3.99 percent. As anticipated in the Summary of Monetary Policy Committee (the Committee) meeting, annual inflation continued to rise in core goods. However, service inflation went down on base effects. Thus, the annual rate of increase in core inflation indicators remained flat month-on-month.
2. Annual unprocessed food inflation declined to 0.56 percent. Processed food prices continued to trend upward in March. As stated in the summary of the March meeting, the temporary lifting of customs duties on wheat imports helped restrain the monthly price hike in bread and cereals, but rising prices of fats and oils brought annual processed food inflation up to 6.39 percent. As a result, annual food inflation ended the first quarter at 3.47 percent. The Committee has noted that annual unprocessed food inflation is likely to increase in the second quarter due to base effects.
3. Rising international oil prices and exchange rate developments continued to put upward pressure on fuel prices in March. Thus, annual energy inflation rose to 7.02 percent. Other energy items are also expected to reflect the cumulative increases in oil prices over the upcoming period.
4. Prices of services increased by 0.40 percent, while annual services inflation dropped to an all-time low of 3.57 percent. The annual rate of increase in restaurants and hotels decreased amid favorable food prices, whereas transport prices continued to rise due to higher fuel prices. Meanwhile, the base effects from communication services may lead to a significant increase in April's annual services inflation.
5. Annual core goods inflation (excluding food, energy, alcoholic beverages, tobacco and gold) continued to rise. The annual rate of increase in clothing prices was slightly up, whereas the annual inflation in other core goods, primarily durable goods, increased rapidly due to rising import prices and the ongoing effects of the depreciating Turkish lira. The raised customs duties on fabric and apparel imports are expected to affect prices of core goods in the second half of 2011.

6. Overall, inflation is expected to increase in the short term due to the lagged effects of rising oil prices and base effects and remain volatile throughout the year.

Factors Affecting Inflation

7. Recent releases suggest that the economic activity is moderating after a strong print in the last quarter of 2010. Indeed, industrial production, capacity utilization and other leading data indicate a slowdown on a quarterly basis. In addition, expectations for the 3-month ahead orders signal that economic activity would continue to grow moderately in the second quarter.
8. Domestic demand remains strong. The production and imports of consumption and investment goods were higher during January-February than the fourth-quarter averages. The ongoing surge in consumer confidence and credit use does not point to a marked slowdown in the first quarter's private consumption spending. Moreover, the investment sentiment for the next 12 months has stabilized at high levels. In light of these data, the Committee has stated that domestic demand remained strong over the first quarter.
9. Imports continue to increase with strong domestic demand. The Committee has indicated that rising oil prices may mask the slowdown in imports, and thus non-energy imports would be a more informative indicator in assessing the impact of the recent policy measures. In this context, the Committee has noted that there was no significant slowdown in the first-quarter's non-energy imports, and reiterated that the restrictive effects of the policy measures on loans and imports would be observed with a lag.
10. External demand displays a weaker pace. The January-February export (excluding gold) quantity index was moderately higher than the fourth-quarter average, while the flat course of the expectations on the 3-month-ahead orders indicates that external demand conditions are unlikely to recover strongly over the short term. The fact that euro area (Turkey's largest trading partner) output is still below pre-crisis levels suggests a similar outlook. Highlighting the ongoing fragility across advanced economies, the Committee has reiterated that the exports would recover slowly and gradually.
11. Employment conditions continue to improve, though, unemployment rates remain higher than pre-crisis levels. While the recovery in non-farm employment continues, leading indicators for investment and employment show that this trend would be maintained over the coming months. Nevertheless, the Committee has maintained the view that unemployment rates would remain higher than pre-crisis levels for a while, containing the unit labor costs.

Monetary Policy and Risks

12. The Committee has assessed the forecasts prepared for the Inflation Report. The data for the first quarter of 2011 indicate that the economic activity, driven by the domestic demand, is more robust than expected. Accordingly, the Committee members have indicated that the revised forecasts would be based on the assumption that aggregate demand conditions provide less support for disinflation compared to the previous period. On the other hand, it was stated that capacity utilization rates are still below pre-crisis levels and unemployment rates are above pre-crisis levels, and thus the output gap is not closed as of the first quarter of 2011. However, owing to the lagged impact of rising oil prices as well as base effects, inflation is expected to display an increasing trend over the short term and, after hovering around the target throughout the year, it is expected to end the year somewhat above the target of 5.5 percent.
13. The Committee has indicated that the above-target forecast for end-2011 inflation can be completely attributed to developments beyond the control of monetary policy. Accordingly, it was stated that Central Bank of Turkey (CBT) will not react to the first round effects of the increases in oil and other commodity prices. However, it was underscored that second round effects will be closely monitored and a deterioration in the pricing behavior will not be tolerated.
14. The effects of the measures taken by the CBT since November on credit volume and domestic demand are expected to be more visible starting with the second quarter. However, the Committee has indicated that raising reserve requirements on short term foreign exchange and Turkish lira liabilities would contribute to containing macro financial risks by rebalancing the external and domestic demand. In light of these assessments, in order to contain the risks towards price stability and financial stability, the Committee has decided to monitor the tightening impact of the implemented policy mix—a low policy rate, a wide interest corridor and high reserve requirement ratios—and take additional measures along the same lines, if needed.
15. In assessing risk factors and related monetary policy measures, current framework takes both price stability and financial stability into account. Therefore, risk factors are not only assessed with respect to their impact on the level but also on the composition (external versus domestic demand) of the aggregate demand. The level of the aggregate demand is related to price stability, while its composition refers directly to financial stability. Risk factors regarding global economy are also evaluated against this backdrop.
16. Although downside risks regarding global economy have decreased compared to the previous quarter, they are still significant. Problems in credit, real estate

and labor markets in many advanced economies are yet to be solved. Moreover, uncertainties regarding debt sustainability issues and the impact of fiscal consolidations persist. On the other hand, rapid increases in oil prices may restrain the global recovery. All these factors continue to pose downside risks regarding the pace of global growth. The possibility of a longer-than-anticipated period of slow global growth not only creates downside risks regarding external demand, but also suggests that short term capital inflows may remain strong. Should such a scenario materialize, a policy mix of low policy rate, high reserve requirement ratios and wide interest rate corridor may be implemented for a long period. 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.

17. Although downside risks remain notable, upside risks regarding global economy are becoming more significant, particularly driven by the lagged impacts of the exceptionally loose monetary policies implemented by the developed economies. If the global economy faces a faster-than-expected recovery, global inflationary pressures may arise sooner than envisaged. Materialization of such a scenario would mean higher policy rates at a global scale and demand-driven domestic inflation, and thus necessitates a tightening by using both policy rates and reserve requirements.
18. The outlook for oil and other commodity prices remains uncertain. Should the increases in commodity prices persist and exert risks regarding the general pricing behavior, the additional tightening may be implemented sooner than implied by the baseline scenario presented in the Inflation Report. However, given that higher oil prices will also worsen the current account balance, a possible policy response will consider macro-financial risks as well. Therefore, the exact content of the policy mix may vary depending on the outlook for external demand, capital flows, and the credit growth.
19. The CBT will continue to monitor fiscal policy developments closely while formulating monetary policy. Our inflation forecasts in the baseline scenario of the Inflation Report assume that the ratio of fiscal expenditures to the GDP will evolve as projected in the Medium Term Program (MTP). 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 medium-term inflation outlook. Increasing government saving—thus sustaining fiscal discipline—under current circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. Therefore saving the extra tax revenues driven by the stronger than expected economic activity would not only reduce financial stability risks, but also increase the efficiency of the new policy mix.

20. 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 CBT and other institutions on the inflation outlook will be assessed carefully. Strengthening the commitment to fiscal discipline and the structural reform agenda in the medium term 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.