1. Overview

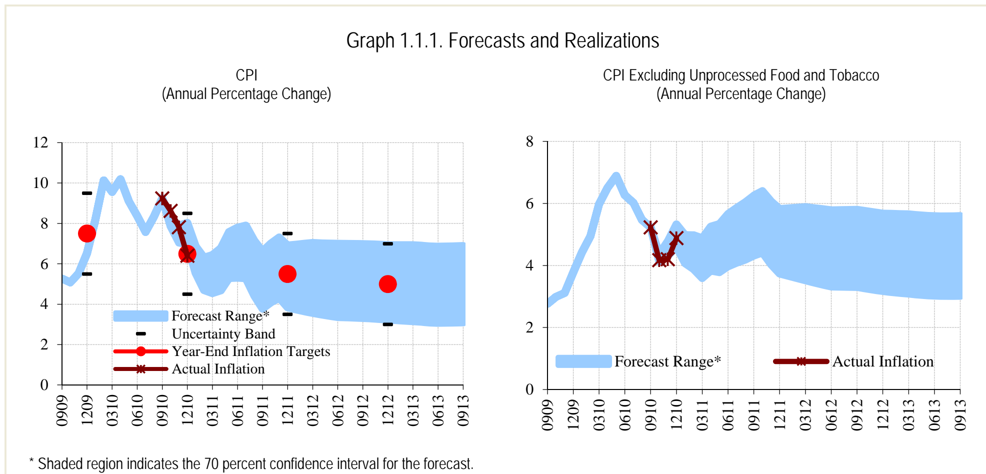
The global economy continued to recover gradually in the final quarter, while downside risks in advanced economies remained a major concern. The balance-sheet repair of financial institutions, firms, and households in advanced economies are still continuing, thereby limiting the support of private consumption and investment to the recovery of the economic activity. On the other hand, the relatively less affected emerging economies are recovering steadily amid robust domestic demand.

The growth discrepancy between advanced and emerging economies and its implications for the Turkish economy were the key driver behind the Central Bank of the Republic of Turkey's (CBRT) monetary policy stance in the fourth quarter. Exceptionally loose monetary policies adopted by advanced economies in order to eliminate downside risks to economic activity not only boosted the global liquidity, but also stimulated the search for yield, attracting more capital flows into emerging economies. Meanwhile, the weak recovery in advanced economies, Turkey’s main export destination, dampened external demand growth. Low interest rates across the globe, strong credit growth amid increased short-term capital inflows, soaring imports and weak external demand caused the current account deficit to widen rapidly in 2010. All of these developments referred to as the “new normal” prompted CBRT to adopt a new strategy that encompasses monitoring of the financial stability in addition to the main objective of maintaining price stability. Accordingly, by diversifying its set of policy instruments, the CBRT, as stated in the previous reports, has started to actively use required reserves and liquidity management tools, in addition to 1-week repo auction rate, its main policy instrument.

1.1. Inflation Developments

The October 2010 Inflation Report indicated that the increases in unprocessed food and tobacco prices, which are beyond the control of the CBRT, added about 5 percentage points to the annual inflation, and suggested that these items would leave sizeable room for disinflation. Indeed, inflation dropped by 2.83 percentage points, registering a rate of 6.4 percent and almost reaching the year-end inflation target. As predicted in the previous Report, the decline in inflation was due to the sharp drop in unprocessed food prices. Accordingly, the annual rate of increase in food prices was 7.02 percent at the

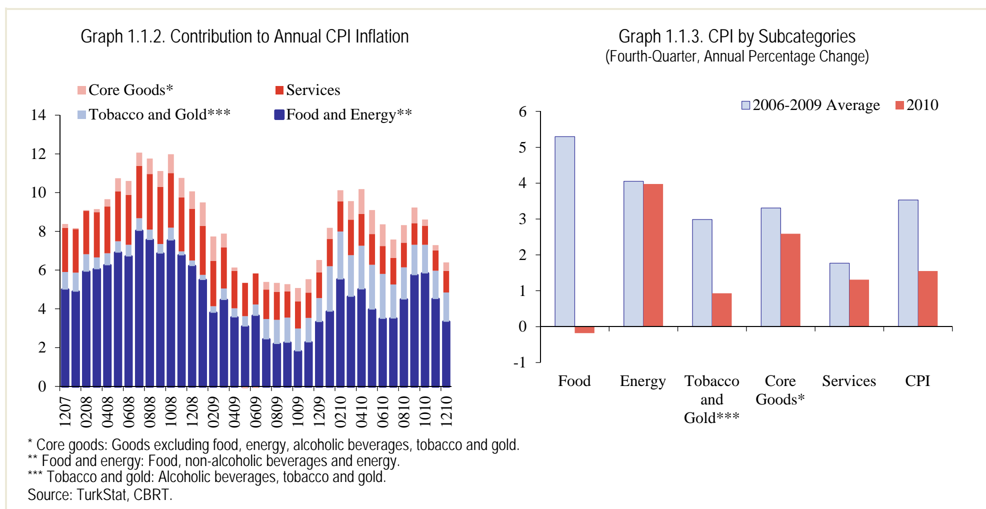
end of 2010, undershooting the October estimate of 10.5 percent. This explains the nearly one percentage point deviation in short-term inflation forecasts. In fact, inflation excluding unprocessed food and tobacco remained in line with the outlook presented in the October Inflation Report (Graph 1.1.1).



Graph 1.1.1. Forecasts and Realizations

* Shaded region indicates the 70 percent confidence interval for the forecast.

Having increased as much as 4.67 percentage points over the year, the contribution of food prices to annual inflation declined to 1.94 percentage points at the end of the year (Graph 1.1.2). Moreover, quarterly inflation across all goods and services items was below the average of previous years (Graph 1.1.3).



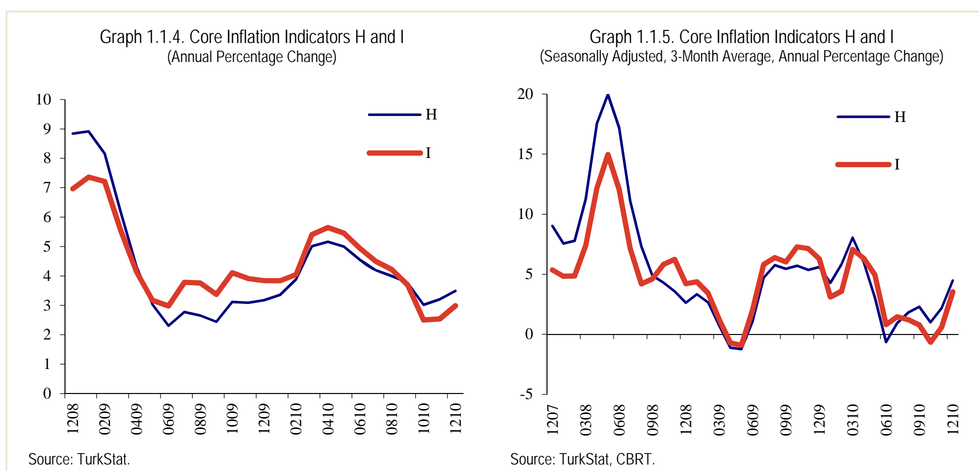
Graph 1.1.2. Contribution to Annual CPI Inflation

Graph 1.1.3. CPI by Subcategories
(Fourth-Quarter, Annual Percentage Change)

* Core goods: Goods excluding food, energy, alcoholic beverages, tobacco and gold.
** Food and energy: Food, non-alcoholic beverages and energy.
*** Tobacco and gold: Alcoholic beverages, tobacco and gold.
Source: TurkStat, CBRT.

The annual rate of increase in core inflation indicators slowed quarter-on-quarter during the fourth quarter (Graph 1.1.4). The base effects from the 2009 tax incentives on durable goods brought the annual rate of increase in these indicators down in October. However, the annual rate of change in core

indicators edged up again in November and December. Near-term trend in core inflation has also increased, but remained in line with medium-term targets (Graph 1.1.5). Core inflation indicators developed by the CBRT using alternative methods also indicate a similar underlying trend.



Graph 1.1.4. Core Inflation Indicators H and I
(Annual Percentage Change)

Source: TurkStat.

Graph 1.1.5. Core Inflation Indicators H and I
(Seasonally Adjusted, 3-Month Average, Annual Percentage Change)

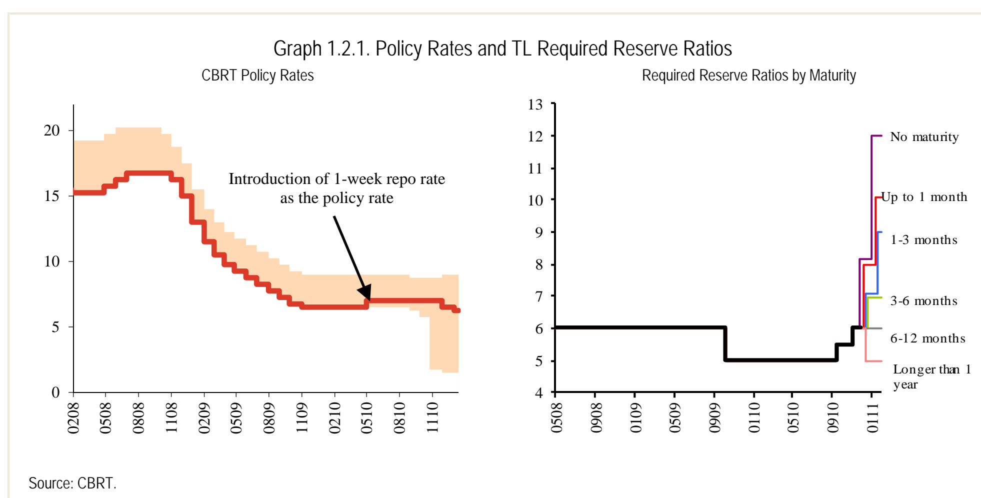
Source: TurkStat, CBRT.

1.2. Monetary Policy Developments

The second round of quantitative easing initiated in the last quarter of 2010 by some advanced economies and the consequent boost of capital inflows to emerging markets have required significant changes in CBRT's policy strategy. Short-term capital inflows have strengthened the divergence between domestic and external demand causing the current account deficit to widen rapidly, thus necessitating macroprudential measures. Core inflation indicators were in line with the medium-term inflation target leaving room for the monetary policy to focus on financial stability. Accordingly, the CBRT has adopted a policy mix, incorporating the active use of alternative instruments including liquidity management facilities and reserve requirements in addition to the short-term policy rates.

The new monetary policy strategy requires the use of multiple instruments in order to achieve domestic and external balances simultaneously. In this context, policy rates, liquidity management facilities, and reserve requirement ratios are used to attain price stability and financial stability. Hence, the Monetary Policy Committee (MPC) has stated that given the current economic climate, the combination of lower policy rates and higher reserve requirement ratios is the most appropriate policy mix in terms of jointly observing financial stability and price stability.

The MPC decided to reduce the 1-week repo auction rate, the policy rate, from 7 percent to 6.25 percent at December 2010 and January 2011 meetings (Graph 1.2.1). In addition to policy rate cuts, the CBRT overnight borrowing rate was reduced by 450 basis points to 1.5 percent. The corridor between the overnight borrowing and lending rates was widened to allow for more fluctuations in short-term interest rates when needed. All these decisions aim to encourage capital inflows from short-term to long-term as well as to prevent the Turkish lira to detach from economic fundamentals.



Graph 1.2.1. Policy Rates and TL Required Reserve Ratios

Source: CBRT.

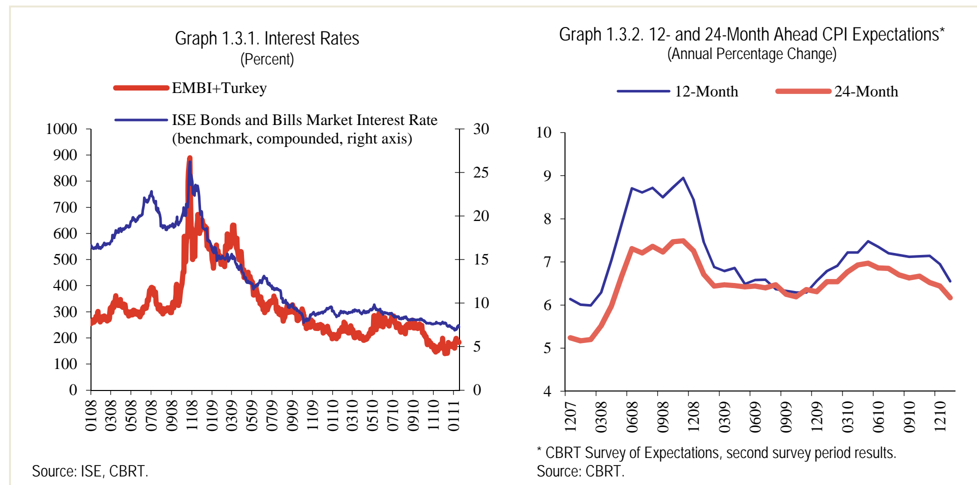
Another issue taken into consideration when formulating the new policy mix was to limit rapid credit growth, an important factor contributing to the widening of the current account. In this context, reserve requirement ratios were decided to be used as active policy instruments. During December and January, the weighted average of the reserve requirement ratios were raised markedly. Moreover, the reserve requirement ratios were allowed to vary by maturities, with lower ratios for longer-term maturities (Graph 6). These decisions aim at slowing credit growth as well as extending the maturity of the banking system's liabilities, thereby reducing maturity mismatches.

While formulating measures for current account deficit, the CBRT has emphasized that the primary objective is price stability. In this context, the MPC has highlighted that the impact of the measures that have been implemented—and are expected to be implemented—within the new policy framework, would result in a tighter stance. Put differently, the monetary tightening due to increase in the weighted average of reserve requirement ratios would more than offset the expansionary effects of the policy rate reductions.

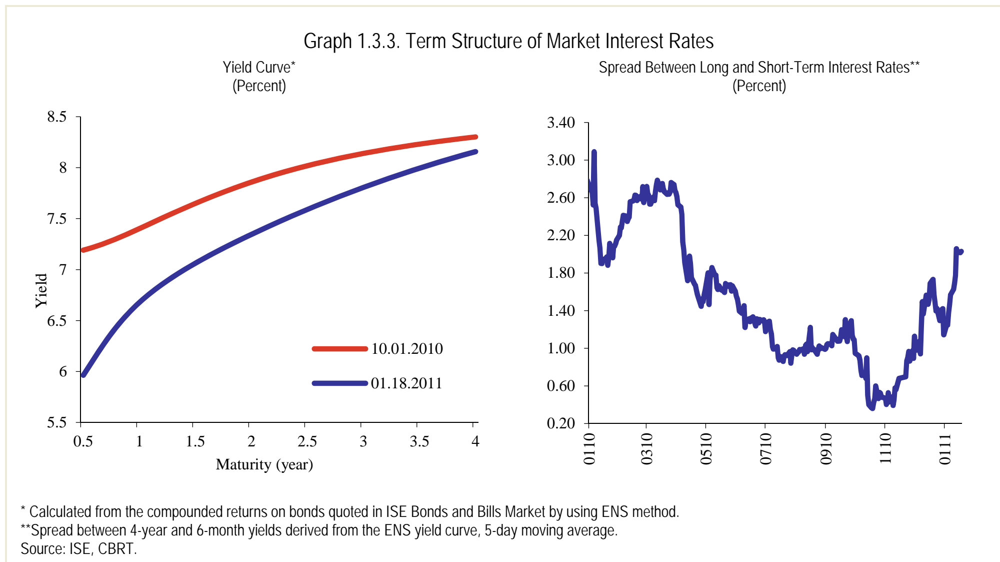
1.3. Inflation and Monetary Policy Outlook

Monetary and Financial Conditions

Despite the volatile global risk sentiment in the fourth quarter, the CBRT's rate cut decisions and the accompanying downward revisions to future policy rate expectations had a marked impact on market rates. In fact, the downward trend in market rates have been more pronounced since the CBRT's announcement in December that measured rate cuts may come about. Therefore, the benchmark bond rate continued to hover around historic lows (Graph 1.3.1). Moreover, the downtrend in inflation expectations has also contributed to the decline in market rates (Graph 1.3.2).



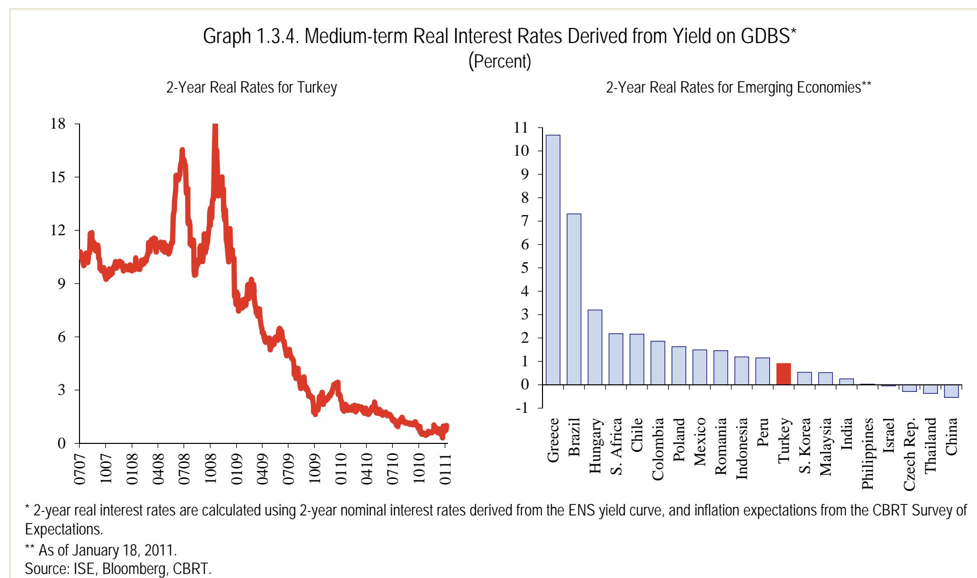
The decline in market interest rates was more pronounced for shorter maturities during the final quarter, resulting in a steeper yield curve relative to the previous quarter. The CBRT's rate cuts caused short-term market rates to fall quickly, while longer-term interest rates displayed only a modest decline due to the absence of a clear signal about the future course of policy rates. Yet, despite the volatile global risk appetite, long-term interest rates remained historically low and relatively stable, suggesting prospects for a prolonged low-interest-rate environment in Turkey (Graph 1.3.3).



Graph 1.3.3. Term Structure of Market Interest Rates

* Calculated from the compounded returns on bonds quoted in ISE Bonds and Bills Market by using ENS method.
**Spread between 4-year and 6-month yields derived from the ENS yield curve, 5-day moving average.
Source: ISE, CBRT.

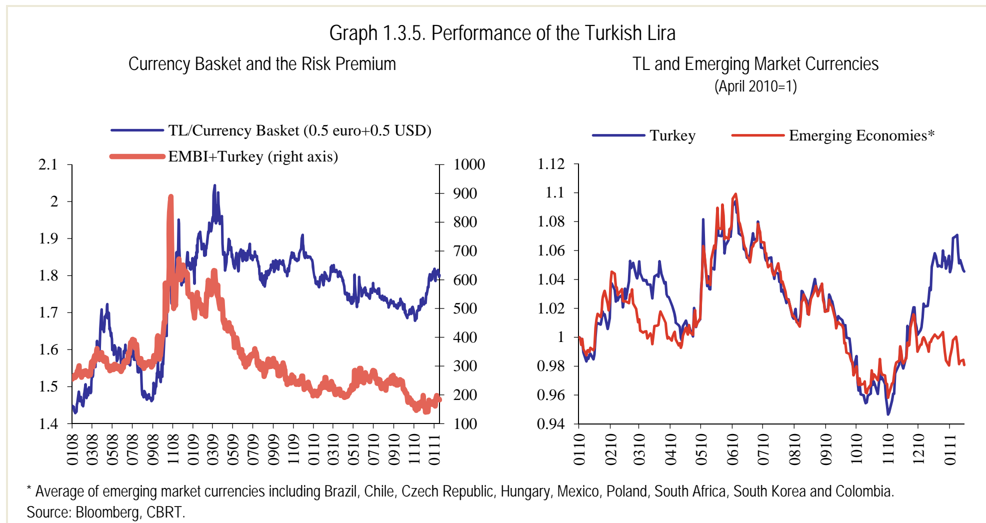
The decline in nominal market rates also affected real interest rates, as medium-term real interest rates continued to hover at unprecedented lows. Additionally, Turkey's real interest rates have hardly differed from those in many other emerging economies (Graph 1.3.4).



Graph 1.3.4. Medium-term Real Interest Rates Derived from Yield on GDBS*
(Percent)

* 2-year real interest rates are calculated using 2-year nominal interest rates derived from the ENS yield curve, and inflation expectations from the CBRT Survey of Expectations.
** As of January 18, 2011.
Source: ISE, Bloomberg, CBRT.

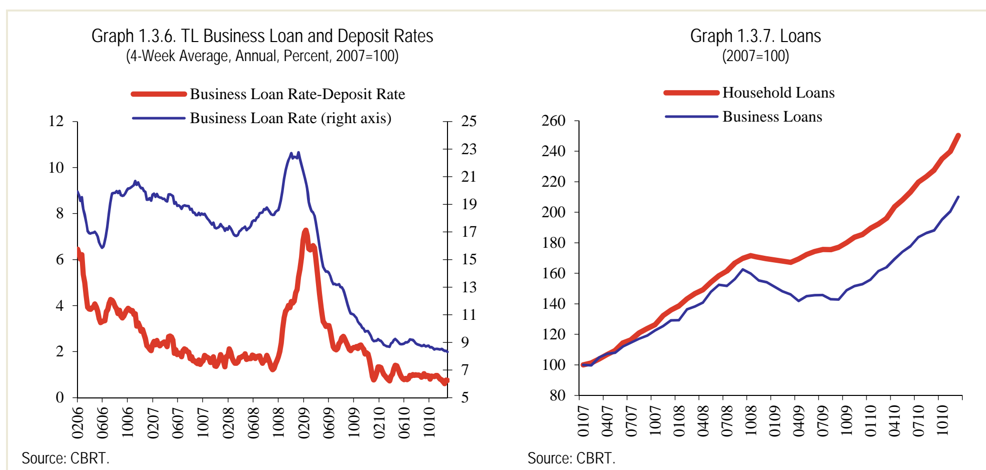
After having followed a similar trend prevailing across other emerging market currencies in the post-crisis period, the Turkish lira has recently taken a different path and experienced a relative depreciation. It is remarkable that this divergence started with the rate cut signal in December and has become more pronounced after the actual rate cuts (Graph 1.3.5).



Graph 1.3.5. Performance of the Turkish Lira

* Average of emerging market currencies including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, South Korea and Colombia.
Source: Bloomberg, CBRT.

Globally low interest rates, easy access to external funds and strong course of the economic activity continued to help improve credit conditions in the final quarter. As a result, the spread between loan rates and deposit rates remained at historically low levels (Graph 1.3.6). Rapid credit growth continued amid low loan rates and improved credit risk indicators (Graph 1.3.7). In the upcoming period, it is critical to closely monitor the course of loans and to continue to take necessary macroprudential measures.



Graph 1.3.6. TL Business Loan and Deposit Rates
(4-Week Average, Annual, Percent, 2007=100)
Source: CBRT.

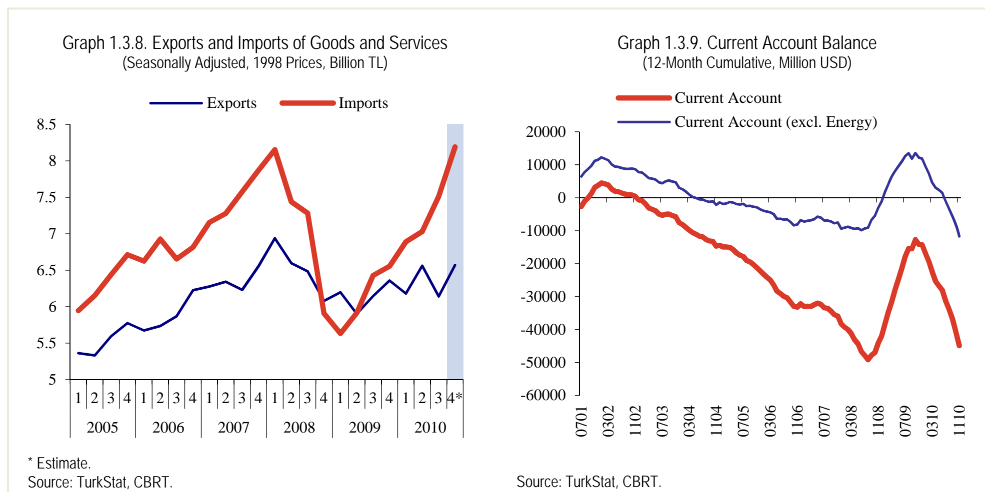
Graph 1.3.7. Loans
(2007=100)
Source: CBRT.

In sum, monetary and financial conditions remained supportive of the economic activity in the fourth quarter. Accordingly, the credit channel has maintained its expansionary effect on consumption and investment.

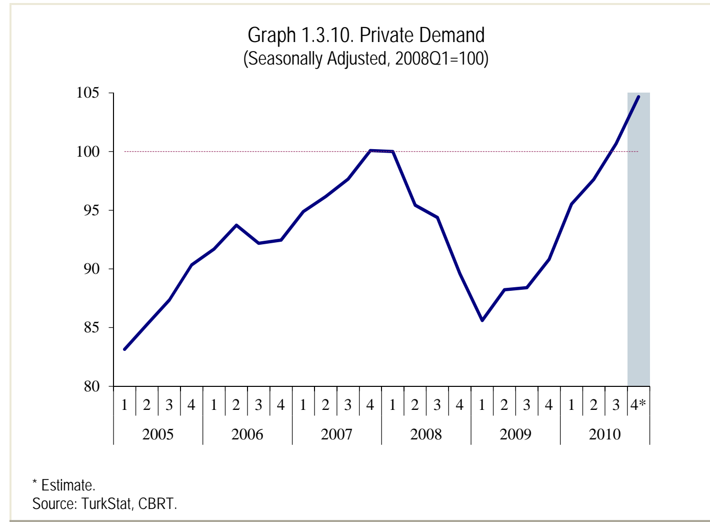
Aggregate Demand Outlook

Third-quarter national income data are consistent with the outlook presented in the October Inflation Report. Following the deepening sovereign debt crisis in European economies since May, the pace of growth slowed down in the third quarter. While domestic demand continued to recover steadily, external demand remained weak during this period. Thus, the divergence between domestic and external demand growth has become more pronounced (Graph 1.3.8).

Recent data releases indicate that the third-quarter slowdown in economic activity is temporary. Exports increased again in the final quarter, while the domestic demand for imported goods accelerated amid rapid credit growth and strong course of the Turkish lira. As a result, the current account deficit continued to widen (Graph 1.3.9).



The slow recovery in the global economy continues to restrain economic activity, whereas the strong domestic demand bolsters aggregate demand growth. Indeed, the rapid pace of growth in private consumption and investment spending that started in the fourth quarter of 2009 continued into the fourth quarter of 2010 (Graph 1.3.10).



Graph 1.3.10. Private Demand
(Seasonally Adjusted, 2008Q1=100)

* Estimate.
Source: TurkStat, CBRT.

Ongoing economic recovery fueled by the robust domestic demand has led to gradual improvement in employment conditions. Even though the rapid recovery in non-farm employment since the second quarter of 2009 has paused in the third quarter of 2010, this appears temporary as suggested by the leading indicators. However, due to high labor force participation rates, unemployment rates are expected to remain elevated relative to pre-crisis levels. Therefore, unit labor costs are unlikely to face cost pressures in coming months.

To sum up, monetary conditions continue to support domestic demand. Private demand recovered more rapidly amid increased consumption and investment spending, therefore aggregate demand conditions provided less support for disinflation than envisioned in the October Inflation Report. The recent policy measures are expected to bring domestic demand back to a more moderate growth path in the upcoming period. In light of these developments, our revised inflation forecasts envisage a framework in which domestic demand growth slows down gradually and external demand continues to recover, albeit slowly. This framework, when compared to the October Inflation Report, implies no significant difference in terms of the impact of aggregate demand conditions on the inflation outlook.

Fiscal Policy

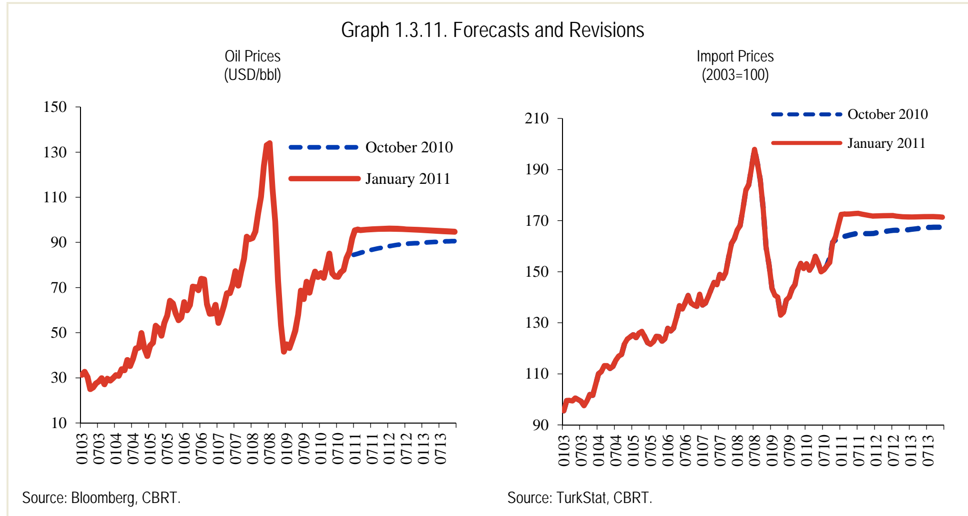
Our inflation forecasts are built on the projections of the Medium-Term Program (MTP) as in the October Inflation Report. The spending of a large fraction of the additional increases in tax revenues amid the stronger-than-

expected economic activity has been the primary driver of the slight upward revision to output gap forecasts. However, as the budget balance remained largely in line with the MTP targets, the medium-term fiscal policy outlook remained mainly unchanged. Hence, our forecasts are based on the assumption that the ratio of non-interest expenditures to GDP would decline gradually, debt-to-GDP ratio would decline further and the risk premium would remain broadly unchanged over the forecast horizon. Furthermore, we assume that tax adjustments would be consistent with inflation targets and automatic pricing mechanisms.

Revisions on Main Forecast Assumptions

The October Inflation Report envisaged food inflation to be 10.5 percent at end-2010, to fall gradually to 7 percent at end-2011 and to be stable afterwards. The sharp decline in unprocessed food inflation resulted in a lower-than-expected food inflation during the fourth quarter. However, the potential impact of the recent upsurge in agricultural commodity prices on processed food prices led to an upward revision in the food inflation assumption from 7 percent to 7.5 percent, adding 15 basis points to 2011 inflation forecasts.

In the October Inflation Report, oil prices were assumed to be 85 USD/barrel for 2011, and 90 USD/barrel for 2012 and beyond. Moreover, given futures prices for commodities, import prices were assumed to rise gradually over the forecast horizon, increasing by an average 6.1 percent year-on-year in 2011. Commodity prices have accelerated further since the release of the October Inflation Report due to the ongoing quantitative easing in advanced economies and the strong pace of growth in emerging economies. In this context, in view of the futures prices of commodities as of the first half of January, the oil price assumption is revised upward to 95 USD/barrel for 2011 and thereafter. Furthermore, again considering the futures prices, import prices are assumed to increase by about 10.9 percent year-on-year in 2011 (Graph 1.3.11). These changes in assumptions led to an upward revision of 35 basis points in 2011 inflation forecasts.



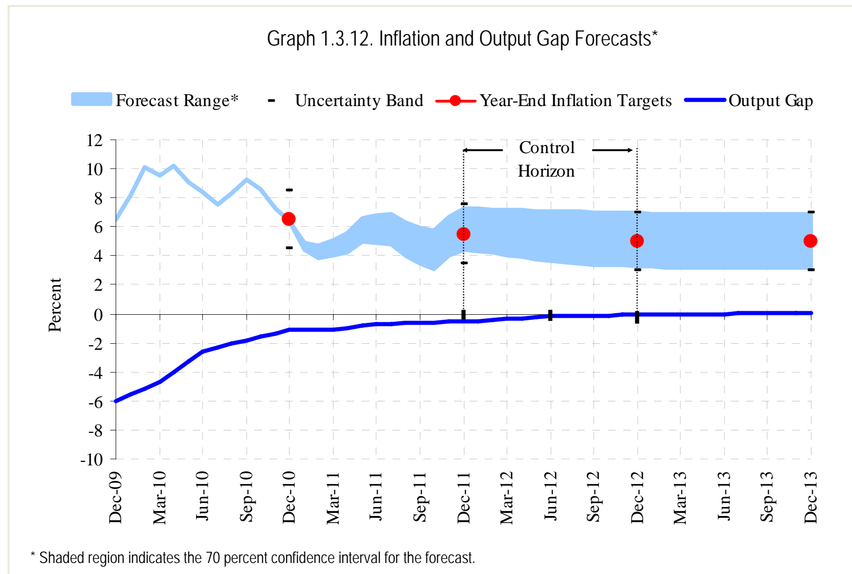
Graph 1.3.11. Forecasts and Revisions

Inflation Outlook

Since the launch of inflation targeting in 2006, the CBRT has publicly announced its medium-term inflation forecasts and provided a qualitative perspective regarding the policy rate outlook. The current climate required the CBRT to observe financial stability along with price stability, and thus necessitated the use of a variety of monetary policy instruments including policy rates in addition to required reserves ratios and liquidity management tools. Given the mounting uncertainties concerning the global economic outlook in the period ahead, the future course of each instrument within the policy mix should remain flexible. In other words, this Report will focus on the net effect of the policy mix rather than providing an explicit path for each policy instrument.

Against this background and assuming that the policy mix is adjusted to deliver a limited additional tightening during the rest of 2011, inflation is expected to be, with 70 percent probability, between 4.5 and 7.3 percent with a mid-point of 5.9 percent at the end of 2011, and between 3.3 and 6.9 percent with a mid-point of 5.1 percent at the end of 2012. Inflation is expected to stabilize around 5 percent in the medium term (Graph 1.3.12).

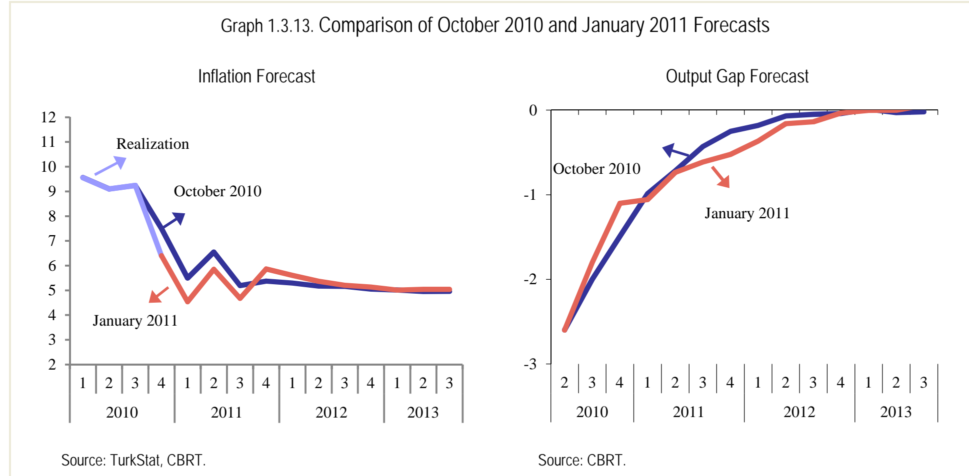
Graph 1.3.12. Inflation and Output Gap Forecasts*



* Shaded region indicates the 70 percent confidence interval for the forecast.

In this context, assuming that a limited monetary tightening brings credit growth rate down to 20-25 percent in 2011, our revised forecasts indicate that inflation would converge to the target by the end of 2011. It should be noted that the envisaged monetary tightening in 2011 may be implemented through various combinations of policy tools. The monetary tightening could be provided by either required reserve ratios or policy rates or a combination of both. Moreover, during the tightening process, both instruments could move in the same or in the opposite direction. However, the baseline scenario envisages the net impact of the policy mix on loans and domestic demand to be restrictive.

The rapid decline in unprocessed food prices pulled short-term inflation forecasts down, while the upward revisions to oil and commodity price assumptions drove end-2011 inflation forecasts higher. The output gap is revised slightly upward for the final quarter of 2010. In addition, considering the lagged effects of the monetary tightening, the output gap is assumed to close more slowly than in the previous reporting period (Graph 1.3.13).



Graph 1.3.13. Comparison of October 2010 and January 2011 Forecasts

Given the correction in unprocessed food prices and the high base effects from early 2010, inflation is expected to fall markedly below medium-term targets and to remain volatile thereafter. Inflation is expected to reach the medium-term target of 5 percent by mid-2012 once the effects of rising commodity prices taper off.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

The baseline scenario envisages a gradual tightening through policy mix changes in order for inflation to remain in line with medium-term targets. Such a tightening mainly aims at slowing down credit growth and domestic demand, and also reducing macroprudential risks. The impact of the monetary tightening in December and January on credit growth is expected to be materialized over the near term. However, the timing and the extent of the transmission of the policy mix may vary depending on the developments beyond the control of the monetary policy. Therefore, the CBRT 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.

Developments regarding the global economy remain central to domestic inflation and monetary policy outlook. Under current conditions, the CBRT is utilizing several instruments in order to monitor both price stability and financial stability. Therefore, global developments, unlike past, not only affect the direction of the policy instruments, but also their combination. Accordingly, global risks will be assessed according to their effects on the pace of the aggregate demand as well as on its composition.

Although there has been a slightly improved prospects for 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 advanced economies and the uncertainties regarding the impact of fiscal consolidations continue to pose downside risks to the pace of global growth. The possibility of a longer-than-anticipated period of anemic global growth and a prolonged period of quantitative easing by advanced economies not only feeds downside risks to external demand but also increases the likelihood that our 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 easing macroprudential risks. Moreover, an outcome whereby global economic problems intensify and domestic economic activity contracts may require an easing in all policy instruments.

Although downside risks are critical, upside risks to global economy are also present. These risks are especially driven by the lagged impacts of the exceptionally loose policies implemented by advanced economies during the past two years. In the period ahead, should the global economy faces a faster-than-expected recovery, global inflation may increase, thus warranting monetary tightening in advanced economies. Materialization of such a scenario would mean higher global interest rates and demand-pull domestic inflation, and thus necessitate a tightening by increasing both policy rates and reserve requirement ratios.

Oil and other commodity prices have recently displayed rapid increases. The increases in commodity prices, if they persist, may pose risks to 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, a

stronger tightening may come about than envisaged in the baseline scenario. However, the policy mix may vary depending on the developments regarding external demand, capital flows and the credit growth outlook.

The CBRT continues to monitor fiscal policy developments closely while formulating the monetary policy strategy. Increasing public savings under current circumstances, and hence, adherence to fiscal discipline is essential for controlling the mounting current account risks driven by the divergence between domestic and external demand. Our inflation forecasts take the MTP targets as given. Should the fiscal stance deviate significantly from this framework and adversely affect the inflation outlook, a revision in the monetary policy stance may be considered.

In the period ahead, monetary policy will continue to focus on achieving price stability on a permanent basis. To this end, the impact of the macroprudential measures taken by the CBRT and other relevant institutions on the inflation outlook will be considered carefully. Fulfillment of the commitments to fiscal discipline in the medium term and strengthening the structural reform agenda will contribute to the improvement of Turkey's sovereign risk, and thus support macroeconomic stability as well as price stability. Sustaining the fiscal discipline will also provide room for monetary policy maneuver, supporting 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.