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As stipulated in the Article 42 of the Central Bank Law, in the case of a significant breach of the inflation target, the Central Bank of the Republic of Turkey (Central Bank) is required to report to the Government and announce to the public the reasons behind the breach of the target and the necessary measures to be taken. As stated in the main policy document titled “Monetary and Exchange Rate Policy in 2011”, which was published on December 21, 2010; the inflation target for 2011 was set jointly with the Government as 5.5 percent. In the same document, it was also indicated that the Central Bank would write an open letter to the Government should end-year inflation exceed the target significantly (by more than 2 percentage points in either direction). Inflation reached 10.45 percent at end-2011, notably exceeding the target. This text elaborates on the reasons why the target was missed and explains the measures taken—and to be taken—to bring inflation back to the target.

Factors Affecting Inflation in 2011

The main factors causing inflation to exceed the target significantly in 2011 are the high rates of increases in import prices and the exchange rate observed through the year. Between the last quarter of 2010 and end-2011, the rise in the domestic currency price of imports exceeded 40 percent. This, on its own, is estimated to have contributed to the annual inflation by approximately 5 percentage points.

Besides the developments in imports prices and the exchange rate, another reason for the breach of the inflation target is the tax adjustment in tobacco products in October and the resulting surge in prices. With an annual rate of increase of 18.6 percent, tobacco prices rose well beyond the inflation target in 2011, adding 1.1 percentage points to annual inflation.

Another factor behind the recent surge in inflation is the high rate of increase in the price of unprocessed food stemming from excessive volatility. The annual rate of increase in unprocessed food prices was 15 percent in 2011, contributing by around 2 percentage points to CPI inflation.

Overall, the developments in import prices, exchange rates and the prices of unprocessed food and tobacco products were the main factors behind the breach of the inflation target at end-2011. Among these factors, the only one that responds to Central Bank policies is the exchange rate. Therefore, it would be useful to assess exchange rate developments since end-2010 in the context of policies pursued.

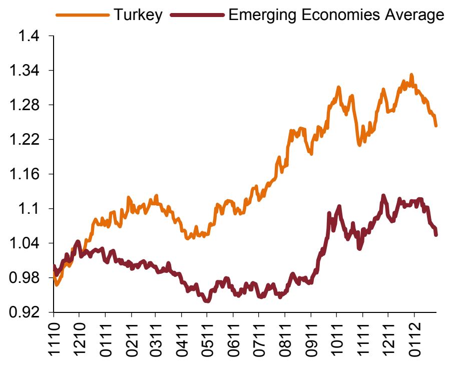
Capital Flows, Monetary Policy and Financial Stability

The ample and low-cost liquidity arising from the extraordinarily loose monetary policies implemented by advanced economies in the aftermath of the global crisis fueled short-term capital inflows towards emerging countries as of 2010. Backed by its strong financial sector and robust growth potential, Turkey has taken a large share out of these inflows. The appreciation in the Turkish lira and rapid credit growth driven by increased capital inflows led to a sizeable deterioration in the current account balance.

Having foreseen that the excessive appreciation in the domestic currency and the rapid credit growth could challenge the sustainability of macroeconomic stability over the medium term; the Central Bank opted for a notable change in its policy strategy and increased the weight of financial stability in its objective function. The fact that, in this period, inflation remained below the target and continued its downward trend made it possible for the Central Bank to focus on financial stability. Accordingly, as of late 2010, the Central Bank embarked on using multiple policy instruments concurrently, and implemented policies aimed at (i) reducing the credit growth to reasonable levels (ii) containing domestic currency appreciation that would disconnect the Turkish lira from economic fundamentals, caused by the extraordinarily loose monetary policies implemented by industrial countries. The Central Bank proved successful in both dimensions to a large extent (Chart 1). At this point, it should be noted that, due to the deterioration in the global risk appetite since August, the depreciation in the domestic currency went beyond the intended levels feeding into the faster-than-expected surge in inflation.

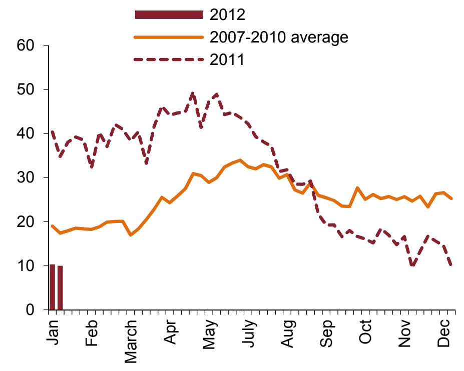
Chart 1: Exchange Rate and Credits

Chart 1.1.1.
TL and Emerging Market Currencies*
(Against the USD, Value of 01.10.2010 = 1)



* Average of emerging market currencies including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea and Colombia, against USD. Increases denote depreciation of the currency.
Source: Bloomberg, CBRT.

Chart 1.1.2.
Loan Growth Rate*
(13-Week Moving Average, Annualized, Percent)



*Adjusted for the exchange rate effect.
Source: CBRT.

In sum, an important part of the gradual depreciation in the Turkish lira between the last quarter of 2010 and August of 2011 is a natural consequence of the policies designed to mitigate macro financial risks. These measures helped contain the effects of the turmoil in the euro area as of August 2011 on our economy. If Turkey had gone through this period with an excessively appreciated domestic currency and a rapidly rising credit growth, the economy could have experienced a hard landing driven by balance sheet deterioration due to the rapid fall in the risk appetite.

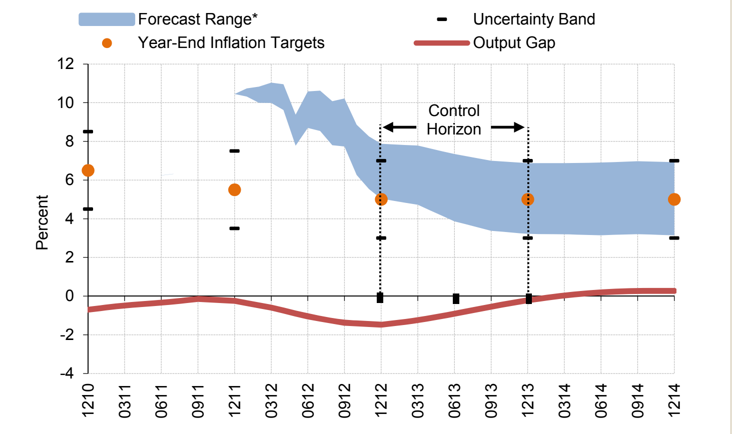
Policies implemented by the Central Bank with a view to mitigate macro financial risks have to be consistent with the price stability objective over the medium and long term. Therefore, temporary price movements should not be allowed to deteriorate the general price setting behavior. In this context, considering that a sound rebalancing process in the economy has already started, the Central Bank has re-focused on price stability as of the last quarter of 2011.

Measures Taken to Bring Inflation back to the Target

In order to prevent the surge in inflation to worsen the price setting behavior, the Central Bank has delivered a strong monetary tightening since October 2011. Accordingly, the interest rate corridor was widened upwards and the cost of funding provided to the market was raised significantly. Moreover, with the aim of minimizing the adverse effects of abrupt changes in capital flows due to uncertainties regarding the global economic outlook, a flexible liquidity management strategy was designed and implemented.

These measures brought credit growth to reasonable levels and inflation expectations were contained. Accordingly, as the accumulated effects of the price movements stemming from import prices, exchange rate, and unprocessed food and tobacco prices fade away, inflation is expected to converge gradually to the target in the forthcoming period (Chart 2). It should be noted that due to the base effects, the decline in inflation will remain subdued in the short term and become more pronounced in the last quarter of 2012.

Chart 2: Inflation and Output Gap Forecast



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

Reducing inflation from 10.45 percent to 5 percent target within 12 months would lead to unfavorable fluctuations in economic activity; accordingly, in the baseline scenario, it takes one and a half year to bring inflation back to the target. In other words, the baseline scenario envisages inflation to reach the target of 5 percent by mid-2013 (Chart 2). However, the target might be attained by the end of 2012, should the risk appetite improve markedly in the forthcoming period and the capital flows towards emerging economies re-accelerate, leading to a stronger appreciation of the Turkish lira than assumed in the baseline scenario.

Risks

The fact that inflation will hover at high levels in the short term poses risks regarding pricing behavior. Three-month accumulated increase in consumer prices in the final quarter of year 2011 was 5.66 percent. This will stay in annual inflation figure for another three quarters. Therefore, it is highly likely that annual inflation will stay significantly above the target until the last quarter of the year, even if the underlying trend in the forthcoming period eases to levels consistent with the target. Although the monetary tightening delivered by the Central Bank since October has reduced the possibility of second round effects, inflation expectations and pricing behavior will be monitored closely and necessary measures will be taken to keep medium-term inflation outlook consistent with the target.

Overall, ongoing problems regarding euro area and uncertainties on the effectiveness of the measures aimed at solving these problems, suggest that financial markets will continue to be volatile in the forthcoming period. These conditions necessitate a flexible approach in monetary policy, which utilizes multiple instruments. The Central Bank will continue to monitor global developments closely and take the required measures promptly.

Another risk for the forthcoming period is the uncertainty regarding oil prices. Although weak global outlook dampens commodity prices, heightened concerns about oil supply recently pose upside risks regarding energy prices. The Central Bank will not respond to temporary price movements, yet will not tolerate any deterioration in expectations.

Excess volatility of unprocessed food prices lead to unpredictable and sharp movements in inflation. This creates challenges for expectation management and often leads to undesired fluctuations in financial markets. Taking measures to reduce the volatility of unprocessed food prices is crucial for attaining price stability in the medium term. In this respect, especially in the fresh fruit and vegetables sector, it is important to take the measures such as increasing the market efficiency, decreasing the sensitivity of production to climate conditions, and improving know-how and incentive structure.

Monetary policy will continue to focus on price stability while preserving financial stability as a supplementary objective. The Central Bank will do its best to mitigate the adverse effects of the volatility in capital flows, by efficiently using the instruments at its disposal. However, it should be underscored that continuous coordination among monetary, fiscal and financial sector policies is crucial, especially amid such a challenging global backdrop. For the medium and longer term, strengthening the structural reforms aiming to reduce the saving deficit would boost the resilience of the economy and reinforce sustainable growth.

Conclusion

Inflation exceeded the target significantly at the end of 2011. Although depreciation of the Turkish lira explains an important part of this development, several factors such as commodity prices, tobacco and unprocessed food prices were also responsible for the breach of the target. The Central Bank has responded by a bold monetary tightening and contained inflation expectations. Accordingly, inflation is expected to move towards the target gradually in the forthcoming period. The Central Bank will continue to monitor developments affecting inflation outlook and take the necessary measures to retain the achievements on price stability.

Inflation Report, published today on our website, which presents the developments regarding inflation and monetary policy as well as our medium term forecasts, is enclosed for your information.

Yours Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Erdem Başçı
Governor

Mehmet Yörükoğlu
Deputy Governor

Enc: Inflation Report, January 2012