1.Overview

The global economy continued to recover in the first quarter of 2011, while the divergence between growth dynamics of advanced and emerging economies continued. Downside risks in advanced economies remain critical, causing these economies to maintain expansionary monetary policies, while domestic demand remains strong in emerging economies amid capital inflows. The divergence between advanced and emerging economies accelerates capital inflows to countries like Turkey, with strong economic fundamentals and relatively low risk. Rapid credit expansion and widening current account deficit fueled by short-term capital inflows feed risks to financial stability and may hamper price stability over the medium term, hence giving rise to adopting different approaches that incorporate financial stability into the monetary policy framework.

1.1. Monetary Policy Developments and Monetary Conditions

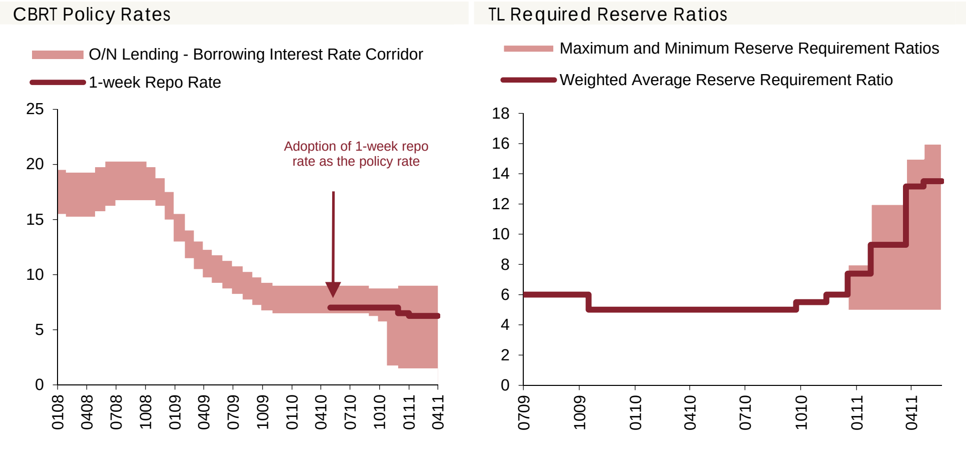
In order to restrain macro financial risks in the domestic economy posed by the global imbalances, the Central Bank of the Republic of Turkey (CBRT) designed and launched a new policy strategy by the end of 2010. The new policy approach preserves the main objective of achieving and maintaining price stability while also observing financial stability as a supporting objective. In this context, in addition to policy rates, complementary tools such as reserve requirement ratios and the interest rate corridor are jointly utilized.

The downtrend in inflation during the last quarter of 2010 allowed the CBRT to give relatively more weight to financial stability during this period. In this respect, the CBRT lowered policy rates in order to reduce short-term capital inflows, and widened interest rate corridor (the difference between overnight lending and borrowing rates) in order to raise the short-term interest rate volatility. In addition, required reserve ratios were raised to slow down credit expansion. Moreover, in order to enhance financial stability by extending maturity of the banking sector liabilities, reserve requirements were differentiated by maturities, with higher reserve requirements for short-term liabilities. These measures reduced the net short-term capital inflows and stopped the acceleration of the credit growth.

In the first quarter of 2011, both the faster-than-expected increases in oil prices and the robust domestic demand necessitated a more cautious stance regarding the inflation outlook. In particular, oil prices hovering significantly above the January Inflation Report's assumptions led to an increased cost pressures. Moreover, the ongoing rapid growth of private consumption and private investment spending increased the need to slow down domestic demand growth in order to contain the second round effects of the surge in oil and other commodity prices.

Even though inflation reached the historically low level of 4 percent in the first quarter, the CBRT has acted with a medium-term perspective, highlighting the upside risks to inflation since February. Accordingly, in order to eliminate the possibility of a deterioration in the general pricing behavior, the CBRT adopted a stronger monetary tightening during the first quarter than envisaged in the January Inflation Report's baseline scenario. Within this framework, policy rate has been kept constant since February, while the weighted average of the reserve requirement ratios for Turkish lira liabilities was hiked by 410 basis points in March and April. Hence, the policy mix composed of policy rates and reserve requirement ratios has been adjusted to deliver a monetary tightening, thus implying a more cautious monetary stance (Chart 1.1.1)

Chart 1.1.1. CBRT Policy Mix



Source: CBRT.

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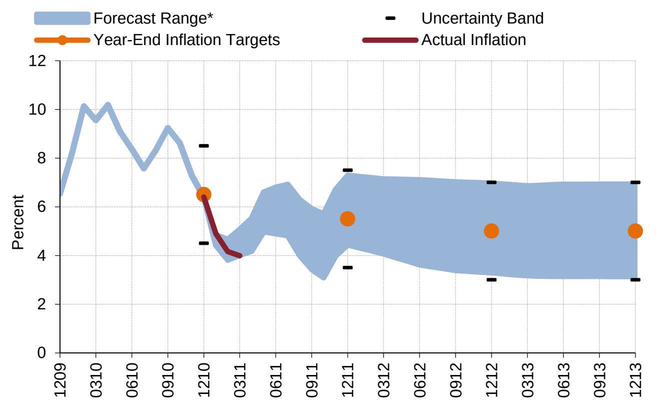
Although credit growth slowed quarter-on-quarter in the first quarter, credit growth rate is still above plausible levels with respect to financial stability. Due to the lagged effects of the ongoing monetary tightening, loan utilization is expected to slow further in the second quarter. Interest rates in Bonds and Bills Market soared up during the first quarter across all maturities, with medium-term real interest rates having increased about 150 basis points since the previous reporting period. The increases in market rates and the cost effects due to reserve requirement hikes are expected to have lagged effects on loan rates. Indeed, deposit and loan rates have been increasing lately. All these developments indicate that the effects of the policy mix have been increasingly more restrictive at the turn of the second quarter of 2011.

1.2. Macroeconomic Developments and Main Assumptions

The October 2010 Inflation Report highlighted that the rise in inflation should be attributed to developments in unprocessed food and tobacco prices that are completely beyond CBRT's control, and indicated that inflation would decline rapidly in the following months. In fact, during the subsequent two quarters, inflation declined by 5.2 percentage points and dropped to 4 percent as of March, reaching the lower bound of our January forecast (Chart 1.2.1).

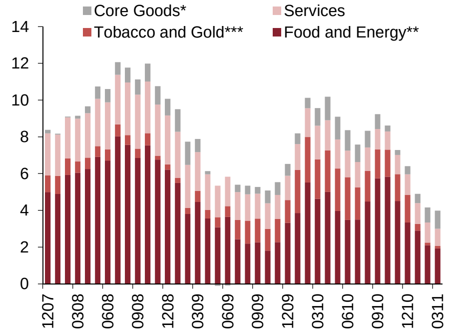
Chart 1.2.1.
January 2011 Inflation Forecasts and Realizations



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

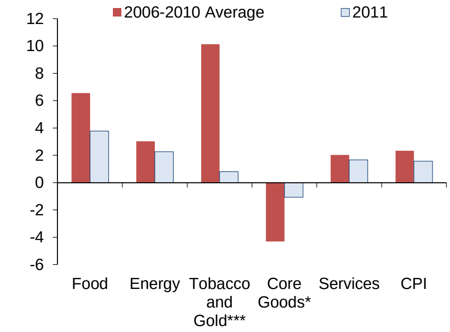
The rapid decline in inflation was mainly owed to the waning base effects from unprocessed food, energy and tobacco prices as well as the favorable course of services prices (Chart 1.2.2). On the other hand, the sharp increase in import prices and the depreciation of the Turkish lira caused core inflation to accelerate. In fact, the rate of change across all subcategories of CPI, except core goods, remained below past year averages during the first quarter (Chart 1.2.3).

Chart 1.2.2.
Contribution to Annual CPI Inflation
(Percentage Points)



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

Chart 1.2.3.
CPI by Subcategories
(First-Quarter Percent Change)



Supply and Demand Developments

The fourth-quarter GDP have been compatible with the outlook presented in the January Inflation Report. The third-quarter slowdown turned out to be temporary as expected and economic activity displayed a robust growth in the last quarter. The post-crisis divergence between domestic and external demand growth became more pronounced in this period, confirming the need to adopt the new policy mix.

2011 first quarter data indicate that the economic activity is more robust than expected with the support of the domestic demand. Accordingly, the revised forecasts are based on the assumption that aggregate demand conditions would provide less support for disinflation compared to the previous period. However, given that capacity utilization rates are below and unemployment rates are above the pre-crisis levels, aggregate demand conditions are assumed not to exert a significant inflationary pressure as of the first quarter of 2011.

Revisions to Assumptions

Since global economy continues to grow in line with expectations, projections for Turkey's export-weighted growth index remained broadly unchanged. Therefore, assumptions regarding external demand conditions were not subject to any major revisions that may affect inflation forecasts.

On the other hand, assumptions about oil and other import prices were revised significantly upward. In the January Inflation Report, oil prices were assumed to average 95 USD/bbl in 2011 and beyond. Moreover, in reference to futures prices for commodities, import prices were assumed to increase by an average of 10.9 percent year-on-year in 2011. However, particularly due to supply-side developments, oil and other commodity prices remained considerably above our assumptions. In this context, using futures prices of the first half of April, the oil price assumption for 2011 and onward is raised to 115 USD/bbl. Furthermore, import prices are assumed to increase by 16.2 percent year-on-year in 2011. These changes in assumptions led to an upward revision of about 50 basis points for end-2011 inflation forecast and a slight upward revision for 2012 inflation forecast.

Another factor affecting 2011 inflation forecasts has been the hike in tariffs on fabric and apparel imports. Although major uncertainties exist about how this development will be reflected on prices, it is assumed that this would add to year-end inflation by about 50 basis points (Box 3.1).

As for the food prices, despite the recent benign course, given the extreme volatility in unprocessed food prices and the rapid increases in agricultural commodity prices, food inflation assumption for end-2011 has been cautiously preserved at 7.5 percent.

In sum, due to developments such as soaring energy prices and renewed tariffs which are beyond the monetary policy control, the mid-point of the end-2011 inflation forecast is revised up by 1 percentage point.

Fiscal Policy

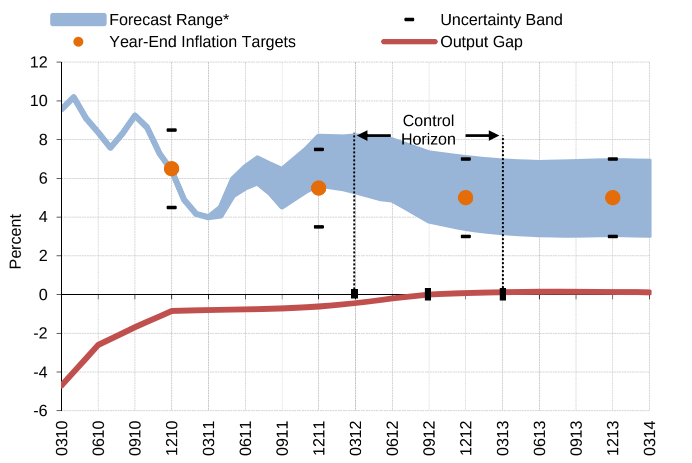
Inflation forecasts are produced based on the Medium Term Program (MTP) projections. Since primary expenditures remained largely in line with the MTP targets in the first quarter, the fiscal policy outlook remained mainly unchanged. Hence, our forecasts are based on the assumption that the ratio of primary expenditures to GDP would continue to decline gradually. We also assume that the debt-to-GDP ratio would decline further, and the risk premium would remain broadly unchanged over the forecast horizon. Furthermore, it is assumed that tax adjustments would be consistent with inflation targets and automatic pricing mechanisms.

1.3. Inflation and Monetary Policy Outlook

Within the new policy framework, changes in monetary policy stance can be implemented not only through policy rates, but also through market liquidity conditions and required reserve ratios. The issue of how and which policy tools would be employed to change the policy stance depends on factors affecting financial stability and price stability. Given the high level of uncertainty regarding the global economic conditions in the period ahead, it would be more appropriate to remain flexible regarding the content of the policy mix. Therefore, the monetary policy stance underlying inflation forecasts will continue to be communicated using the term 'monetary tightening' rather than by explicitly stating the individual course of each instrument.

Against this background, assuming an additional limited monetary tightening during the second half of 2011 that would bring credit growth to 20-25 percent at the end of 2011, inflation is expected to be, with 70 percent probability, between 5.6 and 8.2 percent with a mid-point of 6.9 percent at the end of 2011, and between 3.4 and 7.0 percent with a mid-point of 5.2 percent at the end of 2012. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts



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

The revised forecasts suggest that keeping inflation in line with targets over the medium term requires a measured and vigorous credit growth. Hence, in addition to inflation forecasts, a numerical range for the annual rate of credit growth is also provided in order to give a better perspective. It should be underlined that these numbers for the credit growth rates are not strict targets of the CBRT. The nominal credit growth consistent with the medium-term inflation target may vary from year to year depending on the course of inflation, economic growth and the composition of aggregate demand.

Over the next three quarters, inflation is expected to display significant fluctuations mainly due to base effects driven by food prices. Annual food inflation is expected to rise in the second quarter, decline in the third quarter, and increase markedly in the last quarter. As shown in Chart 1.3.1, headline inflation path also reflects these fluctuations.

The main reason for inflation forecast to overshoot the end-2011 target of 5.5 percent is the sharp rise in import prices as mentioned above. The impact of the cumulative increases in commodity prices since October 2010 on 2011 inflation is estimated to reach around 90 basis points (40 basis points of this impact is reflected in the October Inflation Report forecasts while the remaining 50 basis point is reflected in the current Report). In addition, tariff adjustments are assumed to bring 2011 inflation up by about 50 basis points. Therefore, the reason for end-2011 forecast to exceed the inflation target can be attributed to developments completely beyond the control of the monetary policy. Accordingly, the statement following the April meeting of the Monetary Policy Committee (the Committee) indicated that the Committee would not respond to the first round effects of rising oil and other commodity prices, but highlighted that second round effects will be closely monitored and a deterioration in the pricing behavior will not be tolerated.

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 impact of the ongoing monetary tightening on credits and domestic demand is expected to be more significant starting from the second quarter. However, the extent and the timing of the impact may vary depending on the developments beyond the control of the monetary policy. The CBRT will closely monitor the lagged effects of the policy measures, and will take additional measures if deemed necessary.

In assessing risk factors and the related monetary policy measures under current circumstances, both price stability and financial stability are taken into account. Therefore, risk factors are not only assessed with respect to their impact on the level, but also on the composition of the aggregate demand (external versus domestic demand). This is because the level of the aggregate demand concerns price stability, whereas its composition relates directly to financial stability. Hence, risk factors regarding global economy are also evaluated against this backdrop.

Downside risks regarding global economy remain critical, albeit having been alleviated compared to the previous quarter. Problems in credit, real estate and labor markets in many advanced economies are yet to be fully solved. Moreover, uncertainties regarding debt sustainability issues and the impact of a possible fiscal consolidation persist. Furthermore, rapid increases in oil prices carry the potential to slow down global economic growth. All these factors continue to feed downside risks regarding the pace of global growth. The possibility of a prolonged period of slow global growth not only creates downside risks regarding the external demand, but also keeps prospects for strong capital flows vigorous. Should such a scenario materialize, a policy mix of low policy rate, wide interest rate corridor and high reserve requirement ratios may be implemented for a long period of time. 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.

Although downside risks to global economy remain notable, upside risks are also becoming more significant. Major uncertainties exist regarding the lagged impacts of the exceptionally loose monetary policies implemented by advanced economies on global economic activity and inflation. If the global economy faces a faster-than-expected recovery in the upcoming period, inflationary pressures may arise sooner than envisaged in the advanced economies. Materialization of such a scenario would mean a tightening by using policy rates as well as reserve requirements against higher global policy rates and demand-pull inflationary pressure.

The outlook for oil and other commodity prices remains uncertain. Should the increases in commodity prices persist and hamper the achievement of medium-term inflation targets, an additional tightening may be implemented sooner than envisaged by the baseline scenario. However, given that higher oil prices will also deteriorate the current account balance, macro financial risks will also be monitored through the policy reaction. Therefore, the content of the policy mix may vary depending on the outlook for other factors such as external demand, capital flows and the credit growth.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. Inflation forecasts in the baseline scenario assume that the ratio of fiscal expenditures to GDP will evolve in line with the MTP targets. 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 public savings, and hence, sustaining fiscal discipline is essential under current circumstances in order to control risks fuelled by the widening current account deficit driven by the divergence between domestic and external demand. Saving the additional tax revenues provided by the stronger-than-expected economic activity than envisaged by the MTP would not only ease risks regarding both price stability and the financial stability, but also, enhance the efficiency of the new policy mix.

Monetary policy in the period ahead will continue to focus on building price stability on a permanent basis. To this end, the impact of the macroprudential measures taken by CBRT and other institutions on the inflation outlook will also be assessed carefully. Fulfilling the commitment to maintain fiscal discipline and strengthening the structural reform agenda in the medium term would contribute to the improvement of Turkey's sovereign risk, and thus, enhance macroeconomic stability and the price stability. Maintaining fiscal discipline will also provide more room for monetary policy maneuver 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 critical.