No: 2010 – 35

26 October 2010

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: October 14, 2010

Inflation Developments

1. Consumer prices picked up by 1.23 percent in September and annual inflation rose by 0.91 percentage points to 9.24 percent. The rise in annual inflation was due to the sharp increase in unprocessed food prices. Inflation was generally moderate across all other subcategories. While annual services inflation continued to decrease steadily, core inflation indicators remained in line with medium-term targets.

2. Annual inflation in food and nonalcoholic beverages increased by 4.96 percentage points to 15.33 percent in September due to continued upswings in unprocessed food prices. As noted in the September summary of the Monetary Policy Committee (the Committee) meeting, the steep rise in vegetable prices pushed food and nonalcoholic beverages prices higher. Moreover, unprocessed meat prices continued to increase in September. Thus, annual unprocessed food inflation increased by 20.89 percent over two months, bringing annual inflation in this subgroup to an all-time high of 28.74 percent. Meanwhile, processed food inflation remained subdued despite higher processed meat prices. However, the recent increase in domestic wheat prices driven by rising global wheat prices continues to put upward pressure on processed food prices.

3. Energy prices rose slightly in September, while annual energy inflation continued to decline. Inflation in core goods and services remained broadly contained. The annual rate of increase in the prices of services excluding catering and transport, which are relatively more demand-sensitive, dropped to an all-time low of 1.85 percent. Similarly, the annual rate of increase in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) prices continued to fall. Moreover, recent figures on seasonally adjusted inflation data indicate that underlying inflation remains in line with medium-term targets. The base effects from the temporary 2009 tax incentives on durable goods would serve to bring annual inflation down in October.

4. Against this backdrop, the Committee has reiterated that inflation would be on a declining path in the forthcoming period.

Factors Affecting Inflation

5. Recent data releases suggest that the economy continues to recover. Industrial production grew by a seasonally adjusted 2.7 percent month-on-month in August and by 1.0 percent compared to the previous quarter during July-August. Taking into account the July-August developments as well as the September and the fourth quarter leading indicators, industrial production growth is expected to slow in the third quarter, but then accelerate in the fourth quarter. However, the Committee has noted that, despite posting quarterly gains since the second quarter of 2009, industrial production is still running below pre-crisis levels.

6. Domestic demand displays a relatively stronger outlook. Both the July-August data on the production and imports of consumer goods and the September survey indicators show that private consumption demand continued to recover steadily during the third quarter. Moreover, the improvement in consumer confidence indicates that private consumption demand would remain robust in the final quarter. In addition, investments are expected to recover further in the third quarter and grow markedly year-on-year. In fact, indices for the production and imports of investment goods increased during July-August compared to the previous quarter, while firms’ investment expectations continued to improve steadily over these two months and rose sharply in September. Yet, the Committee has stated that the uncertainty about foreign demand might dampen investment growth, particularly in the manufacturing industry.

7. Uncertainty regarding foreign demand remains elevated. After falling in June and July, the export quantity index excluding gold moved up in August yet remained below its level in May. According to recent foreign trade data, exports grew slightly in September and October, with new manufacturing orders following a similar pattern. Amid weak foreign demand underpinned by signs of slowing global trade and projections of a slowdown in the pace of the global recovery, the Committee reiterated that it would take a while before industrial capacity utilization rates return to pre-crisis levels.

8. Although employment conditions continue to improve, unemployment rates still remain elevated. Industrial employment continued to recover in June, whereas services employment dropped slightly in seasonally adjusted terms. Third-quarter leading indicators suggest that the halt in non-farm employment growth is temporary and employment would continue to rise gradually. Nevertheless, the Committee has reiterated that the unemployment rates would remain higher than pre-crisis levels for some time, containing unit labor costs.

Risks and Monetary Policy

9. The Committee has assessed the inflation forecasts and the economic outlook to be presented in the Inflation Report. In line with the developments outlined above, inflation forecasts were based on an outlook which envisages that domestic demand is stronger compared to the previous period, external demand continues to restrain economic activity, and thus aggregate demand conditions continue to support disinflation, albeit to a lesser degree. Therefore, it is expected that inflation would be on a declining path in the forthcoming period, while core inflation would remain consistent with the medium-term targets.

10. In light of these assessments, the Committee has reiterated that it would be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period. On the other hand, in order to enhance the efficient functioning of the Turkish lira market, the Committee has decided to reduce the borrowing rates by 50 basis points.

11. Developments regarding global economic activity would continue to be the main factor driving inflation dynamics and the monetary policy outlook. Recently, leading indicators of economic activity continue to slow down, underscoring downside risks especially regarding the US economy. Furthermore, ongoing problems in credit, real estate, and labor markets across developed economies and the uncertainties regarding the impact of fiscal consolidations suggest that the downside risks regarding the pace of global growth are likely to persist for some time. The Committee stated that, should the global economy face a longer-than-anticipated period of anemic growth, the monetary tightening envisaged during the final quarter of 2011 under the baseline scenario of the October Inflation Report may be postponed. Moreover, it was indicated that an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity, may trigger a new easing cycle. By contrast, it was underscored that monetary tightening may be implemented in an earlier period, should the recovery in economic activity turn out to be faster than expected.

12. Expectations of more accommodative monetary policies in developed economies have been leading to a surge in capital flows toward emerging markets. This development, coupled with the relative improvement in the creditworthiness of Turkey, exacerbates the risks related to the divergence between the domestic and external demand. While not yet a significant concern regarding financial stability, the Committee has indicated that these developments support the implementation of the “exit strategy” measures. Therefore, the Committee has indicated that it would be appropriate to proceed with the remaining measures outlined in the exit strategy that were

envisaged to be implemented by the end of 2010. Moreover, the Committee has judged that the 3-month repo funding is no longer needed.

13. Should the capital inflows continue, the divergence in the growth rates between domestic and external demand is likely to intensify in the forthcoming period. Additional policy instruments, other than the short-term policy rates, would be needed to curb risks emanating from this channel. In this respect, the Committee stated that, should the disparity between domestic demand and external demand continue, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity management facilities more effectively, to address financial stability concerns including rapid credit expansion and a deterioration in the current account balance.

14. Food and commodity price inflation has accelerated recently. The existing output gap and the strength of the Turkish lira has been limiting the pass-through from food and commodity prices to the prices of core goods and services. However, potential second-round effects continue to be a risk, if the increases in food and commodity prices persist. The Committee indicated that, should such a risk materialize and lead to a deterioration in the price setting behavior which in turn hampers the attainment of medium-term inflation targets, an earlier-than-envisaged tightening in the baseline scenario would be considered.

15. The CBT continues to monitor fiscal policy developments closely while formulating monetary policy. Increasing government saving under the present circumstances is essential to control the current account deficit driven by the disparity between domestic and external demand. The Medium Term Program (MTP) is seen as an important step toward this direction. Accordingly, our revised forecasts take the projections of the government expenditures in the MTP as given, while tax adjustments are assumed to be consistent with the inflation targets and automatic pricing mechanisms. The Committee stated that, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on inflation outlook, a revision in the monetary policy stance may be considered.

16. Monetary policy will continue to focus on price stability in the period ahead. 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. 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.