Durmuş Yılmaz: Recent economic and financial developments in Turkey

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the press conference for the presentation of the Inflation Report, Ankara, 26 January 2010.

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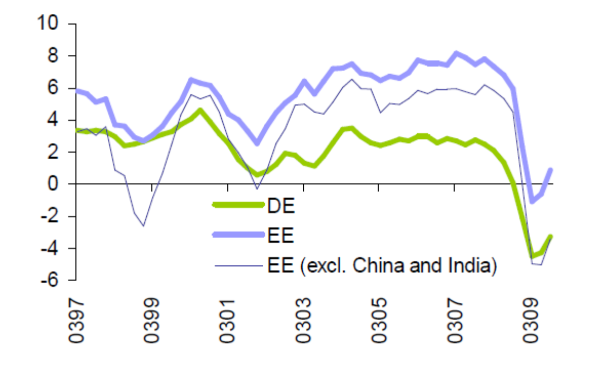
Distinguished Guests and Members of the Press,

Welcome to the press conference held to convey the main messages of the January 2010 Inflation Report, one of the most important communication tools of the inflation-targeting regime of the Central Bank.

The report typically summarizes the economic framework addressed in monetary policy decisions, elaborates global and domestic macroeconomic developments and presents the medium-term inflation forecasts, which have been revised in view of previous quarter developments, along with the monetary policy stance.

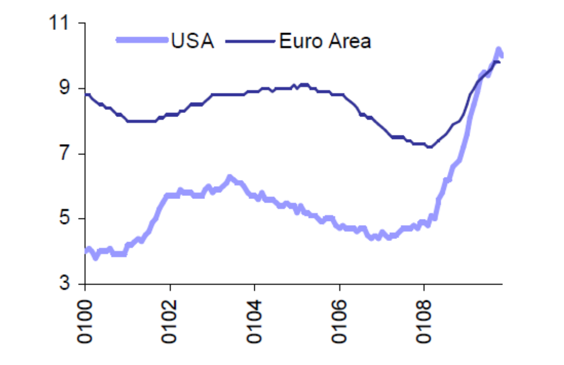
Before moving on to the Central Bank's assessments on the inflation outlook and economic activity, which I will share with you in detail shortly, I would like to summarize the current global conditions. The global crisis, which erupted in developed markets and then spread across the world during the last quarter of 2008, has continued to affect the economic outlook, albeit less forcefully, during the last quarter of 2009. During this period, data releases regarding the global financial system and economic activity displayed an ongoing recovery (Figure 1). However, budget deficits – especially in developed economies – continue to rise, problems across credit markets linger, and employment remains in a precarious state, all suggesting that it would take a long time for the global economy to completely recover (Figure 2). Moreover, ongoing uncertainties regarding the exit strategies from unconventional fiscal and monetary stimulus continue to pose risks on the durability of the recovery process.

Figure 1: Developed Economies (DE) and Emerging Economies (EE) Annual Growth Rates
(Percent)



Source: Bloomberg, CBT.

Figure 2: Developed Economies Unemployment Rates
(Percent)



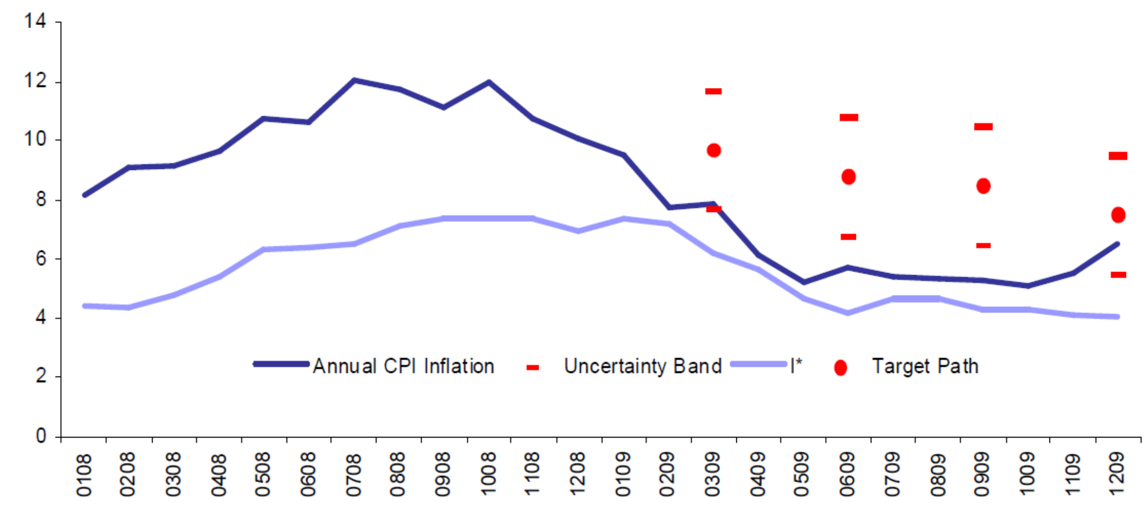
Source: Bloomberg.

1. Inflation developments

Distinguished Members of the Press,

During the final quarter of 2009, factors affecting inflation evolved in line with the outlook presented in the October Inflation Report. Both domestic and external demand displayed a gradual recovery, yet resource utilization remained at low levels. However, an unexpected surge in unprocessed food prices caused the inflation rate to realize one-percentage point higher than forecasted in the October Inflation Report. In other words, the deviation from the end-2009 inflation forecast presented in the October Inflation Report could be explained almost entirely by the increase in unprocessed food prices. Consequently, in the last quarter of 2009, annual inflation climbed to 6.53 percent, remaining within the uncertainty band, albeit slightly below the target set (Figure 3).

Figure 3: Annual CPI Inflation and Target Path

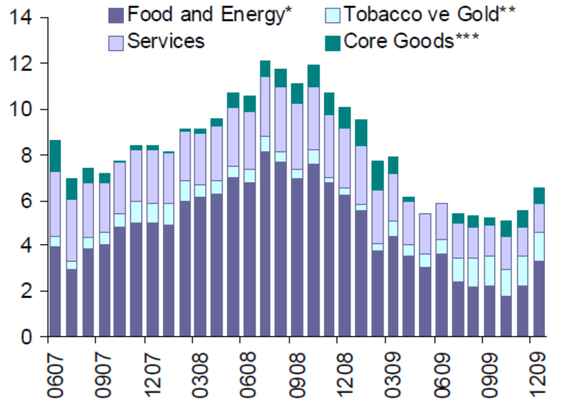


* Temporary tax adjustments corrected I Index.

Source: TurkStat, CBT.

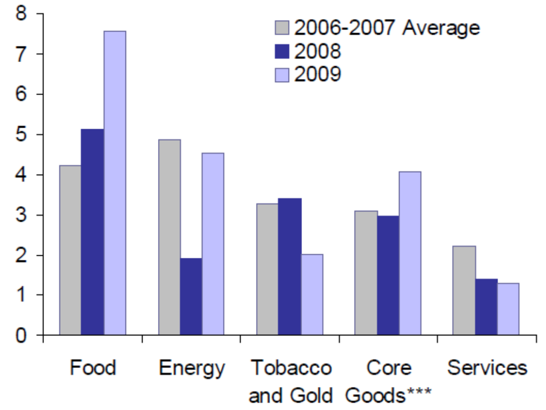
While the contribution of food and energy items to annual inflation increased in the last quarter of 2009, no significant change was observed in the contribution of the categories excluding food and energy (Figure 4). Meanwhile, rising oil and other commodity prices as well as the withdrawal of tax cuts within the fiscal stimulus package were other factors leading to an increase in annual headline inflation in this period. Although these developments caused the prices of core goods to increase more in the fourth quarter than in previous years, the price hikes adjusted for tax effects remained below those of previous years (Figure 5).

Figure 4: Contribution to Annual CPI Inflation
(Annual Percentage Change)



* Food and Energy: Food, non-alcoholic beverages and energy.
** Tobacco and Gold: Alcoholic beverages, tobacco and gold.
Source: TurkStat, CBT.

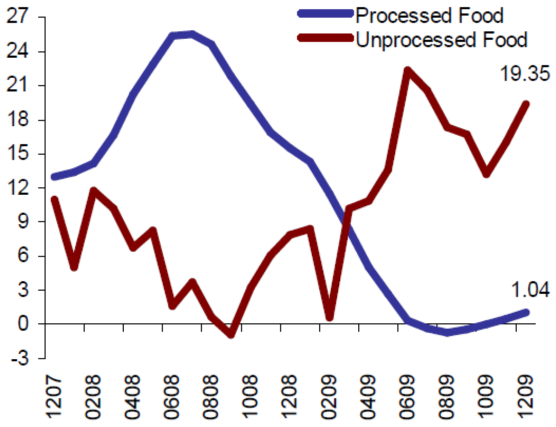
Figure 5: CPI Sub-Groups
(Fourth Quarter Percentage Change)



*** Core Goods: Goods excluding food, energy, alcoholic beverages and tobacco and gold.
Source: TurkStat, CBT.

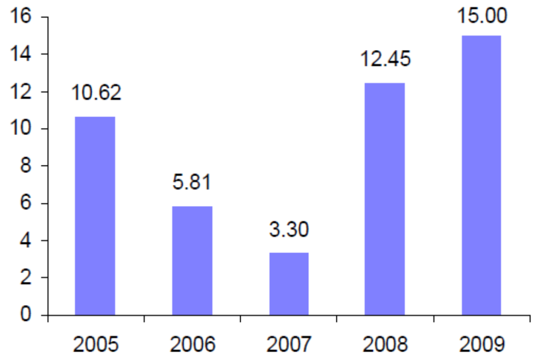
Processed food prices followed a course in line with the outlook presented in the October Inflation Report, whereas unprocessed food prices surged more than expected (Figure 6). Thus, food prices, which increased due to processed food prices in 2008, maintained an upward trend in 2009 due to the surge in unprocessed food prices. As I have already mentioned, these high-rated increases in unprocessed food prices explain substantially both the rise in inflation in the last quarter and the deviation from the end-2009 inflation forecast.

Figure 6: Food Prices
(Annual Percentage Change)



Source: TurkStat, CBT.

Figure 7: Unprocessed Food Prices
(Last Quarter Growth Rates)



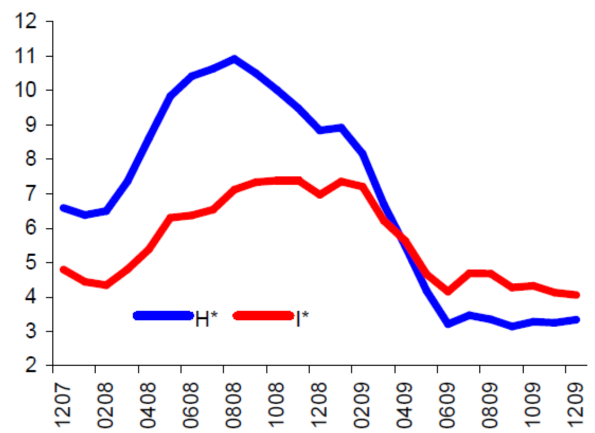
Source: TurkStat, CBT.

In Turkey, annual inflation in unprocessed food prices displays remarkable fluctuations and this creates a significant forecast uncertainty. To illustrate this, following the lowest rate of third quarter change of the past five years in 2009, this group also displayed the highest rate of increase over the last six years due to price hikes in fruits-vegetables and meat in the fourth quarter of 2009 (Figure 7). Here, I would like to remind that, in the third chapter of Inflation Report that will be posted on our website shortly you can find the Central Bank's detailed assessments regarding volatility in unprocessed food inflation, including comparative analyses between Turkey and other countries.

Distinguished Members of the Press,

Let me underline that the rise in annual inflation observed in the last quarter of 2009 can be attributed to several temporary factors, rather than a deterioration in the general price setting behavior. In fact, core inflation indicators in the last quarter pointed to an underlying inflation trend of around 4 to 5 percent and remained consistent with medium-term targets. Although annual inflation in core measures increased modestly with the expiry of tax incentives on durable goods, seasonally and tax adjusted data indicate that the underlying trend of inflation did not deteriorate (Figure 8). Furthermore, the inflation diffusion index, calculated by using the difference between the share of items with increasing prices and the share of items with falling prices in the CPI, hovered around historically low levels (Figure 9). These observations indicate that the increase in inflation in the last quarter of 2009 is mainly due to temporary developments, and to factors beyond the immediate control of monetary policy, rather than the main components of inflation.

Figure 8: Core Inflation Indicators H and I
(Annual Percentage Change)

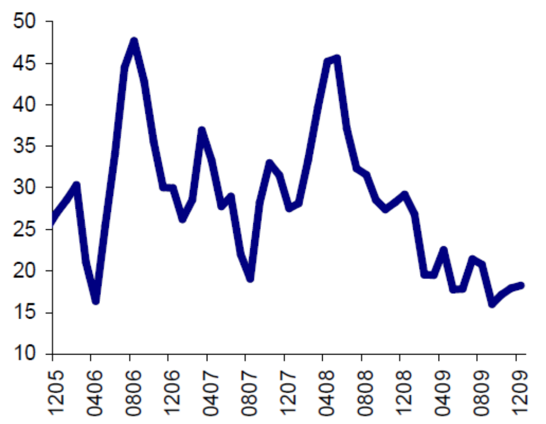


I*: CPI excluding food, energy, alcoholic beverages and tobacco and gold.
H* CPI excluding unprocessed food, energy, alcoholic beverages and tobacco and gold.

(Adjusted for temporary tax effects in 2009.)

Source: TurkStat, CBT.

Figure 9: Inflation Diffusion Index**



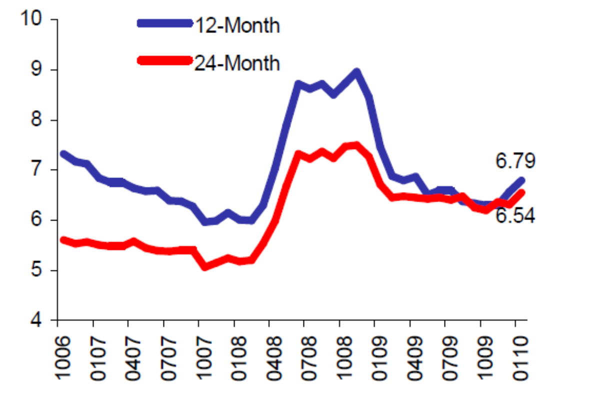
** Seasonally adjusted 2-month averages of the difference between the share of items with increasing prices and the share of items with falling prices in CPI.

Source: TurkStat, CBT.

Parallel to these developments, inflation expectations for 12 months ahead that followed a downward course throughout the year increased slightly in the last quarter; whereas inflation expectations for 24 months ahead remained relatively flat (Figure 10). While expectations displayed a modest increase in January on the back of higher-than-expected inflation due to the surge in food prices in the last quarter of 2009 and on the back of tax adjustments that started to be implemented in early January, it is observed that the change in expectations remained more limited as maturities extended (Figure 11).

Figure 10: 12- and 24-Month Ahead CPI Expectations *

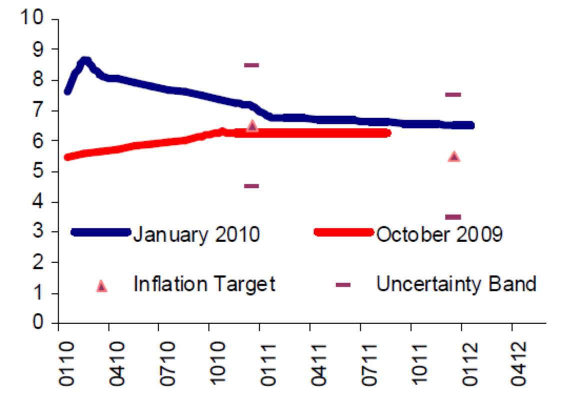
(Annual Percentage Change)



* CBT Business Tendency Survey results from the second survey period.
Source: CBT.

Figure 11: Inflation Expectations Survey*

(Annual Percentage Change)

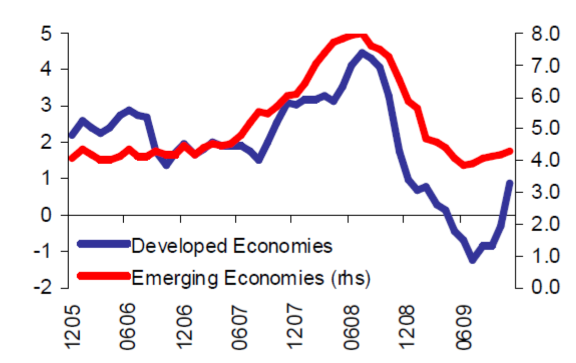


* Calculated using linear interpolation of several maturity yields in the CBT Expectations Survey. Yields are from the second survey period.
Source: CBT.

In the last quarter of 2009, inflation displayed an upward trend on a global basis as well. Inflation rates that had plummeted all over the world due to downward pressures arising from demand and cost conditions since the second half of 2008, started to trend up in August 2009, particularly due to the low base of 2008 in commodity prices (Figure 12 and 13).

Figure 12: CPI in Developed and Emerging Economies

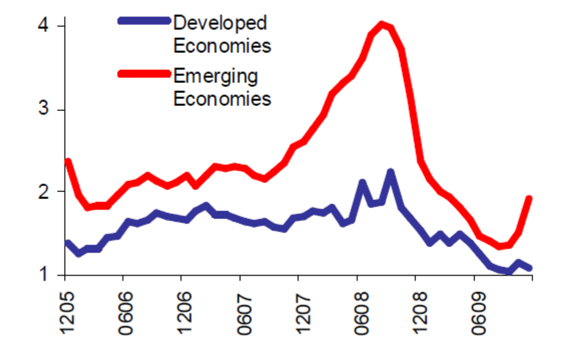
(Annual Percentage Change)



Source: Bloomberg, CBT.

Figure 13: Core CPI in Developed and Emerging Economies

(Annual Percentage Change)



Source: Bloomberg, CBT.

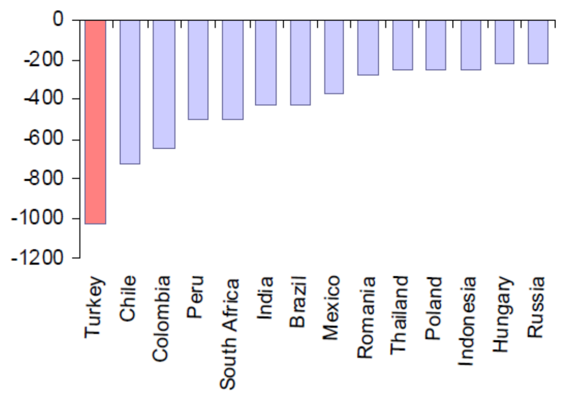
2. Monetary policy response

After commenting briefly on inflation developments, I would now like to cover the policies pursued by the Central Bank during the last quarter.

Anticipating that inflation would decrease sharply as of the last quarter of 2008, the Central Bank of Turkey (CBT) focused on alleviating the potentially harsh impact of the global financial crisis on the domestic economy. In this respect, the CBT has delivered sizeable cuts in policy rates, while providing liquidity support to facilitate the smooth operation of credit markets. The cumulative interest rate cuts between November 2008 and November 2009 reached 1,025 basis points, bringing Turkey's policy rate closer to the average of emerging markets implementing inflation targeting regimes (Figure 14 and 15).

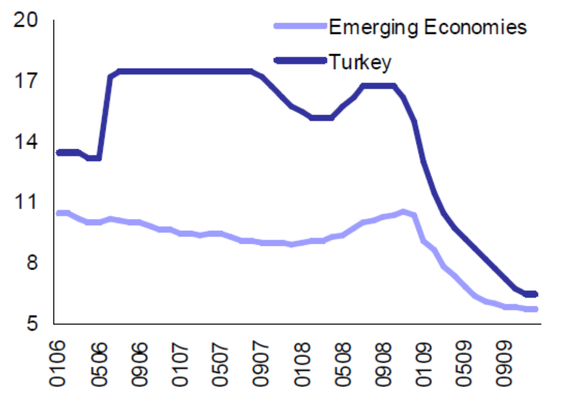
Figure 14: Changes in Policy Rates *

September 2008- January 2010 (Basis Points)



*As of 18 January 2010.
Source: Bloomberg, CBT calculations.

Figure 15: Policy Rates in Inflation-Targeting Emerging Economies *



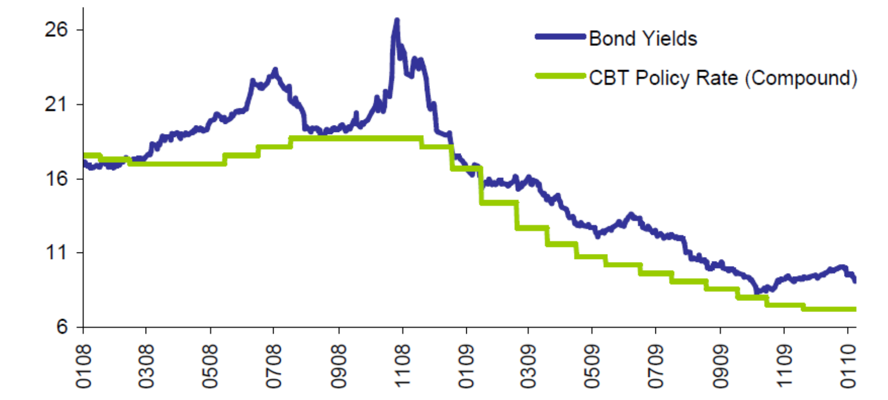
*As of end of December.
Source: Bloomberg, CBT calculations.

Taking into account the favorable developments in the credit markets and the moderate recovery in economic activity in the last quarter of 2009, the Monetary Policy Committee (MPC) slowed the pace of rate cuts, and finally decided to keep rates unchanged at the last two meetings. However, it was also noted that lingering problems across the global economy were still a concern and that uncertainties regarding the strength and durability of the recovery remain. Considering these factors, the MPC reiterated that it would be necessary to keep policy rates at low levels for a long period of time.

At its January meeting, the MPC indicated that tax adjustments and base effects would cause inflation to rise significantly in the first two months of 2010 and afterwards remain above the target for some time. Noting that the underlying trend implied by core inflation indicators would remain at levels consistent with medium-term targets, the Committee emphasized that, given the levels of resource utilization, the state of labor markets, and global economic conditions, general pricing behavior would not be affected adversely by the temporary rise in inflation, and therefore, inflation would display a declining trend once the transitory factors taper off.

Market yields have been broadly shaped by the monetary policy stance during the last quarter of 2009. This is particularly important as it demonstrates the increased effectiveness of monetary policy. Market interest rates slightly increased in October with rising perceptions that the policy rate cut cycle is coming to an end. However, continuing improvement in risk perceptions towards the end of the year recently paved the way for market interest rates to once again ease to historically low levels (Figure 16).

Figure 16: Interest Rate Developments
(Percent)



Source: ISE, CBT.

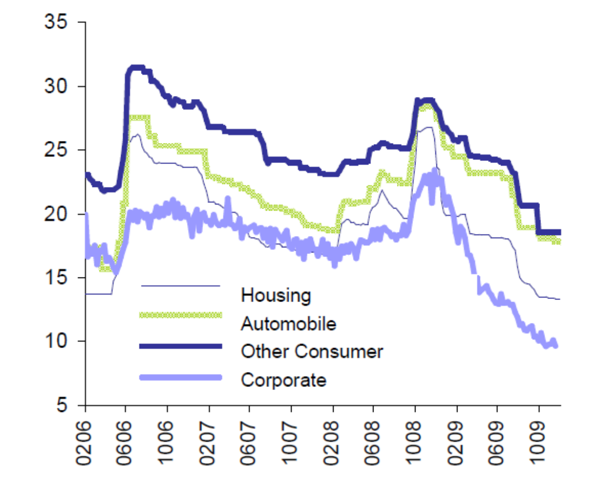
During the crisis, real market interest rates went down progressively on the back of rate cuts and declined to all time lows. Although the limited increase in market interest rates reverberated on medium-term real interest rates in the last quarter of the year, real interest rates currently hover around historically low levels (Figure 17). Likewise, tightness in credit markets continues to ease on account of monetary policy practices and reduced credit risk perceptions (Figure 18).

Figure 17: Medium-Term Real Interest Rates from the Yield on Government Securities*
(Percent)

*2-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from the CBT's Expectations Survey.

Source: ISE, CBT.

Figure 18: Loan Rates*
(Percent)



*Monthly interest rates on consumer loans, yearly interest rates on business loans.

Source: CBT.

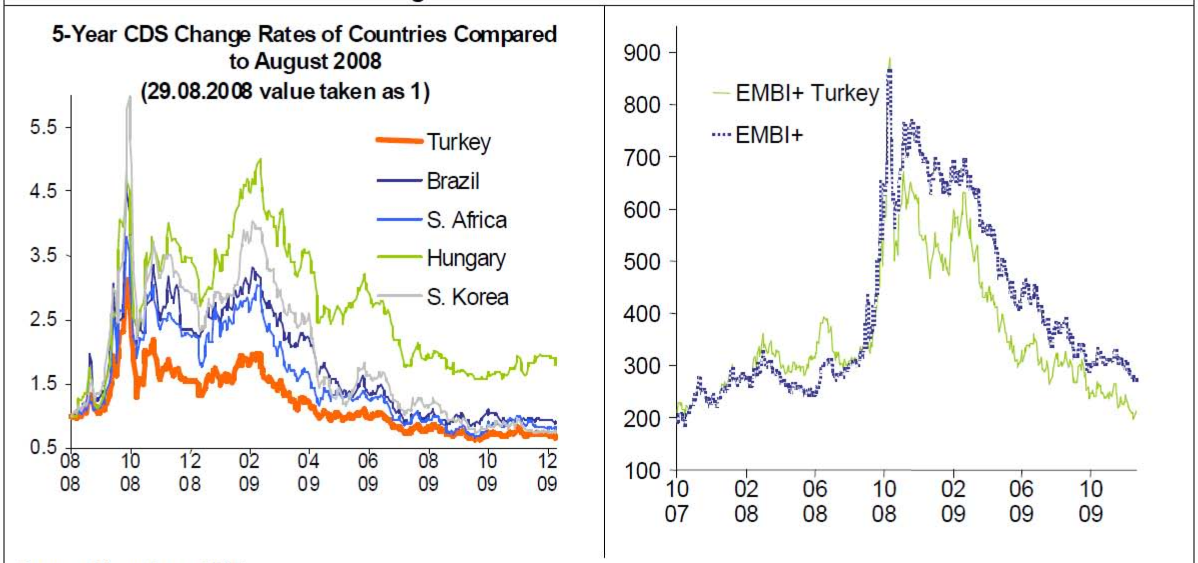
3. Inflation and monetary policy outlook

Distinguished Members of the Press, Distinguished Guests,

After summarizing inflation and monetary policy developments in the final quarter of 2009, in this part of my speech, I would like to share with you the evaluation of the inflation outlook and monetary policy of the Central Bank of Turkey in the upcoming period. Firstly, I will briefly describe the economic framework underlying these forecasts. Then, I will outline the Central Bank's inflation forecasts presented in the Inflation Report that will be posted on our website shortly.

In the last quarter of 2009, perceptions grew that the crisis was over and recovery started, which helped the upward tendency in global risk appetite to continue. This development, coupled with the ample and low-cost liquidity injected to the market in line with expansionary fiscal and monetary policies on a worldwide scale, underpinned optimism in global financial markets and led to continued demand for risky assets. Accordingly, risk premium indicators in most developing countries remained lower than pre-crisis levels (Figure 19).

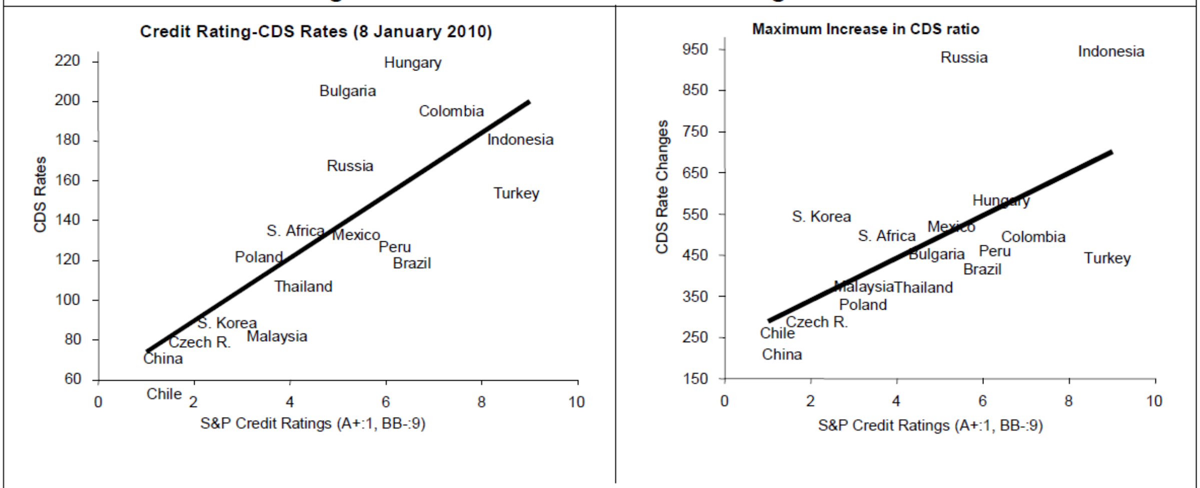
Figure 19: Risk Premium Indicators



Source: Bloomberg, CBT.

As you will recall, on several occasions we have mentioned that Turkey's sovereign credit rating in the post-crisis period was not commensurate with the actual credit risk level in the market. Actually, in the last quarter of the year, consistent with our discourse and projections, the medium and long-term forecasts for Turkey have been revised to positive; several investment institutions have increased Turkey's share in their portfolio, and, more importantly, the leading credit rating agencies have upgraded Turkey's sovereign rating (Figure 20).

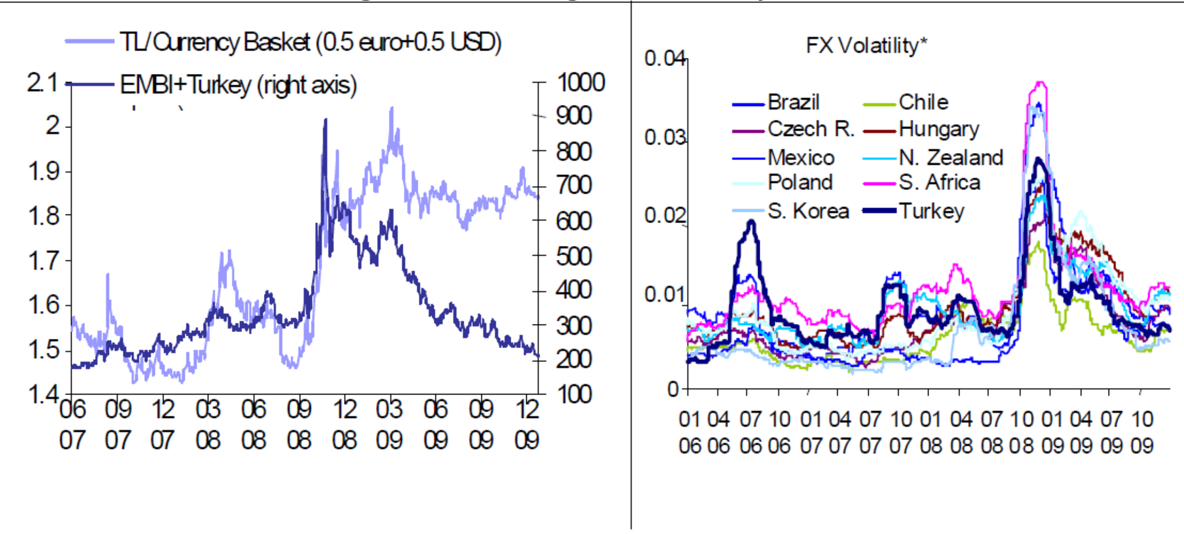
Figure 20: Risk Premium - Credit Rating Relation



*Highest CDS Rates during the crisis compared to pre-crisis period.

The improvement in global risk perceptions in the last quarter led to the appreciation of local currencies of many developing countries. A similar trend was observed in Turkey too and the relatively stable course of the Turkish lira continued in the last quarter (Figure 21).

Figure 21: Exchange Rate Developments

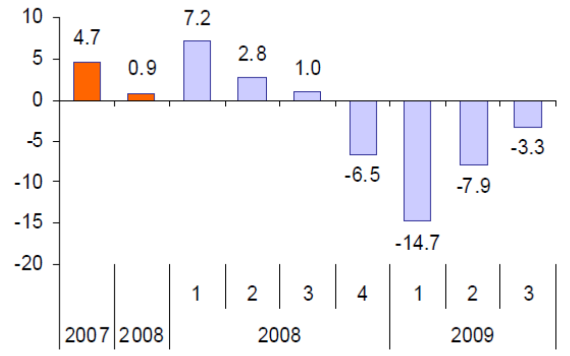


* 50-day moving standard deviation of daily exchange rate changes.
Source: Bloomberg, CBT.

Distinguished Members of the Press,

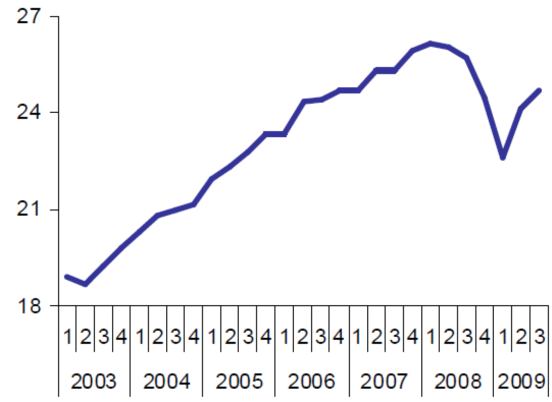
The third quarter gross domestic product (GDP) release was in line with the outlook presented in the October Inflation Report. While the impact of the fiscal stimulus package on domestic demand weakened, the gradual recovery in external demand continued. Within this framework, the GDP decreased by 3.3 percent in the third quarter of 2009 compared to the same quarter last year (Figure 22). In seasonally adjusted terms, the quarterly upward trend continued in the third quarter, albeit slower compared to the second quarter during which the impact of the fiscal stimulus package was substantial (Figure 23).

Figure 22: GDP Growth by Periods
(Percent)



Source: TurkStat.

Figure 23: GDP
(Seasonally Adjusted, at 1998 Prices, Billion TL)



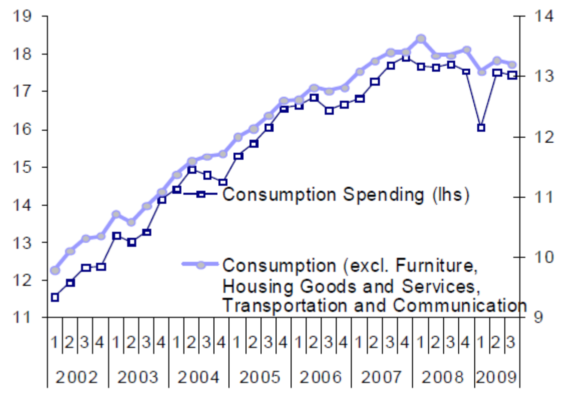
Source: TurkStat, CBT.

On the spending side, inventory change became the demand component that made the largest contribution to quarterly growth (Figure 24). Nevertheless, private consumption demand slowed down slightly after the tax cuts were phased out (Figure 25). Meanwhile, although private sector investments displayed a quarterly rise after a long time, investment expenditures are not expected to display a significant acceleration in the short term given the current uncertainty about demand and low capacity utilization rates, and it is obvious that it would take some time for investments to return to the pre-crisis level.

Figure 24: Contribution to GDP Growth from Spending by Periods
(Percentage Point)

Source: TurkStat, CBT.

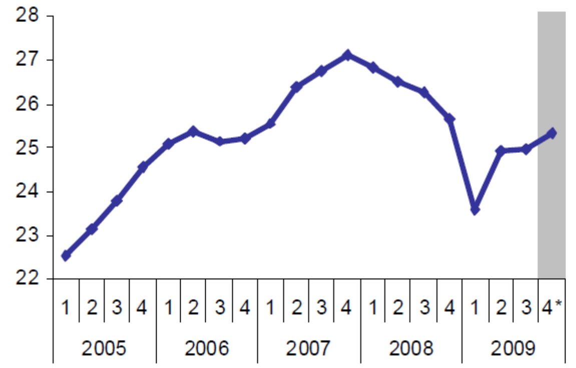
Figure 25: Consumption of Resident and Non-resident Households
(Seasonally Adjusted, at 1998 Prices, Billion TL)



Source: TurkStat, CBT.

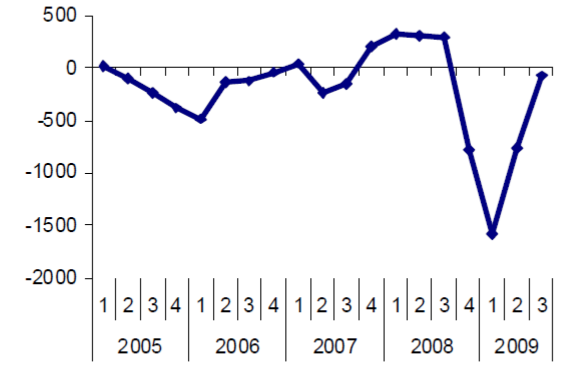
Data pertaining to the last quarter of 2009 indicate that the moderate recovery in aggregate demand continues (Figure 26). Although inventory de-stocking, which started with the sudden contraction in demand in the last quarter of 2008 and remained strong throughout the first half of 2009, grew significantly weaker, demand for consumer goods continued to support disinflation (Figure 27).

Figure 26: Aggregate Domestic Demand
(Seasonally Adjusted, at 1998 Prices, Billion TL)



*Forecast
Source: TurkStat, CBT.

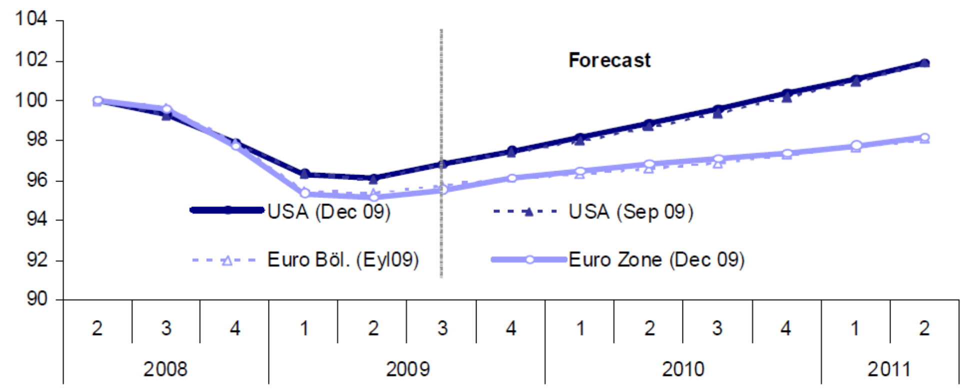
Figure 27: Inventory Change
(Seasonally Adjusted, at 1998 Prices, Million TL)



Source: TurkStat, CBT.

The significant decline in external demand has been one of the main factors driving the sharp contraction in economic activity during the last quarter of 2008 and the first quarter of 2009. As inventory de-stocking decelerated in the third quarter of 2009, the pick-up in aggregate demand led to acceleration in demand for imported goods and the contribution of net exports to quarterly growth became negative (Figure 24). External demand conditions will continue to play a critical role regarding the pace of the recovery in economic activity in the forthcoming period as well. As of December, no significant upward revision in growth forecasts for developed countries – as compared to the forecasts in October Inflation Report – is deemed necessary. Within this framework, even if the recently issued data affirm that moderate recovery in exports continues, given the current level of exports and the expected pace of global economic recovery, external demand is not expected to reach its pre-crisis levels for a long period of time (Figure 28).

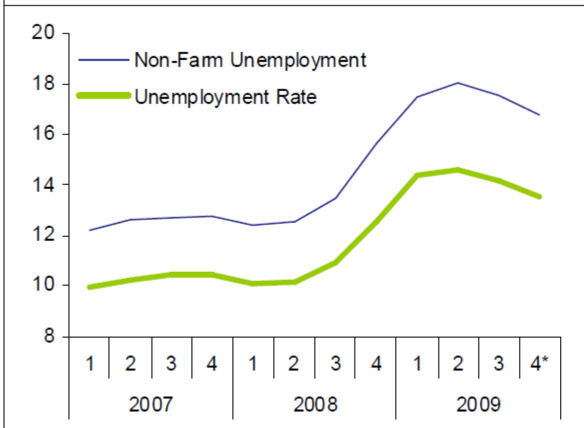
Figure 28: GDP Forecasts for Developed Countries
(Seasonally Adjusted, 2008Q2=100)



Source: Consensus Forecasts, September and December.

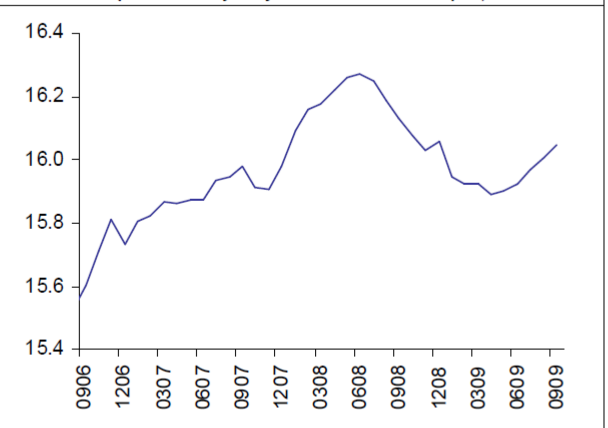
The weak course of external demand would restrain economic activity and employment growth through its impact on industrial production. Indicators such as capacity utilization rates and per capita hours worked across industries suggest that resource utilization remains low throughout the economy. Nevertheless, indicators of the labor market started to recover in the third quarter of 2009. Although the upward trend in unemployment rates reversed in seasonally adjusted terms, the unemployment rate is still quite high compared to the pre-crisis level (Figure 29). The mentioned recovery in unemployment rates as of the third quarter of 2009 was mainly driven by the pick-up in non-farm employment (Figure 30). Assuming that the ample slack would continue to be a drag on investment and employment, recent signs of improvement in employment data is not expected to turn into a significant recovery, suggesting that the unemployment rate will likely remain elevated for an extended period. Therefore, unit labor costs and domestic demand would continue to support disinflation.

Figure 29: Unemployment Rates
(Seasonally Adjusted, Percent)



*As of October.
Source: TurkStat, CBT.

Figure 30: Non-Farm Employment
(Seasonally Adjusted, Million People)

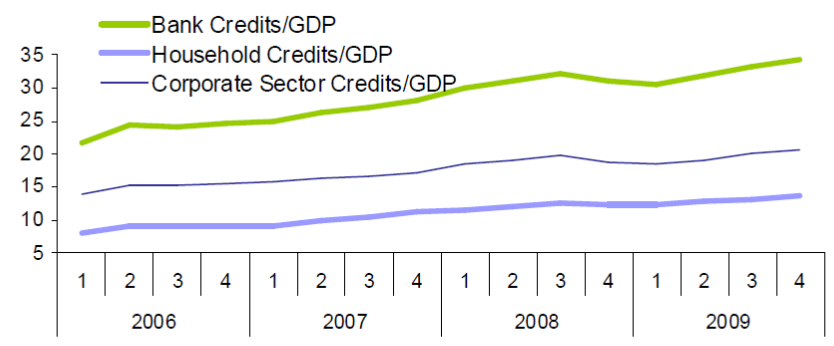


Source: TurkStat, CBT.

Distinguished Guests,

As I have mentioned earlier in my speech, the tightness in credit conditions have been moderating since the publication of the July Inflation Report, owing to the improvement in global liquidity conditions and risk perceptions. Easing financial conditions and declining loan rates have been strengthening the expansionary impact of monetary policy. The October Inflation Report had stated that the credit channel would begin to support domestic economic activity during the fourth quarter of the year. In fact, credit demand started to recover in this period, especially with commercial loans picking up significantly. However, the effectiveness of the credit channel in supporting economic activity is still partly restrained owing to the ongoing tightness in lending standards for small- and medium-sized enterprises.

Figure 31: Ratio of Bank Credits to GDP*
(Percent)



* Corporate sector loans are composed of household loans and domestic business loans. Estimated figures are used for 2009Q4 GDP.
Source: CBT.

It is expected that the credit channel would continue to support domestic activity, and the impact of cumulative rate cuts would become more prevalent over the medium term. However, the rising domestic borrowing requirement of the public sector, ongoing problems in the global economy, and elevated levels of unemployment would continue to restrain credit expansion.

Overall, recent data releases have shown that economic activity is on a gradual recovery path. Even if the gradual recovery in economic activity is expected to continue in the period ahead, resource utilization is anticipated to remain below the long-term average for some time. In this context, our medium-term forecasts suggest that the output gap – albeit closing faster than envisaged in the October Report – will remain disinflationary until the beginning of 2012.

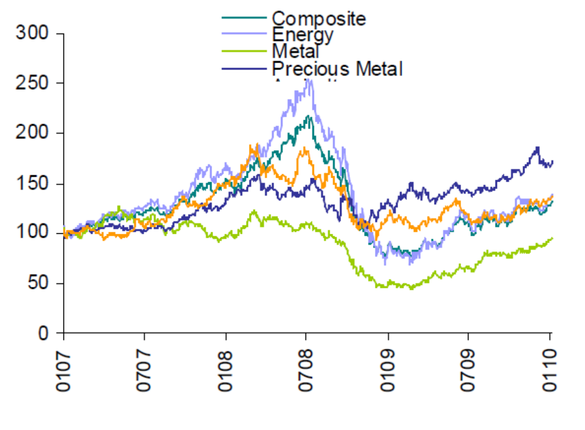
Distinguished Members of the Press,

Although the course of economic activity has been broadly in line with the outlook presented in the October Inflation Report, there have been some developments that necessitated an upward revision in short-term inflation forecasts. As I believe that interpreting these developments accurately is very important, I would like to further elaborate on these developments.

The tax measures implemented in January on fuel, alcohol, and tobacco products, to increase budget revenues, will add around 1.5 percentage points to 2010 consumer inflation. Forecasts presented in the October Inflation Report assumed that prices of these products would increase in line with target inflation in 2010, and thus the total contribution of these items was envisaged to be 0.5 percentage points. Accordingly, tax measures in January have shifted the inflation forecast path by around 1 percentage point through 2010. I would like to underline that this impact will be seen immediately in January 2010 and disappear following January 2011.

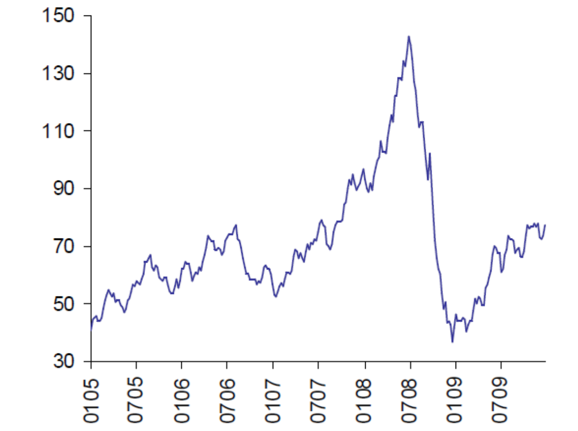
The rise in oil prices was another factor that necessitated an upward revision in our short-term inflation forecasts. Commodity prices continued along a rising trend during the last quarter of 2009, with the improving perception regarding the global economic recovery (Figure 32). Accordingly, oil prices hovered above our assumption of 70 USD per barrel for the fourth quarter (Figure 33). Therefore, oil price assumptions stated in the previous Report have been revised in line with futures prices registered during the first half of January. In this context, the previous assumption of oil prices have been revised up from 75 USD per barrel to 80 USD for 2010, and from 80 USD to 85 USD for 2011 and thereafter (Table 1). This revision has added around 0.2 percentage points to the 2010 inflation forecasts. Moreover, in line with oil prices, imported input prices are also assumed to increase gradually throughout the forecast horizon in response to the gradual recovery in the world economy.

Figure 32: S&P Goldman Sachs Commodity Prices Indices*



* Average of January 2007 has been taken as 100.
Source: Goldman Sachs.

Figure 33: Crude Oil (Brent) Prices
(USD dollar/barrel)



Source: Bloomberg.

The October Inflation Report envisaged annual food inflation to be 5.8 percent for 2009 and 6 percent for the years to follow. However, as I have mentioned earlier in my speech, unprocessed food prices exceeded our forecasts. Therefore, we revised our assumptions for food inflation up from 6 percent to 7 percent for end-2010 (Table 1) and this added around 0.3 percentage points to the 2010 inflation forecast. Similarly, assumptions for 2011 food inflation have been raised to 6.5 percent from 6 percent. We maintain our 6 percent annual food inflation forecast for subsequent years.

Table 1: Sources of Revisions in Inflation Forecasts

	October 2009 ER						January 2010 ER					
CPI Inflation	-						End-2009, 1 point above the predictions					
Output Gap	2009 Q3:-8.1 2009 Q4:-7.4						2009 Q3:-8.1 2009 Q4:-7.3					
Food Prices	2009: 5.8% 2010: 6% 2011: 6%						2009: 9.3%[1] 2010: 7% 2011: 6.5%					
Administered prices and taxes	0.5 point-contribution to 2010 inflation						1.5 point-contribution to 2010 inflation					
Oil Prices	2010: USD 75 2011 and onwards: USD 80						2010: USD 80 2011 and onwards: USD 85					
Eurozone growth forecasts[2]	2010			2011			2010			2011		
	CF	*WEO*	*OECD*	*CF*	*WEO*	*OECD*	*CF*	*WEO*[3]	*OECD*	*CF*	*WEO*	*OECD*
	1.1	0.3	0.0	-	1.3	-	1.3	0.3	0.9	1.6	1.3	1.7

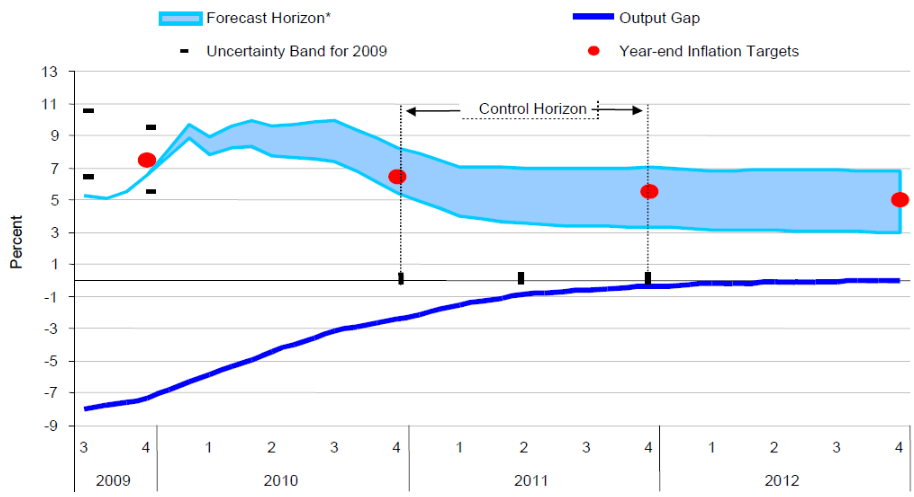
[1] 2009 year-end food inflation realizations
[2] Consensus Forecasts (CF), October 2009 and January 2010 bulletins; World Economic Outlook (WEO), October 2009 bulletin; OECD, June 2009 and November 2009 bulletins.
[3] WEO January 2010 Revision Bulletin, no revision could be made as it had not been published by 26 January 2010, the date for the publication of the January 2010 Inflation Report.

Finally, regarding fiscal policy, it is assumed that the consistent framework outlined in the Medium Term Program (MTP) will be implemented and further enhanced by institutional and structural measures. In other words, it is assumed that no public price/tax adjustments would be made to lead to unpredictable volatilities in inflation and administered prices would be set in line with inflation targets over the next three years. Moreover, it is assumed that the fiscal stance will remain expansionary – but less so than in 2009 – throughout 2010, and subsequently fiscal tightening would be gradually adopted starting from 2011. In this respect, it is envisaged that the rising debt-to-GDP ratios would reverse their course steadily starting from 2011, and hence the risk premium would not display any significant changes throughout the forecast horizon.

Distinguished Guests and Members of the Press,

Against this background, assuming policy rates are kept constant for a long period followed by limited rises thereafter, with policy rates staying at single digits throughout the three-year forecast horizon, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 5.5 and 8.3 percent with a mid-point of 6.9 percent at end-2010; and between 3.4 and 7.0 percent with a mid-point of 5.2 percent by the end of 2011. Furthermore, inflation is expected to decline to 4.9 percent by the end of 2012 (Figure 34).

Figure 34: Inflation and Output Gap Forecasts*
(Percent)



* The probability of inflation to remain within the uncertainty band is 70 percent.

Overall, there has not been any major change in medium-term forecasts and the monetary policy stance, since economic activity has evolved in line with the outlook presented in the October Inflation Report. However, all the main variables affecting the short-term forecast have been subject to an upward revision. In this respect, while short-term forecasts were revised upwards significantly, there has been no major change regarding medium-term forecasts.

The revised forecasts indicate that there will be no significant upside pressures on inflation, even if policy rates remain at low levels for a long period. However, as depicted in the slide, inflation is likely to display a significant increase over the next two months due to tax hikes and strong base effects (Figure 34). Moreover, the annual inflation rate may post a limited increase in the second quarter of 2010, due to the low base effect generated by the Consumer Price Index in the first half of 2009, when the downside effects of the global crisis on prices became more pronounced. Accordingly, even if inflation remains above the target for some time, parallel to the gradual phasing out impact of the tax hikes, inflation is expected to trend downwards, stabilizing at around 5 percent over the medium term.

As you may have noticed, I have frequently referred to the base effect today. The reason for this is that the base effect will influence the course of annual inflation throughout 2010 to a large extent. You will find our detailed explanatory evaluations regarding the base effect and its effects on 2010 inflation outlook in a box under the third chapter of the Inflation Report to be posted on our website shortly. I strongly recommend that you read these evaluations carefully.

The fact that inflation is expected to stay at elevated levels for some time due to tax adjustments and strong base effects highlights the importance of expectations management. In this respect, with the awareness of these temporary factors, it is critical that economic agents focus on the medium-term inflation trend, and therefore, take inflation targets as a benchmark for their pricing plans and contracts.

I would like to emphasize once more that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBT.

4. Risks

Distinguished Members of the Press,

In the last part of my presentation, I would like to talk about the risks with respect to the inflation outlook in the upcoming period and provide some information pertaining to the probable monetary policy strategy should these risks materialize.

The outlook for the domestic economy and the risks thereto has been largely shaped by global developments in line with the intensification of the global crisis as of the last quarter of 2008. Given the important role of trade and global financial channels in the contraction of domestic economic activity during 2009, we believe that global developments would continue to be the main determinant of the outlook for domestic activity and inflation in the forthcoming period. Accordingly, in this part of my speech, I will cover both the possible trends of global and domestic economic activity, as well as their impact on the domestic inflation outlook jointly.

Rising budget deficits and ongoing problems in credit and real estate markets continue to pose downside risks for global activity, especially for developed economies. Although the probability of another disruption in global economic activity has been decreasing, it is still an important source of downside risk on domestic economic activity and inflation. Should global conditions deteriorate again, and consequently delay domestic recovery, the CBT would consider further monetary easing.

Despite the prevailing downside risks on global and domestic economic activity, upside risks have also been emerging since the second half of 2009. The extent of recovery in global economic activity in the second half of 2009 reminds us of some of the upside risks in economic activity as well. Moreover, it should be noted that the impact of the unprecedented expansionary policy measures that have been taken since the last quarter of 2008 would become visible with a lag. Similarly, it should be considered that the 1025 basis points of cumulative easing in CBT policy rates between November 2008 and November 2009 would also be fully conveyed with a lag. In this respect, should the recovery in domestic economic activity turn out to be faster than expected, the limited monetary policy tightening implied in the baseline scenario could be implemented earlier than envisaged.

The fact that inflation will rise in the forthcoming period due to base effects and public price adjustments, poses an important risk factor through its potential impact on inflation expectations. Several adverse factors such as food and oil price increases, base effects and administered price hikes have brought about upward movements in inflation since the last quarter of 2009. Although these factors are temporary, they are likely to cause headline inflation to stay at elevated levels for some time. It is crucial that economic agents fully understand the temporary nature of these developments while forming their medium- and longer-term expectations. Under the assumption that resource utilization would remain low, labor market conditions would have an adverse impact on consumption expenditure, and fiscal policy would generate a gradual depressing effect on the economy, these temporary factors as well as other one-time cost push pressures would not lead to a significant deterioration in general pricing behavior. Currently, the annual rate of increase of services prices and core inflation are consistent with medium-term inflation targets, and no serious risk of pass-through is observed. Therefore, it is foreseen that policy rates would be maintained at low levels for a long period. However, I would like to underline that should any unforeseen developments lead to a deterioration in general price setting behavior, the CBT will not hesitate to tighten monetary policy sooner than envisioned under the baseline scenario drawn up in this Report.

Increasing budget deficits on a worldwide scale, especially in developed economies, continue to pose upside risks on inflation expectations and thus on longer term global interest rates. Countries with relatively sounder banking systems and prudent fiscal policies would be more resilient against these risks. In this respect, the CBT will continue to monitor fiscal policy developments closely while formulating monetary policy. Should the goals set out in the Medium Term Program be implemented through institutional and structural measures, rather than tax and administered price hikes, it would be possible to keep policy rates at single digits throughout the forecast horizon.

The probable course of oil and other commodity prices still remains as another important risk factor. Short-term ample liquidity driven by countercyclical policies that are adopted by public authorities on a global scale can give way to speculative movements in commodity prices. Fast growth trends in countries like China and India, and the rising share of these economies in global commodity demand, exacerbate these speculative motives. Therefore, oil and other commodity prices may continue to rise, even in a scenario of a gradual global economic recovery. At this point, it is worth noting that weak domestic demand conditions would limit the pass-through stemming from upside cost-push shocks. Therefore, the CBT will not react to the first round effects of short-term volatility in commodity prices, especially when domestic resource utilization remains at depressed levels. However, if an uptrend in commodity prices coincides with a strong and durable rebound in global economic activity that would in turn have adverse effects on inflation expectations, then the CBT will tighten monetary policy appropriately to keep inflation in line with medium-term inflation targets.

Since the last quarter of 2008, the CBT, without endangering its main objective of price stability, has focused on containing the adverse effects of the global crisis on domestic economy, and this task has to a large extent been achieved. Monetary policy will continue to focus on permanent price stability in the period ahead. Strengthening the commitment to fiscal discipline and the structural reform agenda would support the relative improvement in Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. In this respect, before concluding my remarks, I would like to underline once more that timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union accession process remains to be of the utmost importance. Thank you for your attention.