No: 2008-24

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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: September 18, 2008

Inflation Developments

1. Consumer prices fell by 0.24 percent in August, bringing inflation down to 11.77 percent year-on-year, largely owing to a reduction in annual food price inflation. Despite the fall in fuel prices, hikes in natural gas and water rates increased annual energy price inflation. The contribution of food and energy prices to annual inflation was down by 0.5 points from July to 7.7 percent in August.

2. The Monetary Policy Committee (the Committee) assessed that favorable outlook in food prices and the sharp decline in oil prices will support disinflation.

3. The annual rate of increase in food and non-alcoholic beverage prices decelerated by 2 percentage points to 13.33 percent. With the ongoing correction in fruit and vegetable prices, annual inflation in unprocessed food prices slowed down to 0.68 percent in August. The favorable trend in unprocessed food prices is expected to continue in the forthcoming period.

4. The relative slowdown in processed food prices has become more significant in August. Recent decline in prices of bread and grains as well as oil and fats has been supporting the downward trend in processed food inflation. Given the downward trend in processed food prices and the low base from last year, annual inflation in processed food prices is expected to ease markedly in September.

5. The Committee observed that, since the release of the latest Inflation Report, food prices have been following a more favorable course than envisaged, thanks to improved agricultural productivity and lower international prices. Food inflation is expected to continue to ease in the remainder of the year.

6. Energy price inflation climbed up to an annual rate of 27.38 percent. Despite the recent fall in oil prices, the cumulative past increases continue to put upward pressure on energy prices. The hike in prices of natural gas, water and solid fuels in August is a case in point. Moreover, the impending hike in electricity tariffs, effective October 1, and the potential rise in natural gas prices indicate that energy prices will continue to restrain the disinflation in the

short term. The hike in electricity tariffs is likely to contribute 0.23 percentage points to CPI inflation in October.

7. The annual inflation in prices of goods excluding energy and food remained unchanged from July, at 4.19 percent. Seasonal discounts in August were relatively limited compared to July, pushing clothing price inflation up by 1.2 percentage points year-on-year. On the other hand, the strengthening of the new Turkish lira and the weak domestic demand brought annual inflation in durable goods down by 1.6 percentage points from July. Meanwhile, prices of pharmaceuticals rose by 4.64 percent, while gold prices were down 11.05 percent in August.

8. On the services front, lagged impacts of supply shocks continued to put upward pressure on prices of transport and catering services. Nevertheless, the Committee noted that the monthly rate of increase in catering prices have recently slowed down, which should become more pronounced as food prices ease further. Inflation in communication services, which were up 4 percentage points year-on-year on account of the base effect and soaring fixed-line tariffs, were the main driver of the rise in annual services inflation in August. Rental inflation, on the other hand, remained on a steady decline.

9. Although the inflation measured by the widely cited core CPI indexes, denoted by H and I, went slightly up year-on-year due to the base effect and the lagged impact of supply shocks, seasonally adjusted figures suggest a downward trend in underlying inflation.

Factors Affecting Inflation

10. Recent readings indicate a significant slowdown in domestic economic activity. Gross Domestic Product (GDP) grew by 1.9 percent in the second quarter of 2008 in annual terms, but displayed a 0.6 percent quarterly decline in seasonally adjusted terms. Net exports made a positive, though modest, contribution to growth, whereas private consumption and investment expenditures slowed down significantly.

11. Tightening global liquidity conditions and moderating domestic and foreign demand have put restrain on the industrial production. Seasonally adjusted data suggest that industrial production remained flat in July compared with the previous quarter, and the sharp downturn in industry capacity utilization rate in August points an ongoing slowdown in industrial production.

12. The uncertainty surrounding the global economy increased the downside risks to foreign demand. Capacity utilization rates in industries such as textiles, clothing, vehicles and machinery-equipment, which account for a substantial

share in exports, declined in August, indicating a lower contribution from external demand to economic growth. On the other hand, the robust demand from oil exporting countries continues to support external demand.

13. The fall in agricultural production in the second quarter is believed to be short-lived since it has been partly driven by regional drought problems. In fact, crop production forecasts for 2008, recently released by the TURKSTAT, point to a rising agricultural production in the second half of the year.

14. Leading indicators for the third quarter point to sluggish recovery in private consumption expenditure. Although consumer confidence indices have rebounded to some extent, they are still at low levels compared with the episodes of vigorous domestic demand. Monetary indicators, consumer loans, consumption indices and the Business Tendency Survey data suggest a similar outlook.

15. Recent readings indicate that investment expenditure have followed a flat course in the third quarter. Indicators such as machinery-equipment production, imports of capital goods and sales of heavy commercial vehicles, point to a continued softening in machinery-equipment investments. July data on production in the non-metallic minerals industry, a leading indicator for construction investments, are slightly up from June in seasonally adjusted terms, but down from the first-quarter average. In addition, building permits fell by 20.1 percent year-on-year in the second quarter. The steady decline in building permits since mid-2007 indicates that construction activities are unlikely to rebound in the upcoming period.

16. Public expenditures registered a fall in the first half of 2008 in annual terms. Public spending is expected to accelerate in the second half of the year, in line with budgetary targets. This will partly offset the slowdown in private expenditures, and hence, support the aggregate demand.

17. Overall, ongoing problems in international credit markets and the global economy continue to restrain both the domestic and external demand. Therefore aggregate demand conditions will continue to support disinflation. Accordingly, inflation is expected to fall gradually in the forthcoming period.

Monetary Policy and Risks

18. The Committee assessed that the current policy rate supports disinflation. Moreover, the decline in the global risk appetite has been keeping longer-term interest rates at high levels and leading to tighter monetary conditions.

19. Central Bank of Turkey (CBT) has been presenting the inflation outlook under alternative scenarios for food and energy prices since the second quarter of the year. This framework should improve the predictability of monetary policy by providing conditional forecasts for different realizations of shocks. As a mater of fact, developments since the publication of July Inflation Report have confirmed the relevance of this strategy. Oil prices have followed a significantly lower course than the level assumed in the baseline scenario. Similarly, recent developments in agricultural commodity prices and in domestic agricultural production indicate a more favorable outlook for food prices than envisaged in the Inflation Report. Accordingly, the Committee assessed that the course of oil and food prices has been closer to the optimistic scenario outlined in the July Inflation Report, and therefore, a measured rate cut would be considered should the favorable outlook in inflation and commodity prices continue.

20. Recently, problems in the global financial markets have intensified. Regarding the inflation outlook, these developments create upside risks through potential portfolio movements and downside risks through aggregate demand. The CBT will not display a sharp reaction to temporary fluctuations in the financial markets, unless there is a long lasting deterioration in expectations and a significant worsening in the general pricing behavior. Yet, current circumstances require monetary policy to be flexible on both sides. Depending on the impact of the ongoing financial turmoil on the domestic economy, the Committee will consider measured rate cuts as well as temporary tightening through active liquidity management.

21. Despite the recent decline in commodity prices, lagged effects of the long lasting supply shocks continue to exert pressure on headline inflation especially through domestic energy prices, keeping alive the risks of generalized backward looking schemes in the wage and price setting behavior. Although the widening output gap should contain the second round effects of the supply shocks, the exact pace of disinflation would still depend on the extent new inflation targets serve as a reference for economic agents. Having this in mind, the CBT will continue to focus on enhancing the credibility of the new inflation targets.

22. A critical underlying assumption for the inflation and monetary policy outlook outlined above is that government expenditures and incomes policy will evolve in line with the official projections, and that there will be no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanisms. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

23. In sum, despite the improvement in inflation outlook, the Committee assessed that recently heightened uncertainties in the global financial markets require monetary policy to remain cautious and decided to keep policy rates constant. Future decisions on policy rates will depend on domestic and external demand, developments in global markets, fiscal policy implementation, and other factors affecting the medium term inflation outlook.

24. Meeting agenda also included an assessment of liquidity developments in money markets. In order to alleviate the tightening in liquidity conditions since May, the CBT has been injecting Turkish lira liquidity into the markets via repo operations. Recent developments suggest that tight liquidity conditions may last through 2009 and onwards. The Committee members, referring to the main policy document "Monetary and Exchange Rate Policy in 2008" dated December 18th 2007, noted that the current outlook for liquidity conditions may call for a technical adjustment in short term interest rates. Accordingly, the Committee decided to initiate the preparations for the redesign of the operational framework of liquidity management in 2009, details of which will be announced in December.

25. Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance the productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.