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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: November 19, 2008

Inflation Developments

1. Consumer prices increased by 2.60 percent in October, pushing annual inflation up to 11.99 percent, mainly on account of the temporary rise in vegetable prices. The plunge in world oil prices helped to ease fuel prices, but the increase in electricity, natural gas and solid fuel prices put further upward pressure on energy price inflation. The contribution of food and energy prices to annual inflation went up to 7.6 percentage points, while annual services inflation declined.

2. The sharp increase in unprocessed food prices in October drove food prices up by 3.91 percent on the back of soaring fresh fruit and vegetable prices that were up around 30 percent. Accordingly, the increase in fresh fruit and vegetable prices accounted for 1.7 percentage points of the 2.6 percent rise in monthly CPI. Annual processed food inflation, on the other hand, fell by a cumulative 6.2 percentage points in three months. The downtrend in processed food inflation is expected to continue into coming months on the back of favorable prices for bread and grains and solid and liquid fats.

3. Although fuel prices dropped by 2.35 percent, energy price inflation climbed to 30.98 percent year-on-year in October amid rising electricity, natural gas and solid fuel prices. Electricity prices have soared by a cumulative 56 percent since the beginning of the year, while solid fuel prices have jumped by 31.5 percent in four months. Price cuts of 15 and 10.3 percent on liquid petroleum gas and bottled gas, respectively, are expected to curb the impact of the natural gas price hike of 22.5 percent in early November on CPI inflation. In view of these developments and the base effect, annual energy inflation is expected to fall in November.

4. Prices of goods excluding energy and food rose by 1 percentage point to 5.17 percent year-on-year in October. In the clothing group, annual inflation remained low, while in the durables group (excl. gold) inflation went up due to the base effect and the exchange rate developments. Given the exchange rate pass-through and the low base from a year ago, the annual inflation in durable goods is expected to rise further in November.

5. Annual inflation in services, which had been on the rise since March, moderated in October with the easing supply shocks and the weakening of domestic demand. Accordingly, annual services inflation was down by 0.5 percentage points to 10.97 percent in October. In fact, inflation in all services categories declined in October. Recently, seasonally adjusted core inflation indicators also point to a slowdown in underlying inflation.

Factors Affecting Inflation

6. The adverse impact of the global financial crisis on the Turkish economy has become more visible. Recent information points to a pronounced slowdown in domestic economic activity. Industrial production fell by 5.5 percent in September from a year earlier. Third quarter industrial production dropped by 2.1 percent in annual terms and 3.5 percent quarter-on-quarter in seasonally adjusted terms. This outcome was mainly driven by the decline in the activities of export-oriented industries.

7. Leading indicators suggest that industrial production will continue to weaken in the fourth quarter. In October, the capacity utilization in manufacturing industry fell to 76.7 percent, down by 6.4 percentage points from a year ago. Similarly, the Business Tendency Survey in October showed that new orders in the manufacturing industry for the next three months and expected production have declined sharply.

8. After having remained flat in the third quarter, private consumption spending will fall markedly in the fourth quarter, as suggested by recent indicators. Domestic sales of automobiles dropped in October while consumer loans fell in real terms from a month ago. In addition, expectations for domestic sales in the next three months have fallen remarkably, and consumer confidence indices displayed a sharp decline on the back of global economic concerns.

9. Leading indicators suggest that the investment spending continued to slow down in the third quarter. In seasonally adjusted terms, both production and imports in the machinery-equipment industry and the electric machinery and appliances industry fell in the third quarter. Likewise, domestic sales of heavy commercial vehicles continued to decline in October. Imports of capital goods, on the other hand, grew at a modest pace in the third quarter on a seasonally adjusted basis. Yet, the recent depreciation in domestic currency will likely to curb the investment demand in the fourth quarter. Meanwhile, medium term investment sentiment of the industrial sector continued to weaken, as suggested by the results of October's Business Tendency Survey. In view of these developments, private investment spending on machinery-equipment is expected to weaken further in the third and fourth quarters. Besides, recent

indicators also point to a marked decline in construction activities in the second half of the year.

10. Due to the sharp global economic downturn, Turkey's export market share has fallen markedly. Exports displayed a year-on-year fall by 3.1 percent in September. Although the increased share of exports to non-EU and US countries signals a potential for market expansion, Turkey's export performance in the near term is likely to be weaker compared to previous years. Given the expectations for export orders in the coming three months and rates of capacity utilization in export-oriented industries in October, export volume is expected to fall in the final quarter. Moreover, the softening in domestic demand and the depreciation of the YTL will lead to a marked slowdown in imports in the fourth quarter. Overall, imports are expected to decline at a slightly faster pace than exports, which will lead to a positive contribution from net exports to GDP growth.

11. In sum, recent readings indicate that the economic activity continued to weaken in the third quarter. Due to tighter credit conditions and the deterioration in consumer and investor confidence, domestic demand will continue to fall in the fourth quarter. Accordingly, aggregate demand conditions will increasingly support disinflation.

Monetary Policy and Risks

12. The meeting focused on the developments since the publication of the October Inflation Report. The Committee stated that ongoing problems in international credit markets and the global economy would continue to restrain both domestic and external demand for an extended period

13. The Committee members expect the pass-through from exchange rates to domestic inflation to remain low in the current period compared to the past episodes. The Inflation Report involved no major revision in the medium term inflation forecasts, as the impact of the pass-through from the exchange rate depreciation to inflation was expected to be largely offset by the favorable food and energy prices and the weakening demand. Recently, weaker-than-expected economic activity has reinforced the Committee's view that the pass-through would remain muted.

14. The Committee has reiterated that the sharp decline in oil and other commodity prices would have a favorable impact on disinflation. Recently, import prices have been easing due to ongoing weakness in global economic activity. Therefore, domestic prices of imported goods are not expected to display a significant rise, notwithstanding the depreciation in the nominal

exchange rate. This should be another factor limiting the exchange rate pass-through.

15. In sum, considering the recent data, the Committee has judged that inflation would display a more rapid fall than envisaged before. The Committee members have stated that although some pass-through from exchange rates to certain core inflation measures is unavoidable, this should be seen as a change in relative prices rather than a rise in underlying inflation. Given that medium term inflation outlook is mainly driven by supply and demand conditions, inflation should trend downwards in the forthcoming period.

16. The Committee underscored the need to remain cautious in monetary policy decisions to ensure a sustained fall in inflation. On the other hand, the Committee members have indicated that recently domestic financial conditions have been tighter than required by the current stance of monetary policy, owing mainly to the intensification of global financial crisis. In this context, it was stated that a measured rate cut would partially offset the extra tightening in monetary conditions.

17. Based on these assessments, the Committee has decided to lower the borrowing rates by 50 basis points. Moreover, the margin between the lending and borrowing rates was reduced by a further 50 basis points in order to contain the potential volatility in short term interest rates.

18. The Committee has underscored the importance of maintaining the smooth functioning of the financial system and the efficiency of credit markets, and has thus decided to implement additional measures regarding the foreign exchange liquidity. As a lender of last resort, the Central Bank has at its disposal the tools necessary to manage the Turkish Lira liquidity directly, and therefore is able to supply the required liquidity to support the smooth functioning of financial and credit markets. Foreign exchange liquidity conditions, on the other hand, are largely determined by global factors. Accordingly, considering the existing level of uncertainty in the global economy, the Committee members have underlined the importance of utilizing the foreign exchange reserves primarily to support the foreign exchange liquidity of the banking system, in line with the plan announced on October the 30th.

19. Central Bank will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective. Future policy decisions will largely depend on the developments in global markets and their reflections on the domestic economy. It should be emphasized that monetary policy needs to remain flexible, and sensitive to new data and developments.

20. Central government budgetary outturns were in line with the targets in the first three quarters of the year. The slowdown in economic activity will moderate tax revenues, and hence create downside risks on budgetary revenues. Inflation outlook presented above assumes that the fall in energy prices will be fully passed through domestic energy prices. In this context, it is important that any needed tightening in the fiscal balance would be implemented through expenditure cuts rather than higher excise taxes. The Committee emphasized that outlook for inflation and monetary policy may be affected by the deviations from this framework.

21. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global financial turmoil. Preserving the fiscal discipline and strengthening the structural reform agenda would also help to mitigate the adverse effects of the ongoing shocks on the domestic economy. 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 productivity gains, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.