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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: April 16, 2009

Inflation Developments

1. Consumer prices increased by 1.1 percent in March, pushing inflation up to 7.89 percent year-on-year, largely due to the sharp rise in unprocessed food prices, as stated in the press releases from the Monetary Policy Committee (MPC) last month.

2. Unprocessed food prices were up 8.58 percent in March, and annual inflation in this category climbed to 10.20 percent. After rising at a more moderate pace in the first two months of 2009 as compared to previous years, fresh fruit and vegetable prices soared by a remarkable 16.99 percent in March, far beyond seasonal patterns, owing to unfavorable weather conditions and the relative increase in foreign demand for these products. Meanwhile, the annual rate of increase in processed food prices continued to fall in March because of the decline in bread and grain prices driven by lower wheat prices, and annual processed food inflation dropped by 3.2 percentage points to 8.30 percent. In sum, with the steep increase in unprocessed food prices, annual food and nonalcoholic beverages inflation surged to 9.18 percent in March from 6.16 percent in February, despite falling processed food prices.

3. Energy prices were nearly unchanged in March, and annual inflation in this category eased to 12.59 percent. The marked slowdown in solid fuel prices during the past two months continued into March, while fuel prices increased due to rising exchange rates and crude oil prices. However, despite the recent uptick, current crude oil prices are still well below their year-ago levels, suggesting that the annual rate of increase in energy prices will continue to slow down in the short run.

4. Prices of goods excluding energy and food remained flat in March. Although prices of tobacco products increased by 7.34 percent, annual inflation in this category dropped by about 1 percentage point to 4.23 percent on the back of the cuts in the Special Consumption Taxes (SCT) in durable goods and the softening in annual clothing inflation. In the durable goods subcategory (excluding gold), prices dropped by 3.95 percent, while annual inflation slumped to –0.95 percent. With the SCT tax cut, prices of automobiles and white goods fell by 6.37 and 6.85 percent, respectively. Moreover, the three-month Value Added Tax (VAT) cut on furniture and IT products announced in

April will put some additional temporary downward pressure on durable goods inflation. However, the Committee noted that exchange rate movements might have a lagged impact on prices of durable goods following the depletion of inventories.

5. The slowdown in services prices that started in the final quarter of 2008 continued into March, and annual services inflation fell by around 1 percentage point to 8.29 percent. With the lagged impact of the sharp contraction in domestic demand, the rate of increase in services prices eased across all subcategories. In particular, annual rent inflation continued to fall at a more solid pace.

6. The decline in the core inflation measures since the fourth quarter of 2008 continued into March, which resulted from the downtrend in underlying inflation and, partly, from the SCT tax cuts in March. Yet, even without the contribution of tax cuts, underlying inflation is still falling. Apart from the SCT tax cut, the VAT cut, effective in April, will also put some downward pressure on core inflation. However, it should be emphasized again that this impact will most likely disappear by the time these tax cuts expire, which are therefore expected to cause fluctuations in the core inflation measures over the short run.

7. Overall, the downtrend in inflation became more pronounced in the first quarter of 2009 on the back of the sharp contraction in economic activity. Furthermore, owing to the cumulative decline in oil and other commodity prices, inflation is expected to decelerate at a more rapid pace in the short run.

Factors Affecting Inflation

8. Recent readings suggest that economic activity continued to weaken in the first quarter of 2009. In this period, domestic demand fell rapidly, while foreign demand remained subdued. Accordingly, industrial production shrunk by 22.5 percent year-on-year during the January-February period. Moreover, the contraction, in seasonally adjusted terms, was deeper than the previous quarter.

9. Recent data releases indicate that tax cuts on selected goods, which are part of the fiscal package, helped to stimulate domestic sales. Domestic automobile sales rose by a record 82 percent month-on-month in seasonally adjusted terms and recorded the first yearly increase since May 2008. Similarly, domestic demand indicators such as imports of consumer goods and domestic sales of household appliances were significantly higher in March. The Committee indicated that the partial rebound in consumer demand does not point to a long-lasting recovery, and is rather a result of the price

incentives created by the fiscal package that brought consumer demand for selected goods forward.

10. Foreign demand remains weak as of the first quarter. Because of slowing economic activity and falling energy prices, imports dropped at a more rapid pace than exports and the foreign trade deficit kept narrowing dramatically since the third quarter of 2008. Thus, the Committee members noted that there is an increasingly lower external financing need given the positive current account balance.

11. The Committee pointed to the negative implications of the economic contraction for the labor market. The slowdown in non-farm employment growth has intensified during the December 2008 and February 2009 period. Accordingly, non-farm unemployment increased by 5.3 percentage points from a year earlier to 19 percent in this period, and total unemployment rose by 3.9 percentage points to 15.5 percent. Increasing labor force participation partly contributed to the surge in unemployment rates. On balance, the rise in unemployment rates is expected to put further downward pressure on disposable income and unit labor costs for quite some time.

12. In view of recent readings, the Committee indicated that the rate of growth might register a double-digit decline in the first quarter of 2009. Yet, confidence indices and coincident indicators of demand expectations suggest that the economy may start to recover slightly by the second quarter of the year.

Monetary Policy and Risks

13. The Committee reviewed the forecasts and the underlying assumptions to be published in the Inflation Report on April 30th. Committee members indicated that international credit markets continued to be under strain and that there were no clear signs of a durable improvement in the global economic outlook. In the January Inflation Report, it was assumed that the recovery in the global economy would start at the beginning of 2010. However, data releases since then have indicated a sharper contraction in 2009, and a more gradual recovery throughout 2010. Therefore, compared to the previous report, the revised forecasts are based on a deeper downturn in 2009, and a more gradual recovery in the global economy.

14. In light of these assessments, the Committee concluded that the probability attached to the early recovery scenario in the January Inflation Report has diminished considerably. It was therefore agreed that, besides revising the baseline scenario, it would be appropriate to present an alternative scenario that envisages a more gradual recovery than in the baseline.

15. During the last quarter of 2008, the collapse of production has been disproportionately severe for export-oriented firms, and—along with increasing labor force participation rates—has brought about a surge in the unemployment rate. Moreover, recent indicators suggest that employment losses have continued during the first quarter of 2009. Therefore, labor market conditions are expected to contain unit labor costs and curb domestic demand in the period ahead.

16. Lower policy rates and expansionary fiscal policy have started to provide some stimulus to domestic demand. However, the Committee anticipates that it will take some time for the global economy to stabilize and thus the recovery in aggregate domestic activity is expected to be gradual. Accordingly, Committee members stated that aggregate demand conditions should support disinflation more forcefully, and for a longer period of time than envisaged in the previous Report.

17. In light of these assessments and the partial improvement in some risk indicators, the Committee has decided to cut policy rates by 75 basis points. The Committee has indicated that the rate cuts have lowered the probability of significantly undershooting the end-year inflation target. Therefore, it was stated that the next rate cut would likely be measured. However, financial strains persist, and there is still a significant amount of uncertainty regarding the feedback between the financial and real sectors, suggesting that downside risks still remain. In this respect, the Committee envisages that it may be necessary for the monetary policy to maintain an easing bias for a considerable period.

18. The stance of fiscal policy is another major factor that may affect the outlook for inflation and monetary policy. Recently, budget revenues have been declining in line with the slowdown in economic activity, while expenditures have been accelerating due to countercyclical fiscal policy, leading to a significant rise in the budget deficit. Possible adjustments in excise taxes and/or administered prices in order to stabilize the budget could result some inflation volatility over the short term. Moreover, the increasing financing requirement of the government might weaken the favorable impact of monetary policy decisions on economic activity. The Committee members hence reiterated that, in order to reap the gains from short-term expansionary fiscal policy, it was important to commit to a credible medium-term fiscal framework that would ensure fiscal discipline and debt sustainability.

19. Central Bank of Turkey 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. Prudent monetary policy is necessary but not sufficient to maintain the

resilience of the economy against the global crisis. Therefore, strengthening the commitment to fiscal discipline and the structural reform agenda is also critical for facilitating expectations management and for supporting the effectiveness of the monetary policy decisions. In this respect, commitment to the European Union accession process, and timely implementation of the structural reforms envisaged in the Pre-Accession Economic Program remain to be of utmost importance.