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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: July 15, 2010

Inflation Developments

1. Consumer prices decreased by 0.56 percent in June and annual inflation declined by 0.73 percentage points to 8.37 percent. The fall in annual inflation was due to plummeting food prices, as noted in the June summary of the Monetary Policy Committee (the Committee) Meeting. Annual services inflation slowed down further, and core inflation indicators continued to be consistent with medium-term targets.

2. Amid falling unprocessed food prices, annual food inflation sank to 5.62 percent in June—lowest level in recent years. The ongoing drop in fresh fruit and vegetable prices as well as meat prices also had a major impact on food prices. With falling processed meat prices in June, the direct impact of meat prices on annual CPI inflation was down 0.2 percentage point month-on-month to 1.4 percentage points.

3. The slowdown in annual services inflation became more pronounced in June as falling meat prices began to have a favorable effect on catering prices. Moreover, seasonally adjusted data indicate that prices decelerated across all categories of services. Annual rent inflation continued to trend steadily down, declining to an unprecedented low of 4.21 percent since the inception of the CPI.

4. The Committee has noted that the year-ago increase in tobacco prices would have a base effect on the annual rate of increase in July's consumer prices. If tobacco prices remain unchanged in July, this base effect will drive annual CPI inflation down by about 0.5 percentage point.

5. The effect of rising solid fuel and tap water prices on energy group prices was broadly offset by the fall in fuel prices amid lower international oil prices, producing only a modest increase in energy prices in June. However, with the waning of the upward base effects that the Committee noted in the June Summary, annual energy inflation dropped by 1.61 percentage points to 12.63

percent. Unless international oil prices rise dramatically, the annual rate of increase in energy prices would continue to slow in the second half of 2010.

6. The year-on-year rate of increase in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) slowed to 4.38 percent with the reversal of the base effect from last year's tax incentives on durable goods. The Committee has reiterated that the tax impact would continue to have a downward impact on annual core goods inflation in July and October. Moreover, Committee members have emphasized that, even when adjusted for tax effects and seasonal variations, the rate of increase in prices of core goods has been decelerating.

7. The Committee has noted that annual headline inflation would display a significant drop in July due to aforementioned base effects.

Factors Affecting Inflation

8. Recent data suggest that the recovery in economic activity is ongoing. Gross Domestic Product (GDP) expanded by 11.7 percent year-on-year during the first quarter owing primarily to the low base in the comparable period last year. In fact, growing by a mere 0.1 percent quarter-on-quarter in seasonally adjusted terms, GDP remained virtually flat. The Committee has noted the large contraction in public construction investments, and indicated that economic activity continues to pick up once the impact of the public sector demand is excluded.

9. Industrial production increased by 1.9 percent month-on-month during May in seasonally adjusted terms, up by 3 percent from the first-quarter average during April-May. The Committee has indicated that production has surpassed pre-crisis levels in sectors more sensitive to domestic demand but still remains low in sectors relatively more sensitive to foreign demand.

10. Domestic demand is displaying relatively stable growth. April-May data on production and imports indicate that the demand for consumer goods has been running above its previous quarter average. Consumer confidence indices and new orders data also point to a further increase in private consumption. Therefore, the Committee expects private consumption demand to grow further quarter-on-quarter during the second quarter but slow down year-on-year as impacts of the low base effect fades.

11. Investment demand continues to recover, but remains below pre-crisis levels. The production of capital goods excluding vehicles continues to grow steadily, while imports of capital goods remain on the rise. Production and imports data suggest that private investments would increase significantly year-on-year

during the second quarter of 2010. Yet, the Committee has stated that the recently increased downside risks to foreign demand owing to the problems in the euro area might dampen new investments, particularly in the manufacturing industry.

12. There are signs of a partial slowdown in foreign demand. The export quantity index excluding gold rose for the fourth consecutive month in May, although recent readings indicate that the massive second-quarter increase in exports may not be durable. According to the data from the Turkish Exporters Assembly, despite having expanded by 13.1 percent year-on-year in June, exports were down month-on-month in seasonally adjusted terms. Moreover, recent survey indicators for the manufacturing industry signal slowing export orders.

13. The Committee has reiterated that the downside risks to the pace of foreign demand growth have risen amid the fiscal crisis in the euro area—Turkey's largest export destination—and emphasized that the depreciation of the euro is another factor that would impede exports. While the July Consensus Forecasts do not offer a major change in euro area growth rates, there are significant compositional changes. Specifically, the decreased contribution of consumption and investment expenditures, especially in countries such as Germany and Italy, implies a weaker outlook for foreign demand of Turkey. The Committee has noted that these developments are likely to have an adverse impact on Turkey's economic activity in coming months, implying that it would take a while before industrial capacity utilization rates return to pre-crisis levels.

14. Although employment conditions continue to improve, unemployment rates remain at high levels. Seasonally adjusted data indicate that non-farm employment continued to recover in April. Weak foreign demand continued to restrain industrial employment, while non-farm employment returned to pre-crisis levels owing to the recovery in construction and services sectors. Nevertheless, the Committee reiterated that the high level of unemployment rates would continue to contain unit labor costs.

Monetary Policy and Risks

15. The Committee discussed the macroeconomic outlook and monetary policy stance underlying the baseline scenario of the July Inflation Report. In light of the developments summarized above, the Committee members indicated that it would be appropriate to base the revised forecasts on a framework in which external demand conditions are weaker compared to the previous Report, while domestic demand continues to recover as anticipated, resource utilization stays at low levels, and thus the contribution of aggregate demand conditions to disinflation increases slightly.

16. The Committee has indicated that the core inflation indicators remain consistent with the medium term targets. This development, coupled with the fall in unprocessed food prices and easing commodity prices, has led to a more favorable inflation outlook than envisaged in the April Inflation Report.

17. In sum, the Committee members agreed that the baseline scenario in the July Inflation Report would envisage that the monetary tightening required to keep inflation in line with medium-term targets would start later and would be more limited compared to the previous forecast. Accordingly, the Committee reiterated that it may be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period.

18. The Committee stated that risks regarding global economy persist. By influencing commodity prices and external demand conditions, global economic activity would continue to be the main factor driving inflation dynamics and the monetary policy outlook. In this respect, the Committee indicated that the timing and the extent of monetary tightening to be implemented during 2011 under the baseline scenario of the July Inflation Report may change depending on the course of the economic activity.

19. Recently, rising concerns regarding debt sustainability in several euro-zone countries and the spillover effects to the financial system have led to renewed turmoil across financial markets, underscoring the downside risks to the global economic recovery. Furthermore, ongoing problems in credit, real estate and labor markets across developed economies, with little policy options left in case of another disruption to global economic activity, suggest that the downside risks regarding the pace of global growth are likely to persist for some time. The Committee indicated that, should the global economy face a longer-than-anticipated period of anemic growth, which would consequently delay the domestic recovery significantly, the monetary tightening envisaged in 2011 under the baseline scenario may be postponed towards the end of 2011. Moreover, it was stated 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, the Committee members underscored that, monetary tightening may be implemented in an earlier period during 2011, should the recovery in economic activity turn out to be faster than expected.

20. The Committee members indicated that, despite the increased downside risks pertaining to external demand, domestic demand remains strong. Although problems regarding the global economy have the potential to restrain domestic demand through confidence and financing channels, countercyclical monetary policy and the ongoing improvement in employment conditions are likely to support the recovery in domestic demand. On the other hand, given the

relative improvement in the creditworthiness of Turkey during the post-crisis period, a possible strengthening in capital inflows in the forthcoming period stands out as another factor that may lead to a faster recovery in the domestic demand in contrast to external demand. Should the divergence in the growth rates between domestic and external demand continue in the forthcoming period, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity management facilities more effectively. Accordingly, if the composition of strong domestic demand and weak external demand continue as envisaged, and if this pattern of growth coexists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, than the Committee may bring forward the measures outlined in the exit strategy that are expected to be implemented until the end of 2010.

21. The Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. Since the second half of 2009, economic activity has been stronger than envisaged in the Medium Term Program (MTP), leading to a better-than-expected performance in budget revenues. Using this fiscal space mostly to reduce the government debt would facilitate demand management and reduce any need for indirect tax hikes, therefore providing more flexibility regarding the conduct of countercyclical monetary policy. In this respect, should the fiscal discipline implemented through institutional and structural improvements, such as enacting and establishing the fiscal rule, it would be possible to keep policy rates at single-digit levels over the medium term.

22. 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.