

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: March 19, 2009

Inflation Developments

1. Consumer prices decreased by 0.34 percent in February, pushing inflation down to 7.73 percent year-on-year. The marked slowdown in economic activity and the changes in oil and other commodity prices continued to help bring inflation down and curb short-term exchange rate pass-through.
2. Energy prices dropped by 0.82 percent in February, and annual inflation in this subgroup eased to 13.74 percent, chiefly owing to falling natural gas and solid fuel prices. Yet, the exchange rate-driven sharp rise in fuel and bottled gas prices limited the downtrend in energy price inflation.
3. The rate of increase in unprocessed food prices was up by a very modest 0.85 percent in February. Accordingly, after having soared because of the sharp rise in vegetable prices over the past four months, unprocessed food price inflation slumped to 0.63 percent year-on-year owing to the dramatic decline in fresh fruit and vegetable prices. Meanwhile, processed food prices continued to decline at a faster pace. The group's prices dropped by 0.68 percent month-on-month, largely due to falling bread and grain prices. With the significant softening in both processed and unprocessed food prices, annual food and nonalcoholic beverages inflation fell to 6.16 percent.
4. The annual rate of increase in processed food prices is expected to slow down further in coming months. However, changes in vegetable prices may cause a temporary spike in unprocessed food prices during March. The Monetary Policy Committee (the Committee) noted that the anticipated rise in unprocessed food prices, as well as the observed increase in prices of tobacco products in March, would likely have an adverse impact on consumer inflation, yet will not cause any deterioration in the underlying inflation trend as price hikes in both groups are expected to be short-lived.
5. Annual inflation in goods excluding energy and food increased by 0.46 points from January to 5.20 percent in February on the back of changes in clothing and gold prices. However, in the durables group (excluding gold), annual inflation went down by 0.18 points month-on-month. Producer prices for durable goods fell for the third consecutive month, partly due to changes in import prices, while aggregate demand conditions continued to soften. As a

result, exchange rate pass-through on prices of durable goods remained low compared to previous periods.

6. The reduction in the Special Consumption Tax (SCT) in March is likely to have some downward pressure on the prices of durable goods in March and April, but is expected to be offset by price increases as the tax cut expires in the middle of June. Therefore, the SCT tax cut is expected to have only a temporary direct impact on inflation. Similarly, the SCT tax cut may cause a temporary downward shift in core inflation indicators as well.
7. Services prices recorded the first monthly decline since the inception of the index, albeit a modest one, and the group's annual inflation dropped by 0.62 points from January to 9.27 percent in February. The fact that the slowdown was evident across all subcategories is viewed as a favorable development. The continued fall in the rate of increase in services prices and other key price indicators suggests that underlying inflation is on a downward trend.
8. Overall, the Committee expects annual consumer inflation to rise temporarily in March owing to soaring unprocessed food prices, but then to continue its downtrend.

Factors Affecting Inflation

9. Recent readings suggest that economic activity continues to weaken. Industrial production, which dropped by 21.3 percent year-on-year in January 2009, displayed a sharp contraction from a month ago in seasonally adjusted terms. Readings on capacity utilization, electricity consumption and exports point to a further significant year-on-year decline in industrial production in February. Seasonally adjusted data for January and February indicate that economic activity continues to decline in the first quarter.
10. Recent data releases indicate that consumer sentiment has recovered somewhat from a quarter ago but remains subdued. Although automobile sales and consumer confidence indices displayed a partial rebound in the first months of 2009, these indicators remain at relatively depressed levels by historical standards. Low production figures despite rebounding orders and sales reflect the ongoing depletion of inventories.
11. Labor market readings confirm the sharp weakening of economic activity. Between November 2008 and January 2009, unemployment increased by 3 points from a year earlier to 13.6 percent. In the same period, non-farm unemployment rose by 4.3 points to 17.3 percent. The Committee noted that the rise in unemployment is partly due to increased labor force participation, but emphasized that the main driver was the slowdown in employment growth.

The number of people receiving unemployment benefits continued to rise in February and it is evident that it will take some time for economic activity to recover. These developments suggest that unemployment will increase further during the first quarter. On balance, the downward pressure on unit labor costs will continue.

12. Foreign demand continues to remain weak in the first quarter. Although data released by the Turkish Exporters' Assembly and leading indicators for export orders indicate no further deterioration in February and March, the Committee, in view of the global economic outlook, expects that aggregate demand is not likely to recover soon.

Monetary Policy and Risks

13. Recent monetary and fiscal policy actions are likely to provide some stimulus to domestic demand, accelerating the depletion of inventories and thus partially adding to the exchange rate pass-through on the prices of durable goods. However, the Committee underscored that monetary policy would not react to changes in relative prices stemming from exchange rate movements, as long as it does not lead to a deterioration in overall price setting behavior. Second round effects should not be a source of concern at this point, given the significant weakness in non-farm employment and the economic outlook.
14. The Committee indicated that the rate cuts so far had lowered the probability of significantly undershooting the end-year inflation target, and hence the next rate cut might be measured. However, it was also stated that tightness in financial conditions still persisted to some extent, and uncertainties regarding the impact of financial turbulence on the real economy remained high, suggesting that downside risks still remained. Although consumer credits and other domestic demand indicators suggest a slight rebound, business loans continue to stagnate.
15. Problems in international credit markets persist while forecasts of global economic growth have been consistently revised downwards. The global economic outlook continues to deteriorate and the recession is expected to be long lasting. In this respect, the Committee members indicated that the likelihood of an early recovery in the global economy, envisaged as an alternative scenario in the January Inflation Report, had almost diminished. Therefore, expecting that economic activity is not likely to recover anytime soon, the Committee stated that it might be necessary for monetary policy to maintain an easing bias for a considerable period.
16. The Committee members suggested that the reduced global appetite for risk and the expected slowdown in capital flows to emerging markets could be

taken into account regarding monetary policy decisions. Yet, it was emphasized that the sharp contraction in investment demand and the rapidly shrinking current account deficit led to a significant drop in financing requirements.

17. The Committee members have noted that budget revenues have been declining in line with the slowdown in economic activity while expenditures have been accelerating due to counter cyclical fiscal policy. It was stated that some easing in fiscal policy is understandable under the current conditions. However, the Committee indicated that the increasing financing requirement of the government might weaken the impact of monetary policy decisions on economic activity. Accordingly, in order to reap the gains from short-term expansionary fiscal policy, it is important to commit to a credible medium-term fiscal framework that would ensure debt sustainability and a sound overall fiscal position.
18. The 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. 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 enhancing the stimulative impact of the monetary accommodation. In this respect, commitment to the European Union accession process, and timely implementation and revision of the structural reforms envisaged in the Medium Term Program remain to be of utmost importance.