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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: September 16, 2010

Inflation Developments

1. Consumer prices increased by 0.40 percent in August and annual inflation rose by 0.75 percentage points to 8.33 percent. The rise in annual inflation was largely due to increasing unprocessed food prices, as noted in the August summary of the Monetary Policy Committee (the Committee) Meeting. Annual services inflation continued to moderate, while core inflation indicators remained in line with medium-term targets.

2. Annual inflation in food and nonalcoholic beverages soared by 4.85 percentage points to 10.37 percent. After having declined for three months in a row, unprocessed food prices rose sharply in August amid higher fresh fruit and vegetable prices, bringing unprocessed food inflation up by 10.78 percentage points to 18.66 percent year-on-year. Moreover, unprocessed meat prices continued to rise, while changes in processed food prices remained modest.

3. The Committee members have noted that the extreme volatility in food prices might continue to have a significant impact on annual inflation in the short run. In fact, leading indicators suggest that annual inflation would rise markedly in September owing to the sharp increases in unprocessed food prices driven by higher vegetable prices. The Committee expects the upsurge to be temporary and annual inflation to be back on a downtrend by October.

4. Annual inflation in core goods and services continued to fall steadily in August. The annual rate of increase in prices of the relatively more demand-sensitive services which exclude catering and transport services, dropped to an all-time low of 2.83 percent. Similarly, the annual rate of increase in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) continued to fall. The Committee has noted that annual core goods inflation declined to 2.2 percent in tax-adjusted terms. Moreover, seasonally adjusted data indicate that underlying inflation is in line with medium-term targets.

5. Against this background, the Committee has restated that inflation would increase temporarily in the short term before reverting to a declining path starting from the last quarter of the year.

Factors Affecting Inflation

6. Recent data releases are in line with the outlook presented in the July Inflation Report. Gross Domestic Product (GDP) grew by 10.3 percent year-on-year and by a seasonally adjusted 3.7 percent quarter-on-quarter during the second quarter. The Committee has noted that the public construction investment made a significant contribution to the acceleration in quarterly GDP growth. However, it was also stated that, even excluding public expenditures, the economy still recovered at a faster pace than in the first quarter.

7. Economic activity is on a milder recovery path following the strong growth in the second quarter. July and August data indicate that the economy slowed markedly in the third quarter. Industrial production ran below its second-quarter average in July, while August's capacity utilization rates pointed to a further slowdown in production. However, the Committee has emphasized that the August data may not be indicative of underlying economic activity as the month was marked by Ramadan and political uncertainty generated by the September referendum. In fact, new order indicators, which feed into industrial production after a two- to three-month lag, showed some recovery in August.

8. Domestic demand displays a relatively stable outlook. July data indicate that production and imports of consumer goods have been more robust than the second-quarter average. July-August survey indicators and consumer confidence indices show that the consumption continues to recover steadily in the third quarter without an acceleration.

9. Investment demand continues to rebound, but remains below pre-crisis levels. The production of capital goods excluding vehicles and the imports of capital goods grew further in July. The steady improvement in firms' investment expectations suggests that investments may continue to recover over the upcoming period. Yet, the Committee has stated that the uncertainty about the pace of recovery in foreign demand might continue to dampen new investments, particularly in the manufacturing industry.

10. Uncertainties regarding foreign demand persist. The export quantity index excluding gold continued to fall in July. Recent foreign trade data indicate that exports grew modestly in August and September. Survey indicators of manufacturing industry do not report a major increase in exports. Therefore, in view of signs of slowing economic recovery across the globe, the Committee

expects that it would take a while before industrial capacity utilization rates return to pre-crisis levels.

11. Although employment conditions continue to improve, unemployment rates remain at high levels. Industrial employment continued to recover in June, while services employment fell slightly in seasonally adjusted terms. Leading indicators for the third quarter suggest that the halt in non-farm employment growth is temporary and employment would continue to rise gradually. Nevertheless, the Committee has reiterated that the unemployment rates would continue to remain at higher levels compared to the pre-crisis period for some time, containing the unit labor costs.

Risks and Monetary Policy

12. Committee members noted that although GDP growth was strong during the second quarter, recent data releases suggest a relatively modest recovery for the second half of the year. External demand continues to suppress aggregate demand, notwithstanding the steady increases in domestic demand. Employment and capacity utilization indicators suggest that upside pressures on inflation are likely to be contained. Accordingly, core inflation indicators are expected to remain consistent with the medium-term targets. In light of these developments, the Committee has reiterated that it would be necessary to maintain policy rate at current levels for some time, and to keep it at low levels for a long period.

13. Although the Committee does not see an acceleration in aggregate demand, the continued divergence between external and domestic demand necessitates that the composition of demand be closely monitored especially in terms of risks regarding the current account balance and financial stability. The strengthening perceptions that developed economies would keep their policy rates at low levels for a long period, and relative improvement in Turkish creditworthiness during the post-crisis period, combined with the surge in capital flows toward emerging markets, have been increasing the risks regarding the divergence between the domestic and external demand. While not yet a significant concern regarding financial stability, the Committee members have indicated that these developments support the implementation of the “exit strategy” measures. Therefore, the Committee has indicated that it would be appropriate to proceed with the measures outlined in the exit strategy that were envisaged to be implemented by end-2010.

14. Therefore, also noting that the liquidity conditions have evolved as envisaged, the Committee has decided to implement the second step of the technical rate adjustment mentioned in Article (b) of the 16th paragraph in the “Monetary

Policy Exit Strategy" document published on the 14th of April 2010, and decided to widen the gap between the one-week repo rate and the overnight borrowing rate by 25 basis points. Moreover, as reiterated in the exit strategy document, both the gap between the overnight lending and borrowing rates and the gap between these rates and the one-week repo rate could be used as operational tools of monetary policy. In this respect, in order to decrease the overfunding to the market and leave less end-day excess liquidity, there could be another reduction in the borrowing rates in the forthcoming period.

15. The Committee members have indicated that the global crisis has demonstrated the importance of central banks having an auxiliary financial stability mandate as well as the objective of price stability. In this context it was reiterated that, should the recent surge in capital flows coexist with rapid credit expansion and a deterioration in the current account balance, thereby leading to financial stability concerns, other policy instruments such as reserve requirement ratios and liquidity management facilities would be utilized more effectively.

16. The Committee members underscored that, as stated in the 19th paragraph of the exit strategy document, depending on future developments—for example, if the pace of credit expansion exceeds desired levels—reserve requirement ratios may be used more actively as a macroprudential tool. In this framework, it was stated that, terminating the remuneration of Turkish lira required reserves would facilitate the effective use of reserve requirement ratios as a policy tool to mitigate macroeconomic and financial risks when necessary.

17. The Committee has indicated that the recent volatility in commodity prices pose risks regarding short-term inflation forecasts. Although the uncertainty regarding the global economy continues to suppress energy and industrial metal prices, climate conditions are having an adverse impact on agricultural commodities. Ongoing increases in the prices of wheat and cotton, which are inputs for core consumer goods, necessitate the need to monitor commodity prices closely.

18. The Committee members stated that the significant fluctuations in food prices are the main factors increasing inflation volatility. Early indicators suggest that inflation would display a significant temporarily jump in September owing to rapid increases in unprocessed food prices. The Committee foresees that vegetable and fruit prices would display a partial correction in the last quarter of the year, and the measures taken regarding meat imports would contain the increases in unprocessed food prices. Nevertheless, it was stated that fluctuations in unprocessed food prices continue to pose risks regarding short-term inflation forecasts.

19. The Central Bank monitors fiscal policy developments closely while formulating monetary policy. The Committee members have indicated that the delay in the enactment of the fiscal rule has increased the importance of current fiscal policy implementation. Budget realizations in the first eight months of 2010 suggest that extra revenues arising due to stronger-than-envisaged economic activity are largely being used to reduce government debt. Sustaining fiscal discipline in the period ahead by bolstering institutional and structural improvements is crucial, both in terms of providing more flexibility regarding the conduct of countercyclical monetary policy, and also for keeping the market interest rates at low levels permanently. In this respect, the Committee will continue to monitor the fiscal developments and their impact on inflation outlook closely.

20. 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 Medium Term Program and the European Union accession process remains to be of utmost importance.