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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: October 15, 2009

Inflation Developments

1. Consumer prices increased by 0.39 percent in September, while inflation declined to 5.27 percent year-on-year. Core inflation measures remained subdued, whereas the annual rate of increase in services prices continued to fall steadily.

2. Annual inflation in food prices dropped slightly over the month to 6.79 percent. The favorable course of fruit and vegetable prices during the past two months continued into September, while meat prices accelerated further. Taken together, unprocessed food inflation eased to 16.70 percent year-on-year. In the processed food category, prices continued to fall year-on-year. Looking ahead, fruit and vegetable prices are expected to pick up owing to seasonal factors in October, while processed food prices are likely to remain on the decline.

3. Energy prices rose by 0.63 percent in September amid rising tap water rates and bottled gas prices. Accordingly, the rate of increase in energy prices climbed to 2.01 percent year-on-year. The hike in electricity tariffs, effective October 1, would add about 0.4 percentage points to CPI inflation.

4. The annual rate of increase in prices of goods excluding energy and food declined to 5.52 percent, owing to ongoing discounts on clothing and footwear in September, in contrast with previous years. In the durable goods (excluding gold) category, prices rose by 0.20 percent in September, and inflation increased to –1.37 percent year-on-year. It should be noted that prices of durable goods are likely to rise markedly in October following the expiration of temporary cuts in Special Consumption Tax (SCT) and Value Added Tax (VAT).

5. Annual services inflation continued to fall in September, down to 5.26 percent, the lowest level in recent history. The drop was particularly evident in rental and transport services inflation. Under current domestic demand conditions, annual services inflation is expected to edge further down in coming months, albeit at a more modest pace.

6. Overall, the Monetary Policy Committee (the Committee) expects consumer prices to accelerate temporarily in October due to seasonal increases in food

and clothing prices, the hike in electricity tariffs and tax adjustments on durable goods. However, the Committee expects that annual inflation would continue to hover around low levels.

Factors Affecting Inflation

7. In line with the Committee's previous assessments, recent data releases indicate that the ongoing recovery in economic activity would be gradual and protracted. During July-August, industrial production declined by 7.7 percent year-on-year, yet registered a modest increase over the second quarter in seasonally adjusted terms. Moreover, September's capacity utilization data do not point to an acceleration in production growth. Therefore, the Committee noted that capacity utilization rates are not likely to revert back to historical averages over the short run.

8. Second quarter national accounts data confirm that the fiscal stimulus-driven recovery in domestic demand has been confined to certain goods categories, and therefore is likely to be transitory as previously stated. This outlook is also supported by third-quarter indicators. The ongoing weakening of the demand for non-durable goods is especially noteworthy, causing consumer goods production to dip below its second quarter average during July-August in seasonally adjusted terms. Similarly, imports of consumer goods were down during July-August compared to the previous quarter. Accordingly, having increased markedly during the second quarter, consumption demand is expected to display a weaker course in the third quarter.

9. Domestic investment demand remains weak. During July-August, the production of capital goods was up from the second quarter, whereas the imports of capital goods remained flat. Excluding transport vehicles, the production of capital goods has also continued along a flat trend. Thus, the Committee noted that the third quarter rise in the production of capital goods has largely been the result of tax cuts, rather than a rebound in investment demand.

10. Foreign demand remains weak. Growth forecasts, particularly for the euro area, point to a more positive outlook for foreign demand over the short term as of September, and expectations about the speed of the medium-term recovery have slightly improved, compared with the July Inflation Report. Recent export figures are consistent with this outlook. The export quantity index rose sharply quarter-on-quarter during July-August in seasonally adjusted terms, but fell by 7.6 percent year-on-year. The medium-term outlook for global growth suggests that it would take a long time for the GDP to reach its pre-crisis levels across advanced economies. This outlook points to a

gradual narrowing of output gaps across advanced economies, implying a sluggish recovery of exports over the near term. Accordingly, the Committee reiterated that foreign demand is likely to continue to weigh down on aggregate demand for quite some time.

11. The June-August data signal that non-farm employment has ceased to contract during the third quarter. During this period, despite having declined by 1.9 percent year-on-year, non-farm employment increased in seasonally adjusted terms for the first time since the second quarter of 2008, driving unemployment down from the second quarter in seasonally adjusted terms. The Committee agreed that, although employment indicators show some improvement, it remains to be seen whether this would turn into a robust recovery across the labor market.

12. The lack of a clear sign of durable global recovery and the ongoing uncertainty about aggregate demand continues to cause companies to operate at low capacity levels. In addition to low capacity utilization and employment rates, per capita hours worked also hovers below pre-crisis levels. The Committee expects the sluggish resource utilization and the resulting idle capacity to continue to adversely affect investment and employment decisions. On balance, labor market conditions are likely to remain a drag on domestic demand, and thereby expected to continue supporting the decline in inflation. Therefore, inflation is expected to remain at low levels for a long period of time.

Monetary Policy and Risks

13. The policy rate cuts implemented since November 2008, and the improvements in global risk perceptions have started to have favorable effects on credit markets. In fact, consumer loan rates, which were reacting rather sluggishly to the policy rate cuts, have displayed a significant decline in this period. Consequently, housing loans have displayed a stable upward trend since September. More generally, the recovery in credit markets is expected to continue throughout the last quarter. However, the effectiveness of the credit channel in supporting economic activity has been somewhat restrained owing to the ongoing tightness in lending standards for the small- and medium-sized enterprises. In this respect, the Committee, after taking liquidity conditions into consideration, has taken the view hat a limited reduction in Turkish Lira reserve requirements would alleviate the tightness in credit conditions, and thus enhance the effectiveness of the expansionary monetary policy.

14. While the Committee members noted the improvements in credit and labor markets, they have come to the conclusion that these developments alone

were not sufficient to end the easing cycle. Yet, given the increased perceptions that the economy had passed its turning point, it was indicated that a slowdown in the pace of the rate cuts would be considered in the next meeting depending on the economic data and developments.

15. Although recent data releases indicate that the worst is likely to be over, concerns regarding the health of the global economy remain. In particular, ongoing problems in credit and labor markets pose downside risks for global activity. Should the global conditions deteriorate again, and consequently delay the domestic recovery, Central Bank of Turkey (CBT) would consider another cycle of rate cuts. Lingering problems across the global economy are not resolved completely and there are still uncertainties regarding the strength of the recovery. Taking these factors into account, the Committee reiterated that it would be necessary for the monetary policy to maintain an easing bias for a long period of time.

16. Another possible scenario, according to the Committee members, is a surge in capital inflows to emerging markets owing to the relative improvement of credit risk across these countries. Ample liquidity driven by the expansionary fiscal and monetary policies on a worldwide scale, coupled with rising risk appetites, have led to large capital inflows to emerging markets. Current slack in the economy would imply that a fall in the cost of imported inputs could be rapidly transmitted to consumer prices, suggesting that a further acceleration in capital inflows may exacerbate downward risks on inflation. Realization of such a scenario could lead to temporarily lower policy rates.

17. The CBT will continue to monitor fiscal policy developments closely while formulating monetary policy. Enhancing the framework set out in the Medium Term Program (MTP) through further structural adjustments to strengthen fiscal discipline, would support the improvement of Turkey’s sovereign risk. Should the goals set out in the MTP be implemented, it would be possible to keep policy rates at single digits throughout the forecast horizon.

18. The course of oil and other commodity prices constitutes another important risk. Ample liquidity driven by countercyclical policies on a global scale creates speculative movements not only regarding emerging market currencies, but also for commodity prices. Therefore, oil and other commodity price developments warrant caution, even under a scenario of a gradual global economic recovery. Nonetheless, weak domestic demand conditions would limit the pass-through stemming from upside cost-push shocks. Therefore, the Committee will accommodate the short-term volatility in commodity prices, especially when the resource utilization remains at depressed levels. However, if an uptrend in commodity prices reflects a strong and durable rebound in global activity that would in turn create inflationary pressures, then

monetary policy will react appropriately to keep inflation in line with medium-term inflation targets.

19. The fact that the crisis itself, and the policy responses in reaction to it, are unprecedented in recent history, creates risks regarding the inflation and monetary policy outlook. It is extremely difficult estimate with precision the impact of the recent monetary policy measures taken at the global scale. Although not having resorted to explicit quantitative easing eliminates some of the risks for the Turkish case, it should still be noted that the full impact of the cumulative easing of 1000 basis points since November 2008 would be seen with a lag. In other words, although baseline scenario does not envisage any policy rate hikes for an extended period, it is important to monitor the impact of the policies closely to ensure an appropriate timely response to any development not envisaged in above assessments.

20. The CBT has been taking the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy. However, 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 thus for supporting the effectiveness of the monetary policy decisions. In this respect, timely implementation of the structural reforms envisaged by the Medium Term Program and European Union accession process remains to be of utmost importance.