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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: May 14, 2009

Inflation Developments

1. Consumer prices increased by 0.02 percent in April, while inflation fell to 6.13 percent year-on-year. Annual inflation was down month-on-month across all major categories, suggesting a more broad-based deceleration in inflation owing to the significant slowdown in economic activity.

2. Unprocessed food prices were down 0.95 percent in April because of declining fruit and vegetable prices. Yet, annual inflation in this category rose month-on-month, albeit modestly, to 10.87 percent in April. Foreign demand for fruits and vegetables has been relatively increasing since the final quarter of 2008. In fact, the quantity of exported fruits and vegetables grew by an average of 25.2 percent in the first quarter as compared to a year earlier, which partially offset the downward pressure on their prices owing to increased production. On the other hand, annual processed food inflation decreased further to 4.99 percent. As a result, annual food and nonalcoholic beverages inflation dropped to 7.70 percent.

3. Energy prices decreased by 1.42 percent in April amid reduced electricity tariffs and falling bottled gas, solid fuel and fuel prices. Accordingly, the rate of increase in energy prices fell to 9.31 percent year-on-year. The reduction in gas tariffs should help further slow the rate of increase in energy prices and thereby is expected to push consumer inflation down by 0.3 percentage points in May. Given the current level of oil prices, the yearly rate of increase in energy prices could continue to slide in coming months.

4. Annual inflation in prices of goods excluding energy and food dropped by 2.17 percentage points in April to 2.06 percent, largely due to prices of durable goods (excluding gold) which fell by 4.43 percent on the back of Special Consumption Tax (SCT) and Value-Added Tax (VAT) cuts. The effects of the tax cuts were most pronounced during March and April. Across the sub-categories, the prices of furniture, automobiles and white goods fell by 7.63, 5 and 2.74 percent, respectively. Accordingly, inflation in durable goods plunged to –5.96 percent year-on-year. However, it must be emphasized again that these tax cuts would only have a short-lived favorable effect on inflation as they are due to expire in the following months.

5. Services prices continue to fall amid the sharp contraction in domestic demand and also because of the lagged effects of weakening cost pressures. The yearly rate of increase in services prices slumped to a historic low of 7.61 percent in April. The decline was evident across all subcategories of services. Annual services inflation is expected to edge further down in coming months.

6. Core inflation measures continue to trend downward, largely owing to the tax cuts that have been in place over the past two months. Put differently, the recent sharp declines in the core inflation measures have been primarily driven by the tax cuts, and therefore the rapid slowdown in these measures is expected to be temporary. However, even without the contribution of these tax cuts, core inflation measures still declined, supporting the view that inflation is still continuing on a downward path.

7. Overall, the Monetary Policy Committee (the Committee) expects inflation to decelerate further in the short run due to the softening in economic activity and the past declines in oil and other commodity prices.

Factors Affecting Inflation

8. The latest data for the first quarter of 2009 confirmed the continuing sharp contraction in economic activity. Industrial production shrunk by 22 percent year-on-year in this period and declined at a faster pace than in the fourth quarter of 2008 in seasonally adjusted terms.

9. Similarly, domestic investment demand contracted dramatically during the first quarter of the year. In seasonally adjusted terms, production and imports of investment goods and sales of heavy commercial vehicles fell sharply quarter-on-quarter. In view of the low levels of resource utilization, and against the backdrop of the ongoing uncertainty regarding the global economy, the Committee expects investment demand to remain weak for quite some time.

10. Recent data releases indicate that there may be some rebound in private consumer demand. The tax cuts that have been implemented as part of the fiscal package to help stimulate the economy have accelerated the depletion of inventories since March. In April, the tax cuts had a partial effect on the production of transport vehicles and machinery and equipment, which account for a significant share of the manufacturing industry. In fact, domestic sales of automobiles were much stronger in April than their first-quarter average in seasonally adjusted terms. Moreover, consumer confidence indices have also gained some ground. Yet, the Committee members noted that some of the rebound in domestic demand could be attributed to the price incentives created by the fiscal package that brought consumer demand for selected

goods forward, and therefore, the pace and scale of the recovery in domestic demand remains to be seen.

11. The private sector's capacity utilization rate rose month-on-month in April for the first time in a long time in seasonally adjusted terms, suggesting that the rise in domestic sales have started to support production. In addition, the recent rebound in the business confidence index signals the possibility of a partial recovery of economic activity going forward.

12. Although there have been signs of a partial recovery in economic activity, there is no sign of improvement in labor market conditions. Applications for unemployment benefits remain high, indicating that unemployment continues to increase. On balance, the decline in non-farm employment and the high level of the unemployment rate are both expected to put further downward pressure on domestic demand and unit labor costs in the upcoming period.

13. Foreign demand remains weak. Exports continued to fall during the first quarter of 2009 due to global recession. Furthermore, coincident indicators for April and May exports do not point to a durable recovery in foreign demand. Although the Business Tendency Survey has shown a partial recovery regarding expectations for foreign demand more recently, foreign demand conditions are not expected to improve significantly without a lasting improvement in the global economic outlook.

Monetary Policy and Risks

14. In light of these assessments, economic activity and employment are not expected to recover anytime soon, suggesting that downward pressures on inflation are expected to last going forward. Accordingly, the Committee indicated that these recent developments are consistent with the outlook presented in the April Inflation Report and has thus decided to cut policy rates by 50 basis points.

15. The Committee believes that the rate cuts have lowered the probability of significantly undershooting the medium-term inflation targets. Recently, improvement in global risk perceptions and expectations regarding the future course of policy rates have also contributed to the decline in longer-term interest rates to historically low levels. In this context, it should be highlighted that changes in monetary conditions affect economic activity and inflation with a lag. Therefore, given the cumulative easing in monetary policy since November 2008, the Committee envisages that the next rate cut may be measured.

16. However, the tightness in financial conditions still persist to some extent, and uncertainties regarding the impact of the problems across financial markets on

the real economy are ongoing, suggesting that downside risks still remain. Although recent indicators regarding the global economic outlook suggests that the worst may be over, it will nonetheless take some time before the global financial system recovers, and therefore a full recovery in economic activity is not likely to be observed anytime soon. Accordingly, it seems necessary for monetary policy to maintain an easing bias for a considerable period of time.

17. Another major factor affecting inflation and monetary policy outlook is the stance of fiscal policy. Budget revenues continue to decline in line with the slowdown in economic activity, while expenditures rise owing to countercyclical fiscal policy, leading to a widening in the budget deficit. 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 underpin fiscal discipline and debt sustainability.

18. 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.