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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: August 18, 2009

Inflation Developments

1. Consumer prices increased by 0.25 percent in July, while inflation decreased to 5.39 percent year-on-year. Despite the fall in average inflation, core inflation measures rose on the back of the year-on-year slowdown in seasonal clothing discounts during July, and because of tax adjustments on some durable goods. Excluding tax effects, underlying inflation continue to hover around low levels.

2. Despite having decelerated in July, annual unprocessed food inflation still remains elevated. In contrast, processed food prices increased by a mere 0.33 percent in July, falling year-on-year for the first time since the inception of the consumer price index. The annual rate of increase in processed food prices is likely to rise owing to base effects in coming months, while there may be a downward correction in unprocessed food prices.

3. Changes in energy prices helped annual inflation ease further. Energy prices dropped by 0.21 percent in July, leading to a sharp decline in annual inflation, partly owing to the high base effect from a year earlier. Crude oil prices fell month-on-month, but the fall could hardly pass through to the domestic market owing to the mid-July lump sum special consumption tax levied on major fuel products. Given that the tax increase will be partly reflected in August inflation and noting the pick up in international oil prices, fuel prices are expected to rise in August.

4. The annual rate of increase in goods excluding energy and food climbed to 4.79 percent in July, largely due to tax adjustments, as stated in the previous Summary of the Monetary Policy Committee Meeting. Prices of tobacco products soared by 11.57 percent due to the minimum lump sum tax adjustment, adding approximately 0.5 percentage points to July inflation. Moreover, prices of durable goods (excluding gold) rose by 2.09 percent due to phased-out tax cuts on certain consumer goods. Taken together, the tax adjustments pushed inflation up by around 0.7 percentage points in July. Meanwhile, clothing prices decreased at a slower pace in July compared to a

year ago owing to early seasonal discounts and a modest rise in clothing consumption.

5. The rate of increase in services prices continued to slow down amid weakening domestic demand. Services inflation declined to a historic low of 5.92 percent year-on-year in July. Across the subcategories, prices for transport services, rents, as well as restaurants and hotels increased at a more moderate pace than a year earlier. In seasonally adjusted terms, the monthly rent inflation continued smoothly along a downward path. At the same time, while tax measures to restore fiscal balances led to a marked increase in compulsory traffic insurance premiums and notary public fees in July, inflation in services is expected to slow further in the forthcoming period.

6. Overall, the Monetary Policy Committee (the Committee) noted that trend inflation is hovering around low levels and advancing along a path that is consistent with medium-term targets.

Factors Affecting Inflation

7. Recent data releases are in line with the outlook presented in the July Inflation Report. Industrial production fell by 9.7 percent in June, at a more modest annual rate than in May. Critically however, much of the improvement in the year-on-year difference was caused by calendar effects. Accordingly, the Committee emphasized that judgments based only on annual growth rates may be misleading. In fact, seasonally adjusted June data indicate that industrial production hardly changed month-on-month.

8. July data on capacity utilization show that the modest recovery in production has continued into the third quarter. In seasonally adjusted terms, total capacity utilization increased by 0.5 percentage point month-on-month, running 1 percentage point above the second-quarter average. The Committee noted that although private sector capacity utilization displayed some recovery during the second quarter, it still remained at relatively depressed levels.

9. Recent indicators for consumption confirmed that the fiscal stimulus measures had only a temporary impact on domestic demand. Accordingly, consumption indices and domestic automobiles sales fell sharply in July, while the demand for consumer loans slowed down as well. Expectations for domestic demand and consumer confidence indices show similar patterns. Specifically, according to the July Business Tendency Survey, three-month-ahead expectations for the number of new orders received from the domestic market declined month-on-month. Similarly, consumer confidence indices decreased for the first time in a long while. The Committee indicated that these

developments added to the uncertainty about the strength of recovery in consumer demand.

10. Domestic investment demand continues to fall. In particular, data on capital goods indicate that machinery and equipment investments declined further in the second quarter. More specifically, the production of capital goods dropped by 35.8 percent year-on-year in the second quarter and remained flat quarter-on-quarter in seasonally adjusted terms. Meanwhile, imports of investment goods fell by 18.3 percent year-on-year, but picked up in quarterly terms. Investment expectations in the Business Tendency Survey and the demand for investment-related credit in Banks' Loans Tendency Survey reveal similar patterns, indicating an unfavorable outlook for investment spending.

11. Foreign demand remains weak. The seasonally adjusted export quantity index (excluding gold) has increased gradually during April-June period. Data published by Turkish Exporters Assembly show that the modest growth of underlying exports continued during July and August. The Committee reiterated that foreign demand is likely to remain anemic in the near term, as the recent signs of global economic recovery do not exhibit a strong enough recovery.

12. Demand uncertainty remains high, causing firms to maintain low inventory levels and embrace a more cautious stance regarding production activities, which continues to suppress investment demand and employment prospects. In fact, there have not been any notable improvements regarding employment conditions. Non-farm employment dropped by 2.8 percent year-on-year during the second quarter, while non-farm unemployment increased by 5.5 percentage points year-on-year to 17 percent. In seasonally adjusted terms, non-farm employment losses are still apparent across industrial sectors and in related services including commercial and transport-communication segments. The growing number of non-farm unemployed as well as the rise in labor participation rates led to an increase in non-farm unemployment.

13. Overall, recent data releases indicate that the ongoing recovery in economic activity would be gradual and protracted.

Monetary Policy and Risks

14. The Committee observed that despite some recent easing, tightness in financial conditions still persists. According to the CBT Bank Loan Tendency Survey, the tightening of business loan lending standards continued—albeit at a slower pace—during the second quarter. Moreover, the survey suggests that any support the credit channel would have regarding the recovery of economic activity would be limited during the second quarter, given that the major driver

of the firms' demand for loans has been the desire to restructure their debt obligations.

15. The Committee members have indicated that bond yields have fallen in line with the outlook presented in the Inflation Report, and predicted that bank lending rates for consumer loans would follow gradually, as the lagged effects of cumulative easing of 900 basis points since November 2008 would start to ease credit conditions towards the last quarter of this year. However, the current unfavorable labor market conditions are expected to restrain the recovery in consumption, and therefore domestic demand conditions would continue to support disinflation. Therefore, in line with the perspective outlined in the Inflation Report, inflation is expected to remain at low levels for a long period of time.

16. The Committee reemphasized the importance of fiscal discipline in maintaining low levels of medium- and long-term interest rates, which are key determinants regarding the recovery of both consumption and investment. The implementation of a credible fiscal framework would bring down risk premiums further, and hence lead to a permanent fall in longer-term interest rates. This, in turn, would foster investment and labor demand, and thereby support the recovery process. Therefore, the establishment of a credible medium-term program ensuring fiscal discipline and debt sustainability would have an expansionary rather than contractionary impact on economic activity.

17. The Committee members stated that recent data regarding the global economy were consistent with the outlook presented in the Inflation Report. Although the data on economic activity suggest that the worst may be over, ongoing tight credit conditions and elevated unemployment rates are expected to hold back the recovery in global economy for a while.

18. The Committee observed that the cumulative effects of the commodity price declines has contributed to the slowdown in domestic inflation over the past year, especially by lowering processed food and energy inflation, leading to a significant base effect. Therefore, headline inflation may increase modestly at the turn of the year through mid-2010, mainly owing to base effects, although trend inflation is expected to remain at low levels in the period ahead. It should be underscored that a rise in inflation stemming from this channel was already factored into the monetary policy stance outlined in the July Inflation Report.

19. Overall, the tightness in financial conditions continues to some extent, and uncertainties regarding the impact of the problems in financial markets on the real economy persist, suggesting that downside risks still remain. Therefore, the Committee reiterated that it would be necessary for monetary policy to maintain an easing bias for a long period of time, and envisaged that further

measured rate cuts would be necessary in the short term unless there is a robust recovery in the economic activity.

20. The CBT has been taking the necessary measures at its disposal to contain the adverse effects of the global crisis on the domestic economy. 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, timely implementation of the structural reforms in the context of the European Union accession process remains to be of utmost importance.