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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: May 18, 2010

Inflation Developments

1. Consumer prices increased by 0.60 percent in April. Annual inflation was up 0.63 percentage points yielding a rate of 10.19 percent. The increase in annual CPI inflation and core inflation indicators was largely driven by the low base effect from last year's tax incentives, as noted in previous reports. Adjusted for tax changes, underlying inflation remains stable.

2. Developments particularly in red meat prices have been significantly affecting food prices. Despite having slowed in March, the rate of increase in unprocessed red meat prices accelerated markedly in April (by 5.77 percent), leading to a further rise in processed meat prices. Accordingly, as of April, the first round impact of meat prices added a total of 1.9 percentage points to annual CPI inflation.

3. The measures taken at the end of April regarding meat import regulations are likely to reverse the run-up in meat prices in coming months. In fact, early observations suggest that unprocessed red meat prices have been slightly down during the first half of May. Moreover, the massive flow of products into the market indicates that vegetable prices may fall markedly in May. In this respect, the Monetary Policy Committee (the Committee) noted that unprocessed food prices may decline significantly in May.

4. Energy prices remained practically flat during April. However, annual energy inflation rose by 1.49 percentage points to 11.75 percent on the back of the base effects from falling commodity prices in the first few months of 2009. Base effects on the annual energy inflation will continue to be strong in May.

5. The year-on-year increase in core goods prices (goods excluding food, energy, alcoholic beverages, tobacco and gold) rose for the second consecutive month owing to the base effect from the tax cuts on durable goods in 2009. By contrast, the year-on-year increase in other goods prices continued to trend downward to 1.72 percent in May.

6. Both services prices and the annual rate of increase in services prices decreased amid the sharp drop in communication prices (by 5.36 percent).

Pursuant to the decision of the Information and Communication Technologies Authority, postpaid rates have been reduced, while prepaid plans are now quoted in Turkish lira terms, which led to a sizable decrease in mobile call rates during April. This brought services inflation down by about 0.9 percentage points. Meanwhile, soaring meat prices continued to weigh on catering prices, while annual rent inflation continued along a steady downtrend.

Factors Affecting Inflation

7. Recent data suggest that the recovery in economic activity is ongoing. Industrial production grew by 0.9 percent month-on-month during March in seasonally adjusted terms. The industrial production index rose by 17.2 percent year-on-year during the first quarter of 2010, supporting the double-digit growth forecast for the first quarter. April's capacity utilization data and other leading indicators point to further recovery in economic activity over the second quarter of 2010. Yet, with the waning of base effects, annual growth rates would gradually decline after the second quarter.

8. Domestic demand is following a stable growth trend. Countercyclical monetary and fiscal policies are having a more noticeable effect on domestic demand, with sectors more sensitive to domestic demand experiencing relatively stronger growth performances. Sectors with strong linkages to non-durable goods manufacturing and construction have been on the rebound. Commercial loan and employment data indicate that the recovery is more pronounced in the services sector, which is more sensitive to domestic demand, compared to the industrial sector.

9. Both the increase in labor compensation driven by employment growth and the favorable developments across credit markets are supporting the recovery in private consumption. The rise in consumption-related tax intakes as well as the production and import data for consumer goods indicates that private consumption demand continued to grow during the first quarter. The Committee noted that, after having declined during the second half of 2009 following the tax cut-driven massive first-half increase, domestic sales of automobiles were back on the rise in the first quarter of 2010. Recent data from consumer confidence indices, new order indices and domestic sales of automobiles suggest that consumption is likely to increase further in the second quarter.

10. Production and imports data for capital goods indicate that private investment demand continued to recover in the first quarter of 2010. According to the Business Tendency Survey, the investment sentiment continues to improve,

while the Bank Loans' Tendency Survey reveals that the developments in the investment-driven loan demand has not made a negative contribution to the total business loan demand for the first time in a long while during the first quarter. Thus, investments are expected to grow moderately further in coming months. Yet, the global growth outlook continues to dampen economic activity, particularly in sectors that are relatively more sensitive to foreign demand, such as export-oriented industrial sectors and related services sectors. Therefore, given the weak global growth outlook, insufficient and uncertain aggregate demand is likely to restrain new investments in the manufacturing industry, while investment demand would remain below pre-crisis levels for some time.

11. Recent developments indicate that uncertainties regarding foreign demand would last for a long period. The export quantity index was down 2.1 percent year-on-year during the first quarter; yet, excluding gold, there is a gradual recovery in exports. The Committee emphasized that the growth outlook for export markets has not gained traction yet and the recovery in exports would be gradual, also noting that the exchange rate movements driven by ongoing concerns regarding the Euro area add to the uncertainties regarding foreign demand. Thus, despite the steady recovery in domestic demand, it would take a while before industrial capacity utilization rates return to pre-crisis levels.

12. Although employment conditions continue to improve, unemployment rates remain at high levels. Seasonally adjusted data indicate that non-farm employment continued to recover in the first quarter. Weak foreign demand continued to restrain industrial production, while non-farm employment surpassed pre-crisis levels on the back of the recovery in construction and services sectors. Nevertheless, the Committee indicated that the high level of unemployment rates compared to pre-crisis levels continue to contain pressures on unit labor costs.

Monetary Policy and Risks

13. The Committee indicated that the effects of the countercyclical monetary and fiscal policy have been increasingly evident on domestic demand. Consumer confidence and employment conditions continue to improve, while the production in sectors that are sensitive to domestic demand is displaying a steady uptrend. This view is supported by the rapid increase in consumption goods imports and the relatively higher capacity utilization in domestically-oriented manufacturing sectors.

14. Credit market developments also confirm that the recovery in domestic demand has been gaining traction. Historically low levels of bank lending rates

and the gradually easing credit standards since the beginning of the year suggest that credit market conditions have been increasingly supportive of the recovery in domestic demand. Particularly, the fact that credit extended to small- and medium-sized enterprises has been recovering since the beginning of the year indicates that credit conditions have been normalizing. The Committee underscored that these favorable developments in credit markets are consistent with CBT's strategy of gradually withdrawing some of the countercyclical measures adopted during the global crisis.

15. The Committee stated that market liquidity conditions have evolved as envisaged, and therefore, conditions are appropriate to implement the first step of the technical rate adjustment described in the "Monetary Policy Exit Strategy" published on the 14th of April 2010. The Committee observed that current one-week repo auctions rates were fluctuating around 7 percent. To eliminate such fluctuations, the Committee decided to start conducting one-week repo auctions via quantity auction with fixed interest rate. In this respect, the one-week repo rate, which becomes the new policy rate, is set at 7 percent—50 basis points above the overnight borrowing rates, as indicated in the exit strategy document.

16. The Committee emphasized that the recovery in external demand has not gained traction despite the upswing in domestic demand. Heightened debt sustainability concerns in Greece and many other European countries have been increasing the downside risks regarding the recovery in Europe—our major trade partner. Moreover, the significant depreciation of the Euro has the potential to adversely affect the competitiveness of exports. Therefore, considering the lingering uncertainties regarding global economy, the Committee reiterated that it may be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period.

17. In sum, the Committee assessed that aggregate demand conditions are currently not exerting significant upside pressures on inflation. The rise in annual core inflation indicators during the last two months can be mainly attributed to the base effect stemming from the previous year's temporary tax cuts on durable consumption goods. The Committee stated that, excluding tax effects, there is no increase in the underlying inflation trend, and hence, core inflation would continue to remain at levels below the end-year target.

18. The forecast in the April Inflation Report envisaged that inflation would increase slightly during the second quarter, hover around 10 percent during the third quarter, and decline gradually starting from the fourth quarter as the impacts of the unprocessed food increases and tax hikes die out. Nevertheless, recent developments suggest that the expected downward correction in vegetable and fruit prices may materialize earlier than envisaged.

In this respect, the Committee noted that unprocessed food prices may display a significant decline in May, bringing inflation to single digit levels. In other words, inflation in the following months may be lower than predicted in the April Inflation Report. Moreover, considering the possible impacts of measures regarding meat import regulations as well as the decline in oil prices, the Committee assessed that end-year inflation may be closer to the 6.5 target than forecasted in the Inflation Report. However, it was stated that the significant gap between inflation expectations and the medium-term targets necessitates close monitoring of the pricing behavior.

19. The Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. Should the fiscal rule—which is to be adopted at the beginning of 2011—be implemented decisively as envisaged, it would contribute to the decline in risk premiums, and by decreasing government borrowing costs enhance the effectiveness of monetary policy. Since the second half of 2009, economic activity has been stronger than envisaged in the Medium Term Program (MTP), leading to a better than expected performance in budget revenues. Using this fiscal space mostly to reduce the government debt, as implied by the fiscal rule, would facilitate demand management and ease the need for indirect tax hikes, therefore providing more room to conduct countercyclical monetary policy.

20. Since the last quarter of 2008, the CBT, without prejudice to its primary objective of price stability, has focused on containing the adverse effects of the global crisis on the domestic economy—which has been achieved to a large extent. 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.