SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: April 18, 2012

Inflation Developments

1. In March, consumer prices were up 0.41 percent and annual inflation remained unchanged at 10.43 percent. The surge in annual energy inflation continued amid the soaring international oil prices in this period. Meanwhile, annual inflation in core goods group decelerated, and the moderate course of services continued to contain consumer inflation.

2. In food and nonalcoholic beverages group, seasonally adjusted unprocessed food prices went down in March due to developments in fresh fruits and vegetables. As for the processed food group, monthly rate of increase of prices slowed down considerably, while annual inflation remained high on account of the cumulative effects.

3. In March, the surge in fuel prices amid soaring international oil prices and the depreciation in the Turkish lira became the main driver of the rise in annual energy inflation. It is expected that the rises in natural gas and electricity tariffs, to be effective as of April, will increase energy prices further; and these increases will have a direct contribution of around 0.5 point to consumer prices.

4. On the services front, annual inflation in all subcategories other than restaurants and hotels went down, while the historically low rate of month-on-month increase in rents became noteworthy in this period. Seasonally adjusted price and diffusion indices suggest that the prices of services sustain a mild outlook. As for the core goods group, the fading effects of the depreciation in the Turkish lira on durable goods prices pulled annual inflation downwards. Nevertheless, the upward trend in core goods inflation excluding durable goods, clothing in particular, continued in March.

Factors Affecting Inflation

5. National income data for the last quarter of 2011 remained broadly consistent with the outlook presented in the January Inflation Report. Accordingly, economic activity displayed a mild growth on a quarterly basis, and the balancing in demand components continued at a strengthening pace. As a matter of fact, domestic demand followed almost a flat course, while net external demand became the main driver of both quarterly and annual growth in this period.

6. The Committee stated that economic activity has been losing momentum for a while, and this deceleration became more pronounced in the first quarter of 2012, which was attributed to domestic demand. Having plummeted in January, industrial production index picked up slightly in February, but January-February average has stood below the average of the previous quarter. In the first quarter, domestic sales of light and heavy commercial vehicles posted a quarter-on-quarter decline. Meanwhile, having exhibited a mild growth, seasonally adjusted consumer loans confirmed the slowdown in domestic demand.

7. Leading indicators suggest a modest recovery in consumption demand in the second quarter. Despite its low level, consumer confidence has improved in recent months. Following the decline in January, expectations on domestic new orders have assumed a gradual recovery trend. Moreover, the absence of any notable setback in new investment plans of the manufacturing firms coupled with the consistent upward trend in non-farm employment indicate that there is no permanent deterioration in expectations on demand. The Committee attributed the slowdown in economic activity in the early 2012 to the tightening policy measures besides some temporary factors such as adverse weather conditions and external uncertainties, and assessed that domestic demand would resume its upward trend in the period ahead.

8. Recent data confirm that the rebalancing between the domestic and external demand continues as envisaged. Notwithstanding the persisting problems in the European economy, exports continue to grow at a steady pace. The ongoing slowdown in domestic demand and the cumulative depreciation in the Turkish lira continue to restrict the import demand and non-energy current account deficit. Accordingly, despite the elevated oil prices, the gradual improvement in the current account balance is expected to continue in the forthcoming period. The recovery in the 12-month cumulative current account deficit, which started in November, is expected to become more pronounced in March and April. As for the medium and long term, the Committee highlighted that the new incentive package based on state aid in investments would pull the current account deficit downwards and bolster growth on the supply side as well.

9. Labor market data point that employment losses in the industrial and construction sectors halted, and employment in these sectors has assumed a re-increasing trend. The Committee estimates that rises in employment will continue in the forthcoming period owing to the improvement in economic activity. As a matter of fact, survey data point to a favorable outlook in job opportunities. Moreover, first quarter indicators signal for a mild growth in employment. Nevertheless, the ongoing downside risks on global economy may restrain employment growth in the period ahead.

Monetary Policy and Risks

10. In light of the past three months' developments, the Committee has assessed the inflation forecast to appear in the April Inflation Report. The Committee members have indicated that main factors affecting inflation are broadly in line with the outlook presented in the January Inflation Report. Yet, it was noted that inflation may hover above the envisaged path in the short term due to hikes in energy prices. The Committee stated that it will not tolerate temporary factors to have an adverse impact on the inflation outlook. Accordingly, it was underscored that additional monetary tightening may be implemented more frequently in the forthcoming period. In other words, notwithstanding the upward revision in energy prices, inflation forecast for end-2012 remained intact at 6.5 percent due to the offsetting impact of tighter monetary policy. In this respect, the inflation forecast is based on the assumption that credit growth will be milder and output gap will be wider compared to the January Inflation Report.

11. The Committee has indicated that inflation is will follow a volatile course in the second quarter. The direct effects of electricity and natural gas price hikes on April inflation is expected to be around 0.5 percentage points. Therefore, inflation will increase temporarily and reach its peak in April. Due to base effects in unprocessed food prices, annual inflation is expected to display a sharp fall in May, and a modest increase in June.

12. It is expected that the tight monetary policy implemented by the Central Bank since October will contain the second round effects, and thus inflation will follow a downward path once the cumulative impacts of temporary factors taper off. Accordingly, the Committee expects that inflation will decline gradually starting from the third quarter and the downward trend will become more evident during the final quarter of the year.

13. According to the Committee members, existing high levels of inflation and the recent deterioration in short-term inflation expectations pose risks on the pricing behavior. Annual inflation is expected to hover significantly above the target until the final quarter of the year due to the sharp price increases witnessed during the last three months of 2011, which necessitates a close monitoring of the pricing behavior. Although the monetary tightening implemented since October has reduced the possibility of second round effects, the Committee will adopt a cautious approach by monitoring inflation expectations closely, and will take necessary measures to keep medium-term inflation outlook consistent with the target.

14. Ongoing uncertainties regarding global economy require the maintenance of a flexible approach in monetary policy against possible volatilities in capital flows. Although sovereign debt problems in the euro area have eased somewhat during the first quarter of the year, bleak growth prospects and still-high borrowing costs across the region keep the debt sustainability debates alive. Moreover,

deleveraging in the euro area banking system feeds into financial fragilities, increasing the probability of a renewed deterioration in the risk appetite. On the other hand, the risk appetite may recover faster than expected, should the measures taken towards the solution of problems regarding the global economy are completed sooner and more decisively than envisaged. Accordingly, the Committee stated that, given the prevailing uncertainties regarding the global economy, it would be appropriate to preserve the flexibility of the monetary policy. Therefore, the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, as needed.

15. Another risk for the forthcoming period is the uncertainty regarding the oil price outlook. Although weak global outlook dampens the upside pressures on commodity prices, prevailing supply-side problems pose an upside risk in the short term regarding energy prices. Should such a risk materialize, the Committee will not respond to temporary price movements, yet will not tolerate any deterioration in expectations.

16. Unprocessed food prices pose downside risks for the inflation outlook in 2012. The probability of a downward correction in unprocessed food prices due to the high base attained by end-2011, coupled with favorable precipitation during the recent months, increase the likelihood of a more benign unprocessed food price path than implied by the assumptions. Inflation may reach the target faster than projected in the baseline scenario, should the food prices display a more favorable course than expected.

17. The Committee monitors fiscal policy developments closely while formulating monetary policy. In this respect, current stance of the monetary policy take the Medium Term Program as given and thus assume that fiscal discipline will be maintained. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework and consequently have an adverse effect on the medium-term inflation outlook.

18. Strengthening the structural reform agenda to ensure the sustainability of the fiscal discipline and reduce the saving deficit will support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. These measures will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities at low levels. In this respect, steps towards the implementation of the structural reforms envisaged by the Medium Term Program remain to be of utmost importance.