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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: June 16, 2009

Inflation Developments

1. Consumer prices increased by 0.64 percent in May, while inflation fell to 5.24 percent year-on-year. Inflation was down across all subcategories, with services prices registering an even more pronounced deceleration. Moreover, the core inflation measures indicate that underlying inflation remains around historic lows.

2. Annual unprocessed food inflation continued to trend upward in May amid accelerating fruit prices. After having declined as low as 0.63 percent in February, annual unprocessed food inflation spiked to 13.59 percent in May, and is likely to remain volatile in coming months. Meanwhile, after hitting a record 25.50 percent in July 2008—amid supply shortages and rising import prices—annual processed food inflation went down to 2.68 percent in May with the reversal of previous unfavorable developments. Accordingly, inflation in food and nonalcoholic beverages dropped to 7.63 percent year-on-year.

3. Annual energy inflation declined by 3.1 percentage points to 6.22 percent in May due to the significant reduction in natural gas tariffs and the ongoing fall in solid fuel prices since December. Given the removal of the base effect from the marked increase in all subcategories of energy—particularly in electricity and natural gas—during July and August 2008, annual energy inflation is expected to decelerate further in the short run. However, higher crude oil prices are likely to limit the downtrend in energy inflation.

4. Annual inflation in goods excluding energy and food fell to 1.44 percent in May, owing to the decline in underlying inflation, the slower price increases for the latest season of clothing and footwear compared to a year earlier, and the high base in furniture prices from a year ago. The impact of the tax adjustments in June on core goods inflation would depend on the extent to which they are passed through prices.

5. Services inflation continued to slow down in May, falling by 0.83 percentage points to 6.78 percent year-on-year. The rate of increase of services prices decelerated across all subcategories. Meanwhile, rent inflation moderated

further, down to 9.49 percent year-on-year. Given the softening in domestic demand, annual services inflation is expected to edge further down in coming months.

6. Overall, the Monetary Policy Committee (the Committee) expects annual inflation to rise in June due to the base effect and the tax adjustments. However, the increase in inflation is seen to be temporary given the one-off nature of the factors affecting June inflation.

Factors Affecting Inflation

7. Recent data releases point to a partial recovery in economic activity. In seasonally adjusted terms, the industrial production index in April and the capacity utilization rate in May indicate that the downward trend in production that began in the second quarter of 2008 ended during the second quarter of 2009. While industrial production plummeted by 18.5 percent year-on-year, the index rose by 0.5 percent month-on-month in seasonally adjusted terms in April. Furthermore, the private sector's capacity utilization rate in seasonally adjusted terms was up by 1.0 percentage point during April-May period compared to the first quarter. Nonetheless, the Committee members noted that most of the recent increases in economic activity were attributable to the short-term effects of the previously implemented fiscal measures. The Committee indicated that there needs to be a robust revival in consumer demand in order for the increases in the capacity utilization rate to be sustainable over the medium term.

8. Although consumer demand continued to rise in April and in May, it remains to be seen whether this will turn into a solid recovery. The Committee noted that consumer demand was stronger in the second quarter than in the first quarter of the year in seasonally adjusted terms. Specifically, domestic automobile sales, which were largely supported by the tax cuts, continued to rise in May in seasonally adjusted terms, leading to an increase both in imports and domestic production. The fiscal package also affected the domestic sales of white goods, which accelerated during March and April. Similarly, consumption indices remained elevated in April and May after markedly rising during March. Having started to rebound in February, the production of chemicals and furniture production, largely intended for the domestic market, continued to recover slightly in April.

9. Despite having fallen significantly year-on-year, imports of consumer goods increased in seasonally adjusted terms during March and April, particularly owing to the rebound in imports of passenger cars on the back of the tax cut introduced by the fiscal package. In contrast, the recovery in consumer non-durable imports was quite limited.

10. Domestic investment demand continues to contract. The production of capital goods fell in April in seasonally adjusted terms, while there has been some recovery in capital goods imports since February. According to both production and import figures, the investment demand for machinery and equipment is expected to slump further year-on-year in the second quarter. Demand uncertainty and lower capacity utilization continue to suppress fixed capital investments. Results of the Business Survey indicate that recently investment appetite continued to remain weak, although the pace of deterioration has slowed down during April and May. The Committee indicated that the current trend in investment demand is far from signaling a robust economic recovery.

11. Foreign demand remains weak. The export quantity index dropped by 13.3 percent year-on-year in April. Coincident indicators suggest that exports decreased by about 40 percent year-on-year in May in US dollar terms. The Committee noted that the sharp contraction in exports during May can be partly attributed to base effects, as the seasonally adjusted data shows that exports have remained flat since October 2008.

12. The softening of economic activity in general, and investment demand in particular, continues to have a dampening effect on employment. Although non-farm unemployment declined to 18.9 percent in March 2009 after hitting 19.3 percent during the first quarter of 2009, it continued to rise in seasonally adjusted terms. Applications for unemployment benefits in April and May suggest that non-farm unemployment may continue to rise in the second quarter in seasonally adjusted terms. The Committee expects that the high rate of unemployment would restrain unit labor costs and domestic demand in the foreseeable future.

Monetary Policy and Risks

13. The Committee believes that resolving the problems in the global economy is likely to take a considerable period of time. Although recent data releases indicate that the worst may be over, the recovery is expected to be protracted given credit market problems and rising unemployment rates.

14. In light of these assessments, the Committee expects that the recovery in domestic economic activity would be gradual, and labor market conditions would not improve anytime soon. Hence, the inflation rate is expected to remain at low levels in the forthcoming period. While inflation could rise in June due to tax hikes and base effects, this increase is expected to be temporary.

15. 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. Accordingly, it seems necessary for monetary policy to maintain an easing bias for a considerable period of time.

17. Although downside risks are still more significant, recent signs of recovery in economic activity should not be discarded. Accordingly, the Committee will consider a deceleration in the pace of rate cuts or a pause should the indications of an improvement in economic activity point to a robust recovery.

18. The Committee also assessed current and projected Turkish lira liquidity conditions. To facilitate the liquidity management of banks and to enhance the transmission of monetary policy, the Committee approved the use of repos up to three-month maturity as needed, in addition to the main one-week repo funding instrument.

19. The Committee indicated that despite recent increases, commodity prices are still at low levels relative to last year, and therefore imported input costs did not exert significant pressure on inflation at this point. At the same time, the Committee members noted that the possible future demand increases for commodities by emerging economies, including China and India, made commodity prices very sensitive to speculation. Therefore, potential commodity price developments could present risks to inflation over the medium term.

20. Another major factor affecting inflation and the monetary policy outlook is the stance of fiscal policy. 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. In this context, the increasing financing requirement of the government might weaken the favorable impact of monetary policy decisions on economic activity. Given these developments, the Committee members once again emphasized 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.

21. While necessary, prudent monetary policy is not sufficient to support 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.