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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: September 17, 2009

Committee Members

Durmuş Yılmaz (Governor), Erdem Başçı, Burhan Göklemez, Turalay Kenç, M. İbrahim Turhan, Abdullah Yavaş, Mehmet Yörükoğlu.

Inflation Developments

1. Consumer prices decreased by 0.30 percent in August, bringing inflation down to 5.33 percent year-on-year. Core inflation measures remained low, while the annual rate of increase in the prices of services continued to fall steadily.

2. The rate of increase in food prices dropped by 1.67 percentage points month-on-month to 6.83 percent year-on-year, on the back of easing unprocessed food prices, owing to falling vegetable and fruit prices. In the processed food category, prices continued to decline year-on-year, however, annual inflation across this category is likely to increase owing to base effects in coming months.

3. Energy prices increased by 1.88 percent in August. Fuel prices jumped by 5.02 percent due to the lagged impact of the mid-July Special Consumption Tax hike and rising oil prices. Moreover, the increase in tap water rates drove energy prices higher.

4. The annual rate of increase in the prices of goods excluding energy and food climbed to 5.70 percent in August, owing to the rise in annual clothing inflation and the monthly increase (1.83 percent) in prices of durable goods (excluding gold) and tobacco products. The seasonal discounts on clothing prices have been more modest than a year earlier because of the relative increase in clothing demand. Meanwhile, the annual inflation in durable goods (excluding gold) increased to –1.71 percent amid rising prices of white goods and automobiles. It should be noted that the tax cuts are due to expire in October, which will likely put upward pressure on annual durable goods inflation in the upcoming period.

5. Given the weak state of domestic demand and the gradual removal of the high base effect of the past supply shocks, the steady fall in services prices over the past year continued into August, bringing the inflation rate in this category down to 5.59 percent year-on-year. Across subcategories, inflation in transport

services, rents, as well as restaurants and hotels continued to fall gradually. Annual services inflation is expected to edge further down over the short run.

6. Overall, the Monetary Policy Committee (the Committee) noted that underlying inflation continues to hover around low levels.

Factors Affecting Inflation

7. Second quarter national accounts data are consistent with the outlook discussed in the July Inflation Report. Gross Domestic Product (GDP) continued to decline year-on-year, but rose sharply quarter-on-quarter in seasonally adjusted terms, signaling that the economic contraction since the second quarter of 2008 has ended. Domestic demand increased on rising private consumption during the second quarter, and net exports continued to register a positive contribution to growth, albeit more modestly.

8. As stated in the Central Bank of Turkey's previous publications and announcements, the Committee reiterated that consumer spending was mainly boosted by the fiscal stimulus packages, and thus the observed recovery may reflect transitory features. Among major spending categories, the demand for goods that benefited from the fiscal measures recovered rapidly during the second quarter: spending on furniture, household appliances and care, as well as transport and communications rose markedly quarter-on-quarter in seasonally adjusted terms. By contrast, the demand for categories that were not affected by the fiscal incentives remained flat.

9. Consumption demand, after having increased markedly during the second quarter, is expected to display a weaker course in the third quarter. In fact, indicators including the sales of white goods, the quantity of imported consumer goods, consumption indices and automobile sales are running below their second quarter levels in seasonally adjusted terms. Moreover, the indicators of market orders and consumer confidence from the Business Tendency Survey seem to reinforce this outlook.

10. Domestic investment demand remains weak. Despite the marked run-up in consumer demand during the second quarter, private machinery and equipment investments continued to fall quarterly, indicating that demand uncertainty remains strong over the upcoming periods. Imports of capital goods declined in July from a quarter earlier, while the Business Tendency Survey indicator of expected future fixed capital investment spending points to a further year-on-year decline in private sector investments. The Committee noted that low capacity utilization rates and uncertainties over aggregate demand will likely further weigh down on investment demand.

11. Foreign demand continues to be weak. The export quantity index continued to fall year-on-year in July, but increased sharply month-on-month in seasonally adjusted terms. Leading indicators suggest that exports continued to grow in August and September, albeit at a slower pace. The Committee noted that exports are expected to recover gradually, matching the pace of global economic recovery, and reemphasized that foreign demand is therefore likely to remain anemic for quite some time.

12. In July, industrial production increased month-on-month in seasonally adjusted terms, running above its second quarter average. The uptrend in capacity utilization rates since April continued into August. The manufacturing industry capacity utilization rate and recent export data suggest that the moderate recovery in industrial production is likely to continue into August and September.

13. Uncertainties regarding aggregate demand remain high and continue to adversely affect labor markets. Specifically, labor market conditions do not display a significant improvement. During May-July, non-farm employment dropped by 2.5 percent year-on-year, while non-farm unemployment increased by 4.5 percentage points to 16.4 percent. In seasonally adjusted terms, while non-farm unemployment fell slightly quarter-on-quarter, the decline was because of a drop in labor participation rate rather than a recovery in employment. Moreover, employment losses are still apparent across industrial sectors in seasonally adjusted terms, indicating that the labor market has yet to recover. Looking ahead, leading indicators do not point to a marked recovery in employment conditions during the third quarter.

Monetary Policy and Risks

14. Committee members have indicated that the future course of monetary policy will largely depend on the strength of the recovery in economic activity. Although second quarter GDP figures seem to reflect a bounce-back in private consumption, inspection of the subcomponents reveals that the increase in consumption is confined to goods that were subject to tax incentives within the fiscal package, suggesting that a durable recovery has yet to materialize. As a matter of fact, recent data releases indicate that, in line with the Committee's previous assessments, the ongoing recovery in economic activity will be gradual and protracted. Accordingly, resource utilization in the economy is anticipated to stay below potential for an extended period, and 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.

15. Provided that the improvements in global risk perceptions continue, the Committee expects that the cumulative policy rate cuts implemented since

November 2008 would begin to have an effect on credit markets over the forthcoming period. In this context, consumer loan rates have been falling steadily since the publication of the July Inflation Report. Also during this period, banks' willingness to extend credits have been increasing markedly, and tightness in financial conditions have been easing. These developments suggest that the credit channel would start to be more effective going forward.

16. However, the weakness in labor markets is ongoing and lingering problems across the global economy have not been resolved completely, suggesting that there are still uncertainties regarding the strength of the recovery. In this respect, the Committee members stated that the improvement in credit conditions would not in itself be enough to end the easing cycle. Yet, given the increased perceptions that the economy had reached a turning point, it was concluded that a slowdown in the pace of rate cuts might be considered, keeping the options open depending on incoming information.

17. Overall, the Committee has reiterated that it would be necessary for monetary policy to maintain an easing bias for a long period of time. The size and the duration of the rate cuts would depend on the pace of the recovery in economic activity.

18. Another factor affecting the outlook for monetary policy would be changes in risk perceptions. The global crisis has highlighted the resilience of the Turkish financial system, leading to an improvement of our relative creditworthiness. Provided that the global risk appetite continues to improve in the forthcoming period, this could lead to a decline in imported inflation through the portfolio channel, increasing the probability of significantly undershooting the inflation targets. Under such circumstances, the Central Bank of Turkey (CBT) would react by extending the easing cycle more than was envisaged in the Inflation Report.

19. An important factor that may affect the risk premium is fiscal policy. Should the framework outlined in the Medium Term Program be supported by structural adjustments which enhance fiscal discipline, the improvements in sovereign credit risk might continue, which in turn, would increase the probability of a further decline in interest rates. In sum, further improvements in the risk premium may lead to a longer rate cut cycle.

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. Monetary policy in the past year has focused on alleviating the impact of the global financial crisis on the economic activity. In this respect, the CBT has delivered sizeable cuts in policy rates, while providing liquidity support to facilitate the smooth operation of credit and financial markets. 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 envisaged by the Medium Term Program and European Union accession process remains to be of utmost importance.