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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: February 15, 2011

Inflation Developments

1. In January, consumer prices were up 0.4 percent, and annual inflation fell by 1.5 percentage points to 4.9 percent mainly on the back of base effects. As anticipated in the summary of the January Monetary Policy Committee (the Committee) meeting, core inflation indicators increased slightly in January.

2. Unprocessed food prices increased by 2.08 percent month-on-month, while unprocessed food inflation eased to 8.05 percent year-on-year. Meanwhile, processed food prices continued to accelerate on soaring prices for bread and cereals as well as oils and fats. Annual processed food inflation is expected to increase gradually in coming months amid higher international food prices. However, annual food inflation is expected to drop markedly in February due to base effects from unprocessed food prices.

3. Energy prices rose by 1.04 percent amid increased fuel prices, driven by soaring international oil prices, and higher water supply tariffs, while annual energy inflation fell 3 percentage points on base effects.

4. Services inflation edged slightly upwards in February. The annual inflation picked up in communication services, slowed in transport services, hotels and restaurants, and remained flat in rents. The recent increases in processed food and fuel prices exert cost pressure on prices of services.

5. The annual inflation in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) rose to 2 percent owing to January's lower-than-average seasonal discounts on clothing and footwear. Moreover, there has been some pass-through to core prices in January from rising import prices and the depreciation of the Turkish lira. Higher prices of services and core goods put upward pressure on core inflation indicators. Moreover, in line with expectations, seasonally adjusted core inflation has also trended up.

Factors Affecting Inflation

6. Recent releases on economic activity have been consistent with the outlook presented in the January Inflation Report. Latest data for the fourth quarter confirm the Committee's expectation that the third-quarter slowdown in

economic activity would be temporary. Indeed, the industrial production index rose sharply in December both on a monthly and quarterly basis. Yet, the Committee has noted that manufacturing new orders show signs of deceleration over the first quarter, largely due to domestic demand.

7. Economic activity continues to recover amid increasing domestic demand. The production and imports of consumer and investment goods were higher in the fourth quarter than the third-quarter average, pointing to an acceleration in domestic demand, particularly for imported goods. However, the improvement in consumer confidence and investor sentiment has recently paused, while consumer loans have been slowing amid sluggish auto loans. Against this background, the Committee has reiterated that the recent measures would restrain the rate of increase in loans and domestic demand over the upcoming period.

8. Foreign demand remains relatively weak despite the recent pick-up. Although the export quantity index excluding gold increased quarter-on-quarter during the fourth quarter after declining in the third quarter, indicators for new orders show no sign of a strong recovery in exports. Meanwhile, the seasonally adjusted imports excluding energy declined slightly in December. The Committee expects import demand to slow further and demand components to follow a more balanced path in coming months.

9. Employment conditions continue to improve, yet, unemployment rates remain at high levels. Employment developments were consistent with the Committee's expectation that the third-quarter pause in the non-farm employment growth would be temporary and employment growth would resume by the end of the year. Indeed, employment in industry increased significantly amid strong activity. Leading indicators suggest that non-farm employment would continue to grow in coming months. Nevertheless, the Committee has reiterated that unemployment rates would remain higher than pre-crisis levels for some time, containing unit labor costs.

Monetary Policy and Risks

10. The Committee expects inflation to further decline in February, display some fluctuations starting with the second quarter, and end the year at a level close to the January Inflation Report forecast. Especially, the base effects stemming from the unprocessed food fluctuations during the previous year would continue to be important for the path of annual inflation. Moreover, the cost-push effects driven by the import prices may lead to an increase in core inflation indicators. On the other hand, the Committee members indicated that the high level of unemployment rates compared to the pre-crisis levels would contain unit labor costs.

11. The measures taken by the Central Bank since November are reducing macro-financial risks by leading to a more balanced growth path, mainly through a slowdown in import growth. The Committee indicated that, in annualized terms, current account deficit would continue to widen, albeit at a decelerating pace, in the first quarter owing to the base effect. Therefore, it is important to monitor seasonally adjusted monthly figures in order to assess the impact of the monetary measures. In fact, in seasonally adjusted terms, there was some improvement in the current account deficit in December, and also a slight deceleration in the pace of credit growth was observed at the beginning of 2011. However, the Committee members have also underscored that available data is not long enough to make a healthy assessment, as the effects of the measures would be observed with some lag.

12. The Committee has indicated that the monetary tightening would restrain the demand side pressures on inflation. In fact, leading indicators suggest that domestic orders have moderated during the first quarter compared to the previous quarter. However, the Committee has also noted that rising energy and other commodity prices would pose supply side risks on the inflation outlook. Therefore, it was underscored that the pricing behavior should be monitored closely.

13. In light of these assessments, in order to contain the risks towards price stability and financial stability, the Committee has decided to closely monitor the tightening impact of the implemented policy mix—a low policy rate, a wide interest corridor and high reserve requirement ratios—until the next meeting, and take additional measures along the same line, if needed.

14. According to the Committee members, uncertainties regarding global economy still persist, requiring monetary policy to be flexible on both sides. Ongoing problems in credit, real estate, and labor markets across developed economies and the uncertainties regarding the impact of fiscal consolidations continue to pose risks regarding the global economy. In this respect, the recovery signals coming from the US economy should be interpreted with caution. Moreover, it was reminded that the financial and sovereign debt related problems in the euro area would persist for a long period. On the other hand, it was stated that global inflation risks due to rapidly rising commodity prices and lagged impacts of the monetary expansion remain as a major concern. In sum, the Committee members have underscored that both the upside and downside risk factors and the related policy responses outlined in the Inflation Report are still applicable.

15. Monetary policy will continue to focus on price stability in the period ahead. To this end, the impact of the macroprudential measures taken by the Central Bank and other related institutions on the inflation outlook will be considered

carefully. 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. Sustaining the fiscal discipline will also provide more flexibility for monetary policy and support the social welfare by keeping interest rates permanently at low levels. In this respect, timely implementation of the structural reforms envisaged by the MTP and the European Union accession process remains to be of utmost importance.