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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: December 17, 2009

Inflation Developments

1. Consumer prices increased by 1.27 percent in November, driving annual inflation up by 0.45 percentage points to 5.53 percent year-on-year, largely due to rising unprocessed food prices. When unprocessed food, energy and gold are excluded, November outturn represents one of the lowest monthly inflation rates recorded in recent years. In addition, the behavior of subcategories does not point to a deterioration in the general pricing behavior. Overall, the November rise in annual inflation is mainly attributable to transitory factors and base effects, and thus underlying trend inflation remains subdued.

2. Food prices have been the major factor underlying the recent increase in inflation. In particular, unprocessed food prices have remained volatile over the year. After having registered the lowest third quarter rate of change in five years, unprocessed food prices ran above seasonal averages during the last two months owing to higher fruit/vegetable and meat prices, which is expected to continue into December. In contrast, the outlook regarding processed food prices remains favorable.

3. Having picked up due to hikes in electricity tariffs during October, energy prices continued to rise in November in line with international oil prices. The annual rate of increase in energy prices is expected to accelerate in coming months owing to base effects. The drop in commodity prices during the final quarter of 2008 had driven energy prices down sharply starting from December 2008. Therefore, the resulting impact of these base effects on inflation is expected to be visible starting from December 2009.

4. Owing to the expiration of the temporary tax cuts, the annual rate of increase in the prices of goods excluding energy and food continued to increase in November. Underpinning this development was the 7.61 percent rise in gold prices owing to soaring international prices as well as the increase in clothing and footwear inflation that was driven by the low base effects from a year ago.

5. Annual services inflation continued along a downtrend during November. Annual rental inflation declined further, while prices for transport and other

services dropped modestly. Higher meat prices had a more moderate impact on restaurants and hotels than in the previous two months. Thus, annual inflation in the overall services index decreased to historically low levels.

6. In sum, the Monetary Policy Committee (the Committee) stated that the upcoming period would be marked by strong base effects, particularly leading to a sizeable increase in annual inflation in December. Yet, the Committee expects core inflation to remain at low levels.

Factors Affecting Inflation

7. Third quarter national accounts releases were consistent with the outlook presented in the October Inflation Report. Gross Domestic Product (GDP) continued to grow quarter-on-quarter, albeit slowly. In particular, the data confirmed that after a robust second quarter, private consumption moderated as tax cuts were phased out. Meanwhile, private investments have recovered slightly quarter-on-quarter for the first time in a long while. Taken together, total final domestic demand has remained flat.

8. Recent readings suggest that the economy is on track for moderate recovery. Industrial production increased by 6.5 percent year-on-year during October 2009, which was the first year-on-year positive growth rate for a long period of time. However, the Committee attributed the production growth largely to working-day effects and noted that industrial production continued to contract year-on-year after adjusting for calendar-related effects. The Committee expects calendar effects to remain prevalent during November and December, and emphasizes that year-on-year comparisons should be based on calendar-adjusted data.

9. The Committee indicated that industrial production grew markedly month-on-month during October, even in seasonally adjusted terms. Yet, production is likely to fluctuate beyond seasonal patterns during the month of Ramadan and the ensuing religious holiday period, and therefore assessments regarding production should not rely on a single month’s realization. Accordingly, comparing the September-October period with the July-August period suggest that industrial production is on a moderate recovery path in seasonally adjusted terms. Thus, it should be noted that it would be inappropriate to conclude a strong and durable recovery in production, based solely on the October data.

10. Leading indicators suggest that the pace of growth continued to slow in the fourth quarter. With the expiration of all tax incentives, the underlying trend for consumption demand has moderated. The unfavorable outlook continues for spending categories more sensitive to current income. The Committee

members noted that, given the precarious labor market conditions, the demand for categories sensitive to current income might continue to be weak. In seasonally adjusted terms, the production of consumer goods remained virtually unchanged in October from a quarter ago, while imports, especially of passenger cars, contracted. Consumer confidence and consumption indices confirm this weak outlook. Therefore, consumption demand is expected to remain mostly flat during the final quarter.

11. Among the factors restraining capacity utilization across manufacturing industries, the share of insufficient domestic demand continued to increase, while the role attributed to weak foreign markets remains high. In addition, aggregate demand uncertainty continues to suppress investment demand. Considering both production and import data, investment demand is expected to recover further during the fourth quarter, yet remain at low levels. The Committee restated that the idle capacity resulting from low resource utilization is likely to have a dampening effect on investment demand for quite some time.

12. Foreign demand remains weak. In this context, the absence of a strong and sustained turnaround in industrial production continues to restrain services sectors with strong industrial linkages, such as trade and transport/communication as well as the outlook for economic activity and employment prospects more generally. In fact, closer inspection of the industrial composition reveals that trade-related services sectors seem to have been particularly more affected by foreign demand conditions. Therefore, without a marked improvement in foreign demand and/or significant diversification in export markets, economic recovery is not likely. Hence, the Committee reiterated its expectation that aggregate demand would recover gradually.

13. Uncertainties regarding aggregate demand linger, and employment conditions are expected to take a long time to fully recover. In fact, unemployment rose by 2.7 percentage points to 13.4 percent year-on-year during September 2009, while non-farm unemployment increased by 3.5 percentage points year-on-year. The labor force participation rate continues to have an adverse impact on the unemployment rate. After hitting a record high in May 2009, non-farm and overall unemployment rates have recently recovered in seasonally adjusted terms, albeit modestly. The end of the decline in industrial employment was viewed by the Committee as an important development. However, given the slow pace of recovery in employment, the unemployment rate is likely to remain elevated for a long time.

Monetary Policy and Risks

14. The collapse of global demand and commodity prices after the intensification of the global crisis during the last quarter of 2008 had been followed by a sharp fall in inflation. Accordingly, annual inflation—the year-on-year rate of change in the consumer price index—is likely to display upward movements owing to base effects, although monthly rate of changes in prices are expected to hover at moderate levels. The Committee therefore stated that strong base effects could lead to a significant increase in annual inflation in the forthcoming period, especially in December; yet core inflation would remain at low levels. Annual inflation could display upward movements through mid-2010 by the same token, yet this possibility had already been reflected in the monetary stance outlined in the October Inflation Report.

15. The Committee indicated that the economic activity is on a moderate but stable upward trend. However, resource utilization, hence inflation, is expected to stay around low levels in the medium term, given the existing low levels of capital and labor utilization. Therefore, core inflation indicators would display a modest pace, and hence annual inflation is expected to revert back to a declining trend in the last quarter of 2010, ending the year below the target.

16. The policy rate cuts implemented since November 2008, and the improvements in global risk perceptions have started to exert favorable effects on credit markets. Committee members have also underscored the important role of the sound domestic banking system in supporting the recovery in credit markets. However, the ongoing tightness in lending standards regarding credit to small- and medium-sized enterprises as well as longer-term loans is still a factor restraining economic activity.

17. Although recent data releases indicate that the worst is likely to be over, concerns regarding the strength of the global recovery remain. Accordingly, taking into account that lingering problems across the global economy have yet to be resolved completely and there are still uncertainties regarding the strength of the recovery, the Committee, in line with the policy stance presented in the Inflation Report, emphasized that it would be necessary to keep policy rates at low levels for a long period of time.

18. In particular, ongoing problems in credit and labor markets pose downside risks for global activity. Should global conditions deteriorate again, and consequently delay the domestic recovery, another cycle of rate cuts would be considered. Committee members stated that although materialization of this scenario has become less likely, it should not be completely disregarded.

19. According to the Committee members, another possible scenario involves a surge in capital inflows to emerging markets owing to the relative improvement

of credit risk across these countries. Ample liquidity driven by the expansionary fiscal and monetary policies on a worldwide scale, coupled with rising risk appetites, have led to large capital inflows to emerging markets. Given the current slack across the economy, a fall in the cost of imported inputs could be rapidly transmitted to consumer prices, suggesting that a further acceleration in capital inflows may exacerbate downward risks on inflation. Realization of such a scenario could lead to temporarily lower policy rates.

20. The course of oil and other commodity prices constitutes another important risk factor. Ample liquidity driven by countercyclical policies on a global scale has encouraged speculative investments not only into emerging market currencies, but also into commodities. Therefore, oil and other commodity price developments warrant careful surveillance, even under a scenario of a gradual global economic recovery. Nonetheless, weak domestic demand conditions would limit the pass-through stemming from upside cost-push shocks. Therefore, the Committee will not react to short-term commodity price volatility, especially when resource utilization remains at depressed levels. However, if an uptrend in commodity prices reflects a strong and durable rebound in global activity that would in turn create inflationary pressures, then monetary policy will react appropriately to keep inflation in line with the medium-term inflation targets.

21. The Central Bank of Turkey (CBT) will continue to monitor fiscal policy developments closely while formulating monetary policy. Enhancing the framework set out in the Medium Term Program (MTP) through further structural adjustments to strengthen fiscal discipline, would support the improvement of Turkey’s sovereign risk. Should the goals set out in the MTP be implemented, it would be possible to keep policy rates at single digits throughout the medium term.

22. The CBT has been taking the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy. However, 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 thus 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.