No: 2009 – 23 **28 July 2009**

SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: July 16, 2009

Inflation Developments

1. Consumer prices increased by 0.11 percent in June, bringing inflation up to 5.73 percent year-on-year. The rise in inflation was primarily driven by the base effect from unprocessed food prices and tax adjustments on some durable goods. However, excluding the contributions of these factors, underlying inflation continues to trend down, hovering around historic lows.

2. Annual unprocessed food inflation increased in June mainly on account of the low base effect. It should be recalled that unprocessed food prices had dropped by about 10 percent in June 2008 at a faster pace than seasonal averages, largely owing to the decline in exports for fruits and vegetables. Having fallen at a more modest pace in June 2009, unprocessed food prices registered an annual rate of increase of 22.35 percent, partly owing to the increase in foreign demand for fruits and vegetables since the final quarter of 2008. After hitting an average of 25.2 percent year-on-year in the first quarter, the growth in export quantity for fruits and vegetables climbed to about 35 percent during April and May. Meanwhile, processed food prices continued to ease in June, running close to year-ago levels. Despite the benign outlook for processed food prices, annual inflation in food and nonalcoholic beverages group rose to 9.68 percent owing to developments in unprocessed food prices.

3. Energy prices rose by 1.63 percent in June on the back of rising fuel and bottled gas prices amid higher oil prices. Despite these price hikes, the annual rate of increase in energy prices continued to decline, bringing energy inflation down to 6.1 percent year-on-year. Fuel prices declined during the first half of July, owing to regulatory measures and the fall in oil prices, before rising again on the back of special consumption tax (SCT) hike on major fuel products and the rise in oil prices. On balance, monthly average of fuel prices in July are expected to be below average fuel prices in June. Along with the removal of the high base effect from the sharp increase in electricity tariffs a year ago, annual energy inflation is expected to decline further in July.

4. Although annual inflation in goods excluding energy and food rose in June, it still remains low at 1.63 percent. Among the subcategories, clothing prices remained below year-ago levels. Prices of durable goods (excluding gold) were up 2.04 percent month-on-month due to phased-out tax cuts, with a

particular boost from rising automobile prices. It should be noted that changes in tax rates are likely to put further upward pressure on core goods inflation in July and October. In addition, the surge in prices of tobacco products (fuelled by minimum lump-sum tax adjustments) is likely to push CPI inflation up by around 0.54 percentage points in July. On balance, the annual rate of increase in prices of goods excluding food and energy is expected to edge up in the second half of 2009.

5. The rate of increase in services prices continued to slow down amid weakening domestic demand. Services inflation fell by 0.51 percentage points month-on-month to an all-time low of 6.27 percent year-on-year. Annual inflation decelerated across all major subcategories. In particular, rent inflation eased further, down to 8.74 percent year-on-year. Accordingly, services prices are expected to edge further down in coming months.

6. Overall, despite some potential fluctuations owing to tax hikes and base effects, the Monetary Policy Committee (the Committee) expects inflation to remain low during the upcoming period.

Factors Affecting Inflation

7. First-quarter national accounts data confirmed the deepening of the economic contraction. During the first quarter, gross domestic product (GDP) plummeted by 13.8 percent year-on-year and posted a steep quarterly decline in seasonally adjusted terms. The global crisis had a growing impact on the labor market, while private domestic demand displayed a sharp contraction. However, with the marked slowdown in imports, net exports registered a positive contribution to growth.

8. Recent data releases point to a partial recovery in economic activity. Despite having slumped by 17.4 percent year-on-year, industrial production increased in seasonally adjusted terms in May. However, the June data on capacity utilization suggests that the pace of recovery in economic activity remains weak. The Committee noted that even though the downtrend in industrial production since the second quarter of 2008 appears to have receded in seasonally adjusted terms, the outlook for growth remains anemic.

9. Consumption indices seem to indicate a modest revitalization during the second quarter. The production of consumer goods rose quarter-on-quarter, particularly regarding goods most affected by the tax cuts. Similarly, imports of consumer goods increased on the back of the robust demand for passenger cars. On balance, the Committee indicated that the second-quarter recovery in private consumption demand is uneven and, currently, not of a durable nature.

10. Domestic investment demand continues to weaken. The production of capital goods dropped by 38.7 percent year-on-year during April-May and fell below its quarter-ago average in seasonally adjusted terms. Meanwhile, the private investment demand for machinery and equipment has plunged further in the second quarter both in quarterly and yearly terms, although there has been some rebound in the demand for imported capital goods.

11. Foreign demand remains weak. The export quantity index was down 19 percent year-on-year during April-May. The recent readings of the export quantity index (excluding gold) point to a very slow and limited growth of underlying exports in seasonally adjusted terms, which is consistent with the current global growth outlook. Ongoing weakness regarding the leading indicators for economic activity across European countries–comprising Turkey's largest export destinations–increases the likelihood of a protracted recovery in foreign demand.

12. The demand uncertainty fuelled by the global economic downturn has prompted firms to embrace a more cautious stance regarding production activities. In this context, employment prospects are unlikely to improve soon given the low rates of capacity utilization and the decline in investment sentiment. The 2009 March-May data indicate that non-farm employment continues to fall, while both male and female labor force participation rates rise further. Thus, non-farm unemployment soared to 18.2 percent during March-May, up by 5.9 percentage points from a year earlier. While applications for unemployment benefits slowed in June compared with the first quarter, they were significantly above their year-ago level. These developments suggest that non-farm unemployment has remained at elevated levels in the second quarter.

Monetary Policy and Risks

13. In light of these assessments, the Committee noted that, although there were signs of a partial improvement in domestic consumption, its strength and durability remains to be seen. It is expected that demand uncertainty and low levels of resource utilization will continue to weigh down on investment spending and employment, while high unemployment will continue to contain private consumption demand. Therefore, inflation is expected to remain at low levels for a long period of time.

14. The tightness in financial conditions continues to some extent, and uncertainties regarding the impact of the problems in financial markets on the real economy persist, suggesting that downside risks still remain. Therefore, the Committee reiterated that it would be necessary for monetary policy to

maintain an easing bias for a long period of time and envisaged that further measured rate cuts would be necessary in the near term unless a robust recovery were observed in the economic activity.

15. The Committee members believe that global interest rates are likely to remain at low levels for an extended period, given the significant slowdown in growth and rising saving rates. The Committee therefore indicated that this view should be emphasized more forcefully to align market yields closer with future policy intentions.

16. Given the increased perceptions that low growth and low interest rates will persist for an extended period, the Committee members assessed that, it would be possible to provide more solid information regarding the policy stance in the upcoming Inflation Report (due on July 29th). Accordingly, the Committee decided to provide a perspective on the policy rate assumptions for the short-term, medium-term, and long-term that underlies the forecasts in the Inflation Report.

17. The Committee reemphasized the important role of global developments as well as fiscal policy for the inflation and monetary policy outlook. The Committee members indicated that providing explicit statements in the Inflation Report regarding the likely response of monetary policy under alternative scenarios would be useful in containing uncertainties and guiding market expectations.

18. 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 in the context of the European Union accession process remains to be of utmost importance.