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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: January 15, 2009

Inflation Developments

1. Consumer prices decreased by 0.41 percent in December, and annual inflation in 2008 materialized at 10.06 percent. Falling oil and other commodity prices continued to push down energy and processed food inflation, and the marked slowdown in economic activity put further downward pressure on services inflation. In addition, core inflation indicators remained on the decline.

2. Unprocessed food prices rose sharply for the third consecutive month in December on elevated vegetable prices, whereas annual inflation in processed food continued to fall, registering a cumulative drop of 10 percentage points in five months on the back of improved production and lower international prices. Inflation in processed food prices is expected to decelerate further in the first half of 2009.

3. Energy prices dropped by 2.58 percent in December, mainly on account of plummeting world crude oil prices that exerted a strong downward pressure on domestic fuel and bottled gas prices. With the sizeable drop in December, the fall in domestic fuel prices reached a cumulative of 20 percent in five months. Given the current falling trend in international commodity prices, energy prices will continue to support disinflation.

4. Annual inflation in goods excluding energy and food continued to decline in December on falling clothing prices, ending 2008 at 3.75 percent. After a sharp rise in October and November, prices for durable goods (excl. gold) decreased by 0.43 percent in December. Yet, the low base pushed the group's annual inflation up by 0.5 points. Recent price developments indicate that the short term pass-through of the recent weakening in the Turkish lira had a significantly lower impact on prices of durable goods compared with previous years.

5. Services inflation remains on the decline owing to lower costs and weaker domestic demand. Annual inflation fell in all sub-categories of services in December. The marked decline in processed food prices continued to have a favorable impact on catering prices, while plunging oil prices brought annual inflation in transport prices down. The downtrend in transport prices is likely to

become more pronounced in the upcoming period. Meanwhile, rent inflation continued to moderate in December, falling by 0.4 points to 11.85 percent year-on-year. The Monetary Policy Committee (the Committee) expects services inflation to decelerate further in coming months.

6. In line with these developments, seasonally adjusted core inflation figures also remained on a downward track in December, suggesting that underlying inflation continued to slow down. This development is particularly remarkable, given that in the last quarter there has been a significant depreciation in exchange rates.

Factors Affecting Inflation

7. Gross domestic product (GDP) grew by 0.5 percent year-on-year in the third quarter of 2008. Seasonally adjusted figures suggest that the level of economic activity was below the previous quarter.

8. Recent readings indicate that the slowdown in the domestic economic activity has further intensified in the fourth quarter. Industrial production, which has been falling since July in seasonally adjusted terms, has shown a 10.7 percent annual drop during October-November period. Readings on capacity utilization also point to a further weakening in the industrial production in December.

9. Fourth-quarter indicators for consumer demand continued to trend downward. Production of consumer goods was significantly down during October-November from a quarter ago. The demand for imported consumer goods also followed the same pattern. After the sizable drop in October and November, consumer confidence indexes remained at low levels in December, and consumer lending declined in nominal terms in the fourth quarter. Overall, recent readings suggest that private consumer spending contracted both in quarterly and annual terms in the final quarter of 2008.

10. Heightened signs of prolonged global economic recession since October worsened the outlook for foreign demand. After having grown by 12.2 percent year-on-year during the first nine months of 2008, exports quantity index dropped by 8.4 percent in October and November. Moreover, December Business Tendency Survey (BTS) has indicated expectations of further deterioration in export orders for the first quarter of 2009.

11. Production and imports of capital goods, key proxies for investment demand, fell by 22.4 and 16.5 percent year-on-year, respectively, during October-November, and were quite below their third-quarter average in seasonally adjusted terms. The data on production, imports and exports of investment goods indicate that machinery-equipment investment spending have dropped

remarkably in the fourth-quarter in annual terms. In fact, according to BTS results, there is a growing number of firms that consider their production capacity as “more than sufficient” in view of their current order books and demand expectations. Hence, twelve-month ahead investment expectations continued to weaken.

12. The slowdown in economic activity is clearly reflected in the labor market. Non-farm unemployment increased by 1.7 points to 14 percent in September-November period from a year ago. The Committee noted that non-farm unemployment is likely to rise further, dampening both unit labor costs and domestic demand in the forthcoming period.

Monetary Policy and Risks

13. The Committee assessed the assumptions underlying the outlook in the Inflation Report. It was stated that currently the most critical variable is the global economic growth. Latest forecasts suggest that ongoing problems in international credit markets and the global economy will last longer than previously envisaged. With the intensification of global financial crisis, overall loss of confidence, wealth destruction and tightening of credit conditions—especially for the business sector—have led to a marked downturn in the global economic activity. Growth forecasts for the global economy have been constantly revised downwards in the last couple of months. The Committee assessed that it would be appropriate to use the predictions appeared in the latest Consensus Forecasts survey for the baseline scenario in the Inflation Report. Accordingly, the outlook in the Inflation Report was based on the assumption of a gradual recovery in the global economy starting from the first quarter of 2010.

14. The Committee stated that significant fall in oil and other commodity prices were having a favorable impact on disinflation. Energy price inflation displayed a significant fall in the last quarter of the year, yet it materialized at around 20 percent by the end of the year. Therefore, given the recent decline in oil prices, the Committee members think there is still ample room for fall in energy inflation. Accordingly, the contribution of energy prices to headline inflation is expected to come down considerably throughout 2009. In a similar vein, processed food inflation is expected to decelerate further.

15. Therefore, downward pressures on both domestic and external demand and inflation will continue. Judging that inflation will be close to the target by mid-2009 and that the probability of undershooting the end-year target has increased, the Committee decided to cut policy rates by 200 basis points.

16. Credit conditions tightened considerably and bank loan rates displayed a sharp rise after the intensification of the global financial crisis. The pace of consumer credit growth suggests that financial conditions were restrictive in the last quarter of 2008, as consumer loans fell in nominal terms for the first time in the near history. Recent easing in monetary policy has helped to relieve the tension in domestic credit markets, as there has been a significant fall in consumer loan rates following the policy rate cuts. Yet, business loan rates remain elevated. The Committee underscored the adverse impact of the weakening economic activity on corporate profits and thus on lending appetite. In this context, it was indicated that the tightening in financial conditions might persist; necessitating interest rate cuts to continue, albeit at a decelerating pace.

17. Uncertainties regarding the impact of the problems in financial markets on the real economy remain at high levels. Developments in the global economy will be the main determinant of the outlook for domestic inflation and monetary policy in the medium term. Hence, in order to enhance the predictability and transparency of monetary policy, the Committee concluded that it would be useful to present two alternative scenarios in the final chapter of the January Inflation Report, each one based on different timing and speed of the recovery in the global economic activity. The two alternative scenarios are embedded in our forecasts through four main channels: External trade, portfolio flows, commodity prices, and credit channels.

18. The first alternative scenario is based on a relatively fast recovery in the world economy. In this scenario we assume that the monetary and fiscal measures taken by the major developed economies will be adequate to start pulling the global economy out of the recession in the second half of 2009. Accordingly, a rapid and stronger-than-envisaged recovery in the global economic activity would lead to a rebound in commodity prices, resurge in capital inflows to emerging economies, pick up in external demand, and relaxation in credit conditions. Under this scenario, meeting medium term inflation targets of 7,5, 6,5 and 5,5 percent in the 2009-2011 period, respectively, could require measured policy rate hikes towards the end of 2009.

19. The second alternative scenario is based on the assumption of a further deepening in global crisis in the first half of 2009 and an extended period of weakness in global economic activity until the second half of 2010. In this scenario a more protracted and slow recovery would lead to another wave of portfolio shock for emerging markets, weak external demand, tighter credit conditions, and further drops in commodity prices. Our forecasts suggest that, in such a case, medium term inflation targets could be undershot even with a measured sequel of policy rate cuts throughout 2009.

20. The Committee noted that pass-through from exchange rates to the domestic inflation has been so far limited compared to previous episodes, owing to weakening domestic demand and falling import prices. Yet, it was indicated that it would be too early to make a conclusive statement on the extent of the medium term pass-through.

21. Finally, it is worth to mention that a critical assumption underlying the inflation and monetary policy outlook outlined above is that government fiscal stance will remain neutral in cyclically adjusted terms, and that there will be no changes in indirect taxes or administered price adjustments, except those required by the existing automatic pricing mechanisms. Any significant deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

22. The Central Bank will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective. The extent and the timing of a possible future rate cut will depend on the factors affecting inflation outlook.

23. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis, especially under current conditions. Preserving the fiscal discipline and strengthening the structural reform agenda is also critical to mitigate the adverse effects of the ongoing shocks on the domestic economy. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. In particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity gains, are monitored closely by the Central Bank with regard to their implications for macroeconomic and price stability.