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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: January 14, 2010

Inflation Developments

1. Consumer prices increased by 0.53 percent in December, driving annual inflation up by 1 percentage point to 6.53 percent, owing to rising unprocessed food prices and base effects stemming from the low levels of last year's energy and clothing prices. In other words, the December rise in annual inflation is largely attributable to transitory factors and therefore does not point to a deterioration in underlying trend inflation.

2. Unprocessed food prices continued to soar in December, recording the largest fourth-quarter increase in six years. In contrast, the developments regarding processed food prices have remained favorable.

3. Energy prices accounted for most of the base effect that drove annual inflation higher in December. In fact, although energy prices rose by a mere 0.65 percent month-on-month, annual energy inflation was up by 3.4 percentage points. Increases in prices of certain energy items in January, due to the Special Consumption Tax and electricity price hikes, will add around 0.4 percentage points to headline inflation. Given these adjustments and base effects, the annual rate of increase in energy prices is expected to increase significantly in January.

4. The annual rate of increase in the prices of goods excluding energy and food slowed down in December to 6.15 percent, mainly due to falling prices of durable goods and pharmaceuticals. On the other hand, annual clothing and footwear inflation increased owing to base effects. The new tax measures implemented on alcoholic beverages and tobacco products in January to restore government balances are expected to add about 1.1 percentage points to CPI inflation.

5. Despite having increased slightly during December, annual services inflation remains subdued. Higher meat prices continued to weigh on catering prices, while annual rental inflation declined further, and prices for transport and other services increased modestly.

6. The Monetary Policy Committee (the Committee) indicated that tax adjustments and base effects would cause inflation to rise significantly over

the next two months and to remain above the target for some time. Yet, the underlying trend implied by core inflation indicators is expected to remain at levels consistent with medium-term targets. In this respect, it was emphasized that inflation would display a declining trend once the temporary factors taper off.

Factors Affecting Inflation

7. Recent data releases suggest that a moderate recovery in economic activity is ongoing. Industrial production grew slightly month-on-month during November 2009 in seasonally adjusted terms; yet, the average production for the October-November period was higher from a quarter earlier. Being on a slight uptrend since the second quarter, capacity utilization continued to grow modestly in the fourth quarter.

8. Industrial production contracted by 2.2 percent year-on-year in November, but grew by 5.8 percent year-on-year in calendar adjusted terms. Accordingly, the Committee once again highlighted the working-day effect due to religious holidays during the final quarter and the base effect resulting from the marked decline in production a year ago. Committee members noted that these effects would cause industrial production to increase substantially year-on-year in December, and stated that assessments regarding the economic recovery should be based on data adjusted for seasonal and calendar-related effects.

9. Leading indicators suggest that domestic demand continues to recover modestly. Consumption demand appears to have lost momentum following the expiration of tax cuts intended to spur economic activity. Furthermore, the rising trend in the production of consumer goods slowed during October-November. Imports of consumer goods have almost flattened. Despite a further recovery during the fourth quarter, production and imports data regarding investment demand indicate that investment demand still hovers around lows levels.

10. Foreign demand continues to grow moderately. October-November average of the export quantity index was up by 0.7 percent year-on-year, increasing in quarterly seasonally adjusted terms. The course of foreign demand in the upcoming period would be closely linked to the pace of the global recovery. According to survey data, export orders do not point to a strong rebound in exports in the short term, while insufficient foreign demand continues to rank high among factors that prevent manufacturing industries from operating at full capacity. Projections for the euro area, our largest trading partner, suggest that it would take a long time for foreign demand to return to previous levels.

11. The outlook for employment and wages is of critical importance for domestic demand over the medium term. Real wages had dropped sharply following the employment slump during late 2008, and have restrained consumption demand. In line with the reflection of the moderate economic recovery on the labor market, real wages started to rise again by the third quarter of 2009. Nevertheless, the current level of foreign demand continues to contain economic activity and employment in general by suppressing industrial activity. Hence, real wages in the short term are unlikely to bounce back to the levels associated with past episodes of strong economic growth, and therefore wage developments would continue to restrain domestic demand for quite some time.

12. In sum, while the downtrend in consumer confidence indices and the ongoing risks regarding the global economy continue to pose uncertainties regarding aggregate demand, the economy continues on a moderate recovery track. Given the current level of the economic activity and the pace of economic recovery, the Committee expects that capacity utilization and employment conditions would take a long time to fully recover.

Monetary Policy and Risks

13. The Committee indicated that tax adjustments and base effects would cause inflation to rise significantly over the next two months and also remain above target for some time. In this respect, January Inflation Report forecasts were revised significantly upwards for 2010, compared to the previous Report. However, noting that the underlying trend implied by core inflation indicators would remain at levels consistent with medium-term targets, the Committee emphasized that, given the low levels of resource utilization, the precarious state of labor markets, and global economic conditions, general pricing behavior would not be affected adversely by the temporary rise in inflation, and therefore, inflation would display a declining trend once the transitory effects taper off. Therefore, there has been no major change in the January Inflation Report regarding the inflation forecasts for 2011 and thereafter.

14. The Committee noted that credit markets have continued to improve in response to the monetary easing and the improvements in global risk perceptions. The tightness in credit conditions have been moderating since the publication of the July Inflation Report. Easing financial conditions and declining loan rates have been strengthening the expansionary impact of monetary policy. The October Inflation Report had stated that the credit channel would begin to support domestic economic activity during the fourth

quarter of the year. In fact, credit demand has started to recover in this period, especially with commercial loans picking up significantly. However, lingering problems across the global economy are not resolved completely and there are still uncertainties regarding the strength of the recovery. Accordingly, the Committee has emphasized that it would be necessary to keep policy rates at low levels for a long period of time.

15. The outlook for domestic economy has been largely shaped by global developments since the intensification of the global crisis during the last quarter of 2008. Given the important role of the trade and global financial channels in the contraction of domestic economic activity during 2009, it is expected that the global developments would continue to be the main driving factor for the outlook for domestic activity and inflation in the forthcoming period. Accordingly, the Committee assessed that both the risks on global and domestic economic activity, as well as their impact on inflation should be considered jointly.

16. Rising budget deficits and ongoing problems in credit and real estate markets continue to pose downside risks for global activity, especially for developed economies. Although the probability of another disruption in global economic activity has been decreasing, it is still an important source of downside risk on domestic economic activity and inflation. Should the global conditions deteriorate again, and consequently delay the domestic recovery, the Committee would consider further monetary easing.

17. Despite the prevailing downside risks on global and domestic economic activity, upside risks have also been emerging since the second half of 2009, given the pace of global recovery over this period. Moreover, it should be noted that the impact of the unprecedented expansionary policy measures since the last quarter of 2008 would be observed with a lag. Similarly, the 1025 basis points cumulative easing in policy rates of the Central Bank of Turkey (CBT) between November 2008 and November 2009 would also be fully transmitted with a lag. In this respect, the Committee indicated that, should the recovery in domestic economic activity turn out to be faster than expected, the limited monetary policy tightening implied by the baseline scenario in the Inflation Report could be implemented earlier than envisaged.

18. According to the Committee members, the fact that inflation will rise in the forthcoming period due to base effects and recent tax hikes, poses an important risk factor through its potential impact on inflation expectations. Several adverse factors (such as food, oil, base effects and administered price hikes) have been leading to upward movements in inflation since the last quarter of 2009. Although these factors are temporary, they will likely cause headline inflation to stay at elevated levels for sometime. It is crucial that the

economic agents fully understand the temporary nature of these developments while forming their medium- and longer-term expectations. Given the low levels of resource utilization, the adverse impact of the depressed labor market conditions on consumption expenditure, and the gradual removal of fiscal stimulus, these temporary factors as well as other cost push pressures would not lead to a significant deterioration in general pricing behavior. Currently, services and core inflation are consistent with medium-term inflation targets, and resource utilization is at low levels. Therefore, it is foreseen that the policy rates would be maintained at low levels for a long period. However, it should be underscored that the Committee will not hesitate to tighten monetary policy sooner than envisioned under the baseline scenario of the Inflation Report, should any unforeseen developments lead to a deterioration in general price setting behavior.

19. Increasing budget deficits on a worldwide scale, especially in developed economies, continue to pose risks on inflation expectations and thus on longer-term global interest rates. Countries with relatively sounder banking systems and prudent fiscal policies would be more resilient against these risks. In this respect, the Committee will continue to monitor fiscal policy developments closely while formulating monetary policy. Should the goals set out in the Medium Term Program be implemented through institutional and structural measures, rather than tax and administered price hikes, it would be possible to keep policy rates at single digit levels throughout the forecast horizon.

20. The Committee Members continue to view the course of oil and other commodity prices as an important risk factor. Ample liquidity driven by countercyclical policies on a global scale facilitates speculative movements for commodity prices. Fast growth trends in countries like China and India, and the rising share of these economies in global commodity demand, exacerbate these speculative motives. Therefore, oil and other commodity price developments may continue to rise, even under a scenario of a gradual global economic recovery. At this point it is worth noting that weak domestic demand conditions would limit the pass-through stemming from upside cost-push shocks. Therefore, the Committee will not react to the first round effects of short-term volatility in commodity prices, especially when the resource utilization remains at depressed levels. However, if an uptrend in commodity prices reflects a strong and durable rebound in global economic activity that would in turn have adverse effects on inflation expectations, then the monetary policy will be tightened appropriately to keep inflation in line with medium-term inflation targets.

21. Since the last quarter of 2008, the CBT, without endangering its main objective of price stability, has focused on containing the adverse effects of the global

crisis on the domestic economy, and this task has been achieved to a large extent. Monetary policy will continue to focus on price stability in the period ahead. 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. In this respect, timely implementation of the structural reforms envisaged by the Medium Term Program and the European Union accession process remains to be of utmost importance.