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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: August 14, 2007

Inflation Developments

1. Consumer prices fell by 0.73 percent in July, bringing annual inflation rate down to 6.90 percent. The cumulative decline in annual inflation over the past four months reached 4 percentage points.

2. Annual inflation in both the processed and unprocessed food groups decreased in July. Despite the rise in annual inflation in vegetable prices in July, annual inflation in the unprocessed food group declined to 8.92 percent, down by 4.3 percentage points from the previous month, thanks to continued correction in fruit prices. Meanwhile, annual inflation in processed food prices fell by 0.53 percentage points due to primarily last year's base effect. In the second half of 2006, processed food prices had surged significantly because of the pass-through from depreciation in the local currency (YTL) and owing to price movements mostly in the bread and cereal products group.

3. Price developments in the energy group supported the disinflation process in July. Despite the high level of crude oil prices in international markets, domestic fuel prices displayed a decline on the back of strong YTL. In addition, the favorable trend in the prices of utilities and other energy items for housing group continued.

4. Consumer durables prices, which displayed a downward trend in April-June period, continued this favorable course in July as well and annual inflation in this group came down to minus 2.15 percent. Another noteworthy development in July was the downturn in the annual inflation of clothing and footwear prices, after a period of successive price increases in the first half of 2007.

5. The Monetary Policy Committee (the Committee) noted the favorable developments in services inflation since early 2007. The slowdown in annual services inflation became more pronounced in July. The monthly inflation rates have declined in all sub-groups (rent, restaurants-hotels, transportation and all other services) compared to the same month of the previous year. Annual services inflation fell by 2 percentage points in the first seven months of 2007, the restaurants-hotels group contributed most to this decline. The lowest annual inflation among the main service expenditure groups was observed in

communication services with 3.50 percent. The impact of the rate cut in local calls on communication services prices in late July will be observed largely in August.

6. Notwithstanding the risks related to energy and food prices, inflation continues to decelerate owing to the lagged effects of the strong monetary tightening. Annual inflation in all core measures declined in July. This was mainly driven by the favorable price developments for durable goods and services. The downward trend in the annual rate of increase of the mostly cited core indicator-H (CPI excluding food, energy, alcohol-tobacco and gold) became more evident in July. The seasonally adjusted monthly inflation measured by using this index continued to slow down.

7. On the other hand, the Committee emphasized that the decline in unprocessed food prices observed last year in August may not recur this year, and consequently noted that food prices and the annual inflation rate might display a temporary rise in August.

Factors Affecting Inflation

8. The Committee assessed that the recent data on economic activity and inflation are consistent with the outlook presented in the July Inflation Report. While private sector investment and consumption demand exhibit signs of recovery, external demand is moderating and aggregate demand conditions continue to support the disinflation process.

9. Leading indicators for the second quarter of the year suggest that private consumption expenditures displayed a trend similar to the one in the first quarter. The slowdown in domestic sales of white goods observed since the third quarter of last year continued in the second quarter of 2007 as well. Similarly, domestic sales of automobiles and imports of consumer goods slowed down during this period. Moreover, the pace of real growth in consumer loans was moderate compared to the first half of 2006. Hence, private consumption spending, in seasonally adjusted terms, is expected to increase moderately in the second quarter of the year compared to the first quarter. On the other hand, June and July data on domestic sales of automobiles, various consumption indices and domestic sales of commercial vehicles point to a recovery in private investment and consumption demand, starting from the third quarter of the year.

10. Investment spending displayed a moderate growth trend. While imports of capital goods and production of electrical machinery increased in the second quarter of the year, machinery-equipment production and sales of light and heavy commercial vehicles decreased in seasonally adjusted terms compared to the first quarter. Meanwhile, the fall in construction permits in the first

quarter compared to the same period of the previous year signals a relative slowdown in construction sector. However, the construction investments may continue to display high growth rates throughout the year, since current construction investments are closely related to past construction permits.

11. In the first half of 2007, non-interest budget expenditures increased noticeably by 25.7 percent compared to the same period of 2006. This development indicates that public expenditures in recent months may have restrained the disinflation process. Based on the projected end-year budget targets, non-interest public expenditures are expected to slow down significantly in the second half of the year. Thus, it is likely that the stimulus from the public expenditures to the aggregate demand may cease in the second half of 2007. It is of critical importance for the continuity of disinflation process that potential measures that may be taken to achieve the program-defined non-interest budget targets would be implemented by cutting expenditures rather than tax adjustments and that incomes policy for 2008 is conducted in harmony with the medium-term inflation targets.

12. External demand maintained its strong course in the second quarter of the year. In this period, exports increased by 13.2 percent in annual terms. According to the data announced by the Turkish Exporters Assembly, the strong performance of exports continued in July as well. The robust course of external demand and the competitive advantage brought by productivity gains are expected to support export growth in the near future. However, it is expected that the strong base effect that will be effective from September onwards will restrain annual growth rate of exports.

13. The strong performance of exports has supported industrial production. Although year-over-year industrial production increased only modestly in June due to the high base in the same period of 2006, seasonally adjusted data point to a moderate growth in the second quarter of the year compared to the previous quarter.

Monetary Policy and Risks

14. Domestic demand has significantly slowed down after the monetary tightening in 2006. The slowdown in domestic demand is affecting inflation with a lag. This effect is particularly noticeable in services prices. Although domestic demand may partly recover in the second half of the year, aggregate demand conditions are expected to support the disinflation process—thanks to declining contribution of net exports and the government spending. Therefore, the underlying disinflation is expected to continue in the upcoming period. However, significant risks remain to the inflation outlook on both sides:

15. Volatile food prices lead to unpredictable movements in headline inflation. Moreover, bad crop of wheat poses risks on the consumer prices through the prices of bread and grain products. The Central Bank does not react to the temporary movements in unprocessed food prices, however closely monitors these developments since they can effect inflation expectations. It should also be noted that the risks posed by the food prices are not one sided, as the base effects may result in favorable surprises in the forthcoming period.

16. The stickiness in inflation expectations is considered as an important risk to the inflation outlook. Although the headline inflation has been easing down significantly in the past four months, inflation expectations of financial market participants have not shown any improvement. Corporate sector expectations are still significantly above the medium term targets despite the downward trend in the past couple of months. The prevailing gap between medium term inflation expectations and the targets poses uncertainties on the wage setting behavior—especially in the public sector—and hence the service prices, pointing to the risk of a slower-than-envisaged pace of disinflation. Materialization of such a risk could result in a more cautious policy than stated in the July Inflation Report.

17. The Committee closely monitors the developments in the international liquidity conditions and the credit markets. Recent market volatility has the potential to effect inflation through several distinct channels: In the short term the depreciation in domestic currency and the subsequent pass-through may have an inflationary impact, although this impact would partly be offset by the decline in oil and other commodity prices driven by rising concerns over the outlook for global growth. On the other hand, the recent developments in the international liquidity conditions and the credit markets will contain the downward trend in the bank lending rates, and also curb the banks' appetite for extending credit. Accordingly, likelihood of the materialization of the risk that "domestic demand conditions may turn less supportive for the disinflation process, once the prevailing uncertainties fade out and the long-term interest rates continue to decline during the second half of the year", as quoted in the last months Summary of the Monetary Policy Committee Meeting, has been reduced.

18. In this respect, the Committee, as of the meeting date, maintained the policy stance outlined in the Inflation Report, and thus envisioned a measured easing starting from the last quarter of 2007. However, the Committe added that the exact timing and the extent of the easing may vary depending on the incoming information regarding global liquidity conditions, external demand, public expenditures and other determinants of medium term inflation outlook.

19. The developments in the global markets and their reflections on the domestic markets are closely monitored. The Central Bank will utilize the available tools to mitigate the adverse impact of developments in the global markets on the inflation outlook. Within this framework, the Committee, during the meeting, also assessed liquidity developments in the domestic money market, and evaluated liquidity management strategies. The YTL liquidity is expected to be at sufficient levels in the forthcoming period. However, barring extraordinary market fluctuations, the Central Bank, by using existing open market operation tools, may regulate the liquidity levels on both sides when needed, to ensure that the overnight rates in the money market stay close to the Central Bank borrowing rates.

20. Prudent monetary policy is necessary but not sufficient for securing the resilience of the economy to global shocks. The role of fiscal policy and structural reforms are also critical in this process. In this respect, the European Union accession process and the implementation of the structural reforms envisaged in the economic program remain to be important for long-term stability. Particularly, advances in structural reforms that would enhance the quality of fiscal discipline are monitored closely with regard to their effects on both macroeconomic and price stability.