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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: September 13, 2007

Inflation Developments

1. Consumer prices rose by 0.02 percent in August, bringing annual inflation to 7.39 percent. As predicted in the summary of the previous Monetary Policy Committee (the Committee) meeting, the rise in annual inflation rate was due to price increases in the unprocessed food group. Favorable developments in the prices of other goods and services suggest that this recent increase in annual inflation rate would be temporary.

2. Volatility in the unprocessed food prices, which has been experienced since early 2007, also continued in August. According to seasonally adjusted figures, there was a notable rise in the prices of the unprocessed food group last month, due to price hikes primarily in fresh vegetables and also to a lesser extent in unprocessed food products other than fresh vegetables and fruits. Annual inflation rate in the processed food group, on the other hand, fell in August thanks to last year's base effect.

3. Favorable developments in the prices of the energy sector have continued in August. Prices of energy items for housing group displayed a limited increase, while domestic fuel prices dropped following the decline in crude oil prices in international markets. Overall, price developments in the energy group, with a 2.56 percent year-to-date inflation rate, have supported the disinflation process.

4. Strong monetary tightening continues to be effective on prices of consumer durables. In line with the slowdown in demand, the prices of consumer durables group have declined in the last five months and this trend has spread across the group. As of August, the annual inflation rate in this group came down to – 2.80 percent.

5. The Committee noted that the recent developments in services inflation have been more favorable than expected. The downward trend that has been observed in the services inflation since the beginning of 2007 has became more significant in August. Annual inflation in all services items has come down, with rents being the most remarkable. Following the benign course of fuel prices, annual services inflation in the transportation group declined in

August. Recent rate cuts in local phone calls affected telecommunication group, as expected.

6. The impact of monetary tightening on disinflation was also evident in core CPI measures. The annual rate of increase in the widely cited core indicator-H (CPI excluding food, energy, alcohol-tobacco and gold), which has been declining since April, continued to fall in August. Seasonally adjusted monthly changes in this index have also indicated a downward trend in inflation.

7. In light of these assessments the Committee concluded that the improvement in services inflation was beyond expectations, while developments in other price categories were in line with the outlook presented in the July Inflation Report.

Factors Affecting Inflation

8. Gross Domestic Product increased by 3.9 percent in the second quarter of 2007 compared to the same quarter of the previous year. In that period the contribution of net external demand decreased but remained positive, whereas the contribution of domestic demand increased moderately. Of the domestic demand components, private consumption expenditures declined in annual terms as projected in the July Inflation Report. This can be attributed to the lagged effects of monetary tightening on the demand for consumer durables. Meanwhile, investment expenditures accelerated in the same period and became the main determinant of the growth in domestic demand.

9. The analysis of seasonally adjusted expenditures showed that the key developments in the second quarter were the increases in public investment expenditures and private sector machinery-equipment investments. The contribution of public expenditures to the GDP was almost half of the overall growth rate. As stipulated in the Summary of the Monetary Policy Committee Meeting in August, private consumption demand followed a trend similar to the one observed in the first quarter and increased modestly compared to the previous quarter. Against this background, the moderate growth in the domestic demand has continued.

10. Leading indicators for the third quarter point to a recovery in private consumption demand. According to seasonally adjusted figures, domestic sales of automobiles in the July-August period, domestic sales of white goods, and imports of consumer goods in July increased significantly compared to the previous quarter. The Committee noted that despite recent upsurge, sales figures remained well below the levels seen in the first half of 2006. On the other hand, the July-August average of the CNBC-e

consumption index was well above its second-quarter level, while consumer confidence indices confirmed the recovery in private consumption demand. The pace of consumer loans in recent months also revealed a similar outlook.

11. The recovery in investment demand, which has started in the second quarter, has continued in the third quarter as well. Imports of capital goods picked up in July and commercial vehicle sales in the July-August period increased noticeably compared to the same period last year. Seasonally adjusted figures were also significantly above their second quarter levels. Other indicators for investment demand, such as imports of machinery-equipment and electrical machinery, also indicated an upward trend in the third quarter. All in all, initial readings in the third quarter pointed out acceleration in investment demand, particularly in investment good imports.

12. There was a noticeable increase in public expenditures in the second quarter, which contributed as many as 1.8 percentage points—almost half of the total value added—to annual GDP growth and slowed down the disinflation process. While forming the inflation outlook, the Committee projected that, in line with budget targets for 2007, there would be a significant decline in the contribution of public expenditures to growth in the second half of the year, and that would restrain the growth in total domestic demand.

13. Despite the strong course of external demand, the rate of increase in imports exceeded the growth rate of exports in June and July, following the recovery in domestic demand. While the robust course of exports is expected to continue for the rest of the year, there may be a slow down in annual growth rates due to loss of working days caused by religious holidays and the last year's high base effect. As the growth of imports outpace that of exports, net exports are expected to have a negative effect on GDP growth in the second half of the year.

14. Since mid-2006 strong monetary tightening has restrained the growth rate in employment, particularly in services sector. The downward trend in non-agricultural unemployment rate has ceased in recent periods, easing the pressure on wages. It is believed that this outlook will be maintained provided that the incomes policy is conducted in harmony with the inflation target. Meanwhile, ongoing productivity gains in the manufacturing industry is another factor that restrains unit labor costs.

15. In sum, it is projected that the recovery in private investment and consumption demand will continue without a significant acceleration, the contribution of external demand and public expenditures to growth will decrease and thus, aggregate demand and capacity conditions will continue to support the disinflation process.

Monetary Policy and Risks

16. Since the impact of monetary policy on economic activity and inflation is observed with a lag, the Committee takes the monetary policy decisions on a medium term perspective. In this respect, it is particularly important to identify the short term temporary movements from medium term trends. Recent readings reveal important information on the medium term inflation trends:

17. Although the headline CPI inflation was up in August, several sub-items of the index indicated significant favorable developments. The deceleration in services inflation is promising for the medium term inflation trend. Moreover, seasonally adjusted figures of the core indices suggest that the underlying inflation is moving towards the medium term targets.

18. Recently announced GDP figures confirmed that the domestic demand has continued to slow down in the second quarter of 2007, on the back of the last years' monetary tightening. Although private domestic demand is expected to pick up in the second half of the year, disinflationary impacts of the significant slowdown observed in the past four quarters is expected to last for a while. In this respect, inflation is expected to further decelerate owing to the lagged effects of strong monetary tightening, notwithstanding the risks related to energy and food prices.

19. The developments in international liquidity conditions and credit markets are closely monitored. The Committee reemphasizes that these developments should be evaluated with a medium term perspective. Further deepening of the international credit and money market concerns is likely to affect the Turkish economy as well as other countries. Such a development would lead to a tightening in credit conditions and thus support the disinflation process in the medium term through the demand channel. In fact, recently the banks have been less willing to extend credits and the downward trend in consumer loan rates has subsided. Besides its impact on domestic demand, the Committee members have highlighted that recent developments in global credit markets have raised the concerns of a slowdown in global economic activity, increasing the downside risks on external demand.

20. Accordingly, recent developments on inflation as well as domestic and global growth prospects imply an improved outlook for medium term inflation. Moreover, the Committee assesses that global developments are likely to restrain both the domestic and external demand, increasing the downward risks on achieving the 4 percent target in the medium term. As explained through the main policy documents on the general framework of the inflation targeting regime, the Central Bank will be equally responsive to the upside

and downside risks to attaining the target. Observing the higher downside risks on medium term inflation implied by recent developments and referring to the conditional statement stipulated in the July Inflation Report, the Committee decided that current conditions call for initiating the measured rate cuts mentioned in the Inflation Report, and lowered the policy rates by 25 basis points. The Committee underlines that the current monetary policy stance continues to be restrictive.

21. Besides the developments in global markets, other important risks to the inflation outlook can be described as follows:

22. Significant hikes in public expenditures were the main factor restraining the disinflation process in the first half of the year. Adhering to the government's budget projections, the Committee's medium term inflation outlook rests on the assumption of a significant slowdown in public expenditures during the second half of the year. Developments on the opposite direction would pose risks to the aggregate demand, and therefore to the medium term inflation outlook. The Committee closely monitors the developments in public spending.

23. Food inflation continues to be a risk to the inflation outlook. Not only the volatile vegetable and fruit prices but also the adverse developments in grain products—owing to low crop yields driven by drought conditions—are affecting the food prices. The projections on the harvest of grain products for 2007 suggest that these developments may persist for a while. Sustained increases in international soft commodity prices, especially for wheat and corn, add to the risks on food prices. The Committee members think that monetary policy should not react to the volatility in food prices so long as the second round effects are contained.

24. Oil prices have continued to rise recently. Although strong domestic currency limits the impact of oil prices on domestic prices, past cumulative increases in oil prices require caution for second round effects. Especially, uncertainty pertaining to the electricity prices are considered as a major risk factor for the medium term outlook.

25. Inflation expectations remain sticky. Despite the significant fall in inflation in line with the Committee's projections, medium term expectations have not shown any improvement. Although survey based expectations are among the main indicators monitored by the Central Bank, the Committee observes that their information content can vary in time. In particular, the Committee members perceive the existing stickiness in expectations as more of a structural phenomenon arising from transition from high to low inflation episode. Therefore, the Committee predicts that inflation expectations would eventually adjust to lower levels, as the inflation further decelerates in the

medium term. At the same time, the Committee believes that Central Bank can have an active role in realigning public's inflation expectations by putting more emphasis on its own institutional forecast.

26. These risks not only require the monetary easing process to be cautious and measured, but also increase the degree of data dependency of the fortcoming policy decisions. The exact timing and extent of further easing may vary with the incoming information on global liquidity conditions, external demand, public expenditures and other determinants of medium term inflation outlook.

27. Should the risk perceptions deteriorate significantly in the forthcoming period, the Central Bank may resort to an active liquidity management strategy to contain the short-term effects of a possible volatility in the financial markets.

28. Under current conditions, the role of fiscal policy and structural reforms are critical for improving the resilience of the economy against global shocks. 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. Advances in structural reforms that would enhance the quality of fiscal discipline are monitored closely with a special emphasis on macroeconomic and price stability.