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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: July 17, 2008

Inflation Developments

1. Consumer prices were down by 0.36 percent in June, bringing annual inflation down to 10.61 percent. This development was mainly driven by the fall in the annual rate of increase in unprocessed food prices, notwithstanding ongoing rapid increases in processed food and energy prices. The surge in food and energy prices accounts for 6.80 percentage points of annual inflation as of June.

2. The Monetary Policy Committee (the Committee) noted that unprocessed food prices have been relatively favorable in recent months with a decline of around 10 percent in June, which is a significant fall even if corrected for seasonal factors. The decline can largely be attributed to fresh fruit and vegetable prices that dropped by a remarkable 21.69 percent due to reduced exports. As a whole, the group's annual inflation fell to 1.60 percent. The Committee noted that the correction in unprocessed food prices might be partially reversed by the renewed exports to Russia in early July.

3. In contrast, processed food prices continued to increase, mainly due to a steep rise in bread and grain prices that hit a monthly rate of 4.11 percent in June. Yet, inflation in processed food excluding bread and grains has displayed some moderation compared with the past four months. The 2008 harvest is likely to produce better yields than last year, helping processed food inflation to moderate in the second half of the year.

4. Energy prices increased by 1.75 percent in June amid rising fuel and energy (natural gas) prices, pushing the group's annual inflation up to 19.8 percent. Energy prices are expected to rise further in July due to increased electricity rates. New electricity tariff rates, which have been effective as of July 1, are likely to have a direct effect of about 0.5 points to CPI inflation.

5. Annual inflation in clothing and footwear moderated in June, while inflation in durable consumer goods increased. Current demand and cost conditions in the clothing sector lead to a decline in relative price of clothing. Moreover, the weakening of the Turkish lira between January and April continued to have lagged impacts on prices of durable goods, albeit to a lesser degree in June.

6. Annual services inflation remained flat in June. The annual rate of increase in prices for catering and transport services remained elevated due to developments in food and energy prices. On the other hand, annual inflation in services other than transport and catering have declined by 0.44 percentage points over the previous month.

7. Although second-round effects of rising oil and food prices, lagged impacts of exchange rate pass-through, and last year's low base have led to an increase in core inflation indicators during the second quarter of the year, core inflation indicators registered a modest decline in June in seasonally adjusted terms. Moreover, medium-term inflation expectations seem broadly contained in July, after having deteriorated over recent months.

8. The Committee also noted that the hikes in electricity rates and the last year's low base would lead to a significant but temporary rise in annual inflation in July.

Factors Affecting Inflation

9. Recent readings on supply and demand conditions are in line with the outlook presented in our April Inflation Report. Gross Domestic Product (GDP) in the first quarter grew by 6.6 percent in annual terms.

10. Although annual percentage changes suggest a vigorous GDP growth, seasonally adjusted figures point to a quarterly growth rate of around 0.8 percent. The year-on-year growth rate is largely driven by the low base effect from the same period last year. The Committee thus emphasized that seasonally adjusted figures are key to a sound assessment of the main trends in economic activity. Overall, seasonally adjusted figures suggest an ongoing but moderating economic activity.

11. On the expenditures front, GDP growth was mostly driven by private demand, whereas public expenditures had a limited contribution to growth. Although total final domestic demand increased by 7.5 percent compared with a year earlier, it posted a quarterly decline in seasonally adjusted terms.

12. With exports having accelerated in recent months, the negative contribution of net external demand to growth has been smaller than the two preceding quarters. Compared with a quarter ago, the contribution of domestic demand to growth has fallen while that of net foreign demand has picked up on a seasonally adjusted basis.

13. Recent indicators point to a further slowdown in consumer demand in the second quarter. Consumer confidence indices were down from a quarter ago,

while the slowdown in real consumer loans continued. The seasonally adjusted CNBC-e consumption index continued to fall in the second quarter. The production of chemicals also declined further. Furniture manufacturing picked up in the second quarter, yet remained weaker than it was in periods of vigorous demand. Domestic sales of automobiles displayed a significant fall during January-June period. Imports of consumer goods also declined during the same period, particularly due to a dramatic decline in the demand for passenger cars.

14. Investment demand followed a similar pattern to consumer demand in recent months. Domestic sales of light and heavy commercial vehicles were weaker compared to the previous quarter, while the production of machinery-equipment and electric machinery remained flat. Imports of capital goods were down in quarterly terms during January-June on the back of a slump in transport vehicles. Excluding those vehicles, imports of investment goods were still falling, albeit more modestly.

15. Despite a slight rebound in the first quarter of 2008, housing permits, which have been flat since early 2006, remained stable in the second quarter in seasonally adjusted terms. The total number of construction permits in the first quarter was down by 1 percent from a year ago. The slowdown in the private construction sector is even more notable once the positive contribution from the public sector is excluded. Moreover, the fact that production of nonmetallic minerals grow at a lower pace than the exports suggest that the domestic construction activity has continued to moderate.

16. External demand remained strong. The export quantity index increased by 18.2 percent in the first quarter, and by 11.4 percent during April-May in annual terms. Seasonally adjusted figures point to an ongoing yet slightly moderating growth in exports in real terms. The robust pace of exports and the recent slowdown in imports suggest that the contribution of net exports will be higher in the second quarter compared to the previous quarter.

17. Although external demand remained robust, annual growth rate in industrial production moderated to 4.2 percent during April-May period. Seasonally adjusted figures suggest that industrial production expanded at a subdued pace during the first quarter and grew moderately in the second quarter.

18. First quarter data on the labor market point to a modest recovery in aggregate terms, although employment in services continue to slow down. During the March-May period, non-farm employment rose by 2.4 percent over a year ago, while non-farm unemployment fell by 0.1 points to 12.3 percent. The Committee emphasized that current conditions in the labor market continue to restrain the unit labor costs and domestic demand.

19. Labor productivity indicators based on the value-added in the non-farm sector continued to rise in the first quarter, partially offsetting the cost-push factors imposed by surging world oil and commodity prices on the real marginal costs.

20. In sum, difficulties in international credit markets continue to restrain the domestic demand, while external demand remains relatively robust. Overall, aggregate demand conditions continue to support disinflation

Monetary Policy and Risks

21. The meeting agenda also included an assessment of the inflation forecasts and their underlying assumptions to appear in the July Inflation Report. Despite the favorable developments in the unprocessed food inflation, processed food prices increased at a faster pace than anticipated. Therefore, the Committee envisioned a slightly higher path for the food prices compared to the previous Report. Considering that oil prices have been drifting at significantly higher levels than assumed in the previous Report, the Committee noted that the revised assumptions for oil prices should incorporate some room for caution.

22. Consequently, inflation forecasts, which incorporate the revised assumptions for oil and food prices, suggest that inflation will stay at high levels for a short period before gradually moderating towards the 7.5 percent target by the end of 2009. The Committee underscored that, adverse impacts of the supply side shocks on the economy would be more limited should the economic agents align their expectations for the next three years with the target rates of 7.5 percent, 6.5 percent and 5.5 percent, respectively.

23. The revised inflation forecasts are based on quite conservative assumptions for food and energy prices, implying that downside risks on these factors are as significant as upside risks. Should the upside risks materialize, monetary policy will be conducted so as to minimize upside deviations from the targets. Downward surprises in food and energy prices, on the other hand, will be perceived as an opportunity to bring inflation back to target in a shorter period than envisaged in our baseline scenario.

24. Despite the expected decline in inflation in the medium term, uncertainties exist regarding the degree of inflation persistence. Long-lasting supply shocks have been keeping headline inflation at elevated levels and thus increasing the risk of rising backward looking schemes in the wage and price setting behavior. Although the widening output gap should contain the second round effects of the supply shocks, the exact pace of disinflation would still depend on the extent new inflation targets serve as a strong reference for economic agents. Having this in mind, the CBT will continue to focus on enhancing the

credibility of the new inflation targets. In this context, developments in the general pricing behavior and the underlying inflation trends will be monitored closely.

25. International financial markets remain fragile and the credit conditions continue to tighten up. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. Moreover, rising commodity prices continue to be a threat for price stability. These uncertainties have been dampening the risk appetite and thus slowing down the capital flows to emerging markets, leaving these economies susceptible to shifts in the market sentiment. Domestic uncertainties have exacerbated these effects, as manifested by the significant rise in the sovereign credit risk of Turkey in the first half of the year, compared to the average risk premium of emerging economies. The CBT will not display a sharp reaction to temporary fluctuations in the financial markets, unless there is a long lasting deterioration in expectations and a significant worsening in the general pricing behavior.

26. Finally, our medium-term projections assume that government expenditures will evolve in line with the official projections and that there will be no further increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanisms. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

27. Regarding the monetary tightening since May, the Committee indicated that the current level of the policy rate was supportive of disinflation. Yet, it was also emphasized that ongoing uncertainties and supply side shocks continued to pose risks on inflation. Therefore, the Committee members assessed that monetary policy should continue to maintain a cautious stance. Accordingly, a further measured rate hike would be considered, when needed, to prevent the potential second-round effects of the risk factors. The Committee once again underlined that the timing of a possible future rate hike would depend on developments in global markets, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.

28. The Committee also indicated that it would be useful to clarify some issues related to operational aspects of monetary policy. Excess liquidity sterilized in the overnight market has been shrinking in the second half of 2008 due to a reduction in the amount of FX purchased through regular auctions; fall in Treasury's foreign debt rollover ratio, and rising money demand. Accordingly, the Central Bank has provided the required liquidity into the system via repo auctions, targeting overnight interest rates to materialize at levels close to Central Bank borrowing rate. Still, there has been some undesired volatility in the overnight rates due to unforeseen movements in the liquidity, mainly

arising from the banks' demand for reserves. Considering these developments, the Committee has decided to reduce the margin between the borrowing and the lending rates by 50 basis points.

29. Current projections do not point to a permanent shortage in the liquidity. In case of a temporary shortage, the Central Bank will provide the required liquidity through repo auctions, targeting the overnight interest rate in the money market to stay close to the Central Bank borrowing rate. Hence, the key policy rate will continue to be Central Bank's overnight borrowing rate.

30. Prudent monetary policy is a necessary but not a sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical in the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. 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 the productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability.