SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: October 22, 2008

Inflation Developments

1. Consumer prices increased by 0.45 percent in September, and annual inflation fell down to 11.13 percent mainly with the significant easing in annual food price inflation. The contribution of food and energy prices to annual inflation declined to 7 percent in September.

2. Deceleration in food prices became more pronounced in September. Food inflation decreased by a cumulative 4.2 points in the last two months to 11.07 percent year-on-year. The decline in fresh fruit and vegetable prices, driven by higher production compared to a year ago, has led to further slowdown in unprocessed food prices. In addition, after a drought-driven persistent increase over the past twelve months, pulse prices finally declined in September, which was another key driver of the downward trend in unprocessed food prices.

3. Processed food prices fell by 0.29 percent, which is the lowest September inflation for this sub-group in recent years, leading to a substantial reduction in its annual inflation, as predicted in the previous Summary of the Monetary Policy Committee (the Committee) Meeting. In view of higher agricultural production and lower international prices, the Committee reiterated that annual processed food inflation would continue to ease in the remainder of the year. The Committee also noted, however, that inflation may display a modest and temporary rise in October due to volatile vegetable prices.

4. Energy price inflation dropped by 0.6 points in September to 26.79 percent year-on-year. Although world oil prices have plummeted recently and fuel prices have moderated, sharp increases in prices of solid fuels –21.22 percent in the last three months– curbed the downward trend in energy price inflation. The hike in natural gas and electricity rates is expected to put upward pressure on energy prices in October, with a contribution of 0.27 points to CPI inflation.

5. The annual inflation in prices of goods excluding energy and food remained stable for the third consecutive month, at 4.17 percent. In the clothing group, domestic and foreign demand conditions have limited inflation. Prices of durable goods fell slightly in September after a steep decline over the past two months, while the base effect drove the group's annual inflation up by 1 percentage point. Given the depreciation of the new Turkish lira (YTL) and the low base from the fourth quarter in 2007, the annual inflation in prices of durable goods is expected to rise further in the final quarter.

6. Services inflation continued to increase on the back of rising prices of transport and communication services. Lagged pass-through effects of former upswings in oil prices continued to put upward pressure on prices of transport services via rising school bus rates. Meanwhile, the annual rate of increase in prices for communication services went up to 9.10 percent due to surging fixed-line tariffs and mobile call rates. On the other hand, annual rental inflation remained on a steady decline.

7. CPI excluding energy, unprocessed food, tobacco and gold (the H index), went slightly down year-on-year, while inflation measured by the I index, which further excludes processed food prices, increased by 0.2 percentage points. Recently, both indexes have risen at a slower pace in monthly seasonally adjusted terms compared to previous quarters, indicating a slowdown in the underlying inflation.

Factors Affecting Inflation

8. Problems in international credit markets and in global economy have continued to put restrain on domestic economic activity. In August, industrial production and manufacturing production dropped by 4 and 5.7 percent, respectively, from a year ago. Production went down in almost all sub-industries in August. Data on industrial production in July-August period and on the manufacturing industry tendency survey in September suggest that industrial production contracted in the third quarter. The weakening in domestic and foreign demand will continue to have an adverse impact on the economic activity in the final quarter. In fact, motor vehicles, textiles and clothing exports in the first three weeks of October have displayed a significant fall. Besides, Business Tendency Survey results regarding three-month ahead expectations for sales and stocks of final goods also support the outlook mentioned above.

9. Private consumption spending was flat in the third quarter, as suggested by the data on consumer loans, imports of consumer goods, consumption and confidence indices, and domestic sales of automobiles and white goods. The deepening global financial crisis indicates that credit conditions may further tighten. In fact, consumer loan growth for the first three weeks of October confirms this picture.

10. Private investment spending continued to slow down in the third quarter. July-August average of both imports and production of machinery-equipment, electric machinery and appliances and other non-metallic minerals was down from a quarter earlier. Meanwhile, domestic sales of heavy commercial vehicles and investment appetite in that industry have declined. In view of the

global financial turmoil, private investment spending is expected to slow down in the fourth quarter.

11. In the second quarter, the moderation in imports had been more significant than that in exports in real terms, resulting in a positive contribution from net exports to growth. With a similar trend in external trade as well as increased tourism revenues, net exports are likely to continue to have a positive contribution to growth in the third quarter. The expected slowdown in the global economic activity, which led to a reduction in import demand, especially in advanced economies, poses a threat to Turkey's export performance for the upcoming period. Although the significantly increased share of exports to non-EU member states and the US signals an increased potential for market expansion, export growth is likely to decelerate in the coming months. Moreover, the softening in domestic demand and the depreciation of the YTL will lead to a marked slowdown in imports in the fourth quarter. Overall, imports are expected to slow down at a faster pace than exports, which will help net exports to support GDP growth.

12. In sum, recent readings indicate a significant slowdown in domestic economic activity. Ongoing problems in international credit markets and the global economy will continue to restrain both domestic and external demand. Accordingly, aggregate demand conditions will increasingly support disinflation.

Monetary Policy and Risks

13. The meeting agenda included an assessment of the inflation forecasts to appear in the October Inflation Report. The Committee stated that inflationary impact of the recent exchange rate movements would be offset by the favorable outlook in food prices and the sharp decline in oil prices. Therefore, medium term inflation forecasts did not change significantly compared to the previous quarter.

14. Inflation is expected to display a limited and temporary rise in October due to volatile vegetable prices, yet continue to decline gradually in the medium term. Accordingly, the Committee at this point does not envision a significant revision in medium term inflation forecasts. However, it should be noted that the intensification of the financial market turmoil requires caution in terms of both the monetary policy and the inflation outlook. In this respect, the Committee decided to keep borrowing rates –the key policy rates– unchanged.

15. On the other hand, the Committee decided to lower the lending rates by 50 basis points in order to contain the potential volatility in the short-term interest rates. It was noted that, since overnight rates may move towards the Central Bank lending rates during times of temporary liquidity squeeze in the market,

narrowing down the margin between Central Bank lending and borrowing rates would reduce the uncertainty regarding the overnight rates. This margin will be narrowed further, the extent of which would depend on liquidity developments.

16. The meeting agenda also included an assessment of the developments in the local foreign exchange markets. The Committee emphasized the essence of a liquid foreign exchange market for a healthy financial system, and stated that supporting the liquidity positions of the banks should be the priority under current conditions. The Committee also suggested that raising the transaction limits at the Foreign Exchange Deposit Markets would be helpful in this regard. It was also agreed that other measures could be implemented if needed. In this respect, it was noted that the Central Bank retains the option of conducting foreign exchange sales auctions or direct interventions, should there be unhealthy price movements due to a loss of depth in the foreign exchange markets.

17. Looking ahead, credit conditions are expected to continue to tighten in the forthcoming period. Regarding the inflation outlook, these developments create upside risks through potential portfolio movements in the short term, but downside risks through weaker aggregate demand in the medium term. Given the uncertainty surrounding the global economic outlook, monetary policy needs to be flexible on either side. Therefore, future monetary policy decisions will depend on the impact of the ongoing global financial turmoil on the domestic economy.

18. Commodity prices continue to be volatile, creating risks to the inflation outlook. Despite the downward revision in projections for food and energy prices, our main scenario is still based on quite conservative assumptions, implying that the risks are on both sides. Should the upside risks materialize, monetary policy will be conducted so as to minimize deviations from the targets. Downward surprises in food and energy prices, on the other hand, will be perceived as an opportunity to bring inflation down at a faster pace than implied by our medium term targets.

19. Finally, a critical underlying assumption for the inflation and monetary policy outlook outlined above is that government expenditures and incomes policy 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 in place. In particular, this means any needed tightening in the fiscal balance would occur largely through expenditure cuts rather than higher excise taxes. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

20. The Central Bank will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy. Future policy decisions will largely depend on the developments in global markets and their reflections on the global financial markets.

21. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global financial turmoil. Preserving the fiscal discipline and strengthening the structural reform agenda would also help 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 CBT with regard to their implications on macroeconomic and price stability.