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SUMMARY OF THE MONETARY POLICY COMMITTEE MEETING

Meeting Date: February 14, 2008

Inflation Developments

1. Consumer prices rose by 0.80 percent in January, bringing annual inflation to 8.17 percent. Despite sharp price hikes in energy items such as electricity and natural gas, the partial correction in unprocessed food prices and the decelerating services inflation pulled the headline inflation down in January.

2. Although unprocessed food prices were up by 2.96 percent in January, the base effect from the dramatic upsurge during the same period last year brought the group's annual inflation rate down to 5 percent. Processed food inflation, on the other hand, continued to rise on the back of increasing worldwide wheat and grain prices, reaching 13.36 percent per annum.

3. The annual growth rate in energy prices rose by 16.26 percent in January mainly owing to sizable hikes in electricity and natural gas tariffs. Electricity prices increased by 19.19 percent and natural gas prices went up by 8.04 percent, which in total added by 0.56 points to January inflation. Fuel prices, another energy item, remained almost unchanged during the month.

4. The annual rate of inflation in goods excluding energy and unprocessed food remained unchanged from December. Deeper discounts in clothing and footwear items during January compared to earlier years lowered the group's year-on-year inflation to 2 percent. Prices of durables (excluding gold) rose by 1.03 percent in response to higher furniture prices, reversing the downward trend in durables good inflation since June 2007. Gold prices were up by 8.75 percent.

5. Annual services inflation moderated despite the marked rise in transportation rates. In January, The VAT cut had a smaller effect on catering and accommodation prices, but public dormitory fees classified under this group went up significantly. Rent inflation, on the other hand, has continued to decelerate and yielded an annual decline of 5 percentage points over the past twelve months. Disinflation in services is expected to continue in the upcoming period.

6. The Monetary Policy Committee (the Committee) underlined that unfavorable weather conditions may lead to a significant rise in unprocessed food prices in

February compared with the same period in 2007, possibly leading to a temporary upward shift in annual inflation. Inflation excluding food and energy items is expected to remain close to 4 percent.

Factors Affecting Inflation

7. Recent readings suggest that the economy continues to grow at a moderate pace. Industrial production grew by 5 percent in annual terms during the last quarter of 2007. Also, quarter on quarter growth rate was significantly positive in seasonally adjusted terms.

8. Industrial production declined annually in December 2007, as there were fewer working days compared to the previous year due to the religious holiday. The January capacity utilization rates and production expectations of the industrial sector along with the low base effect of the same period of the previous year, suggest that industrial production in January may display a sizeable growth on annual basis. For a better evaluation of the main trend in the manufacturing industry, December and January data should be read together. Taking this into account, the Committee assessed that industrial production continues to grow modestly.

9. The strong Turkish lira fosters the demand for imported goods. As a matter of fact, the quantity of consumer good imports, particularly automobiles and durables, rose sharply during the last quarter of 2007 compared to the same period of the previous year. Also domestic sales of automobiles displayed a quite significant rise, in both annual and quarterly terms, during October-December period. Even though automobile sales in January were down from December, they still increased by 37.7 percent in annual terms.

10. Although the relative price effect stimulates demand in industries like consumer durables, the weakened global credit conditions restrain the overall domestic demand. In fact, consumer loans, which displayed some acceleration in the second half of 2007, settled back into a pattern of mild growth following the turmoil in mature markets. Moreover, according to the Consumer Tendency Survey, household spending on automobiles, durables and semi-durables is on the decline.

11. Machinery-equipment production, a key indicator of investment activities, fell 4.4 percent in annual terms in the fourth quarter of 2007 but was up from the previous quarter in seasonally adjusted terms. During the same period, electrical machinery production increased by 23.3 percent annually, backed by vigorous export growth. Domestic sales of heavy commercial vehicles displayed sharp rises in January on a monthly and yearly basis. The Committee noted that the recent rise in domestic sales of heavy commercial

vehicles did not point to a overheating when the significant slowdown in the past two years is taken into account. Imports of capital goods increased both annually and quarterly. Notwithstanding the relative price effect driven by the strong currency, uncertainties in global markets are expected to restrain investment demand in the forthcoming period.

12. The fact that nonmetallic mineral manufacturing has been contributing less to industrial production since 2005 confirms the slowdown in the construction sector. In January, the rate of capacity utilization in this industry declined in annual terms. Besides, the diffusion index based on “consumers’ intention to buy or build a house during the next twelve months” from the Consumer Tendency Survey, continues to trend downward, which suggests that the construction industry might weaken further in the upcoming period.

13. External demand does not display a significant deceleration at this point. The export quantity index rose by 7.1 percent during October-December 2007 compared to a year earlier. According to the records of Turkish Exporters Assembly, annual export growth amounted to 49.3 percent in January in US dollars, and exports will expand further in February. Yet, the low base effect from the previous year should be taken into account in reading these figures. Excluding seasonal patterns and price movements, the real export growth remains modest. Yet, the expected slowdown in global economic activity may lead to a reduction in the contribution of external demand to economic growth in the medium term.

14. Overall, assessments on broad economic activity suggest that aggregate demand conditions will continue to support disinflation.

Monetary Policy and Risks

15. Uncertainties regarding the developments in mature markets restrain the recovery in domestic demand. In fact, consumer confidence indices display a downward trend since September. Recently, medium and long term loan rates have been following a flat course despite the policy rate cuts, suggesting that ongoing difficulties in the global credit markets partly offset the impact of monetary easing on the credit supply.

16. Monetary conditions continue to support disinflation. The Committee noted that monetary policy remains restrictive even after the recent rate cuts. The modest growth rate of the monetary indicators point to a similar picture. The currency remains strong, curbing inflationary pressures and easing the impact of rising commodity prices on domestic production costs. The recent upward movement in medium to long term interest rate can be explained by an increase in the risk premium rather than the deterioration in inflation

expectations. As a matter of fact, survey based inflation expectations series show no indication of worsening in inflation expectations.

17. Considering the size and the duration of ongoing supply-side shocks, the Committee has been citing the core indicators frequently. Although its highest priority is price stability, the CBT, in line with its medium term approach, will not react aggressively to the shocks beyond the control of monetary policy, as doing so could create undesirable fluctuations in economic activity and distortions in relative prices. In this context, the period in which inflation reaches to the target will depend on the course of food and energy prices.

18. Risks to the inflation outlook can be summarized as follows:

19. Inflation expectations were not affected by the energy price hikes in January, possibly indicating that inflation targets continue to serve as an anchor for expectations. Yet, the main risk factor for the current medium term inflation outlook is a potential second round effect of the accumulated supply shocks, which may also create a higher than expected inflation inertia. The course of agricultural commodity prices, oil prices and the rigidity in medium term inflation expectations has been feeding these risks. Although the Committee has taken these factors into account in January Inflation Report, the risks originating from a potential second round impact of elevated food and energy prices should not be overlooked. Therefore, the Committee will keep a close eye on the price setting behavior along with various core inflation measures. The policy strategy will be to tolerate the first-round impact on inflation resulting from food and energy prices, yet to remain responsive to the second round effects.

20. The difficulties in the mature markets continue, despite the measures taken by the central banks. Although there is an increasing consensus that the world economy will slow down, there is still considerable uncertainty regarding the degree and extent of the slowdown. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown should not be ruled out. While the possibility of a sharper than envisaged slowdown in global economic activity, through a portfolio shock and its potential impact on the exchange rates, may constitute an upside risk for the short-term inflation outlook, it also poses downside risks for inflation in the medium term through a possible weakening in external and domestic demand.

21. Maintaining the prudent fiscal policy during an episode of worsening risk appetite is of utmost importance. Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented primarily through expenditure cuts rather than

hikes in indirect taxes. Any deviation from this assumption may alter the inflation and monetary policy outlook.

22. The Committee underlines that oil and food prices affect inflation all over the world, and Turkey has been one of the rare countries managing to deliver a significant decline in inflation in 2007. Although unprocessed food prices may display temporary fluctuations, inflation excluding energy and food items is expected to remain close to 4 percent. Yet, ongoing uncertainties in the global economy and the risks to the price setting behavior compel the CBT to be attentive to the incoming information. Accordingly, the Committee will closely monitor the lagged impacts of the recent rate cuts. Besides, the second round effects on the wage and price setting behavior of elevated food and energy prices and of the developments in incomes policy will be watched closely. The timing of further easing will depend on developments regarding global market conditions, external demand, fiscal policy implementation, and other factors affecting the medium term inflation outlook.

23. So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. However, the support from fiscal policy and structural reforms are critical in preserving the resilience of the economy against possible further deterioration in global sentiment. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain crucial. 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.