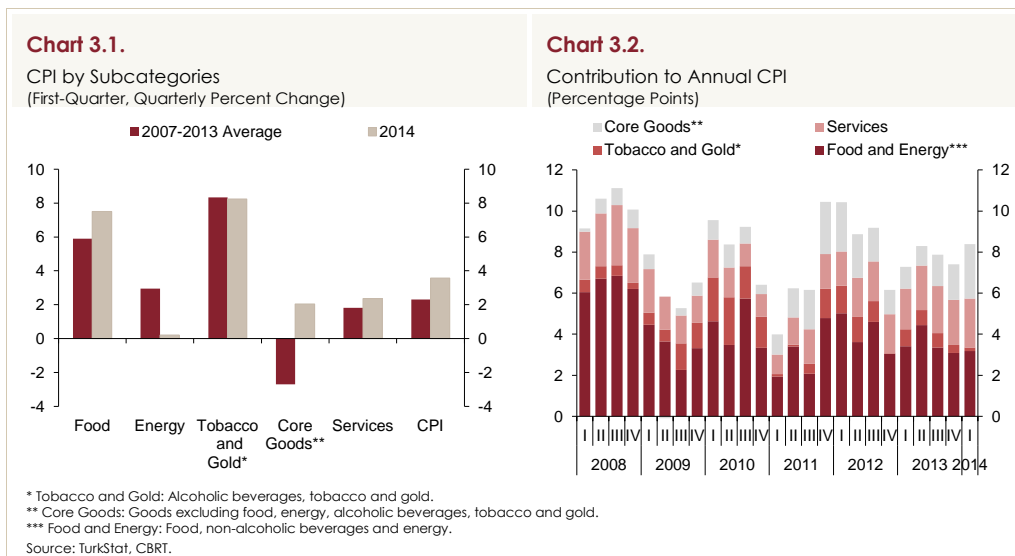


3. Inflation Developments

In the first quarter of 2014, annual consumer inflation posted a quarter-on-quarter increase by 1 percentage point to 8.39 percent. Core goods prices, which have a relatively higher exchange rate pass-through, mainly fuelled the rise in inflation. The annual rate of price increase in core goods rose notably due to the considerable depreciation of the Turkish lira and the tax rise on automobiles that constitute almost one fifth of this category. Additionally, core inflation indicators recorded remarkable increases also due to the upward trending of prices of services. In the first quarter of the year, the inflation outlook was shaped by the sluggish course of the Turkish lira coupled with the unfavorable pace of food prices led by precipitation lower than seasonal normals. Moreover, the deterioration in inflation expectations, which started in the second half of 2013, continued into this quarter. Also, the upsurge in domestic manufacturing industry prices in this period highlighted the role of cost-side factors in the rising consumer inflation.

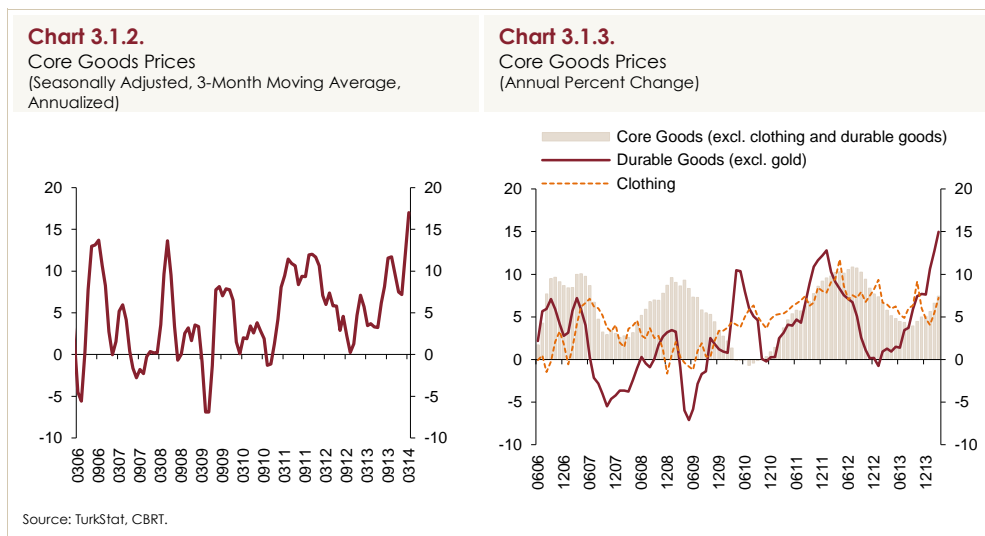
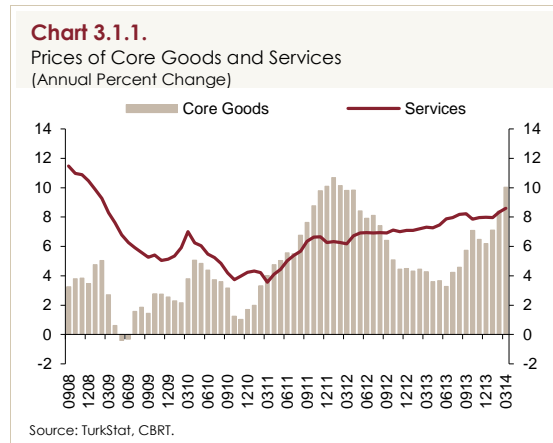
Across subcategories, core goods, food and services recorded higher-than-average price increases in the first quarter of the year, while energy prices put a cap on the rise in annual inflation (Chart 3.1). Against this background, the contribution to annual inflation from prices of core goods rose by 0.91 percentage points, while that of services and food increased by 0.20 percentage points each in the first quarter of the year (Chart 3.2).



In sum, in the first quarter of the year, exchange rate developments negatively affected consumer inflation particularly through the core goods prices and the rise in food and services inflation pushed consumer inflation above the path projected in the January Inflation Report. Given the negative course of food prices and the lagged effects of exchange rate movements, annual inflation is expected to remain high for a while. Nevertheless, both the recent appreciation of the Turkish lira and the projected slowdown in the private final domestic demand is expected to contain upside pressures on consumer inflation.

3.1. Core Inflation Outlook

Prices of core goods rose by 2.05 percent and annual inflation in core goods prices increased by 3.84 percentage points to 10.04 percent in the first quarter of the year (Table 3.1.1 and Chart 3.1.1). This rise is attributed to the depreciation of the Turkish lira as of the second half of December besides the tax adjustments on automobiles. Moreover, the deterioration in the pricing behavior also affected core goods inflation adversely. Thus, the quarterly rate of price increase in core goods hit the recent-year high in seasonally adjusted terms (Chart 3.1.2). Across subcategories, the most remarkable increase in annual inflation was seen in durable consumption goods mainly due to automobile prices. The uptrend in annual inflation in core goods excluding clothing and durable goods, which have a relatively slower pass-through from exchange rates, was more robust in the first quarter of the year. The annual inflation in clothing soared by 2.43 percentage points, indicating that the deterioration in the inflation outlook spread across core goods (Chart 3.1.3).



Increases particularly in automobile prices that exceed the levels implied by the exchange rate pass-through and tax hikes point to a possible deterioration in the pricing behavior beyond cost factors

(Table 3.1.1). Accordingly, the annual core goods inflation will likely continue to rise in the short term; yet the recent appreciation of the Turkish lira will mitigate inflationary pressures on core goods in the second half of the year through exchange rate and expectations.

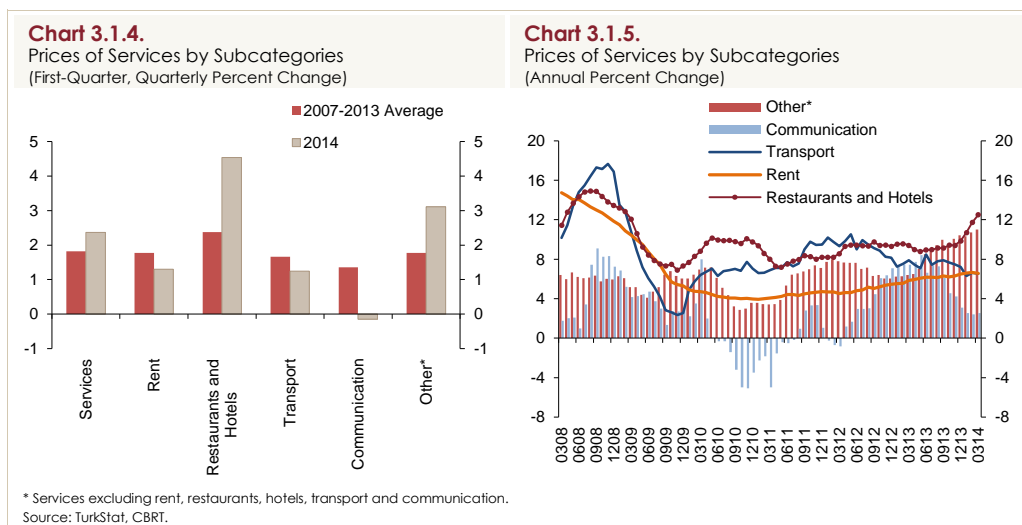
Table 3.1.1.

Prices of Goods and Services
(Quarterly and Annual Percent Change)

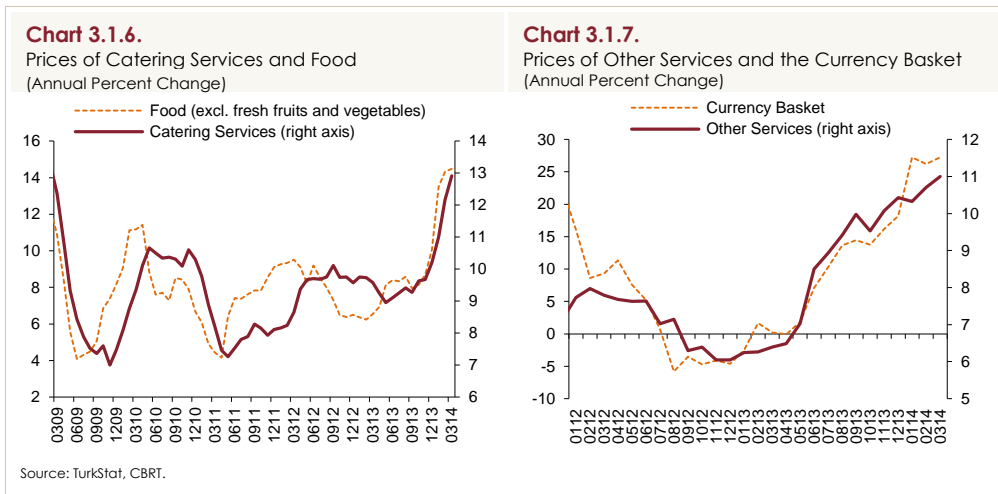
	2013					2014
	I	II	III	IV	Annual	I
CPI	2.63	1.33	0.97	2.28	7.40	3.57
1. Goods	2.95	0.90	0.46	2.72	7.18	4.08
Energy	0.86	-0.92	2.95	2.20	5.15	0.21
Food and Non-Alcoholic Beverages	7.06	-1.69	0.19	4.01	9.67	7.50
Unprocessed Food	13.87	-4.70	-2.29	6.46	12.88	10.79
Processed Food	1.63	0.99	2.27	2.04	7.11	4.57
Core Goods	-1.52	4.86	-0.62	3.48	6.20	2.05
Clothing and Footwear	-12.35	20.95	-10.43	10.38	4.82	-10.32
Durable Goods (excl. gold)	2.54	0.05	3.75	1.12	7.62	9.54
Furniture	4.09	0.65	1.59	2.89	9.50	3.14
Electrical and Non-Electrical Appliances	0.18	-2.66	0.12	0.91	-1.48	3.86
Automobile	3.03	0.72	5.55	0.67	10.27	16.65
Other Durable Goods	1.05	1.53	1.80	2.69	7.25	2.78
Core Goods (excl. clothing and durable goods)	0.93	1.15	0.75	2.13	5.05	3.21
Alcoholic Beverages, Tobacco and Gold	12.41	-1.35	0.68	-4.39	6.74	8.24
2. Services	1.78	2.50	2.32	1.16	7.98	2.37
Rent	1.25	1.59	1.70	1.81	6.50	1.30
Restaurants and Hotels	2.07	2.18	2.85	2.42	9.86	4.54
Transport	1.88	2.34	2.63	0.18	7.20	1.24
Communication	0.40	1.28	1.30	0.09	3.09	-0.14
Other Services*	2.58	4.02	2.65	0.82	10.43	3.10

* Services excluding rents, restaurants, hotels, transport and communication.
Source: TurkStat, CBRT.

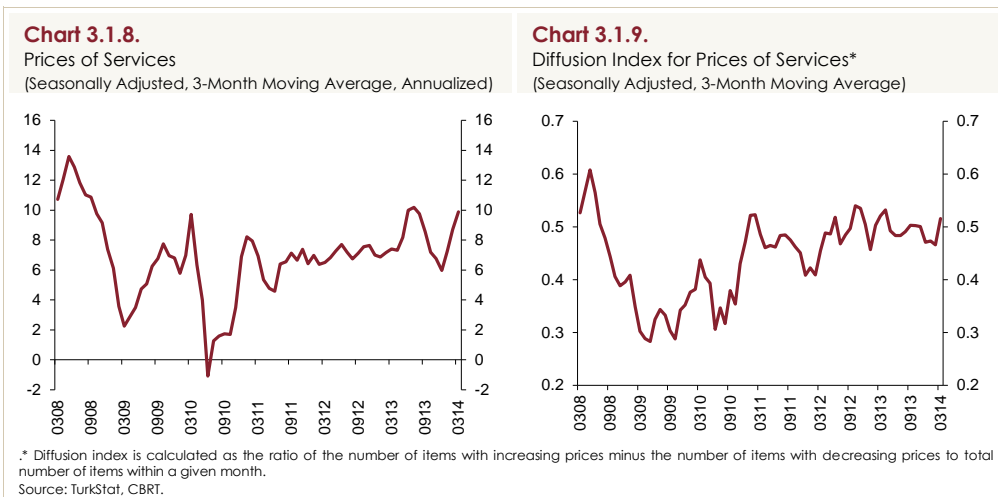
Annual inflation in services, which is another component of core inflation, went up by 0.62 percentage points since end-2013, and hit 8.60 percent in March (Chart 3.1.1). Rent, transportation and communication services registered lower-than-average price increases in the first quarter of the year, while prices of restaurants, hotels and other services recorded increases, which are far above the historical averages (Chart 3.1.4). The price hike in restaurants and hotels was driven by the prices of catering services, which surged by 4.55 percent in the first quarter of the year (Table 3.1.1). As for other services, high-rated increases in prices of health, entertainment, culture and maintenance services were featured. Thus, annual inflation in prices of restaurants, hotels and other services (12.51 and 10.99 percent, respectively) hit the 5-year high in the first quarter of the year (Chart 3.1.5).



The major determinants of the services prices include wages, demand conditions and backward-looking pricing behavior besides cost-side factors like energy and food prices as well as exchange rate. Thus, the first-quarter uptick in services inflation is attributed to the rise in these cost factors in addition to the minimum wage. In fact, the price hike in food, which is an input for catering services, was clearly passed to the services prices in this quarter (Chart 3.1.6). Moreover, prices of other services were also adversely affected by the exchange rate developments due to pricing in foreign currency (package tours etc.) and the use of imported inputs (maintenance etc.) in the offering of services (Chart 3.1.7).

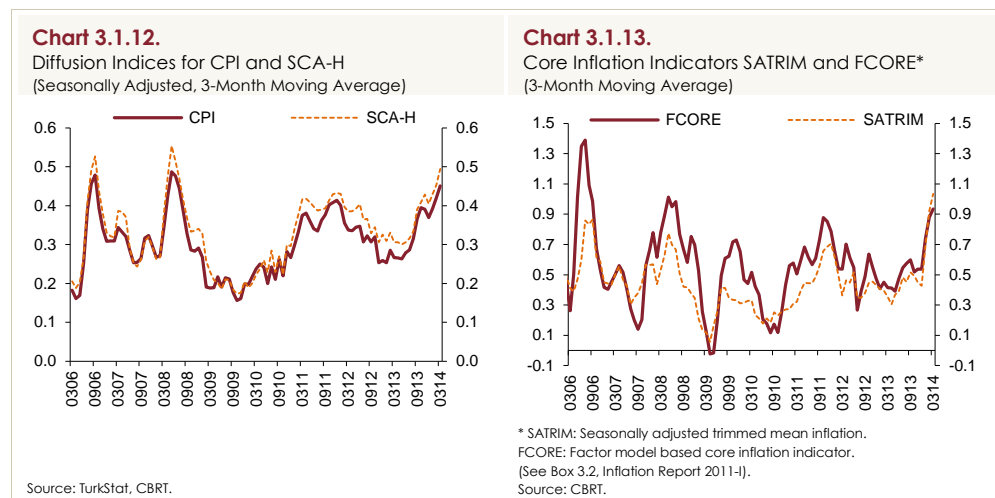
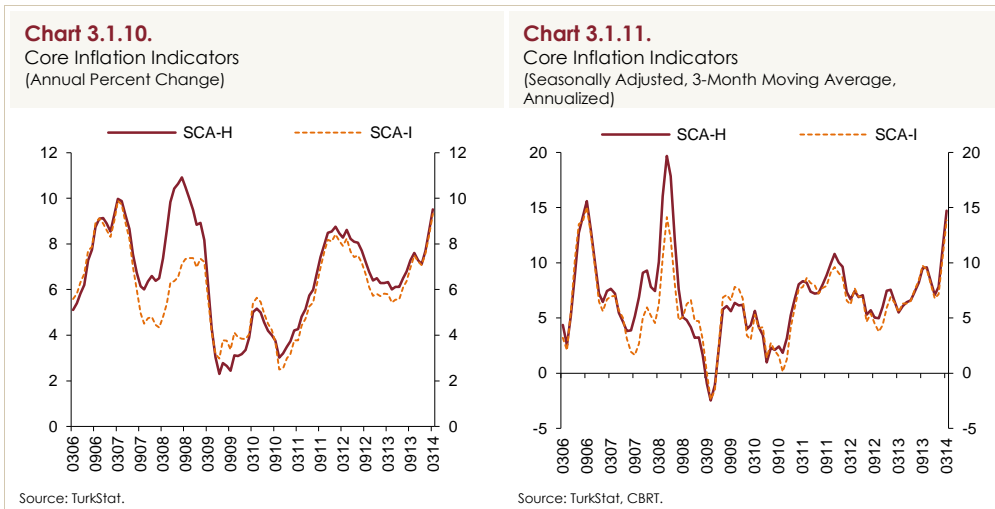


In addition to cost factors, prices of services were also affected by the recent rise in inflation expectations. In fact, indicators regarding the underlying trend and pricing behavior deteriorated in this period. The underlying trend of the services sector implied by the seasonally adjusted data and the diffusion index increased compared to the year-end (Charts 3.1.8 and 3.1.9).



Parallel to the first-quarter outlook in core goods and services, annual inflation in the SCA-H and SCA-I, which are among core inflation indicators, displayed an upsurge (Chart 3.1.10). In other words, SCA-H and SCA-I inflation, which hovered around 7 percent at the end of the year, went above 9 percent in March. A joint analysis of seasonally adjusted SCA-H and SCA-I indices, the alternative

core inflation indicators monitored by the CBRT, and diffusion indices suggests that the underlying trend of inflation increased considerably in the first quarter of 2014 compared to the end of 2013 (Charts 3.1.11, 3.1.12 and 3.1.13). This outlook, which is unlike previous periods, largely reflects the lagged effects of the depreciation in the Turkish lira and the unfavorable course of processed food prices besides the notable deterioration of the pricing behavior.

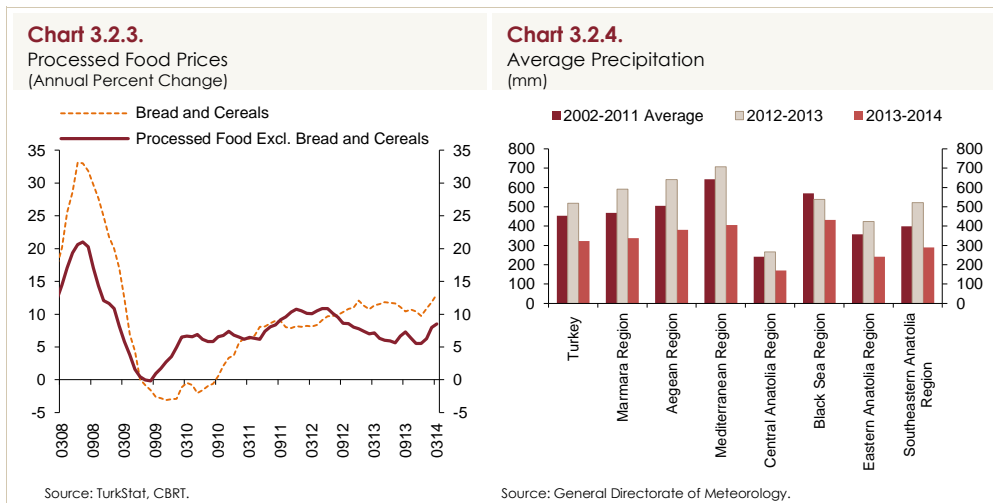
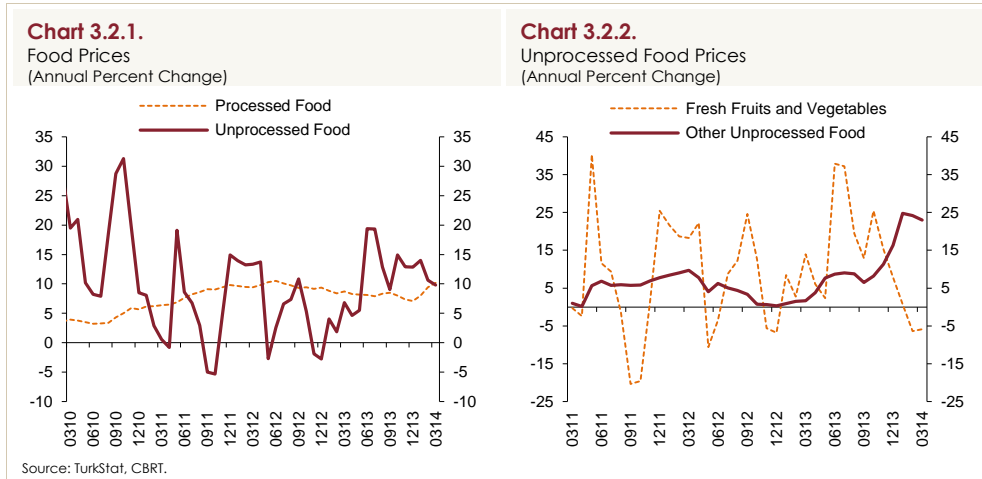


3.2. Food, Energy and Alcohol-Tobacco Prices

Annual inflation in food prices reached 10.12 percent in the first quarter and stood above the projections of the January Inflation Report. This rise was driven by the increase in food prices excluding fresh fruits and vegetables, which were pushed up by supply-side constraints amid the lower-than-normal precipitation, hikes in international prices of some products and the course of the Turkish lira.

Due to the historically low prices of fresh fruits and vegetables, annual inflation in prices of unprocessed food receded by 3.06 percentage points to 9.82 percent compared to the last quarter of 2013 (Chart 3.2.1). Meanwhile, other unprocessed food prices limited the fall in unprocessed food price inflation in this period (Chart 3.2.2). Processed food prices surged by 4.57 percent, driving the annual

inflation in processed food prices to 10.21 percent in the first quarter of the year (Table 3.1.1 and Chart 3.2.1). This was mainly attributed to the overall price hike across sub-items and the increases in prices of bread and cereals in particular (Chart 3.2.3). Drought-led risks stemming from low precipitation waned upon the seasonally normal level of the rainfall in March; yet upside risks to food prices are still brisk (Chart 3.2.4).



Posting a considerably low increase compared to past averages, energy prices crept up by 0.21 percent in the first quarter of the year and put a cap on consumer inflation (Table 3.1.1 and Chart 3.1). The Turkish lira saw a dramatic depreciation in this period and average oil prices fell by around 1.5 USD on a quarterly basis. Fuel prices edged down due to the price ceiling imposed by the EMRA, while prices of home utilities remained flat in the first quarter. As a result, the annual inflation in energy prices has been following a relatively low course (currently 4.46 percent). However, it should be noted that the cumulative effects of the depreciation in the Turkish lira will pose an upside risk on energy prices through administered energy items in the upcoming period.

In January, SCT rate hikes pushed the prices of alcoholic beverages and tobacco products upwards by 7.46 percent in the first quarter of the year. This added 0.4 percentage points to consumer inflation.

3.3. Domestic Producer Prices

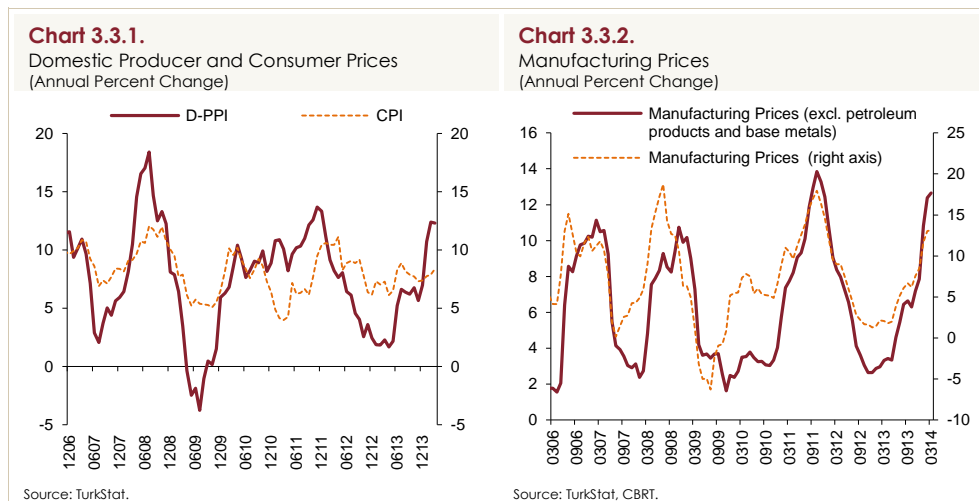
In the first quarter of 2014, domestic producer prices increased by 5.52 percent due to the upsurge in manufacturing prices (Table 3.3.1). Thus, annual D-PPI inflation went up by 5.34 percentage points quarter-on-quarter to 12.31 percent (Chart 3.3.1).

Table 3.3.1.
D-PPI and Subcategories
(Quarterly and Annual Percent Change)

	2013					2014
	I	II	III	IV	Annual	I
D-PPI	0.50	1.95	1.93	2.43	6.97	5.52
Mining	3.90	2.12	4.60	1.49	12.64	4.91
Manufacturing	1.87	0.88	3.97	1.50	8.45	6.29
Manufacturing (excl. petroleum products)	1.73	1.03	3.45	1.57	8.00	6.26
Manufacturing (excl. petroleum and base metal products)	1.74	1.10	3.17	1.63	7.85	6.27
Electricity and Gas	-13.17	1.44	0.75	0.11	-11.16	-1.17
Water	5.35	1.50	1.29	2.28	10.77	3.66

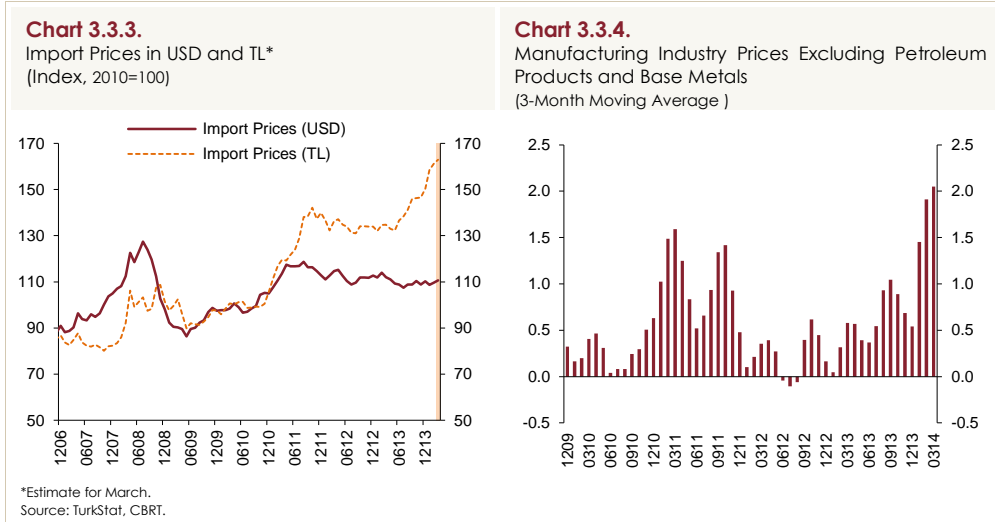
Source: TurkStat, CBRT.

Amid the depreciation of the Turkish lira, manufacturing industry prices displayed a noteworthy increase in the first quarter of the year (Table 3.3.1 and Chart 3.3.2). This rise spilled over across sub-items, yet was most apparently seen in prices of food products, base metal, clothing, machinery and motor vehicle manufacturing. USD-denominated import prices remained mild, while the TL-denominated import prices recorded a robust increase in this period (Chart 3.3.3).



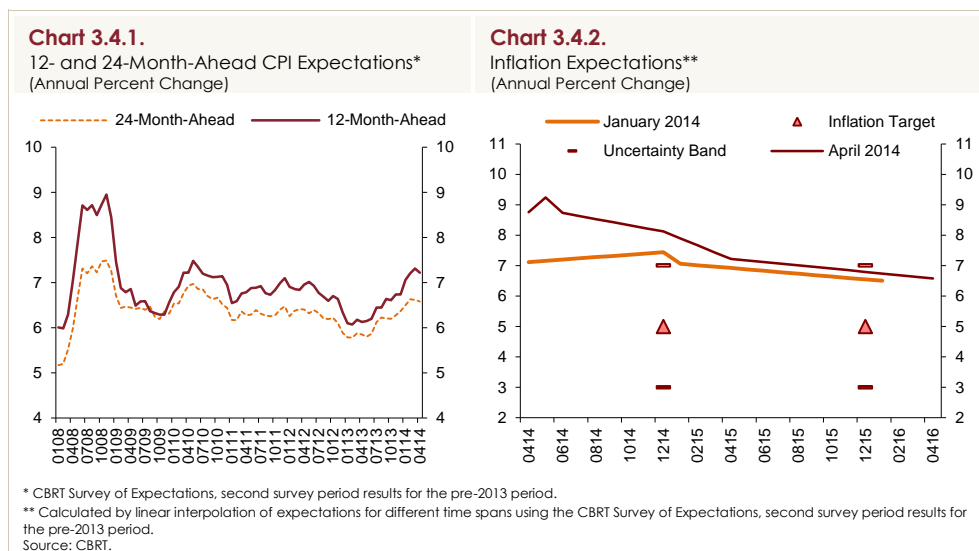
The uptrend in the manufacturing industry excluding petroleum products and base metal prices that entail information on the underlying trend of producer prices continued with a stronger pace in this quarter (Chart 3.3.4). Recent hikes in manufacturing prices have reflected considerably on consumer prices, particularly through the motor vehicles and food manufacturing prices. Moreover, the effect of dramatic increases in clothing and textile manufacturing prices on consumer prices in March

is estimated to continue in the upcoming period. Overall, the first-quarter outlook for producer prices indicated that cost-side pressures on consumer prices have been quite noticeable.



3.4. Expectations

Medium-term inflation expectations, which deteriorated in the second half of 2013 upon the depreciation of the Turkish lira, continued with an uptrend in the first quarter of 2014 amid the unfavorable course of food prices and soaring core inflation due to the lagged effects of the exchange rate. On the other hand, medium-term expectations improved in April owing to waning uncertainties. As of April, 12- and 24-month-ahead inflation expectations stand at 7.2 and 6.6 percent, respectively (Chart 3.4.1). Analysis of maturities suggests that 12-month-ahead inflation expectations were revised upwards compared to the previous quarter, while 24-month-ahead inflation expectations indicated a more limited rise (Chart 3.4.2). Meanwhile, inflation expectations still hover above the inflation target of 5 percent set for end-2014 and 2015.



The dispersion of medium-term inflation expectations reveals a slight deterioration in inflation expectations in April compared to the start of the year (Charts 3.4.3 and 3.4.4). Particularly, the number of respondents expecting 24-month-ahead inflation to be in the range of 6.5 and 7.49 percent displayed a notable increase.

