THE CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2007-II

CONTENTS

1.Overview

Annual inflation was 10.86 percent in the first quarter of 2007, remaining within the uncertainty band. The high course of annual inflation partly owes to the elevated unprocessed food prices and the hikes in the prices of tobacco products. Moreover, although the lagged effects of the exchange rate pass-through have moderated, some cumulative impact still remains. The impact of monetary tightening on inflation, on the other hand, remains to be seen. Accordingly, annual inflation stayed at high levels in the first quarter of 2007.

The recent data on economic activity has been in line with the outlook presented in the reports published by the Central Bank of Turkey (CBT) since July 2006. Private consumption demand displayed a noticeable slowdown following the monetary tightening since June 2006. The co-existence of decelerating growth rate of imports; owing mainly to the slowdown in consumption and investment goods imports; and the relatively strong momentum of exports led to a significant contribution of net exports to growth. Hence, the negative impact of the slowdown in domestic demand on growth is largely compensated by the robust external demand. Rising non-interest public expenditures was another factor contributing to economic growth. Notwithstanding the positive stimulus from net foreign demand and public expenditures, growth rate of the economy fell below last five years' average, due to the considerable slowdown in private sector domestic demand.

1.1. Monetary Policy and the Outlook

Monetary Policy Committee (the Committee) decided to keep the tight monetary policy stance during the first quarter of 2007, against risks such as the gap between medium-term inflation expectations and the targets, prevailing uncertainties in the global economy, and the uncertainties regarding the lagged effects of monetary tightening.

We expect the lagged impact of tight monetary policy stance to be effective on domestic demand for a while, suggesting that the demand conditions will continue to contribute to the disinflation process. Recent leading indicators reveal a similar outlook for the first half of 2007. Seasonally adjusted data indicate that private consumption expenditure does not exhibit a noticeable rise in the first quarter of 2007. Private sector demand is expected to remain subdued for the second quarter of the year. Given the robust growth in the Euro Area, the strength of euro, and the ongoing increases in productivity, we anticipate that exports will continue to support the economic growth.

In addition, barring further adverse shocks, a notable base effect stemming from last year’s market turbulence and from the adverse supply shocks such as the hikes in energy and unprocessed food prices is expected to ease annual inflation in the coming months.

Although the macroeconomic developments in the last quarter are broadly consistent with the outlook presented in the January Inflation Report, several factors are in place for the inflation outlook to be updated:

- Taking into account the recent revisions in the growth rate figures of 2006, the output gap for the last quarter of 2006 is revised upwards compared to that in January Inflation Report.

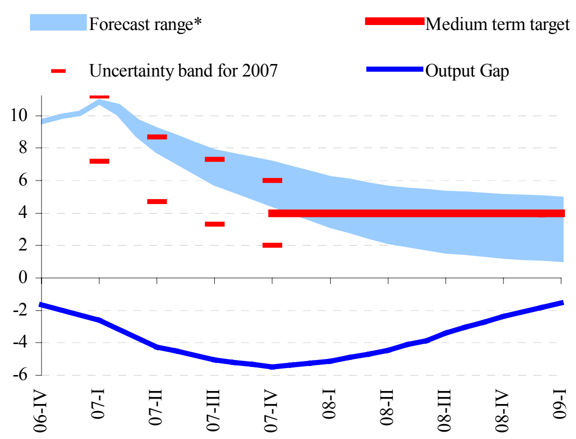
- The short-term inflation forecasts were revised upwards due to several factors: first of all, the anticipated correction in the unprocessed food prices has not materialized. Secondly, there have been some tax driven hikes in the prices of tobacco products. And third, in spite of a partial improvement in services prices, the decline in annual service inflation has been less than anticipated. As a consequence, the annual inflation by the end of March exceeded the median of the forecast path presented in the January Inflation Report.

- The assumption of oil prices is revised up from USD 55 to USD 60 due to the upward movement in oil prices in past quarter.

The “Risks” section of January Inflation Report asserted that, the tight monetary stance can be maintained for an extended period in case inflation shows a stronger-than-expected resistance. Indeed, the upside revisions mentioned above as well as the first quarter data on inflation expectations and services inflation further underpin the need to stay cautious to ensure the consistency of the medium-term outlook with the targets. Within this framework, the forecasts presented in this Report are based on a scenario where the policy rates are constant in the second and third quarter of the year and eased thereafter; however, this easing is envisioned to be more cautious than the one outlined in the January Report. In other words, the Committee —as hinted in March meeting and stated in April meeting— envisions a policy perspective in which the cautious policy stance is enhanced.

The projections consistent with this perspective point out that downward trend in inflation will be more discernible in the second quarter of 2007. It is forecasted with 70 percent probability that annual inflation rate will be within 4.5 – 7.1 range (mid-point 5.8) at the end of 2007 and within 1.3 – 5.0 range (mid-point 3.2) at the end of 2008. These projections imply that meeting the medium-term target of 4 percent requires the maintenance of the tight monetary policy stance.

Graph 1.1.1. Inflation and Output Gap Forecasts



*The probability of inflation lying within the forecast range is 70 percent.

It should be stressed that this policy perspective is constructed under the current information set and assumptions, and thus, it should by no means be perceived as a commitment on behalf of the CBT. Therefore, the policy perspective is subject to change as the economic conditions and the assumptions change.

1.2. Risks

Recent data is broadly consistent with the main outlook presented througout the Inflation Reports since July 2006. The impact of monetary tightening in the second half of 2006 on the demand is visible especially through the slowdown in the expenditures of durable goods and machinery-equipment. Robust performance of exports has been offsetting the contractionary impact of the slowdown in private domestic demand and contributing positively to the economic growth rate. Nevertheless, uncertainties over the monetary transmission mechanism prevail to be a risk for medium-term inflation outlook. While the recent hikes in public expenditures seem to further blur the outlook, the proposed cut-down in certain non-interest public expenditure items have somewhat relieved these concerns. In sum, a lower-than-expected impact of slowdown in domestic demand on inflation still remains as a risk factor. Should such a risk materalize, the CBT may further tighten the policy stance.

Another risk related to the medium-term inflation outlook is the stickiness in inflation expectations and backward looking price setting which would lead to a higher-than-expected inertia in the disinflation process. The improvement in inflation expectations came to a halt in the last three months. Although the expectations should come down gradually as the headline inflation eases, the sticky medium-term inflation expectations remain to be a risk for the inflation outlook through its possible reflections on the price and wage setting behavior. The CBT will keep its cautious stance for an extended period should such risk materialize.

Possible fluctuations in global markets remain as a risk to the inflation outlook. The prevailing uncertainties on the US economy and on global imbalances still have the potential to trigger fluctuations in international markets which may have adverse impact on emerging economies. Moreover, the elevated levels of the oil prices do not help to ease the risks related to global financial markets. On the other hand, the Treasury's strong cash accounts and the recent slowdown in the deterioration of the current account have the potential to mitigate the impact of possible fluctuations in the financial markets. In what so ever, should a shock lead to heigthened perception of uncertainty, the CBT will retain the medium-term perspective and announce the appropriate strategy to bring inflation back to the target.

Price stability is essential for increasing the potential of the economy, achieving a high sustainable growth rate, and enhancing social welfare. Attaining the ultimate goal of price stability will only be possible with prudent monetary policy. Economic agents should be patient in this process in order to reap the long-term benefits of the price stability.

Prudent monetary policy is necessary but not sufficient for achieving long-run price stability. The role of fiscal policy and structural reforms are also critical in this process. Developments in structural reforms that would enhance the quality of fiscal discipline in the medium and long run are closely monitored both in terms of macroeconomic stability and price stability. The European Union accession process and the sustained implementation of the structural reforms envisaged in the economic program also remain to be of concern. Continued determination in implementing the decisive steps taken in these areas in recent years will strengthen the resilience of the economy against possible changes in the global economy.

2. International Economic Developments

2.1 Economic Performance and Monetary Policy Developments

Even though the US economy grew as high as 3.7 percent in the first quarter of 2006, the growth rate dropped to 3.1 percent in the last quarter. This slowdown in the growth rate driven mainly by the slowdown in the housing and mortgage markets may continue in 2007. The future developments in this market will be instrumental in determining whether this deceleration will develop into a recession or not. The moderation in growth produced a favorable effect on inflation and brought core inflation down. Nevertheless, the volatile energy prices and the tight labor market conditions have constituted inflationary pressure. This inflationary pressure is reflected to core inflation through indirect effects. Hence, core inflation is still above desired levels. Federal Reserve (Fed) rates have been kept on hold at 5.25 percent, which suggests that Fed remains vigilant despite the slowdown in growth. Future interest rate decisions will be shaped according to the developments in growth and inflation.

Table 2.1.1. Growth Rates

(Annual Percentage Change)

	2006	**2007***	2006-I	2006-II	2006-III	2006-IV	**2007-I***
World	5,4	**4,9**	-	-	-	-	-
USA	3,3	**2,3**	3,7	3,5	3	3,1	**2,3**
UK	2,7	**2,6**	2,5	2,8	3,0	3,0	**2,8**
Asia-Pacific							
Japan	2,2	**2,2**	2,9	2,1	1,5	2,3	**1,9**
China	10,7	**10**	10,3	10,9	10,7	10,7	-
E. Europe	6,0	**5,5**	-	-	-	-	-
Latin America	5,5	**4,9**	-	-	-	-	-
Eurozone	2,7	**2,4**	2,2	2,8	2,8	3,3	**2,8**
Germany	2,5	**2,1**	1,9	2,8	3,1	3,7	**3,0**
France	2,0	**2,0**	1,4	2,6	2,0	2,5	**2,2**
Italy	1,8	**1,8**	1,7	1,7	1,6	2,8	**2,2**

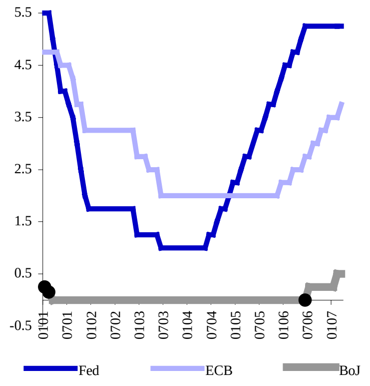
* Forecast.
Source: Consensus Forecasts, Eurostat, World Economic Outlook.

In the last quarter of 2006, unlike the first three quarters, the US current account deficit has demonstrated a downward trend. Both the vigorous growth observed in trading partners of US and the depreciation of the US dollar indicate that the US current account deficit will continue to decline. This development is perceived to be favorable in terms of global economic balance. Moreover, the US economy has recently displayed positive fiscal performance in response to increasing revenues. If supported by social security and health reforms, this positive outlook will reinforce favorable expectations for the future.

In the fourth quarter of 2006, Eurozone grew by 3.3 percent compared to the same period of the previous year and by 2.7 percent for the entire year (Table 2.1.1). In the said period domestic demand was the main determinant of growth. The major component of this domestic demand-driven growth was the increase in profit margins and acceleration in investments owing to credit expansion. Additionally, Germany's hosting World Cup 2006 and rising consumer expenditures in response to advance consumption due to Value Added Tax (VAT) increase scheduled for January 2007 were other factors assisting growth in the Eurozone. In the upcoming period, employment growth and improved labor market conditions are expected to increase real disposable income and consumption expenditures. Moreover, positive financing conditions, higher corporate profits and increase in labor productivity are expected to keep investment brisk. Additionally, with relatively balanced global growth rates, export demand is expected to keep increasing, and support growth in the coming periods. In light of these developments, the Eurozone is expected to grow by 2.8 percent in the first quarter of 2007 and by 2.4 percent throughout 2007. Volatile oil prices stand out as the most critical risk factor against Eurozone GDP growth.

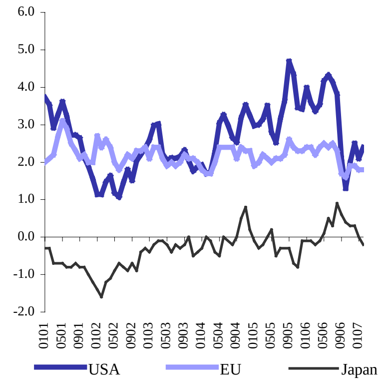
The Eurozone Harmonized Index of Consumer Prices (HICP) inflation fell as of August 2006 due to the decline in crude oil prices (Graph 2.1.2). While the decrease in energy prices exerted downward pressure on inflation, the VAT increase in Germany created upward pressure on inflation. Considering the current oil prices, inflation is expected to remain below 2 percent due to the base effect, with a volatile course throughout 2007. Meanwhile, the unobserved secondary effects of the VAT increase and the possible oil price hikes are considered to be risk factors that are likely to increase inflation in the upcoming period.

Graph 2.1.1. Policy Rates
(Percent)



Source: ECB, BoJ.
Federal Reserve Bank of New York.

Graph 2.1.2. Inflation Rates
(CPI, Annual Percentage Change)



Source: Statistics Bureau of Japan, Eurostat, US Department of Labor, Bureau of Labor Statistics.

The European Central Bank (ECB) has perceived the excess liquidity that resulted from the ongoing monetary and credit expansion as a medium and long-term risk to price stability and has maintained its policy of gradual tightening. Within this framework, on March 8, 2007 (Graph 2.1.1), the ECB Governing Council raised interest rates to 3.75 percent by 25 basis points at each of the seven meetings held since December 2005. However, at the last ECB Governing Council meeting of April 12, 2007, interest rates were kept unchanged. Additionally, given the positive outlook of growth, it was emphasized that the ECB will continue to be on the accommodative side.

The Japanese economy grew by 2.2 percent in 2006, mainly driven by private sector investment pulled by corporate profits and export performance (Table 2.1.1). In the upcoming period, public sector investment are expected to downward trend, exports are anticipated to increase parallel to the rise in foreign demand, and domestic private demand will keep its upward trend in line with high corporate profits and moderately rising household incomes. Within this context, the 2007 growth rate is estimated to be 2.2 percent. Due to fall in oil prices, annual rate of increase in consumer prices has been around zero percent in March 2007. Annual rate of increase in consumer prices is expected to be around zero percent in the short term and increase above zero in the long term as long as the output gap continues to be positive (Graph 2.1.2).

At its meeting in March 2006, the Bank of Japan (BoJ) ended its excess liquidity policy that has been implemented for five years, and in the face of developments in the following period, decided to raise its policy rate by 25 basis points up to 0.5 percent at the meetings held on 13-14 July 2006 and on 20-21 February 2007. In the two consecutive meetings following the latest rate hike, BoJ decided to keep policy rates unchanged (Graph 2.1.1). BoJ is expected to raise its policy rates gradually in the upcoming period, in the light of economic growth and price developments.

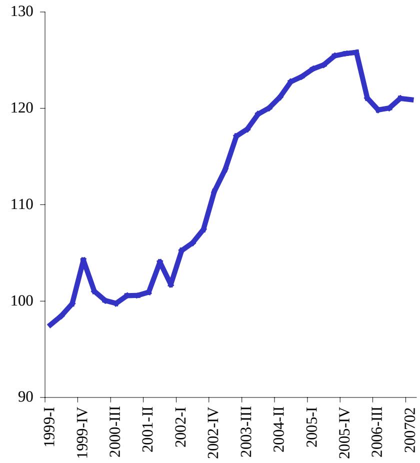
The Chinese economy had a 10.7 percent growth driven mainly by increase in investment and exports, despite the deceleration in fixed capital investment due to tight monetary policy implemented in 2006. As a result of control measures, China's foreign trade surplus showed a tendency to decline in the first quarter of 2007 in comparison to the last two quarters of 2006. Chinese economy is expected to gradually grow at moderate rates in 2007 and 2008 and expectation for 2007 is around 10 percent (Table 2.1.1).

2.2. International Markets

2.2.1. Financial Markets

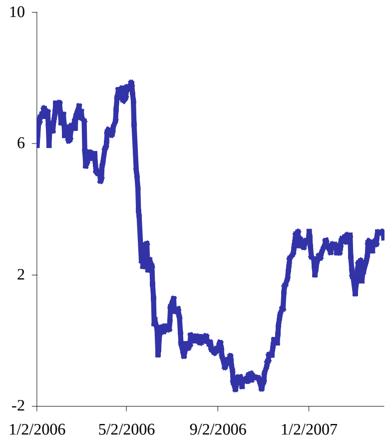
The unfavorable outlook owing to the US economic data released at end-February 2007 and the concerns over US real estate markets coupled with the remarks about a possible hard-landing in the US led to a new wave of sales in international markets. However, the relatively positive outlook of the March data release gave support to soft landing while also limiting the adverse impacts of financial turbulence experienced at end-February. Meanwhile, Eurozone's rapid growth trend and signals of recovery in Japanese economy are expected to ease the effects of a possible slowdown in US economy. In light of these developments, both developed markets and emerging markets have displayed a rapid recovery in the post-February period and caught up with their 2006 end-year performances.

Graph 2.2.1. The Monetary Developments Index for Developed Countries (1999=100)



Source: Central Banks, CBRT and IMF-IFS.

Graph 2.2.2. Credit Suisse Global Risk Appetite Index



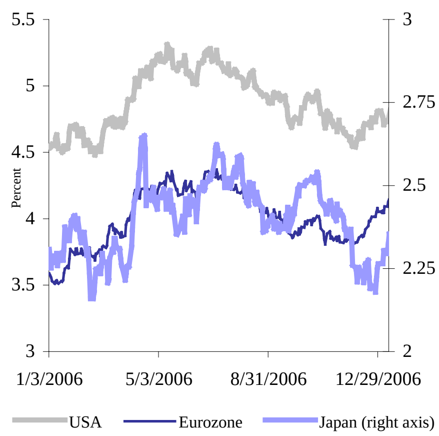
Source: Credit Suisse

The Monetary Developments Index for Developed Countries, calculated by the monetary growth in US economy, Eurozone and Japanese economy with a view to provide insight on the global liquidity conditions, plunged in the second quarter of 2006 in the aftermath of monetary tightening decision by BoJ. In the following period, the Index followed a stable course due to monetary base expansion in the Eurozone, despite the partial tightening of the BoJ and the Fed (Graph 2.2.1).

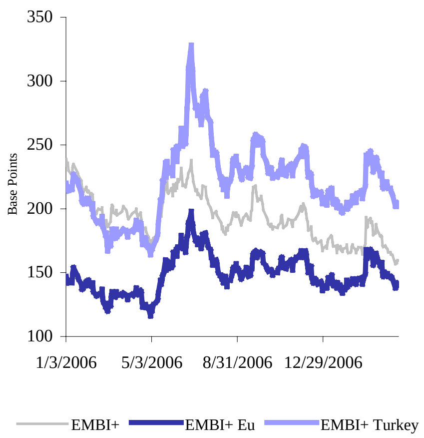
The Credit Suisse Global Risk Appetite Index (CSRA), which reflects the risk perception of global investors, slumped due to fluctuations in May and June, but rebounded in the following period as a result of the positive outlook of data on developed countries. The recovery process in the risk appetite was interrupted by the US-originated fluctuation in late-February; however, as this development has been temporary, the CRSA Index retraced its pre-fluctuation level (Graph 2.2.2).

The analysis of interest rate developments in developed countries demonstrates that Eurozone’s continued monetary expansion and long-term above-potential growth performance, and expectations of new interest rate hikes in response to ECB’s emphasis on inflation pushed yields higher. Despite unchanged policy rates since Fed still perceives inflation as a threat under current circumstances, yields have been on the rise again in the US. Even though the annual inflation rate in Japan turned into negative in February, BoJ's remarks on optimistic expectations for the second half of the year and thus expectations of another rate hike rebounded the yields (Graph 2.2.3).

Graph 2.2.3. Developed Countries Bond Yields (30-year)



Graph 2.2.4. EMBI+ Developments

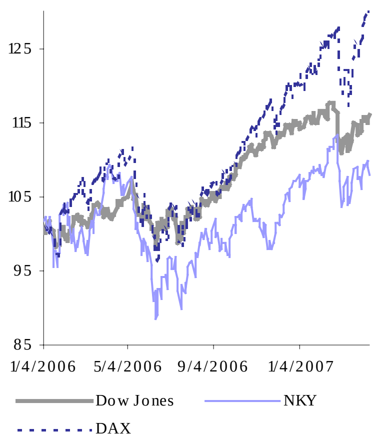


Source: Bloomberg.

Yields of developing countries that had displayed a positive performance after May 2006 gradually converged yields of developed countries as of end-2006. The Emerging Markets Bond Index (EMBI+), Emerging Europe and Turkey sub-indices have increased by end-February in response to the sudden but short-term fluctuations in developed countries. In the successive period, all three indices recovered rapidly along with the added impact of the recovery in the CSRA Index. As of May 2006, the Turkey sub-index recorded higher values above the EMBI+ and as of April 12, 2007, the difference between these two indices has been 43.4 basis points (Graph 2.2.4).

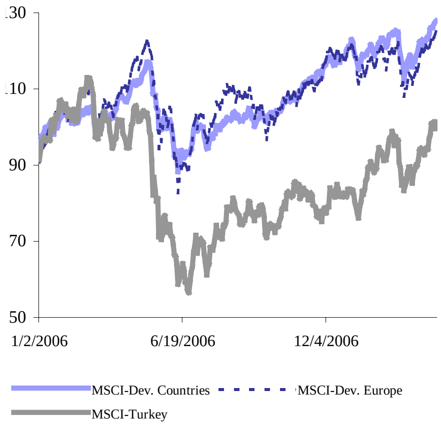
The stock markets of developed countries pursued a remarkably strong course from the second half of 2006 until February 2007. Returns on developed countries' stocks that plunged at end-February, recovered rapidly after February and reached their pre-February levels. The DAX Index displayed a more prominent upsurge, with the exception of late-February, as a result of the high growth performance of the Eurozone and Germany (Graph 2.2.5). As regards developing countries, the Developing Countries and Developing European Countries sub-indices of the Morgan Stanley Capital Index (MSCI) showed a strong upward trend in the last quarter of 2006 and reached pre-turbulence values, while the increase in the Turkey sub-index was rather limited (Graph 2.2.6). Although the fluctuations experienced at end-February caused a decline in these indices, emerging stock markets recovered rapidly.

Graph 2.2.5. Developed Countries Stock Market Developments (2006 January=100)



Source: Bloomberg.

Graph 2.2.6. Emerging Market Countries Stock Market Developments (2006 January=100)



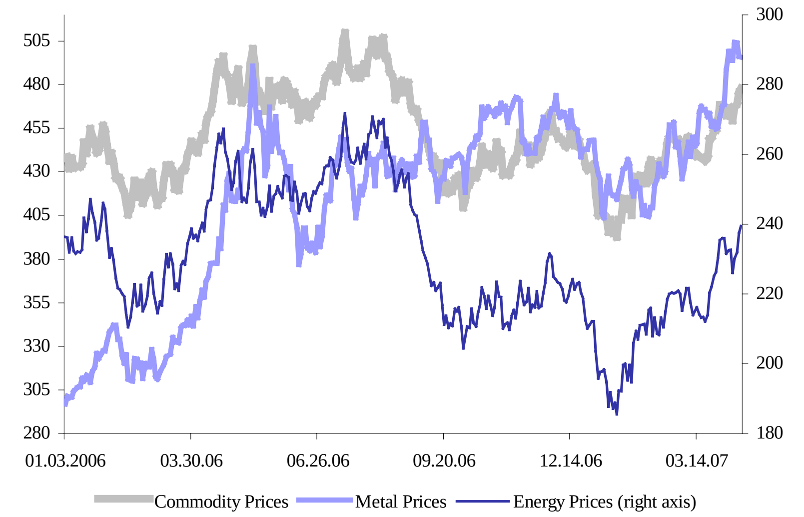
Source: Morgan Stanley.

Uncertainties over inflation and growth in industrialized countries, which led to sharp fluctuations in international relative prices throughout the last quarter of 2006, continue to stand in the forefront as the most significant global economy-related risk factor that will affect developing countries in the coming period. Against this background, a possible increase in developed countries interest rates and a possible slowdown in the US economy may adversely affect the financial assets of emerging market countries. Nevertheless, positive global liquidity conditions and high risk appetite suggest that international conditions will produce a favorable outlook in the second quarter of 2007.

2.2.2. Commodity Markets

In the first quarter of 2007, the Goldman Sachs (GS) Commodity Index remained the same in comparison to the same period of 2006, but dropped by 2.1 percent from the last quarter of 2006. When analyzed in terms of averages, the index re-ascended from mid-January onwards in line with the rise in energy prices, in spite of the decline from the last quarter of 2006. Comparison of the data as of April 12, 2007 with 2006 end-year data, yields an 11.4 percent increase in the main index, an 13.4 percent in the energy sub-index, which has a 70 percent weight in the index, and an 17.0 percent increase in the industrial metals sub-index (Graph 2.2.7).

Graph 2.2.7. Commodity Prices



Source: Goldman-Sachs.

In the first quarter of 2007, the prices of six basic metals traded in the London Metal Exchange (LME) rose by 24.9 percent over the 2006 average and by 6.8 percent over the last quarter of 2006. Recent developments suggest that copper prices, which dropped in the last quarter of 2006, re-accelerated in response to the increasing demand from China and low stock levels. Nickel, with very low stock level, continues to display abrupt price movements. The price of aluminum, which weighs high in the metal sub-index, maintains its stable course (Table 2.2.1).

Crude oil prices, which declined in the last quarter of 2006, resumed its upward trend as of mid-January. This was mainly due to the increasing demand driven by harsh winter conditions. Yet, OPEC countries' production cut in order to comply with the new production quotas effective as of February 1 was another factor boosting price hikes.

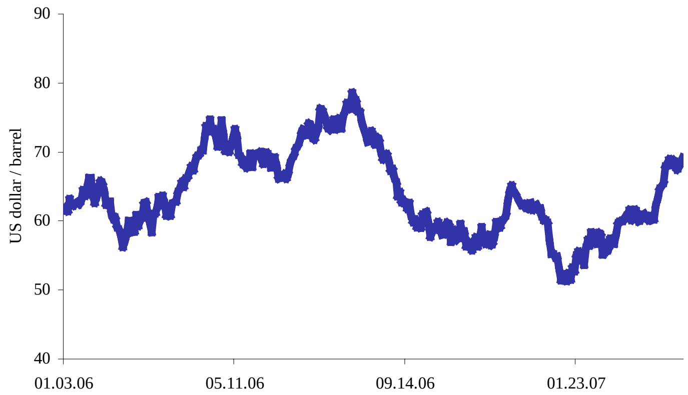
Table 2.2.1. London Metal Exchange Developments

Tons/ USD	Value				(Percentage change)		
	2006	**2006Q4**	**2007Q1**	**12.Apr**	**07Q1 / 06Q4**	**2007Ç1 / 2006**	**12 April / 2007Q1**
Aluminum	2.595,2	2.676,9	2.747,8	2.835,0	*2,7*	*5,9*	*3,2*
Copper	6.678,8	7.220,5	5.975,1	7.690,0	*-17,2*	*-10,5*	*28,7*
Lead	1.281,8	1.522,8	1.750,7	1.980,0	*15,0*	*36,6*	*13,1*
Nickel	23.223,3	30.778,0	38.809,6	46.400,0	*26,1*	*67,1*	*19,6*
Tin	8.747,4	9.904,9	12.590,0	14.250,0	*27,1*	*43,9*	*13,2*
Zinc	3.248,0	3.956,5	3.441,3	3.510,0	*-13,0*	*6,0*	*2,0*

Source: Bloomberg.

In the subsequent period, the imbalance between US crude oil and petroleum products stocks disturbed the markets, and the political tension in the Middle East led to a sharp upsurge in prices, as high as USD 68 per barrel.

Graph 2.2.8. Oil Prices



Source: Bloomberg.

The new level of crude oil prices and its likelihood to remain unchanged creates concern. At the extraordinary meeting of OPEC on December 14, 2006, reasons for the quota reduction were stated as the expectation of a slowdown in global growth and the positive course of main indicators in oil markets such as stock and idle capacity. Even though, at particular times, imbalances may be observed between crude oil/petroleum products stocks, total stocks keep their high levels, while uncertainties over US economy hinder forecasts for global growth. A continued strong course of global growth might lead to abrupt movements in crude oil prices, especially in the second half of the year, and force OPEC to review their production quotas.

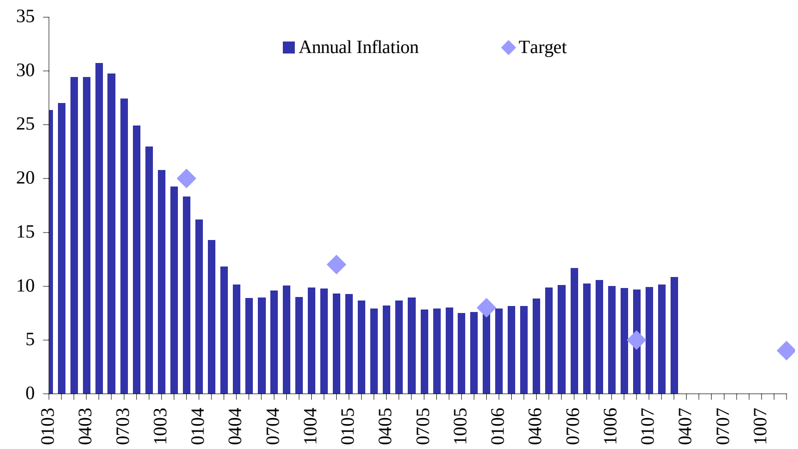
3. Inflation Developments

3.1. Inflation

Annual inflation increased in the first quarter of 2007 to 10.86 percent over the previous quarter (Graph 3.1.1). By the end of the first quarter, however, it has lain inside the uncertainty band around the target path. The first-quarter rise of 2.36 percent in consumer prices is quite high compared to the last three years' figures, which can be attributed to: (i) elevated unprocessed food prices, (ii) tax-driven price hikes in tobacco products (iii) the continued, but slowing, lagged effects of the depreciation of YTL.

The rise observed in annual consumer inflation in the first quarter is believed to be temporary, and given the weakening effect of the exchange rate shock of 2006 on prices, it is projected that inflation will gradually moderate in the upcoming months.

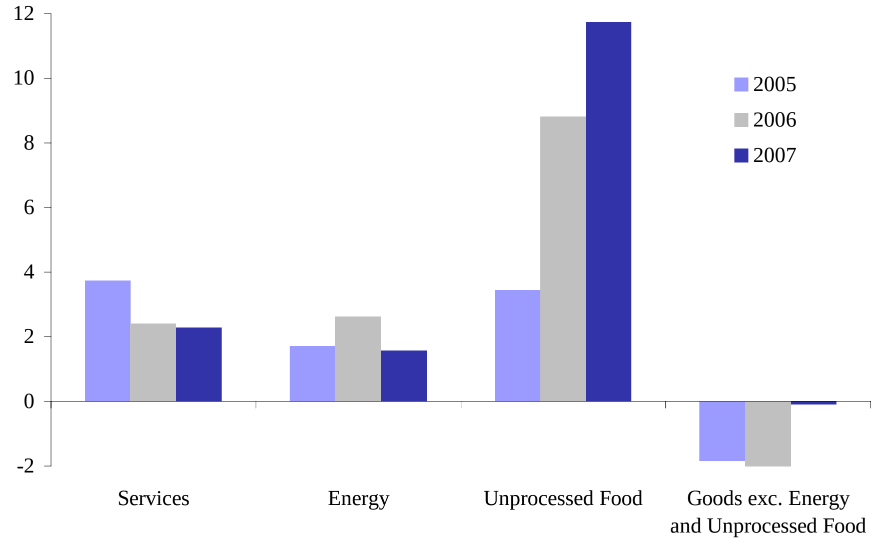
Graph 3.1.1. End-Year Inflation Target and Annual CPI Inflation



Source: TURKSTAT.

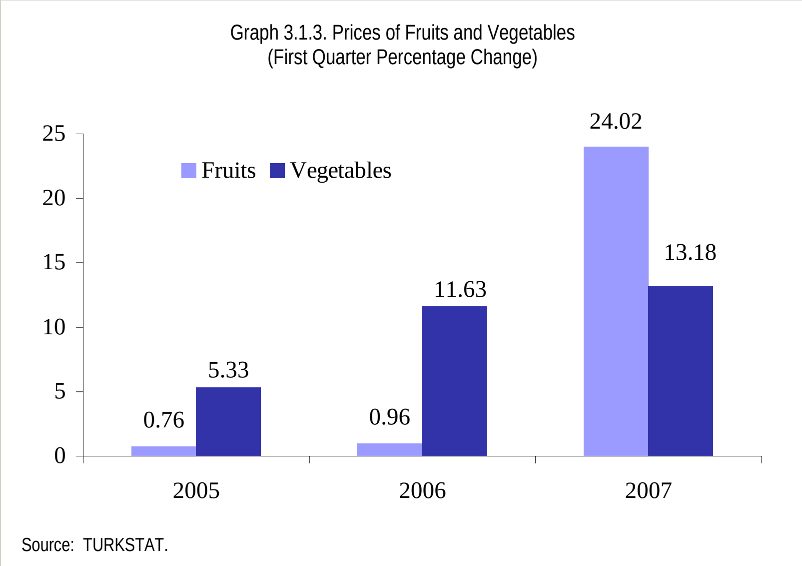
The price developments in unprocessed food and in "goods excluding energy and unprocessed food" pushed annual inflation up in the first quarter. Compared to the first quarter of 2006, the rate of increase in services prices improved slightly while the rate of increase in energy prices decelerated (Graph 3.1.2).

Graph 3.1.2. Consumer Prices
(First Quarter Percentage Change)



Source: TURKSTAT, CBRT.

Unprocessed food prices displayed a significant rise in the first quarter compared to last year. Price developments in this group were among the most influential factors to push up consumer inflation in the first quarter (Graph 3.1.2). Prices of greenhouse vegetables, in particular, increased sharply in January, on the back of an expanded export capacity. Although prices of these vegetables were partially corrected in February and March, both the cumulative effects from January and the rapidly rising fresh fruit prices brought the rise in unprocessed food prices up to 11.74 percent (Table 3.1.1). The fact that fresh fruit prices increased by 24.02 percent in the first quarter, up from 0.76 percent and 0.96 percent in 2005 and 2006, respectively, was the most remarkable development in this group, in the first quarter of 2007 (Graph 3.1.3). Inflation in fruits and vegetables that decelerated in the last quarter of 2006 retraced its earlier run-up, as monthly increases above seasonal rates perceived, which shows that the risks pertaining to unprocessed food prices still prevail.



Energy prices displayed a relatively favorable trend in the first quarter compared to previous years. The moderate rise in energy prices in January and February was replaced by a 1.1 percent rise in March due to soaring fuel oil prices in line with the developments in the international crude oil prices. Energy for the housing group followed a favorable trend in the first quarter and displayed a lower rise than the same period in 2006 -except for tap water-, the price of which is adjusted by municipalities and displays sharp increases.

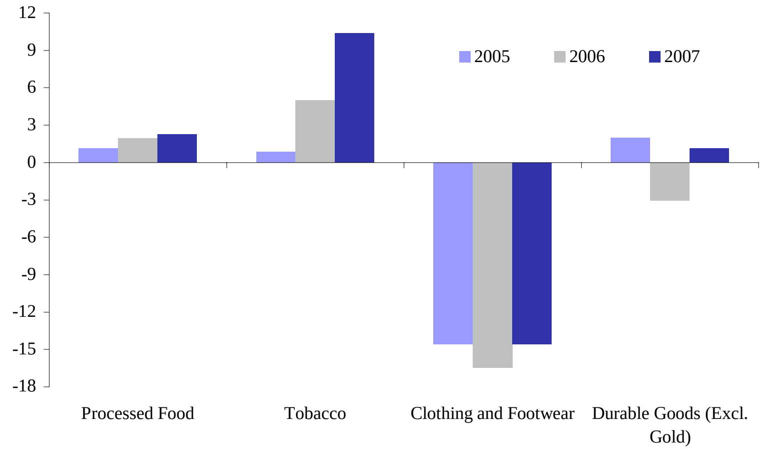
Table 3.1.1. Goods and Services Group Prices
(Quarterly Percentage Change)

	2006					2007
	I	II	III	IV	Annual	I
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**
1. Goods	**0.80**	**3.67**	**0.88**	**3.10**	**8.69**	**2.39**
Energy	2.63	4.94	0.69	1.92	10.52	1.58
Unprocessed Food	8.81	-3.67	1.83	5.81	12.94	11.74
Goods Excluding Energy and Unprocessed Foods	-2.01	5.54	0.67	2.70	6.93	-0.10
Durable Goods	-1.66	8.69	1.34	-1.58	6.61	1.23
Durable Goods (Excl. Gold)	-3.04	5.40	2.84	-2.20	2.78	1.13
Semi-durable Goods	-3.65	9.14	-2.14	4.75	7.81	-3.37
Non-Durable Goods	4.64	-1.12	3.01	3.04	9.82	6.75
2. Services	**2.41**	**3.36**	**3.83**	**2.09**	**12.21**	**2.29**
Rent	4.08	3.69	6.67	4.25	20.01	3.94
Restaurants and Hotels	3.02	4.25	3.40	2.24	13.54	2.60
Transportation Services	1.27	1.36	6.26	3.50	12.89	0.10
Other Services	1.80	3.32	2.32	0.76	8.45	2.10

Source: TURKSTAT, CBRT.

The first-quarter decline in prices of goods excluding energy and unprocessed food remained below that of 2006. Compared to end-2006, the year-on-year inflation in this group rose to 9.01 percent, by increasing 2.1 percentage points, mainly due to developments in tobacco products, consumer durables, clothing and footwear, and processed food prices (Graph 3.1.4). In this sense, it is recommended that the above goods be examined in detail to develop a healthy evaluation of the upward pressure on annual inflation.

Graph 3.1.4. Prices of Selected Goods Excluding Energy and Unprocessed Food (First Quarter Percentage Change)



Source: TURKSTAT, CBRT.

The Special Consumption Tax (SCT) hike on tobacco products affected cigarette prices in the second half of February, resulting in an upsurge of 10.37 percent in prices of tobacco products in the first quarter with a 0.5 percentage point added on annual consumer inflation.

Annual inflation of durable goods (excluding gold) rose by 4.4 percent over end-2006, owing mainly to the low base effect stemming from the significant decrease in durable goods prices in the first quarter of 2006 as a consequence of the long-lasting cumulative appreciation of the New Turkish lira. As regards sub-groups, prices of furniture and electrical/non-electrical appliances fell slightly behind the same period last year while prices of automobiles increased (Table 3.1.2). Among consumer durables, imported automobiles reacted the most to the fluctuations in May 2006. Given the price hikes and the deterioration in automobile loans, domestic automobile sales have been falling down since June 2006.

Another noteworthy development in the sub-items of durable goods is that prices of white goods rose by 8 percent in the first quarter of 2007, up from a relatively moderate increase in 2006. Domestic sales of white goods during January-February 2007 displayed a moderate slowdown compared to the last quarter of 2006 while exports of white goods continued to rise dramatically. Moreover, iron and steel prices, which followed a steep upward trend in the first quarter parallel to the developments in commodity prices in international markets, point to the fact that cost-driven pressures are still in place. In sum, it is believed that both cost pressures and strong external demand elevate white good prices .

Table 3.1.2. Prices of Durable Goods
(Quarterly Percentage Change)

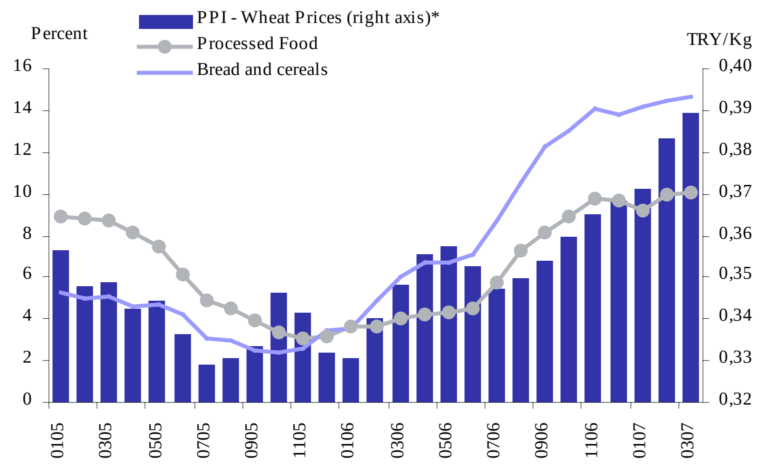
	2006					2007
	I	II	III	IV	Annual	I
Durable Goods (Excluding Gold Prices)	**-3.04**	**5.40**	**2.84**	**-2.20**	**2.78**	**1.13**
Furniture	-7.81	7.45	9.21	-3.17	4.74	-0.60
Electrical and Non-Electrical App.	-5.55	4.51	-0.54	-2.25	-4.03	-0.52
Automobiles	2.93	7.09	2.57	-2.28	10.48	3.22
Other Durable Goods	-1.17	-1.86	1.43	0.91	-0.73	0.82

Source: TURKSTAT, CBRT.

Occasional irregularities in the seasonal movements of clothing prices lead to volatilities in this group’s annual rate of increase. The clothing and footwear prices declined less than the first quarter of 2006 and the group’s annual inflation rose to 4.19 percent. Even though this may look at first glance like an unfavorable development, the total discount rate in winter (from December 2006 to March 2007) suggests that this year’s rates approached those of the last year. However, the upward trend in apparel manufacturing prices requires close scrutiny of clothing prices.

The annual inflation in processed food prices also increased, albeit at a subdued pace. This rise was mainly driven by price hikes in bread and cereals (coupled with the lagged effects of the post-May depreciation of YTL) (Graph 3.1.5). The upsurge in the annual inflation of bread and cereals prices started in the last quarter of 2005 and became quite marked after the second quarter of 2006, mainly due to the concurrent acceleration observed in wheat prices (Graph 3.1.5). The decreased cereal production in 2006 suggests that the rise in wheat prices was primarily due to supply-side factors. Given the global increase in cereal prices and the expectation of a continued decline in domestic production, it is projected that the supply-driven rise in cereal prices will continue during the remainder of the year.

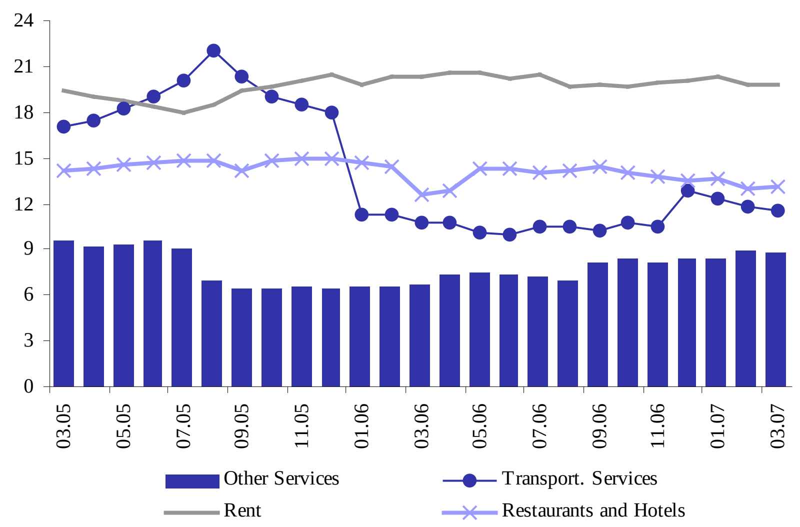
Graph 3.1.5. Processed Food and Bread-Cereals Group Prices
(Annual Percentage Change)



* The level of wheat prices is illustrated on the Graph.
Source: TURKSTAT, CBRT.

With a 2.29 percentage-point rise in the first quarter of 2007, services prices improved slightly over its year-ago level. The first-quarter inflation in rents and hotels-restaurants decelerated to some extent compared to the previous year (Table 3.1.1). Transportation services prices that displayed a moderate increase in response to fuel oil prices, and the average rate of increase in services prices excluding rents, restaurants-hotels and transportation above year-ago levels are the most remarkable developments in this period.

Graph 3.1.6. Services Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Since the services group is not subject to competition and productivity growth as much as the goods group, services prices are more susceptible to domestic supply and demand developments. Apart from demand-side factors, wages, oil prices and prices of the final products used for services are also important in setting services prices. Moreover, the widespread use of backward indexation is another determinant in the pricing policy for this sector.

Recently, the slowdown in domestic demand continues and oil prices do not present an unfavorable outlook compared to the last quarter in 2006. Nevertheless, the fact that wage increments in overall economy exceed the medium-term inflation target and that annual inflation rates that are widely used as a benchmark for the indexation mechanism pursue a high course cause services inflation to remain high (Graph 3.1.6) (Box 3.1).

While Consumer Prices Index (CPI) inflation increased by 2.36 percent in the first quarter, the special CPI Aggregate-B, excluding unprocessed food products (SCA-B), increased by 0.89 percent (Table 3.1.3). When the effect from tobacco products is also omitted, the rise in CPI inflation falls to 0.34 percent. These figures are evidence that unprocessed food products and tobacco products were the two main factors pushing up consumer inflation in the first quarter.

On the other hand, annual inflation in the SCA-H index (Special CPI Aggregate excluding energy, unprocessed food products, alcoholic beverages, tobacco and gold) and in most of the indices increased due to the low base of the same period last year. As a consequence of the long-lasting cumulative appreciation of the New Turkish lira, prices of durable goods had displayed a remarkable decline in the first quarter of 2006. The lack of a similar movement this year caused the annual increases of the special aggregates to rise. Moreover, the shifts in seasonal pattern of clothing and footwear groups (early launch of new season) have also been pushing these indices upwards.

Table 3.1.3. Special CPI Aggregates (2003=100)
(Quarterly Percentage Change)

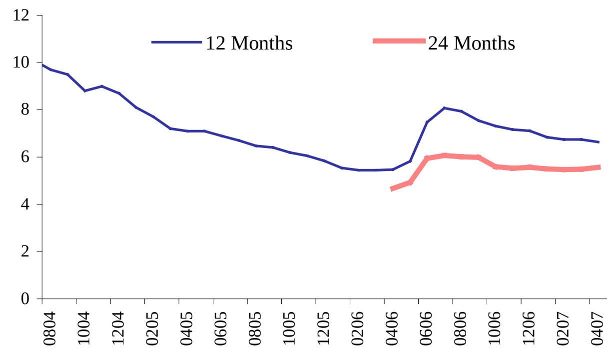
	2006					2007
	I	II	III	IV	Annual	I
CPI	**1.25**	**3.58**	**1.69**	**2.81**	**9.65**	**2.36**
A. CPI Excluding Seasonal Products	2.31	2.79	3.23	1.36	10.04	2.62
B. CPI Excluding Unprocessed Food	0.12	4.79	1.67	2.38	9.21	0.89
C. CPI Excluding Energy	1.01	3.38	1.86	2.96	9.51	2.49
D. CPI Excluding Unprocessed Food and Energy	-0.38	4.77	1.86	2.47	8.95	0.76
E. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products	0.74	3.62	1.98	3.16	9.82	2.03
F. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Other Goods with Administered Prices and Indirect Taxes	1.75	3.82	1.86	3.39	11.25	2.24
G. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Other Goods with Administered Prices, Indirect Taxes and Unprocessed Food	0.26	5.59	1.88	2.91	10.99	0.17
H. CPI Excluding Energy, Alcoholic Beverages and Tobacco Products, Unprocessed Food and Gold	-0.96	4.77	2.18	2.70	8.89	0.03

Source: TURKSTAT.

3.2. Expectations

The improvement in medium-term inflation expectations that had been observed since August 2006 came to a halt in the first quarter, which can be attributed to the rising consumer inflation and the uncertainties generated by short-lived fluctuations in global markets in March (Graph 3.2.1).

Graph 3.2.1. CPI Inflation Expectations Regarding the Next 12 and 24 Months *
(Annual Percentage Change)



* CBRT Expectation Survey, second survey period expectations.
Source: CBRT.

According to the Expectation Survey of the second survey period in April, the expected end-year inflation rate increased by 44 basis points to 7.48 percent compared to the figures mentioned in the previous inflation report. This was partly owing to the higher-than-expected inflation rate in the first quarter. However, the fact that the 12-month ahead inflation expectations decreased by some 20 basis points, and the 24-month ahead expectations displayed no significant change signals that this short-term deterioration is not perceived as a permanent one. Nevertheless, the above-target 12- and 24-month ahead inflation expectations, which are, by April, 6.63 and 5.57 percent, respectively, pose a risk to the pricing behavior in overall economy (Table 3.2.1). Yet, inflation expectations are believed to gradually improve parallel to the decline in annual inflation in the upcoming period.

In sum, as regards the developments in the coefficient of variation, an indicator of the uncertainty over inflation expectations, the uncertainty over the 12-month ahead expectations increased at a subdued rate after the short-lived fluctuations in March while there has been no significant change regarding the uncertainty over the 24-month ahead expectations.[1]

Table 3.2.1. CPI Inflation Expectations

Current Period	Survey Period	End-Year Average Expectation*	Next 12 Months		Next 24 Months	
			Average Expectation*	Coefficient of Variation	Average Expectation*	Coefficient of Variation
January-06	1	5.68	5.49	0.10		
	2	5.67	5.54	0.11		
February-06	1	5.75	5.45	0.10		
	2	5.81	5.45	0.11		
March-06	1	5.8	5.46	0.10		
	2	5.78	5.44	0.09		
April-06	1	5.76	5.41	0.10	4.64	0.11
	2	5.79	5.47	0.10	4.67	0.09
May-06	1	6.27	5.57	0.11	4.79	0.13
	2	6.75	5.83	0.15	4.93	0.16
June-06	1	8.82	6.66	0.15	5.37	0.15
	2	9.78	7.48	0.16	5.95	0.20
July-06	1	10.17	7.89	0.16	6.13	0.19
	2	10.28	8.07	0.16	6.07	0.16
August-06	1	10.59	7.98	0.13	6.06	0.17
	2	10.46	7.94	0.13	6.02	0.15
September-06	1	9.77	7.62	0.13	5.91	0.18
	2	9.63	7.54	0.10	5.99	0.16
October-06	1	9.96	7.38	0.11	5.80	0.17
	2	9.88	7.31	0.11	5.60	0.15
November-06	1	9.84	7.13	0.08	5.55	0.13
	2	9.85	7.16	0.09	5.52	0.14
December-06	1	9.93	7.23	0.11	5.58	0.13
	2	9.96	7.11	0.07	5.56	0.12
January-07	1	6.98	6.84	0.08	5.43	0.14
	2	7.04	6.84	0.07	5.50	0.13
February-07	1	7.16	6.77	0.08	5.43	0.13
	2	7.13	6.75	0.07	5.47	0.13
March-07	1	7.26	6.83	0.13	5.48	0.12
	2	7.28	6.75	0.10	5.48	0.11
April-07	1	7.44	6.64	0.11	5.54	0.15
	2	7.48	6.63	0.11	5.57	0.14

* Average expectation figures presented in the table are specified through comparing the appropriate means designated based on the comparison of arithmetic mean, median, mode, alpha-and trimmed mean and extreme value analysis.
Source: CBRT.

[1] The coefficient of variation, which indicates the deviation among participants' expectations, is the ratio of standard deviation to the mean in a data set with the appropriate mean.

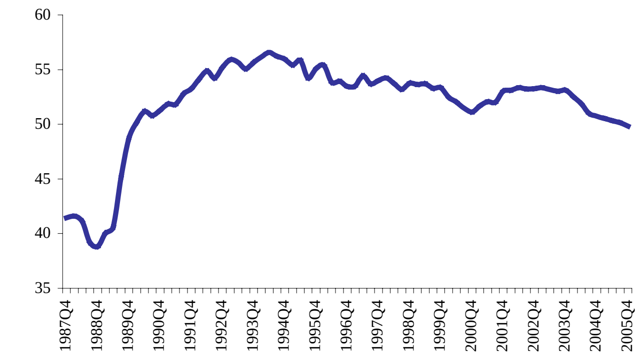
BOX 3.1. WAGES AND SERVICES INFLATION

This Box includes an analysis of how the increases in wages and salaries affect services inflation. The fact that wages and salaries make up a significant part of private disposable income and that private consumption expenditures are very susceptible to private disposable income requires close monitoring of wage and salary developments, primarily in terms of demand. The above-target wage and salary increases can lessen the effectiveness of monetary policy via expectations, especially in sectors where backward-indexation prevails. Moreover, wage and salary increases directly affect inflation via cost increases, particularly in labor-intensive sectors such as services. In this framework, the course of wage and salary increases in the public sector is very important for achieving the inflation target as private sector wages are affected from the incomes policy of the public sector.

Public sector wage and salary increases for 2007 are considerably above the 2007 inflation target of 4 percent. The minimum wage was raised by 6 percent nominally in January, and it is announced that a further 4 percent-increase will be added in July, so the minimum wage will have been raised by 8.1 percent on average in 2007 compared to 2006. As for salary increases, salaries of low-paid civil servants were raised by 6 percent in January, 2 percent of which represents the inflation difference; while salaries of high-paid civil servants were raised by 5 percent, including the same 2 percent contribution. Salary increases for the second half of the year are set as 4 percent for low-paid civil servants and 3 percent for high-paid civil servants. Any inflation difference that might occur in the first half of the year will be added to these rates. Retirement pensions of civil servants, workers and Bağkur members are also raised accordingly.

The fact that public sector labor payments take up almost half of the total labor payments make public sector wage and salary adjustments of great significance with respect to demand-side inflation developments (Box 3.1.Graph 1). According to the data released by SSK, 44 percent of employees get the minimum wage[1], which makes it clear that the public sector has a direct impact on private sector labor payments via minimum wages. Moreover, public wage adjustments also indirectly affect overall wage increases, as they set a precedent for private sector wages excluding the minimum wage.

Box 3.1.Graph 1. Public Sector Labor Payments/Labor Payments (%, Annualized Data)

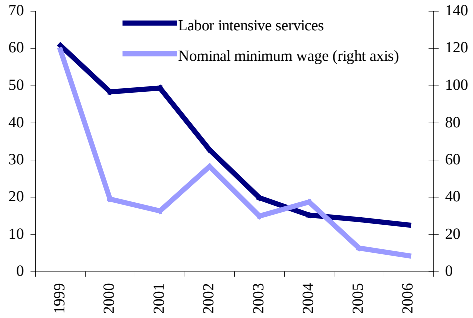


Source: TURKSTAT.

[1] SSK Statistics Almanac for 2005.

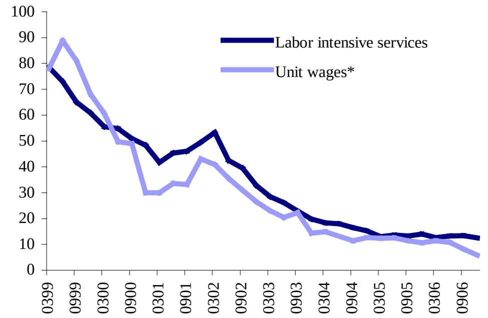
Aside from their effect on demand, wage adjustments are also influential on especially services inflation via costs and expectations.[2] Among services prices, prices of labor-intensive services are particularly sensitive to changes in wages. In this context, wage adjustments that are not consistent with the inflation target impede efforts to reduce the rigidity in services inflation. Accordingly, annual labor-intensive services inflation changes in line with the increases in minimum wage and manufacturing industry unit wages (Box 3.1.Graph 2, Box 3.1.Graph 3 and Box 3.1.Graph 4)

Box 3.1.Graph 2
Labor-Intensive Services Prices and Nominal Minimum Wage
((Annual % Change)



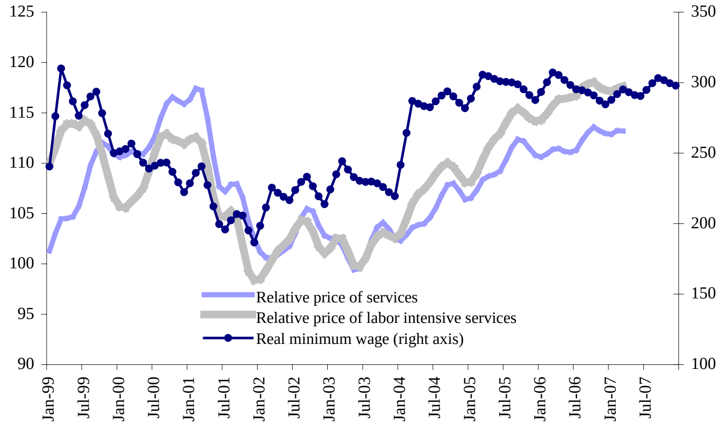
Source: TURKSTAT, *Ministry of Labor*

Box 3.1.Graph 3
Labor-Intensive Services Prices and Unit Wages
(Annual % Change)



Source: TURKSTAT
* Unit Wages in Manufacturing Industry

Box 3.1.Graph 4. Real Minimum Wage Level and Services Sector Relative Price Indices
(Quarterly Moving Average)



Source: TURKSTAT.

Against this background, it is believed that along with the factors that could affect costs, demand and expectations, public sector wage and salary adjustments are critical for the inflation target, especially in connection with the rigidity in services inflation. Public sector wage and salary payments, which took up 12 percent of total consumption expenditures in 2006, increased by 25 percent in annual terms in the first quarter of 2007 according to central government budget figures, which requires careful monitoring in terms of the inflation target.

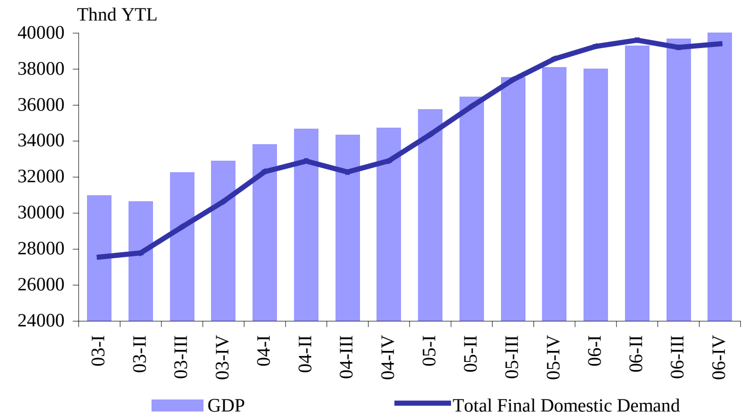
[2] Wage increases are believed to have a stronger impact, particularly via costs, on services inflation. According to the figures of the Input-Output table for 1998, the ratio of wage payments in the services sector to total production is 19.5 percent while that of manufacturing industry is only 8.3 percent.

4. Supply and Demand Developments

4.1. Supply-Demand Balance

In the last quarter of 2006, Gross Domestic Product (GDP) increased by 5.2 percent over the same period of 2005. According to seasonally adjusted figures, the GDP grew by 0.8 percent over the previous quarter. During this period, domestic demand remained below the GDP, as in the third quarter of the year. The GDP that includes the revisions for the first nine months, grew by 6.1 percent for the whole year (Graph 4.1.1).

Graph 4.1.1. GDP and Total Final Domestic Demand
(Seasonally Adjusted)



Source: TURKSTAT, CBRT.

Analyzing economic growth in terms of production, the value added of the agricultural sector increased by 9.7 percent in the fourth quarter. Along with the revisions for the first nine months, the sector grew by 2.9 percent throughout 2006. Supported by the strong export performance, the value added of the industry continued to increase in the fourth quarter. Construction sector exhibited a strong growth, albeit at a lower rate compared to overall 2006. The slowdown in domestic demand, and consequently, in imports, limited the increases in the value added of commerce and transportation-communication sectors.

Analyzing in terms of demand components, the rate of increase in private consumption expenditures that realized at very low levels in annual terms became the most important factor restraining growth (Table 4.1.1). According to seasonally adjusted figures, the demand for durable goods, which has partially improved after a sharp decline in the third quarter decreased in annual terms due to the base effect generated by the rapid growth in the last quarter of 2005 and continued to be the most important factor limiting consumption demand. Annual increases in demand for food and semi and non-durable goods continued, albeit at a subdued rate compared to the first nine months of the year. The rate of increase in public consumption expenditures, which recorded high rated in the first nine months of the year, dropped in the last quarter.

As regards the sub-items of private investment expenditures, it is seen that the machinery-equipment investments displayed only a slight increase as expected –, while construction investments continued to grow. As a result of the sluggish increase in public investments, fixed capital investments rose by 4.4 percent in annual terms – a rather low level compared to previous periods. Along with the slowdown in domestic demand, imports lost pace, primarily in consumption and investment goods. However, exports maintained their strong performance. As a result of these developments, net exports made a significant contribution to growth and mainly offset the impact of weak domestic demand on growth.

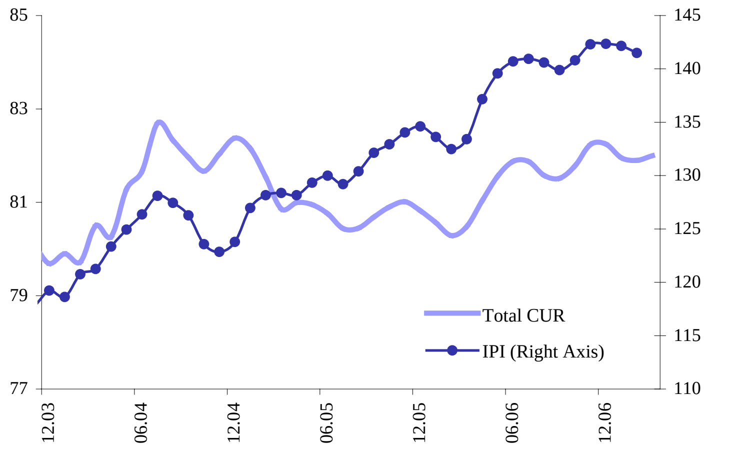
Table 4.1.1. GDP Developments by Expenditures
(Constant Prices, Annual Percentage Change)

	2005					2006				
	I	II	III	IV	Annual	I	II	III	IV	Annual
1-Consumption Expenditures	4.1	3.9	9.8	14.1	8.1	8.3	12.2	3.3	0.2	5.6
Public	4.4	4.0	3.2	0.0	2.4	10.1	18.3	14.8	0.7	9.6
Private	4.1	3.9	10.4	16.7	8.8	8.1	11.5	2.3	0.1	5.2
Durable Goods	3.2	2.9	26.0	31.3	15.0	12.7	15.9	-8.3	-6.3	2.9
Semi-dur and Non-dur. Goods	9.0	3.0	3.7	39.6	12.9	11.8	30.3	19.8	4.2	15.8
Food and Beverages	3.3	8.6	10.8	8.7	8.2	6.6	5.5	1.2	0.2	3.1
2-Fixed Capital Formation	10.3	20.0	30.6	33.0	24.0	32.1	14.0	11.3	4.4	14.0
Public	30.7	30.2	38.2	17.1	25.9	32.8	-11.9	-4.1	1.8	-0.2
Private	8.8	18.4	29.0	41.6	23.6	32.1	18.4	15.0	5.6	17.4
Machinery-Equipment	5.1	15.4	26.8	43.5	21.4	34.9	15.4	7.2	0.3	13.9
Construction	20.8	28.8	33.2	35.9	29.9	24.1	27.9	29.8	21.6	26.4
3- Changes in Stocks	0.6	-0.7	-3.0	-6.3	-2.5	-4.9	-0.9	-3.8	1.3	-2.1
4-Exports of Goods and Services	14.0	6.7	3.9	10.9	8.5	6.8	9.1	11.5	6.2	8.5
5-Imports of Goods and Services	10.6	9.1	11.2	15.3	11.5	10.0	13.7	3.6	1.0	7.1
Net Exports*	0.5	-1.9	-2.7	-2.3	-1.7	-2.2	-3.5	3.4	2.4	0.3
6-Total Domestic Demand	5.6	6.8	10.9	11.6	8.8	8.2	10.6	1.4	2.7	5.6
7-Total Final Domestic Demand	5.5	8.4	14.5	19.1	12.1	14.1	12.7	5.3	1.4	8.0
7-GDP (Expenditure side)	6.6	5.5	7.7	9.5	7.4	6.7	8.3	4.8	5.2	6.1

*Contribution to GDP, percent.
Source: TURKSTAT.

In the January-February 2007 period, the industrial production index increased by 10.8 percent over the same period last year, which can be attributed to the low base effect generated by industrial production that fell in January 2006 due to natural gas cuts and adverse weather conditions. As a matter of fact, seasonally adjusted data do not suggest a briskness in industrial production (Graph 4.1.2). The slowdown in domestic demand restrains industrial production, while strong export performance supports it. Seasonally adjusted data on capacity utilization rates indicate that industrial production continued to increase modestly in March. However, considering the base effect observed in the first quarter of 2006, industrial sector production and its value added are also expected to keep increasing at high rates in annual terms in the first quarter of 2007.

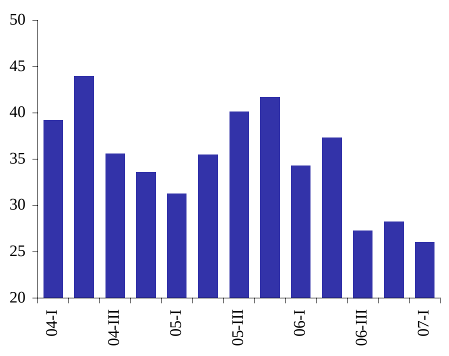
Graph 4.1.2. Industrial Production Index – Capacity Utilization Rate (Seasonally Adjusted, Quarterly Moving Average)



Source: TURKSTAT, CBRT.

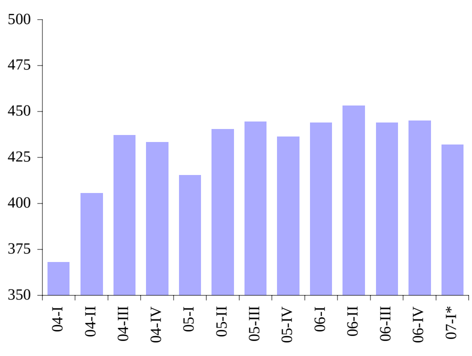
Automobile sales that dropped sharply in the third quarter of the year as a result of the fluctuations in May-June 2006 recovered in the fourth quarter but re-weakened during January-February 2007 (Graph 4.1.3). Sales of white goods reveal a similar outlook (Graph 4.1.4). In this context, the ebbing demand for durable goods continues to limit private consumption expenditures.

Graph 4.1.3. Domestic Sales of Automobiles (Seasonally Adjusted, Monthly Average, Thousand)



Source: AMA, CBRT.

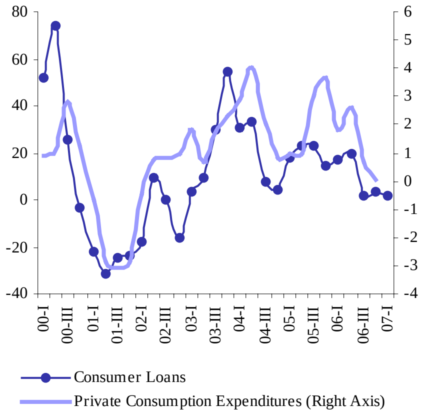
Graph 4.1.4. Domestic Sales of White Goods (Seasonally Adjusted, Monthly Average, Thousand)



* January-February period is included.
Source: WGSA, CBRT.

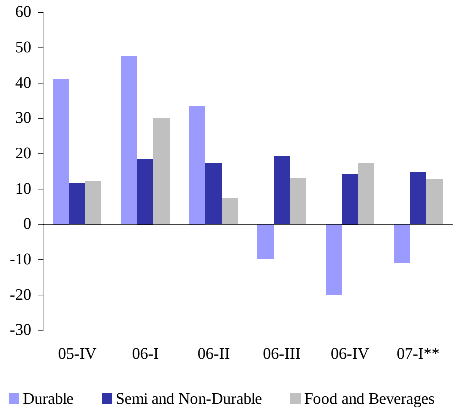
Consumer loans, another indicator of consumption expenditures, continue to display a sluggish trend (Graph 4.1.5). Since first quarter of 2007, vehicle loans have been declining , whereas other sub-items of consumer loans have not accelerated over the second half of 2006. The data on imports of consumption goods also indicate that expenditures on durable goods dropped in annual terms (Graph 4.1.6). Therefore, considering the high base effect observed in the first half of 2006, annual increases in private consumption expenditures are not expected to change significantly in the same period of 2007.

Graph 4.1.5. Consumer Loans and Consumption Expenditures (Quarterly Real Percentage Changes*)



* Private consumption expenditures are annualized.
Source: TURKSTAT, CBRT.

Graph 4.1.6. Imports of Consumption Goods By Items (Annual Percentage Change)



* The imports of durable goods data derives from the total imports of automobiles and durable goods covered by BEC (Classification Of Broad Economic Categories). The food imports data derives from the total imports of processed and unprocessed products of food and beverages.
**T Latest data cover the January-February period.
Source: TURKSTAT.

Construction permits issued to the private sector increased by 13 percent in 2006. Accordingly, it is estimated that private construction investments will also continue to grow in 2007, although not as high as it was observed in 2005 and 2006. On the other hand, the slowdown in machinery-equipment investments is expected to persist in the short term. During January-February 2007, imports of capital goods increased over the last quarter of 2006, while sales of light commercial vehicles that declined parallel to automobile sales continued to restrain machinery-equipment investments (Graph 4.1.7). Production in the investment goods producing sectors of machinery-equipment and electrical machinery and electrical appliances/apparatus does not indicate an acceleration in investments either (Graph 4.1.8).