October Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with base year 2003, the CPI increased by 1.79 percent and the PPI by 0.68 in October 2005. Annual inflation in the CPI and PPI became 7.52 percent and 2.57 percent, respectively (Graph 1).

2. In October, the special CPI aggregate F, which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices, and indirect taxes, increased by 2.23 percent in monthly terms, while the G index, obtained by excluding unprocessed food from the F index, displayed a 1.75 percent-increase (Table 1). The year-on-year increase in October for these indices became 6.41 percent and 6.70 percent, respectively. Meanwhile, the index obtained by excluding seasonal products from the CPI excluding energy, alcoholic beverages and tobacco index, increased by 6.85 percent in year-on-year terms (Graph 1).

3. In October, agricultural prices increased by 1.86 percent, whereas the PPI excluding agriculture (industrial prices) rose by 0.38 percent (Table 1).

Table 1: General CPI, PPI and Sub–groups

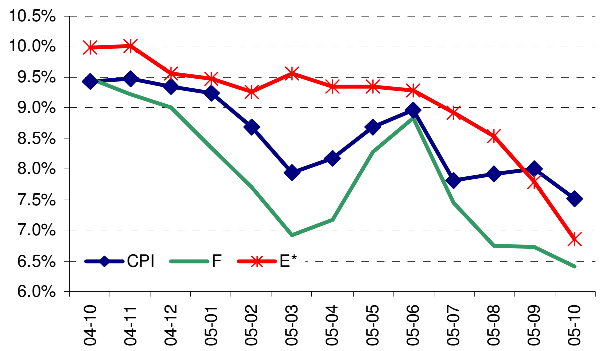
	2005 October	2004 Dec. - 2005 Oct.	2004 Oct.- 2005 Oct.
CPI	**1.79**	**5.79**	**7.52**
Special CPI Aggregates			
A. *CPI Excl. Seasonal Goods*	0.54	7.39	8.06
B. *CPI Excl. Unprocessed Food*	1.39	6.42	7.98
C. *CPI Excl. Energy*	1.89	5.50	7.13
D. *CPI Excl. Unprocessed Food and Energy*	1.42	6.21	7.62
E. *CPI Excl. Energy, Alcoholic Beverages and Tobacco*	2.02	4.55	6.28
F. *CPI Excl. Energy, Alcoholic Beverages and Tobacco, Other Administered Prices and Indirect Taxes*	2.23	4.48	6.41
G. *CPI Excl. Energy, Alcoholic Beverages and Tobacco, Other Administered Prices, Indirect Taxes and Unprocessed Food*	1.75	5.07	6.70
PPI	**0.68**	**3.69**	**2.57**
Agriculture	1.86	-0.81	1.93
Industry	0.38	4.94	2.73

Mining	0.16	13.58	9.98
Manufacturing	0.38	5.72	3.29
Energy	0.32	-9.39	-8.21

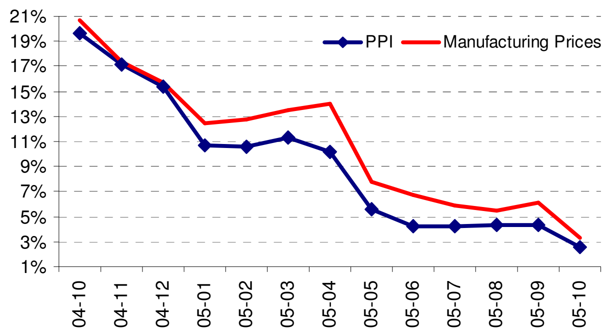
Source: SIS, (2003=100)

Graph 1: Inflation (Annual Percentage Change)

CPI and Selected Aggregates



PPI and Manufacturing Industry



E*: CPI excluding energy, alcoholic beverages, tobacco and seasonal goods

F: CPI excluding energy, alcoholic beverages, tobacco, other goods with administered prices and indirect taxes

Source: SIS (2003=100), CBRT

Developments in Consumer Prices

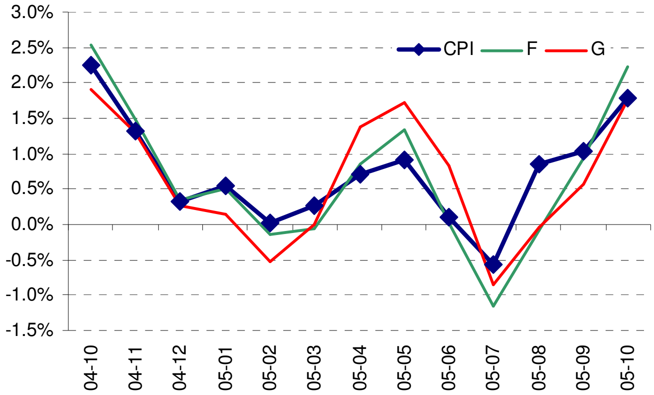
4. The main determinants of the CPI increase in October are (i) seasonal developments in the prices of food, (ii) high increase in the clothing and footwear group due to seasonality, (iii) price increase in the housing group and (iv) the rise in prices of household goods.

5. The monthly price increase in the food and non-alcoholic beverages group is 2.25 percent. The effect of Ramadan in October and other seasonal increases in prices account for the increase in this group.

6. In October, prices in the clothing and footwear group increased by 7.25 percent due to the effect of the new season products, while prices in this group displayed a 2.97 percent decrease in the first ten months of the year. It is anticipated that the rate of increase will still be high in November, though lower than that of October. However, for 2005 in general, increases in prices of the clothing and footwear group are expected to remain below the end-year inflation target.

7. The monthly price increase in the housing group is 1.47 percent. The main determinants of housing prices in October were the increase in fuel oil prices triggered by price increases in petroleum products, as well as the increase in rents.

Graph 2: CPI and Special CPI Aggregates (F and G) (Annual Percentage Change)



F: CPI excluding energy, alcoholic beverages, other publicly administered prices and indirect tax
G: CPI excluding energy, alcoholic beverages, other publicly administered prices, indirect tax and unprocessed food
Source: SIS (2003=100)

8. In October, prices of household goods rose by 1.87 percent mainly due to increases in prices of white goods and furniture. Prices in the entertainment and culture group displayed a further decrease of 0.60 percent in October, following the decline observed in September. The main determinant of this decline is the substantial fall in the prices of package tours item, which builds up a significant part of the group, due to seasonal effects.

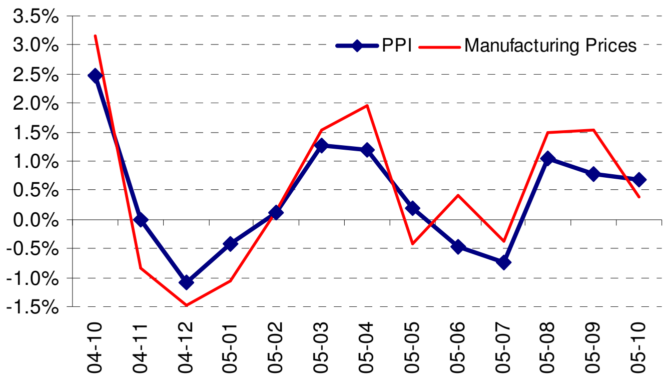
Developments in Producer Prices

9. Along with the 0.68 percent increase in producer prices in October, the cumulative increase in the PPI was realized as 3.69 percent during the first ten months of the year.

10. Agricultural prices, which started to climb seasonally in September, increased by 1.86 percent in October. Price increases in the agriculture sector are expected to continue during the rest of the year. Meanwhile, the agricultural prices, which dropped by 0.81 percent in the first ten months of 2005, had a positive impact on the PPI.

11. Manufacturing industry prices increased by 0.38 percent in October. The increase in prices of petroleum products remained at 0.35 percent in October as the price increases that were observed at the end of September reversed their course in October. Meanwhile, price increase in sectors sensitive to oil prices, namely chemical goods and plastic and rubber production continue, albeit at a lower pace. In October 2005, the price increases in clothing and textile productions, which were realized at lower rates compared to previous years, partially limited the rise in the manufacturing industry index. Moreover, one of the factors that limited the price increase in the manufacturing industry was the price of food production, which dropped due to the sharp decline in the poultry sector.

Graph 3: PPI and Manufacturing Industry Prices (Monthly Percentage Change)



Source: SIS (2003=100)

II. OUTLOOK

Inflation Developments

12. In the Inflation and Outlook Report issued last month, we drew attention to the fact that the impression as to disinflation coming to a halt had stemmed mostly from the rise in oil prices. In fact, along with the weakening of this negative impact caused by the oil prices, inflation was seen to fall below the target in October.

13. In October, the primary effects of oil price increases on annual inflation are estimated to be around 1.5 percentage points. The data pertaining to price developments and expectations confirm that the effects of oil price increases on inflation have mostly been of primary nature. In other words, oil price increases only affected the sectors where petroleum products are used directly as input, and inflation expectations maintained their favorable course. However, as a result of the relative revival in the economy and structural factors, rapid price increases continue in the services items such as rents and restaurant-hotels groups. Furthermore, high price increases stemming from oil prices that are observed in some of the sub-groups of transportation and housing group, continue to pose a risk to the target set for 2006. Meanwhile, inflation in the goods group excluding energy being in tune with the 2006 target is considered as a favorable factor.

14. Developments in the producer price index provide positive signals pertaining to inflation in the upcoming period. Industrial production prices excluding items directly affected by the petroleum products are at historically low levels. However, it should be kept in mind that producer prices may be changing rapidly depending on the cost factors, which limit their informative value pertaining to the future tendency of inflation. Analysis of the special CPI aggregates rather than that of the producer prices is a better approach for a healthier evaluation of inflation in the upcoming period.

15. Following the decline in September, a general slowdown in the annual rates of increase the special CPI aggregates is observed in October. This is considered to be a positive development pertaining to the inflation in the upcoming period. It is especially noteworthy that despite the substantial increase in the prices of seasonal products in October, the annual rates of price increases of all the special CPI aggregates involving these products maintained their downward trend.

16. Irregularities in the seasonal movements covered by the special CPI aggregates make it more difficult for the developments in these aggregates to be interpreted. Besides, as the number of observations is not sufficient, the series cannot be seasonally adjusted in statistical terms. To overcome this hurdle to a certain extent, i.e. to seasonally adjust the special CPI aggregates, multiple series are being produced within the Central Bank by excluding the seasonal products (several food and clothing products having variable weights within the index) from selected special CPI aggregates. The slowdown in the annual growth rates of these series is a significant indicator for inflation in the upcoming period. For example, the annual rate of increase of the index formed by excluding seasonal products from special aggregate (E), which excludes energy, alcoholic beverages and tobacco products maintained its gradual decline within the past year, falling below 7 percent (Graph 1).

17. Consequently, not only the analysis of the sub-items of inflation, but also the special CPI aggregates point to the forecast that inflation adjusted for temporary factors is below the 2005 target, but above that of 2006, while signaling that the main trend is likely to be downward. In this case, the analysis of supply and demand developments has crucial significance for the evaluation of the attainability of the 2006 inflation target.

Factors Affecting Inflation

18. The data obtained during the last month do not indicate a substantial change in the supply and demand conditions compared to the previous month. Foreign demand remains relatively stable despite some slowdown in recent years. Domestic demand is increasing in a controlled manner, and the improving investment climate is continuing.

19. Seasonally adjusted data regarding private consumer spending show that the demand for durable consumption goods is in an upward trend in the third quarter. In addition, the results of the business tendency survey and consumer tendency survey give clear signals that consumer spending has continued to rise in the last period. However, the said upward trend seems to be more controlled compared to that of the first half of 2005 and it is not expected that there would be any obvious pressure on inflation in the short-term. There is no doubt that the current supply-demand conditions are very different than those of the period 2001-2003. Although today's demand conditions do not exert any pressure on inflation, the positive contribution of demand factors to the downward trend in inflation is seen to have weakened. In this regard, sustaining high productivity increases has become critical in order to achieve stable economic growth along with the decline in inflation in the next period. The continuation of productivity increases, in turn, will depend on the determination to pursue structural reforms that would support production and investments.

20. The recent recovery in the investment climate is important for boosting the output potential of the economy. The machinery-equipment manufacturing that had declined on a yearly basis starting from March, resumed growth in August due to the removal of the base effect. It is expected that this trend in machinery-equipment manufacturing should continue in the rest of the year as well. Besides, the rise of 23,1 percent and 23,5 percent in electrical machinery manufacturing and in imports of capital goods, respectively, in the period of July-August 2005 compared to the same period of 2004 shows that the demand for machinery-equipment investment continues. Moreover, in the third quarter of 2005, domestic sales of commercial vehicles, which have increased considerably compared to the same period of 2004, seem to support the strong investment tendency. Also, the seasonally adjusted data regarding imports of capital goods and domestic sales of commercial vehicles indicate an increase in the third quarter compared to the previous period. Furthermore, the reversal of decline that was observed in the investment climate according to the business tendency survey is a positive development for investor confidence.

21. The continuation of a favorable investment climate is especially important for not putting pressure on the output capacity when the economy grows rapidly and for ensuring productivity increases. Increased productivity limits the unit labor costs and restrains the inflationary pressures that may be created due to the revival in economic activity.

22. Obviously, net foreign demand and domestic value added factors must be considered to evaluate the aggregate supply and demand equilibrium. According to recently announced forecasts, the world economy will continue to grow in the coming year, although there will be somewhat of a slowdown. However, it is very unlikely that the foreign demand arising from this growth could create an additional inflationary pressure. The reason is that the persistent and rapid increase in exports and imports and increased competition would restrain potential pressures to be created by foreign demand on inflation.

23. Credit developments are another factor that is closely monitored with regard to the inflation outlook. Recently, credit utilization growth by individuals and companies seems to have stabilized. Housing credits are still in high demand. Clearly, the fact that long-term interest rates have declined considerably in 2005 could support the credit expansion and domestic demand in the next period. In the normalization process of the economy, the continuation of credit expansion resulting from the decrease of fiscal dominance and the increase of financial deepening should not come as a surprise. Moreover, world examples show that there is still much to be done regarding the total credit volume. In this transition period, the Central Bank sees the rapid credit expansion as a development to be followed carefully in terms of risks that might arise for price stability and financial stability.

24. To summarize, it can be said that although the current supply-demand conditions do not put pressure on inflation, the existence of these factors do not completely remove concerns over the secondary effects of oil price increases. However, considering the productivity increases, the level of capacity utilization ratio and the current situation of the labor market, it is highly likely that the main trend of inflation will be downward if no major shock occurs in the coming period.

Monetary Policy and Risks

25. Monetary policy concerns the future inflation instead of the present one. The congruence of inflation forecasts with the medium-term targets is the fundamental consideration of monetary policy decisions. As underlined in previous reports, the "medium-term" spans the upcoming one and a half year starting from today. This time span represents the control horizon that indicates how far ahead monetary policy is capable of affecting inflation. To this end, the Central Bank has shifted its focus on to the 2006 year-end inflation target since the second half of 2005. It is clear that along with the structural transformation in the economy the phases of the monetary transmission mechanism have prolonged, also changing the definition of the control horizon. In a stable economic environment, the prolongation of the monetary transmission mechanism and the extension of the control horizon would not be surprising. Indeed, in developed countries where inflation targeting is implemented, the effects of monetary policy on inflation are extended for a period longer than two years.

26. In the next period, the major risk factors that might endanger the achievement of the inflation target are generally linked to international developments. The first of these risks is the probability of persistence of high increases in oil prices. Estimations of oil prices are subject to frequent change; therefore, they do not display a clear vision. Consequently, the probability of the continuation of high oil prices is evaluated by the Central Bank as one of the major risk factors. Undoubtedly, as long as inflation expectations do not deteriorate, price increases stemming from oil prices will not have a sizably large effect on monetary policy. However, inflation expectations must be managed with the utmost care in an economy, which has suffered from persistent high inflation. In an environment where price stability has not yet been established, monetary policy must continue to pursue a cautious stance. In this context, the probability of the emergence of secondary effects due to oil price increases and the deterioration of inflation expectations should not be disregarded. As a result, oil prices have become a factor that requires extra caution from the monetary policy standpoint.

27. The second major risk for future inflation is the likely fluctuation of international liquidity conditions. The historically low interest rates in developed countries in recent years have caused global funds to flow into emerging market economies like Turkey that have taken major steps towards stability. In the event of a reversal of this trend, there might be fluctuations in financial markets. In such volatile conditions monetary policy should adopt a more cautious attitude. On the other hand, it should also be kept in mind that such similar developments have been experienced many times during the last four years and their negative effects remained temporary due to economic stability and the atmosphere of confidence established by determined policies. In the event of the resumption of such a situation, the continuation of steps such as tax and social security reform that are intended to increase the budget flexibility bears vital importance, if the volatility in the economy is to remain at minimum in the next period as well. It must be remembered that, favorable expectations should be preserved in order to put an end to the price instability that has caused serious damage to the economy for more than three decades.

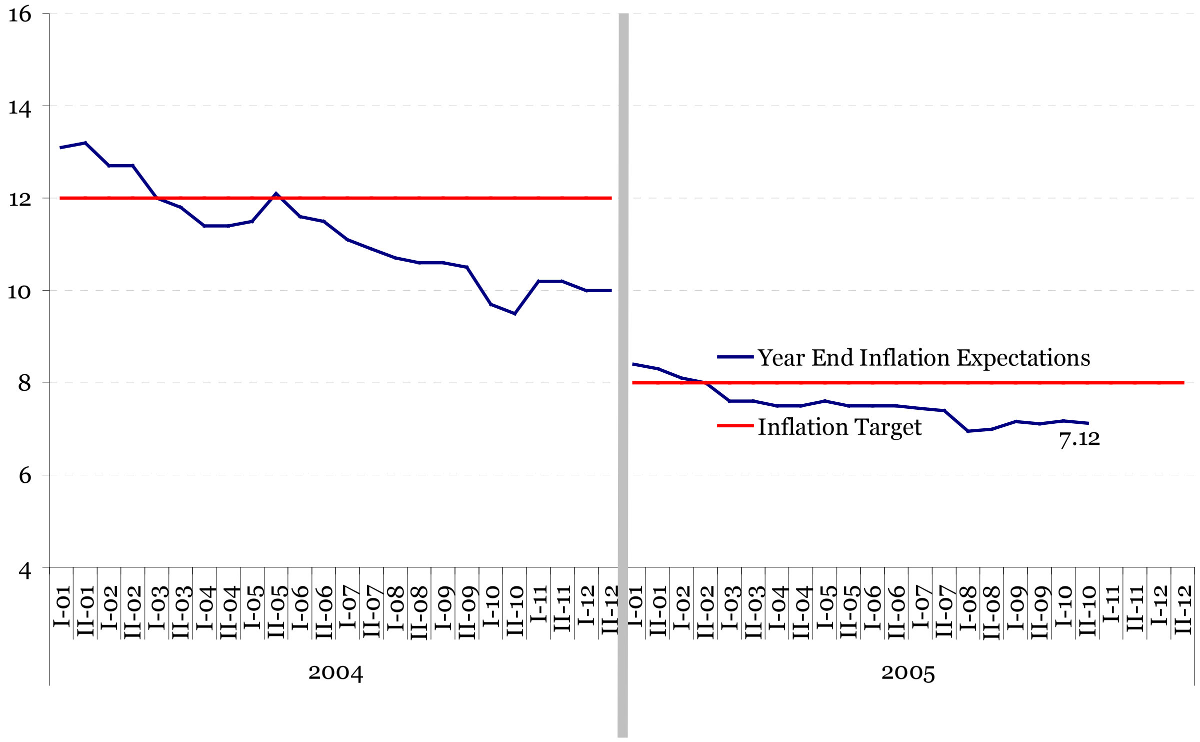
28. The third risk for the achievement of the 2006 inflation target is the continued rigidity in services price inflation. In the next period, increases in service prices that are not sensitive to oil prices are expected to gradually slow down. However, considering the high productivity rates in tradable goods and due to the structural transformation process the economy is undergoing it will not be surprising if services price inflation continue to stay well above goods prices. At present, the share of the services group within the CPI is small. However, in time the share of the services group is expected to grow as a result of increases in relative prices of the services group and changes of consumer preferences. Therefore, the total contribution of price increases in the services group to the 2006 inflation is estimated to be more than half of the target. To attain such an inflation target under these conditions, price increases in the goods group should remain between 3 and 3.5 percent next year. This is possible only if oil price increases slowdown and their secondary effects remain limited, as well as the current trend in global liquidity persists and the domestic demand is kept under control.

Conclusion

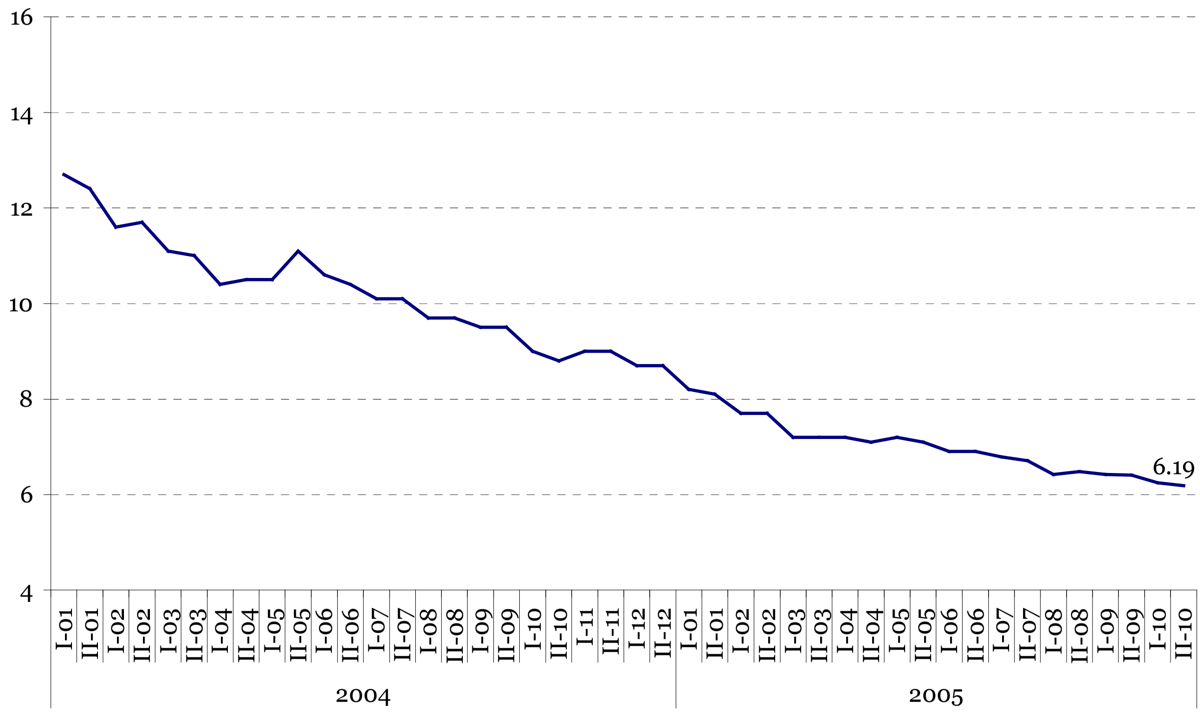
29. In the light of the above evaluations that also take into account the views put forward at the Monetary Policy Committee meeting, dated 8 November 2005, it has been decided to cut short-term interest rates applied at the CBRT Interbank Money Market and Istanbul Stock Exchange Repo-Reverse Repo Market by 0.25 percentage points. In case there is no extraordinary development in the last two months of the year, 2005 inflation is expected to achieve the year-end target. Although there could be some fluctuations in the following months, it is predicted that the main course of inflation, excluding temporary factors, will be downward. However, the consistency of future inflation with the medium-term targets will be conditional upon the favorable course of the above-stated risk factors, even if the monetary and fiscal policies are strictly implemented. In the light of the currently available information, the short-term interest rates are more likely to move downward, rather than upward, in the next period, however the likelihood of them remaining stable is gradually increasing compared to previous periods. It is not possible to make a clear-cut statement about the future direction of this trend due to several factors: the main trend of inflation is proceeding above the medium-term targets, the positive contribution of favorable demand conditions to the downward trend in inflation has become less significant compared to the last three years, the rigidity of services price inflation persists, the uncertainties around liquidity conditions still exist and there are concerns over the secondary effects of oil prices. In this context, it should be underlined that any new data and information associated with the inflation outlook in the next period will make the Central Bank to revise its stance about the future.

Graph 4: Inflation Expectations According to CBRT Expectations Survey

Year-End Inflation Expectations and Inflation Target: 2004-2005



Inflation Expectations for the Next 12 Months



Source: CBRT Expectations Survey