April Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with 2003 base year, the CPI rose by 0.71 percent and the PPI by 1.21 percent in April 2005. The annual rates of increase of the indices were 8.18 percent and 10.17 percent, respectively.

2. The special CPI aggregate (F), which excludes energy, alcoholic beverages, tobacco products, other goods and services with administered prices and indirect taxes, decreased by 0.01 percent in April 2005. Meanwhile, another special CPI aggregate (G), which excludes unprocessed food along with the above-mentioned sub-groups in special aggregate (F) increased by 0.84 percent (Table 1). The rates of annual increase in these aggregates was recorded as 6.25 percent and 8.36 percent, respectively (Figure 1).

3. The PPI excluding agriculture (industrial sector) rose by 1.91 percent in April 2005. The annual increase in the PPI, excluding agriculture, was 13.31 percent (Figure 1).

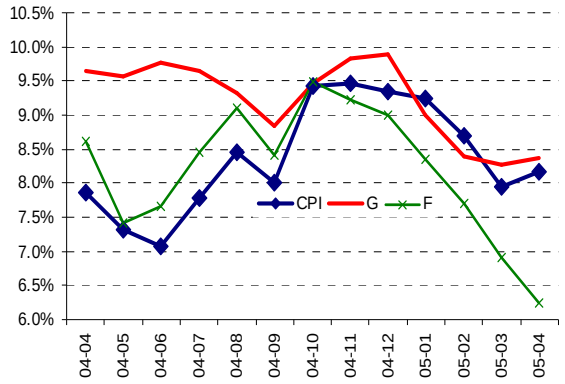
Table 1: General CPI, PPI and Sub-groups

	2005 Apr	2004 Dec-2005 Apr	2004 Apr-2005 Apr
CPI	**0.71**	**1.55**	**8.18**
Special CPI Aggregates			
A. *CPI Excl. Seasonal Goods*	0.63	2.70	9.92
B. *CPI Excl. Unprocessed Food*	1.16	1.54	9.66
C. *CPI Excl. Energy*	0.64	1.31	7.01
D. *CPI Excl. Unprocessed Food and Energy*	1.15	1.24	8.53
E. *CPI Excl. Energy and Alcoholic Beverages*	0.67	1.26	7.24
F. CPI Excl. Seasonal Goods Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes	-0.01	0.29	6.25
G. *CPI Excl. Seasonal Goods Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food*	0.84	0.46	8.36
PPI	**1.21**	**2.18**	**10.17**
Agriculture	-1.28	0.35	0.01
Industry	1.91	2.69	13.31
Mining	5.29	2.89	14.60
Man. Industry	1.95	2.57	14.01
Energy	0.33	4.32	3.61

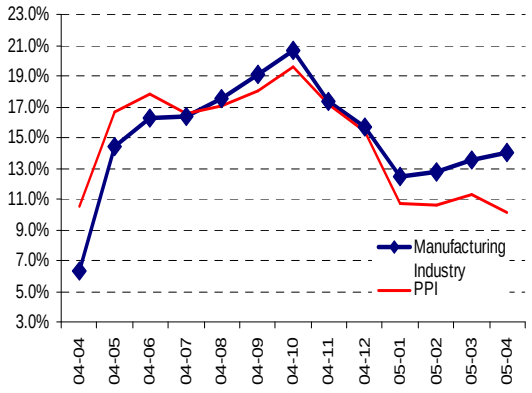
Source: SIS (2003=100)

Figure 1: Inflation (Annual Percentage Change)

CPI and Special CPI Aggregates (F, G)



PPI and Manufacturing Industry



Source: SIS (2003=100)

Developments in Consumer Prices

4. The key factors influencing the consumer price inflation in April 2005 can be summarized as i) new season effects in the clothing and footwear group, ii) developments in fuel oil prices, and iii) the decline in food prices.

5. With the beginning of the new season, prices of the clothing – footwear group rose by 8.60 percent. The annual increase in this group is 5.75 percent as of April. Seasonal increases, which were observed mostly in May last year, may have shifted to April in 2005. However, this is not an ascertained fact. Moreover, considering the fact that the increase in this group had been lower in April 2004, it is seen that the annual increase has been influenced by the base effect, as well.

6. Meanwhile, the monthly increase in transportation prices became 2.09 percent, owing to the increase in fuel oil and automobile prices. The annual price increase in the transportation group is considerably above the inflation target as a result of the developments in oil prices.

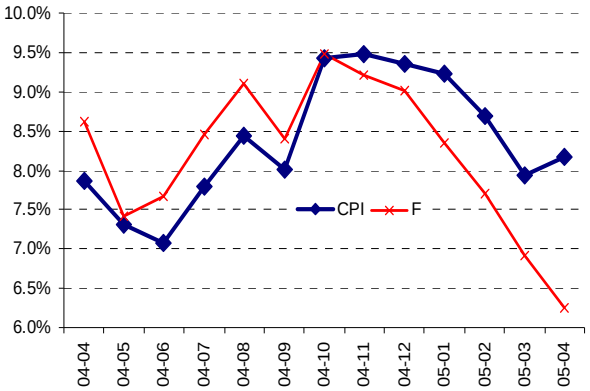
7. In April, prices of the food and non-alcoholic beverages group decreased by 0.96 percent compared to March. The drop in prices of unprocessed food products was influential in the

said decrease. The annual increase in the food and beverages group was limited to 3.52 percent.

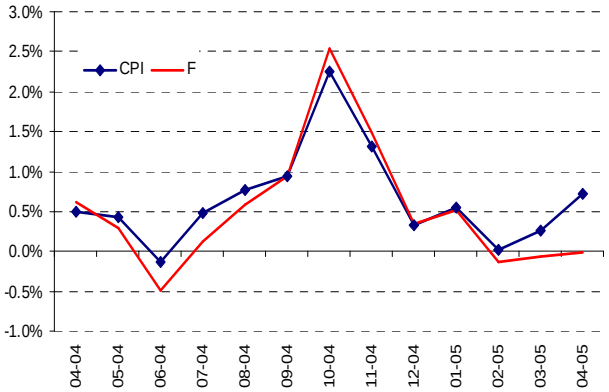
8. In April, the increase in prices of restaurant and hotel services slowed down compared to March, due to seasonal factors. However, on an annual basis, the price-increasing tendency in the sector continued, and the annual inflation figures of April 2005 and April 2004 overlapped.

Figure 2: CPI and Special CPI Aggregate (F)

Annual Percentage Change



Monthly Percentage Change



Source: SIS (2003=100).

Developments in Producer Prices

9. In April 2005, the increase in the PPI mainly stemmed from the increase in the PPI excluding agriculture, similar to the previous month. Prices of the industrial sector rose by 1.91 percent. Meanwhile, the fall in prices of the agricultural sector by 1.28 percent is remarkable.

10. Manufacturing industry prices, which are the main source of the increase in the industrial sector, rose by 1.95 percent in April. The upsurge in prices of coke coal and refined oil products elevated the manufacturing industry prices. The said upsurge resulted from international oil prices and exchange rate developments during the period. Although the oil prices have slightly declined in the later portion of April, it is very likely that oil prices will follow a fluctuating course in the upcoming period. Hence, as also stated in the previous

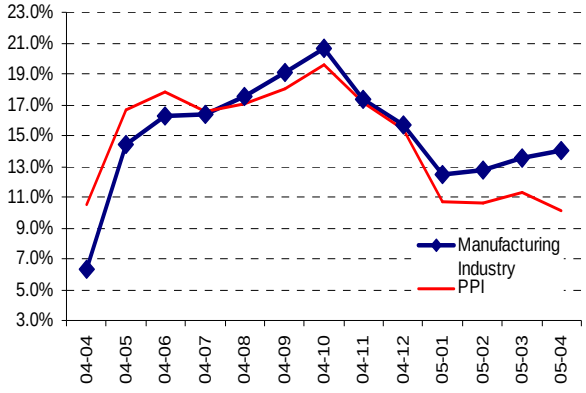
reports, oil price-oriented increases in the manufacturing industry might continue in the coming period.

11. In April 2005, there was a monthly increase of 3.08 percent in the primary metal industry prices, which maintained a downward trend since the beginning of the year. Meanwhile, price increases are also observed in the manufacturing of electric machinery and devices and the manufacturing of machinery and devices. In the first quarter of the year, international metal prices rose. However, the appreciation of the New Turkish Lira (YTL) nullified the effect of these increases on the PPI. Nevertheless, despite the limited decline observed in international metal prices in April, prices of the mentioned commodities rose as a result of the depreciation of YTL.

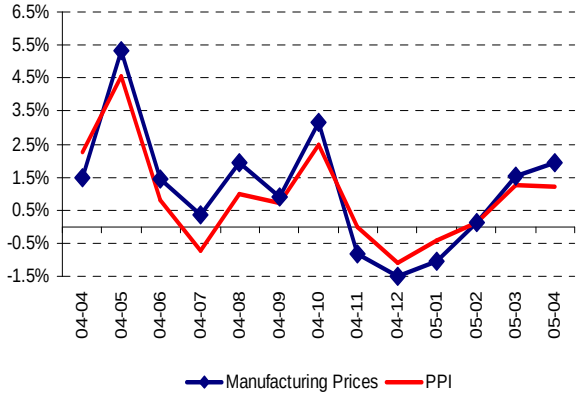
12. It is likely that a concurrent rise in international input prices and exchange rates will lead to an upsurge in the PPI and eventually affect the CPI. However, considering the weakening relationship between the PPI and the CPI, and the current demand conditions, it should be underlined that the said effect is expected to remain limited owing to the calculation method of the PPI.

Figure 3: PPI and Manufacturing Industry Prices

Annual Percentage Change



Monthly Percentage Change



Kaynak: DİE (2003=100)

II. OUTLOOK

Inflation Developments

13. The first development that stands out among inflation developments in April is the continuation of the decline in inflation. The limited increase in the annual inflation figures is due to the base effect brought about by the relatively positive outlook of both cost conditions and public price increases in April 2004. While interpreting the inflation figures in the light of the current monetary policy strategy, the latest tendencies should be taken into consideration rather than the annual figures, which are backward-looking indicators. In this context, the inflation figures pertaining to the first four months of the year and the information about the future inflation included in these figures bear significance. The inflation figures of the first four months of 2005 are at historically low levels. According to the index with the 2003 base year, the cumulative inflation rate became 1.55 percent in the first four months of 2005 whereas it was 2.65 percent in the same period of the previous year. The figures pertaining to the first four months of 2005 indicate that the inflation tendency will remain below that of inflation in 2004. Moreover, (F) and (G) items of the special CPI aggregates, which are derived from the CPI index with the 2003 base year, point to a continuation of the downward trend of inflation.

14. It is still early to talk about absolute price stability although cumulative inflation has been at historically low levels in the first four months of 2005. It should not be forgotten that the VAT reduction made on food, health and education sectors at the beginning of 2005 significantly limits price increases in these sectors. This effect can clearly be seen especially in the prices of health services, which were subject to a six-month price adjustment at the beginning of the year. Meanwhile, it should be underlined that this effect is temporary and it may disappear in the future due to a narrowing in profit margins, which will emerge in case of an increase in costs. Furthermore, it is observed that the rate of decline is less in the services sector prices and the rigidity of the said prices continued in the first quarter of 2005, despite positive developments in inflation rates observed in recent years. The price increases in rents, restaurant and hotel services decreased compared to the previous year, but still maintain a higher trend compared to the general inflation level.

15. Petroleum prices, which have recently increased due to the briskness of the international crude oil prices and exchange rates, accelerated the price increases especially in housing and transportation sectors under the CPI. Meanwhile, it is observed that oil prices and exchange rates have accelerated the rise in the PPI substantially with the contribution of the new

methodology that stipulates the inclusion of pre-tax prices in the indices. Fluctuations in agricultural sector prices eased in the first four months compared to the same period last year mostly due to the measurement and scope changes in the indices and this trend is expected to continue in the agricultural sector in the upcoming period. On the other hand, fluctuations in producer prices in the industrial sector may persist. At this point, it should be stated once more that the pass-through effect of the PPI to the CPI is weak in prices calculated according to the indices of base year 2003.

Outlook of the Factors Affecting Inflation:

16. The data issued during the last month has not affected outlook evaluations announced in the press release "March Inflation and Outlook". On the production side, developments in industrial production in the January-March 2005 period and the expectations for April indicate that the stable production trend is continuing. According to the SIS Monthly Industrial Production Index, industrial production increased by 8.2 percent in January-March 2005 period compared to the same period last year. When the manufacturing sector is analyzed by sub-sectors, it is observed that the slow-down in the increase in consumption demand continues, whereas demand for intermediate goods and investment goods support growth in production. As a matter of fact, in this period, imports of intermediary goods and investment goods have increased substantially. Taking into account the current production trend, the base effect created by the high production level recorded in the second quarter of 2004 is expected to be reflected on current figures as of April and annual growth rates for industrial production are expected to go down in the upcoming months, compared to the first quarter of 2005.

17. According to the data published by the SIS, the ratio of capacity utilization was realized at 77.6 percent in January-March 2005 period maintaining the level recorded in the same period last year. Despite the rapid rise in industrial production in the same period, no rapid movement was observed in the capacity utilization rates. This verifies the opinion that production capacity has expanded due to investment expenditures in 2004. Developments in prices and production in Q1 confirms the importance of investments in attaining recovery in economic activity without putting extra pressure on prices. Therefore, it is the right time to reiterate the importance of completing the structural arrangements for removing the bureaucratic hurdles, before production and direct capital inflow, impeding the way to investments.

18. The indicators for the first quarter of 2005 show that the rise in investment expenditures is continuing, albeit with a relative slow down. In the January-March period, machinery-equipment manufacturing increased by 6.3 percent compared to the same period of the previous year while year-on-year growth in imports of capital goods recorded a rise of 11.6 percent. Compared to the same period last year, domestic sales of light commercial vehicles increased by 4.8 percent in the first quarter of 2005. Meanwhile, investment expenditures maintained their high level. All these data suggest that private investment expenditures will become one of the primary determinants of growth in 2005 once again. Despite a relative slow-down, the tendency towards machinery-equipment investments, which was very high in 2004, also continues in 2005 and this supports the rise in productivity. Meanwhile, stable growth in construction investments in 2004 helps the establishment of new production units and fosters growth in supply potential. In other words, sustained growth in investment expenditures increases the potential production level and enables economic growth without generating inflationary pressure.

19. As for demand developments, the current data indicate that the relative slow-down in demand for consumer durables, especially for automobiles, is continuing. According to the data published by the Automotive Manufacturers Association, domestic auto sales in the January-March 2005 period declined by 25.9 percent compared to the same period of the previous year. As for the domestic sales of white goods in the January-March period, they increased by a mere 0.4 percent compared to the same period of the previous year. Besides, the developments in the sub-groups of industrial production also reveal that domestic demand is directed more towards investment goods and demand growth in consumption goods has been materializing in a controlled manner.

20. The growth rate of consumer credits had slowed down in 2004 due to the measures taken during that year in order to limit the acceleration of consumer credits and credit card claims. In the first four months of 2005, the slowdown in the annual growth rate of vehicle credits continued, while housing credits were observed to maintain their high growth rate. Meanwhile, 'other credits' sub-item of consumer credits increased significantly, due to the credits extended by the public banks in February 2005, against the claims of wage earners arising from their interest income. Paying credit card debts that have a higher interest rate cost by using some of these funds has favorably affected the financial standing of households. The effect of these developments on domestic demand and the course of credits should be closely monitored.

21. The general tendency of the consumer confidence indices points to a controlled increase in domestic demand. Besides, the ongoing decline in the weight of consumption goods in the composition of imports confirms the view that the relative drop in the growth rate of private consumption expenditures also continues in the first quarter of the year. The tax increase on certain items, called luxury consumption goods, will support this tendency.

22. In the light of this information, existing demand conditions are not believed to be at a level to exert pressure on prices in the short-run. Due to the facts that the rates of capacity utilization are not yet very high, the domestic demand manifests a modest increase, and the upward trend in investment expenditures continues, no demand-led pressure on prices is expected in the short-run. As a matter of fact, the forecasts demonstrate that in 2005, developments in production and demand will not be at a level that could jeopardize the disinflation process.

23. Developments in the productivity increase are becoming more important in order to sustain both the disinflation process and high growth performance concurrently. The possibility of acceleration in the coming period in employment growth signals a slowdown in the increase of labor force productivity. It is believed that the increase in investments will be directed toward new capacity formation rather than expanding the existing one, and this in turn is believed support employment growth. Meanwhile, taking into account the current situation of the labor market, the increase in unit labor costs is believed to be limited. It should be kept in mind that these forecasts are made with the assumption that the public incomes policy will continue to be consistent with the inflation target. In the light of this analysis, with the basic assumption that fiscal discipline is maintained and there is no marked delay in the structural reforms, in 2005, the increase in labor force productivity is expected to be in line with the increase in real wages.

24. Substantial fluctuations occurred in world raw material prices last year and input costs rose significantly. Although oil and basic metal prices eased during the recent period, there is a strong possibility that this trend might be reversed. The possibility that the volatility in international raw material markets may continue in the coming period poses a risk in terms of inflation in any case. At this point, two issues should be emphasized. Firstly, as long as an environment of confidence is maintained, temporary fluctuations in inflation will not distort the expectations and the main trend will still be downward. Secondly, as a result of the structural change in the pass-through effect of raw material prices and the foreign exchange

rate to inflation, the effect of fluctuations in global markets on inflation will be more limited compared to the previous periods.

25. Even though the determined policies implemented in the last four years and the prevailing structural adjustments enhanced the resistance of the economy, the level of long-term interest rates indicates the necessity of significant improvements in terms of price stability. Because one of the main indicators of confidence in the persistence of price stability is the level of return of the long-term government securities that were issued in terms of domestic currency. The decline in long-term interest rates is possible only by maintaining perpetual confidence in macroeconomic stability and economic policies, not by the artificial Central Bank cuts in short-term interest rates. Moreover, it is a fact that the current level of the Central Bank's interest rates is below those of the market. At this point, it should once again be emphasized that macroeconomic stability and structural adjustments are crucial in reaching price stability and sustainable growth path.

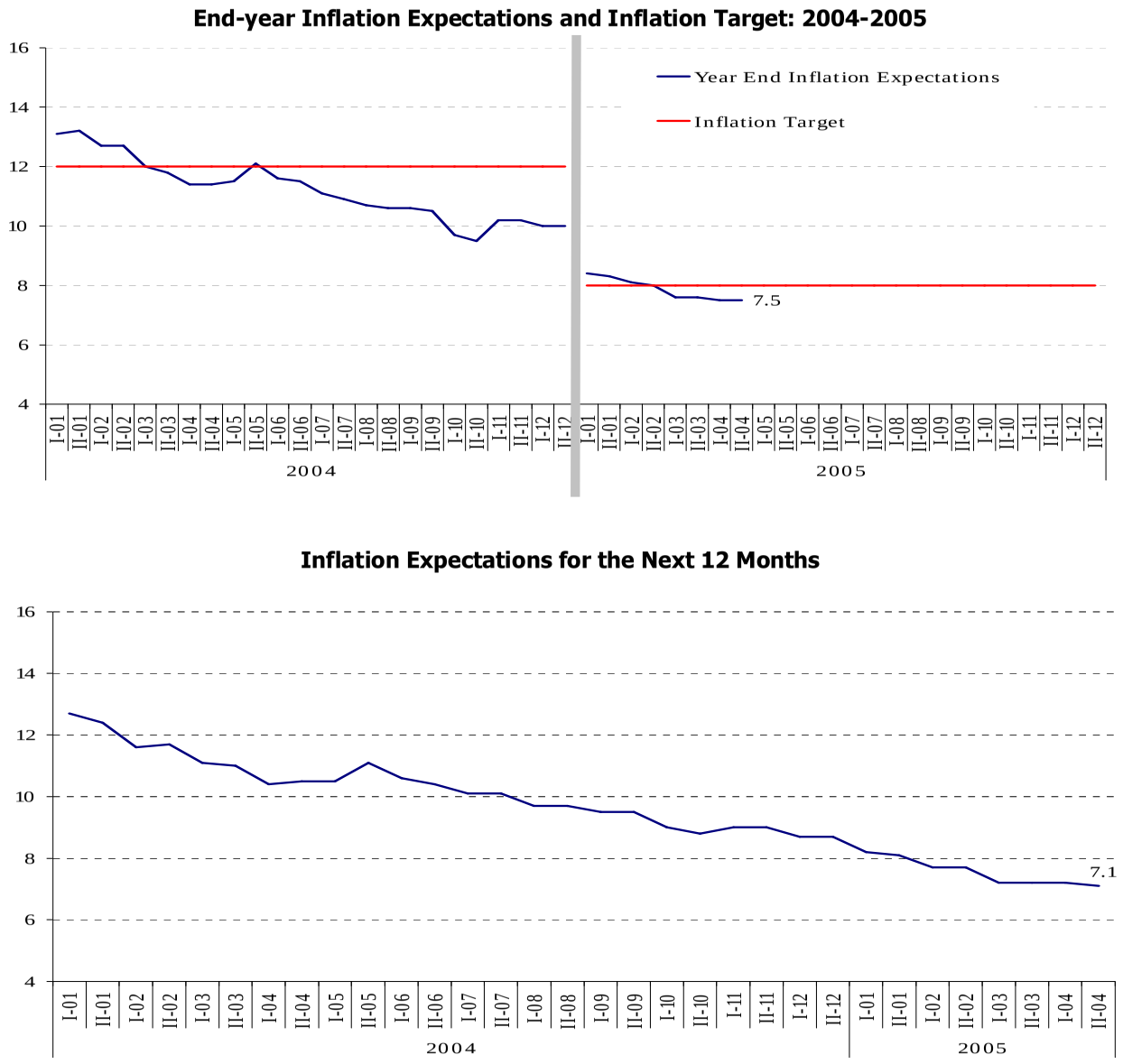
26. The risks created due to the possibility of reversal in international liquidity tendencies are still continuing. Meanwhile, developments related to the process of EU membership may lead to volatility in the markets in the coming periods. However, it should be kept in mind that the Central Bank operates with a medium-term point of view and is concerned with the general balance of the economy rather than short-term fluctuations. Moreover, as long as the fiscal discipline and structural reforms are carried on without concession, the influence of the mentioned shocks will remain as temporary shifts from the general tendency.

Monetary Policy

27. In summary, it is considered that the factors affecting the inflation outlook in 2005 are not a threat to the end-year target. Within the framework of the baseline scenario, in which fiscal discipline is sustained, structural reforms will not lose pace and the economy will not be exposed to any great exogenous shocks, 2005 inflation is not expected to exceed the target. It is also believed that recent developments in costs will continue to effect the inflation, however the inflation tendency, which excludes the exogenous factors, will be downward. In accordance with the above-mentioned analyses, which takes into account the evaluations made at the Monetary Policy Committee meeting held on May 9, 2005, the Central Bank decided to cut the short-term interest rates applicable to the CBRT Interbank Money Market and the Istanbul Stock Exchange Repo-Reverse Repo Market by 0.5 point to be effective as of May 10, 2005. While the Central Bank is maintaining its cautious and optimistic stance for the inflation, the necessity that the cautious stance should also be

sustained in the medium-term for the continuation of the decline in the inflation, is emphasized. In this framework, besides structural reforms, the course of unit costs, domestic demand, secondary effects of oil prices, and international liquidity conditions will be closely monitored in coming periods.

Figure 4: Inflation Expectations according to the CBRT Expectations Survey



Source: CBRT Expectations Survey