

August Inflation and Outlook

I. PRICE DEVELOPMENTS

1. According to the indices with base year 2003, the CPI increased by 0.85 percent and the PPI by 1.04 in August 2005. Annual inflation in the CPI and PPI became 7.91 percent and 4.32 percent, respectively (Graph 1).

2. The special CPI aggregate F which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices, and indirect taxes, dropped by 0.09 percent in monthly terms, while the G index, which is obtained by excluding unprocessed food from the F index, decreased by 0.03 percent (Table 1, Graph 2). The year-on-year rise in August for these indices became 6.74 percent and 7.47 percent, respectively (Graph 1).

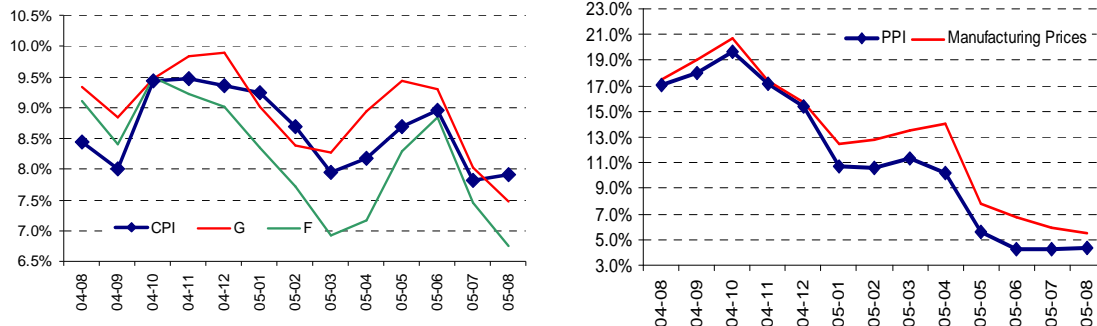
3. In August, agricultural prices decreased by 0.53 percent, whereas the PPI excluding agriculture (industrial prices) increased by 1.45 percent (Table 1).

Table 1: General CPI, PPI and Sub-groups

	2005 August	2004 Dec. - 2005 August	2004 Aug.- 2005 Aug.
CPI	0,85	2,87	7,91
Special CPI Aggregates			
A. CPI Excl. Seasonal Goods	1,57	6,08	9,55
B. CPI Excl. Unprocessed Food	1,02	4,11	8,64
C. CPI Excl. Energy	0,89	2,70	7,59
D. CPI Excl. Unprocessed Food and Energy	1,11	4,18	8,42
E. CPI Excl. Energy and Alcoholic Beverages	-0,08	1,58	6,66
F. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices an Indirect Taxes	-0,09	1,26	6,74
G. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices an Indirect Taxes and Unprocessed Food	-0,03	2,67	7,47
PPI	1,04	2,18	4,32
Agriculture	-0,53	-4,09	0,06
Industry	1,45	3,94	5,48
Mining	2,09	9,99	12,18
Manufacturing	1,48	3,72	5,48
Energy	0,73	5,45	3,58

Source: SIS, (2003=100)

Graph 1: Inflation (Annual Percentage Change)
CPI and Special CPI Aggregates (F and G) **PPI and Manufacturing Industry**



Source: SIS (2003=100)

Developments in Consumer Prices

4. The main determinant of CPI increases in August was the tax adjustments made in the prices of alcoholic beverages and tobacco products in July. The said adjustments had slightly affected the July inflation. The net contribution of price increases to the alcoholic beverages and tobacco group to the rise in the CPI in August was approximately 0.80 point. In addition, housing and transportation groups became the main groups that exerted upward pressure on August inflation. The decline in prices of the clothing and footwear group restrained the increase in inflation.

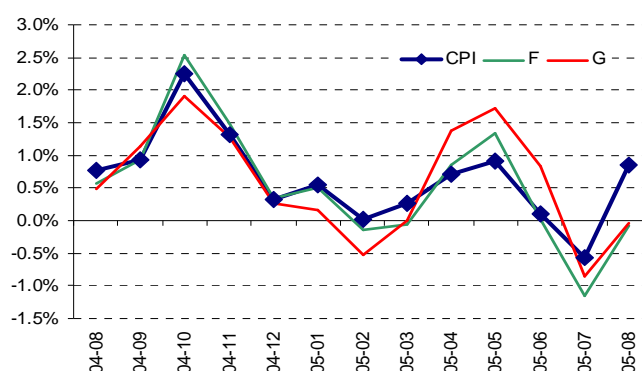
5. Prices in the housing group increased by 0.91 percent due to the 2.63 percent increase in rents and the rise in prices of petroleum products. It is considered that the increases in prices of white goods and electrical household devices resulted from the exchange rate.

6. The 1.42 percent increase in the transportation group stemmed from the increase in local transportation (shuttles and public buses) and intercity transportation fees. Cargo and shipment charges also rose during this period. Unless there is a reversal in

the upward trend in oil prices in the upcoming period, other adjustments likely to be made in transportation fees may display similar courses.

7. The prices in the clothing and footwear group decreased by 5.07 percent and became the main factor that brought down inflation in August. Clothing prices are likely to be at high rates in September, October and November due to the start of the fall–winter season.

Graph 2: CPI and Special CPI Aggregates (F and G)*(Monthly 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. The volatility of inflation in the clothing and footwear group substantially increased in 2005 compared to previous years. In this context, price changes were sharper in both directions. The aforementioned movements in clothing prices are also leading to fluctuations in monthly increases in the special CPI aggregates. (Graph 2).

9. In August, inflation in the food and non-alcoholic beverages group was % - 0.07. No significant movement is expected in this group in September. In October, however, food prices may increase due to the start of Ramadan.

10. Analyzing the special CPI Aggregates (SCA), annual increases in E, F and G aggregates decreased compared to the previous month and remained below CPI inflation. The fact that the inflation in these aggregates remained well below general CPI inflation points to the strong influence of petroleum and tobacco products on

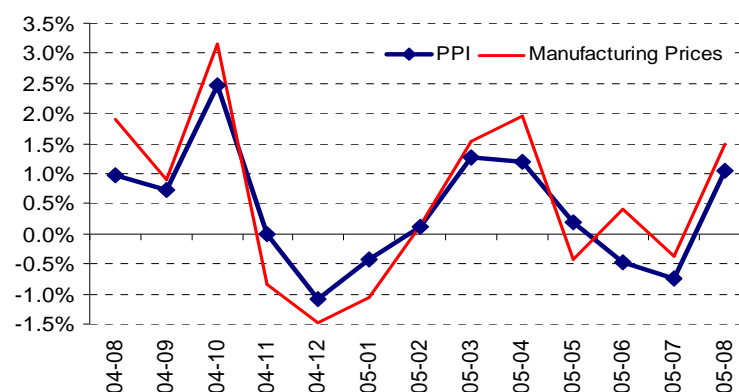
inflation. The main information provided by the SCA shows that the inflation trend is consistent with the end-year target of eight percent. (Table 1).

Developments in Producer Prices

11. In August, the downward trend in agricultural prices continued, albeit at a slower pace. Thus, the drop in agricultural prices in the June – August period became 6.25 percent. The rate of decline was 7.45 percent in the same period of the previous year.

12. The increase in the PPI index stemmed from the 1.48 percent rise in the manufacturing industry (Graph 3). Along with the price increases in coke and refined petroleum products, price increases in the manufacturing of tobacco and textile products also played a significant role in the increase in the manufacturing industry.

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



Source: SIS (2003=100)

13. The high rate of increase in the production of tobacco products is remarkable. It is understood that this increase mainly resulted from the reflection of the changes in the lump-sum tax on prices while calculating the indices of the said sub-sector. It is considered that as a result of the quotas applied to China, EU countries' demand for textile products have moved towards other countries including Turkey, and this affected the increase in production prices of textile products.

14. The general upward trend in prices of manufacturing industry in the last two months was not observed in August. On the other hand, prices increased in chemical

goods and plastic-rubber production, which use oil products as input. The increase in international oil prices is also considered to be influential in this development. Price increases in groups related to the manufacturing industry, such as electrical machinery and appliances production, were affected by the devaluation of the New Turkish lira in August 2005. As mentioned in previous reports, the manufacturing industry, and thus the PPI, is very susceptible to oil prices and exchange rates.

II. OUTLOOK

Inflation Developments

15. The main determinant of August 2005 inflation was the adjustment made in the special consumption tax of tobacco products. Undoubtedly, what matters most for monetary policy is the information value of these figures related to the future, rather than the inflation realizations. In August, even though annual inflation seems to be higher compared to July 2005, according to the prices that are adjusted excluding tax increases the annual inflation of August 2005 is lower than that of July 2005. In fact, in August 2005 the annual increase in special CPI aggregates calculated by excluding tax (F and G) has slowed down compared to the previous month.

16. As a result, price increases due to tax adjustments are only temporary and do not convey any information on the future trend of inflation. Thus, the influence of these increases on future inflation figures and expectations will remain rather limited. The CBRT makes a distinction between the temporary and permanent effects of shocks on inflation and does not respond unless these shocks affect the medium-long term inflation forecasts. Within this context, the tax shock of August 2005 sets an important example. If the effects of shocks are thought to be temporary and if it is considered that inflation will gradually come closer to the target in the medium term, such shocks will not be taken into consideration in monetary policy decisions, even if they threaten the short-term attainability of inflation target.

17. At this point it is crucial to properly analyze the temporary/permanent factors of the effects of oil price developments on inflation. As mentioned in the Inflation

and Outlook and Monetary Policy Report published last month, the main factor underlying the loss of pace in the disinflation process is the developments in oil prices. The primary effects of oil price increases on twelve-month cumulative inflation differ between 1 and 1,5 points. Moreover, the delayed primary effects are expected to appear in 2006. In other words, even if oil prices remain stable as of today, the effects of recent increases on 2006 inflation will be above a negligible level. At present, the fact that medium term expectations are not remarkably affected is a favorable development. Although the annual disinflation process has slowed down, expectations related to the next twelve months keep declining. Besides, the relative price effects are not yet observed in the pricing behaviors of the sectors that do not use oil as input. For these reasons, CBRT's reactions to the increases in oil prices have been minimal so far. However, it should be kept in mind that the necessary response will be made, if there is a deterioration in inflation expectations and pricing behaviors in the upcoming period.

18. Prices of the services group are one of the main factors that might pose a risk in terms of inflation in the future period. The disinflation process in the services group has had a tendency to stabilize since the last quarter of 2004. It is early to ascertain whether this decline is permanent or not, in spite of the downward trend in the sector in August. The increases in rents prices were realized above the indexation to past inflation. In August 2005, the rents sub-group displayed the highest increase in the last four years and became 2.63 percent. The increase in the said sub-group reached 13.1 percent in the first eight months of the year. This trend is not expected to turn downward in the short term. The increases in entertainment-culture and restaurant-hotel groups were realized above the general inflation trend in the first eight months of the year. Meanwhile, price increases in the goods group are predicted to be low due to ongoing increased productivity and openness and improved competitiveness. The increases in public prices and tax adjustments will be shaped by the developments in exchange rates, oil prices and fiscal discipline.

Outlook of the Factors Affecting Inflation

19. There is no doubt that the extent of the secondary effects of oil prices will largely depend on demand developments. Provided that the demand strengthens in

the upcoming period, prices can rise in those sectors, where petroleum products are used as input, in order to compensate the narrowing margins. Moreover, in case the demand is strong enough, price increases can also be observed in the sectors, where petroleum products are not used as input, as a result of the relative price effect. In this context, the trend to be displayed by demand conditions in the upcoming period is influential.

20. Credit developments stand out as important data on economic activity and domestic demand. In August 2005, high annual rates of increase continued in consumer credits and individual credit cards, whereas in housing credits, monthly rates of increase slowed down. Individual credit card liabilities decreased on a monthly basis, while vehicle credits maintained a stable trend. The business tendency survey indicates that the rise in domestic sales occurred in a controlled manner as of July. Although automobile and white goods sales declined in July 2005 compared to the previous year, production in these sectors maintains high levels owing to foreign demand. Nevertheless, surveys and the latest realizations point out that the increase in foreign demand also slowed down relatively. Meanwhile, consumer confidence indices and capacity utilization ratios are at lower levels compared to the previous year. Housing and new office investments display a significant rise, in spite of the slowdown in machinery-equipment investments. To sum up, although the developments in production, capacity and domestic demand were insufficient to change the outlook of the previous month, they strengthened the perceptions that total demand developments will occur in a controlled manner.

21. In the second quarter of 2005, the rise in national income is expected to be low compared to the first quarter. However, it is predicted that the growth rate will converge to program projections from the third quarter on, thus, economic growth will be in line with the level expected in the program throughout 2005. As foreseen in the previous Inflation and Outlook Reports, employment increased due to the fact that investments promoted new employment areas in 2005. These developments increase the pressure on unit labor costs and may pose a risk to inflation due to their deferred effect on domestic demand. Nevertheless, in light of the above-mentioned developments, especially the fact that the deferred demand on durables is largely met, domestic demand is expected to occur in a controlled manner throughout 2005.

Moreover, it is predicted that the employment supply will grow rapidly due to the increasing participation in employment and rapid population growth and that this development will continue to limit unit labor costs in the overall economy. There is no doubt that the contribution made by unit labor costs to the downward trend of inflation will be less compared to previous years. In this context, it is crucial that the incomes policy of the public sector, which is a factor that directly affects pricing behaviors, is conducted in consistency with the inflation target.

22. It is believed that the effect of the rise in civil service salaries for 2006 disclosed last month would remain limited if the extra burden to be imposed on the budget is compensated. Meanwhile, for the sake of keeping the quality of fiscal discipline as well as the indirect effects under control, it is very important to compensate this extra burden by expenditure-dampening policies instead of making public price adjustments and tax increments.

23. At this point, it should be highlighted that the Central Bank, which has a medium-term perspective, will certainly attach greater importance to the medium-term outlook of fiscal policy. As the formal inflation targeting strategy will be adopted in the upcoming period, the medium-term perspective needs to be more clearly manifested. Within this framework, a three-year budget system and a centralized budget implementation will be put into practice as of fiscal year 2006, and thus, a more transparent, accountable and predictable budget policy will be achieved. All these implementations will be closely monitored, as they will play important roles in making the medium-term perspective more prevalent. The framework in question would also contribute to enhancing the quality of fiscal discipline.

24. There has recently been a recovery in producer prices, excluding agriculture. It is expected that this recovery would continue in September and further accelerate with the effect of the rise in the prices of petroleum products and natural gas. In case the rise in the prices of oil and natural gas continues, the rapid increase in producer prices index might continue as well. As the effects of these developments have been until now only partially been reflected on electricity prices, the pressure exerted by input prices on inflation has remained limited. A prospective rise in

electricity prices in the upcoming period might pose risk to the medium-term inflation trend.

25. Lastly, any fluctuations in international liquidity conditions and news from the EU about Turkey's accession still apply as risk factors with respect to inflation. However, it should be kept in mind that Turkey has undergone similar processes many times in the past four years and such unfavorable impacts have been short-lived thanks to the economic stability and confidence established by the economic program. All these factors point to the fact that giant steps have been taken towards long-lasting economic stability. We believe that, provided that the current economic program is maintained, the effects of any unfavorable developments would remain limited and the main trends would be determined by economic fundamentals. Undoubtedly, ensuring full-fledged macroeconomic stability, achieving sustainable development and attaining lasting price stability would be possible only if the structural reforms are carried out with the same degree of determination.

Conclusion

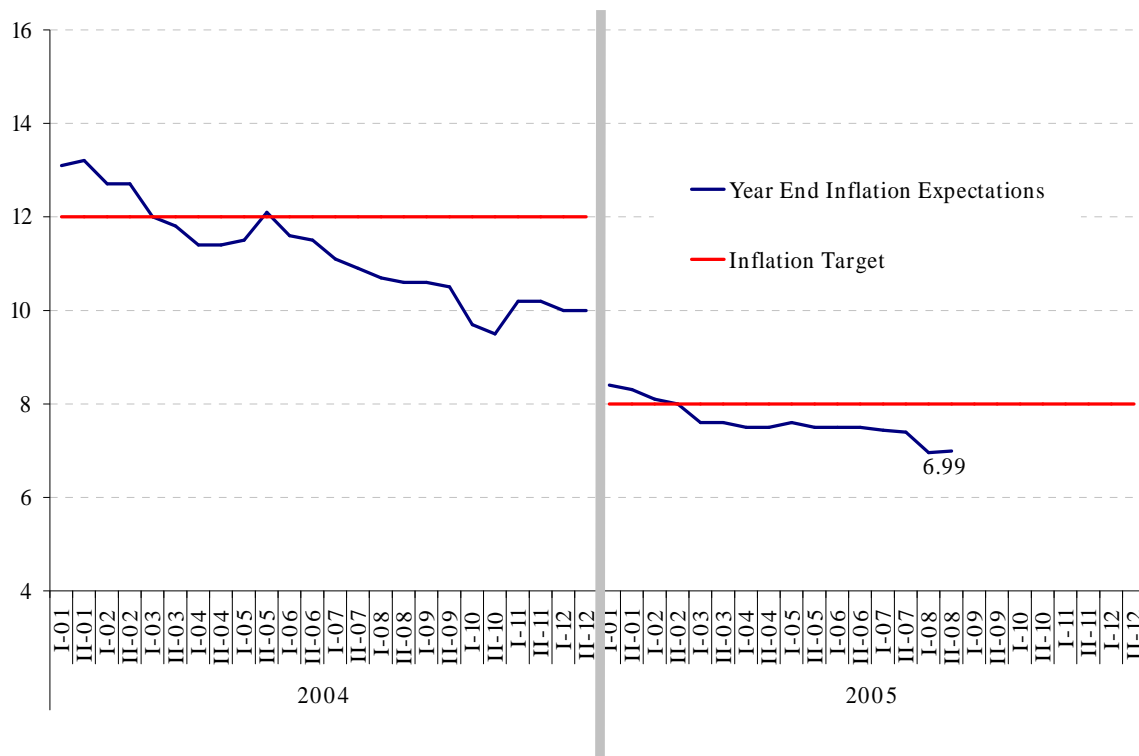
26. Within the framework of the main scenario, in which there is no halt in fiscal discipline and no external shocks and providing oil prices do not shift much above current prices, it is projected that annual inflation will move downwards as of the end of the last quarter and reach the end-year target. However, as has been reiterated before, the period, during which the inflation figures for 2005 were taken into account, is now over. Any decisions made as of today should be considered within the context of 2006. The factors that urged the Central Bank to be more cautious about the inflation target for 2006 in the last two months have been the rigidity in services inflation, uncertainty in demand indicators, rapid credit rise and worries about the secondary effects of the rise in oil prices. While the recent data on demand indicate that the total rise in demand will remain controlled, other developments will be closely monitored.

27. In light of the above evaluations that take account of the views put forward at the Monetary Policy Committee meeting dated September 8, 2005, it has been decided to maintain the level of short-term interest rates applied at the CBRT Interbank Money Market and the Istanbul Stock Exchange Repo-Reverse Repo

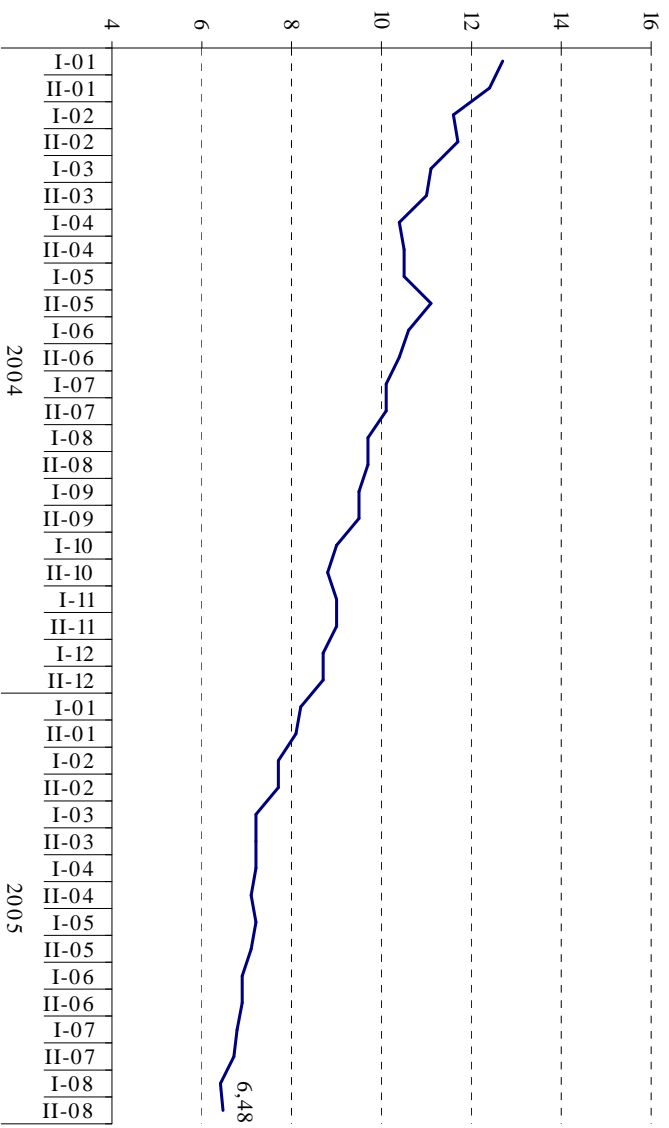
Market. With current available data, it can be asserted that short-term interest rates will most probably move downwards in the upcoming period. Clearly, any new data that would affect the future trend of inflation and any risks that may emerge would necessitate the revision of this position.

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