

June Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with the base year 2003, while the CPI rose by 0.10 percent, the PPI declined by 0.48 percent in June 2005. The annual rates of increase of the indices were 8.95 percent and 4.25 percent, respectively.

2. The special CPI aggregate (F), which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes, increased by 0.03 percent in June 2005. Meanwhile, another special CPI aggregate (G), which is obtained by excluding unprocessed food from (F), increased by 0.84 percent the same month (Table 1). The annual rates of increase in these aggregates were recorded as 8.84 percent and 9.30 percent, respectively (Figure 1). Meanwhile, the rate of monthly increase of the index obtained by excluding seasonal goods, (A), became 0.78 percent and the annual rate of increase was realized as 9.50 percent.

3. In June 2005, agriculture prices dropped by 3.37 percent, whereas the PPI excluding agriculture (industrial sector) rose by 0.34 (Figure 1).

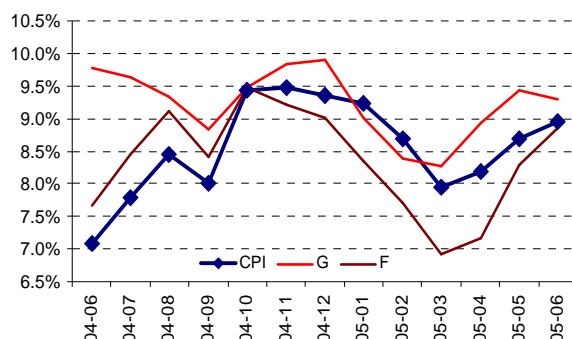
Table 1: General CPI, PPI and Sub-groups

	2005 June	2004 Dec- 2005 June	2004 June- 2005 June
CPI	0.10	2.59	8.95
Special CPI Aggregates			
A. CPI Excl. Seasonal Goods	0.78	3.95	9.50
B. CPI Excl. Unprocessed Food	0.68	3.33	9.34
C. CPI Excl. Energy	0.04	2.63	8.40
D. CPI Excl. Unprocessed Food and Energy	0.73	3.54	8.76
E. CPI Excl. Energy and Alcoholic Beverages	0.04	2.65	8.72
F. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes	0.03	2.54	8.84
G. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food	0.84	3.59	9.30
PPI	-0.48	1.89	4.25
Agriculture	-3.37	-1.14	-3.30
Industry	0.34	2.75	6.50
Mining	-2.26	4.72	7.58
Manufacturing	0.42	2.57	6.70
Energy	-0.03	4.68	3.29

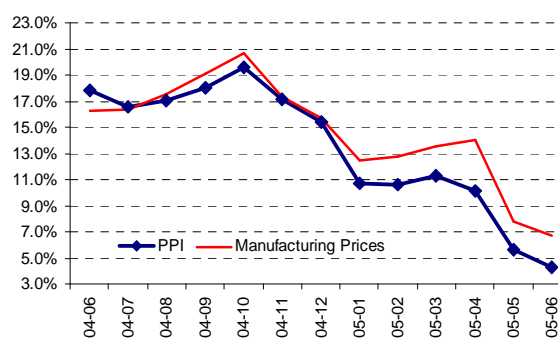
Source: SIS, (2003=100)

Figure 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. Price developments in the entertainment-culture sector and the education sector along with the direct and indirect impacts of the increase in petroleum prices affected the CPI inflation in June. The 1.63 percent decline in the prices of food and non-alcoholic beverages was the main factor that led to low monthly inflation.

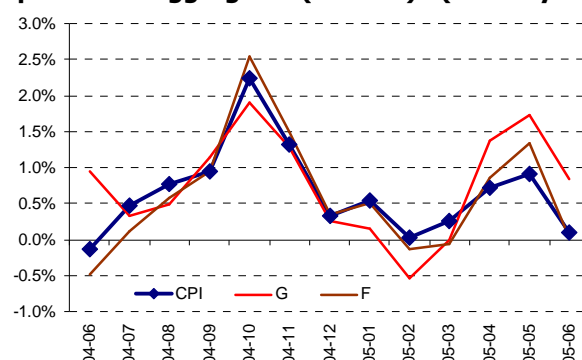
5. In June, the sub-item index of the entertainment-culture group rose by 4.01 percent. The cumulative increase in this item in the first six months of 2005 was recorded as 8 percent and the annual increase as 9.57 percent. The price developments in the said sub-items were mostly shaped by the developments in the prices of domestic and foreign tour services and entertainment-culture instruments, which include technology-intensive durable goods. These price developments, along with the seasonal price adjustments, point to an obvious revival in the demand for tour services. Price increases in this group are also being closely monitored in relation to the secondary effects of oil prices. In the meantime, the relatively high increases that were observed in the prices of entertainment-cultural instruments, despite stable exchange rate for the last two months, are considered to have resulted from demand conditions.

6. The 3.24 percent monthly (20.34 percent annually) increase in the education sector is above the expectations for the month of June. However, while in the past registration for primary and secondary schools started in the second half of August, this year they started in June due to a decision taken by the Ministry of Education. This led to early price adjustments in the education sector. Despite the fact that adjustments made in the prices of private

primary and high schools (6.94 percent and 7.98 percent) were in line with the 2005 end year target, the sharp rise in annual increases mainly stemmed from the change in registration dates. A decline in the annual rates of this group is expected as of August 2005.

7. In the meantime, another factor that pushed up the CPI inflation in June was the increase in oil prices. The direct (petroleum, LPG, diesel oil) and indirect (prices of plane and bus tickets) effects of price increase in petroleum give rise to the monthly price increase of 0.71 percent in the transportation group. In the housing group, price increases of natural gas and heating oil items were remarkable. The direct effects of the increase in the prices of oil products, effective as of June, on housing and transportation prices are expected to be observed mostly in July. Meanwhile, the high rate of increase in rents, one of the sub items of the housing group, is expected to continue in the coming months.

Figure 2: CPI and Special CPI Aggregates (F and G)* (Monthly Percentage Change)



*F: CPI excluding energy, alcoholic drinks, tobacco, other publicly administered prices and indirect tax

G: CPI excluding energy, alcoholic drinks, tobacco, other publicly administered prices, unprocessed food and indirect tax

Source: SIS (2003=100)

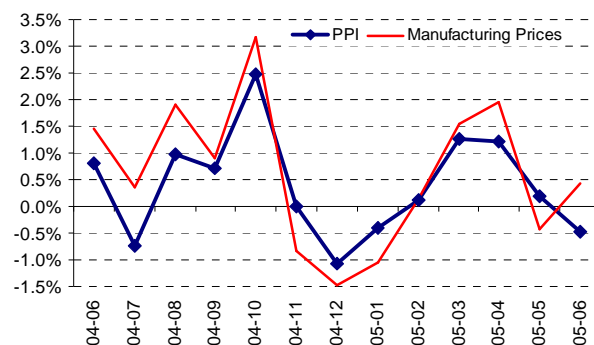
Developments in Producer Prices

8. In June, agriculture prices dropped by 3.37 percent and became the determinant of the decline in the PPI. This decline in agriculture prices is higher than those realized in the same periods of the last two years, on the basis of the new index. Apart from the seasonal characteristics of June, Russia's partial ban on imports of Turkish products, mainly fruits and vegetables, affected this decline. On the other hand, with the partial lift of the ban at the end of the month, this additional decline effect is anticipated to be temporary.

9. There was a 0.34 percent increase in industrial sector prices. In this context, the fact that the increase in manufacturing industry prices remained limited (0.42 percent), despite the high rates of increase (9.27 percent) in the prices of coke and refined petroleum products, is notable. At this point, the decline in the prices of sub-items that constitute the manufacturing industry should be underlined.

10. In the manufacturing industry, the decline in the prices of clothing, textile products and leather products manufacturing is favorable in terms of the future course of clothing group prices. Besides, it is considered that the decrease in prices of the primary metal industry and chemical products manufacturing will help the decline in the prices in the sectors that utilize these materials as input. However, it should be borne in mind that the PPI will mainly be shaped by crude oil prices and international raw material prices, coupled with the course of exchange rates, in the coming period.

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



Source: SIS (2003=100)

11. The increase in natural gas prices at the end of June shows that the developments in crude oil prices are starting to be reflected on other energy group prices. Moreover, the high course of crude oil prices in the coming period might lead to adjustments in electricity prices. Within this context, similar to the first half of the year, the rate of increase in energy group prices is also predicted to be above the rate of increase in the prices of other PPI sub-items in the second half of the year.

II. OUTLOOK

Developments in Inflation

12. In the first six months of the year, cumulative inflation was realized as 2.59 percent. This figure points to a positive outlook for the achievability of the end-year inflation target. However, the fact that this rate is merely 0.37 point below the cumulative inflation in the same period of the previous year points to a possibility of slowdown in the disinflation process. Meanwhile, the 2.59 percent cumulative increase does not provide accurate information about the general inflation trend since it has not been seasonally adjusted. For example, although it is not the equivalent of seasonal adjustment, the special CPI aggregate that excludes seasonal products (A) shows that cumulative inflation became 3.95 percent in the first six months of the year. In other words, it would be misleading to draw the conclusion that the inflation trend is well below the target level and will be much below the end-year inflation target by merely taking into account the limited increase of the first six months. Nevertheless, even if temporary effects are excluded from current data, it is still very likely that end-year inflation will remain below the target.

13. Nevertheless, it should be borne in mind that the information the data contains with respect to future inflation, rather than the actual data itself, is essential for the Central Bank. Rigidity in the services sector prices continued in the first half of the year. The services sector is a significant criterion for future inflation. Although price increases in the services sector that are above the general inflation trend are attributed to structural factors, it is obvious that the trend in the said sector does not present an outlook that is consistent with the 2006 inflation target. As of June 2005, year-on-year price increases in subgroups with services items such as education, restaurant-hotels, and recreation-culture were realized above the general inflation trend. Developments in the subgroups indicate that demand factors are as influential on the rigidity in services sector inflation as previous pricing habits and structural factors are. It is rather early to jump to conclusions about this matter. However, the specified developments should be carefully monitored and treated with caution.

14. It is estimated that annual inflation will follow a downward course in the upcoming months. Developments in oil prices could undoubtedly lead to a delay in the likely downward course. However, significant developments with respect to monetary policy cover a better medium-term perspective that extends to a time span exceeding a year, rather than a few months. The upward trend in annual inflation and a major part of the special CPI aggregates

points to the necessity of adopting a cautious stance in order to achieve the 2006 inflation target. Analyzing by developments in the special CPI aggregates, it is seen that the aggregates are above the end-year target as of June 2005 and have been following a volatile course for a while. Although this observation does not signify an increasing inflation trend, it signals the likelihood that the disinflation process may have significantly lost pace.

15. At this point, it should once again be emphasized that the word 'inflation' as used by the Central Bank essentially refers to the increase in the consumer price index. In other words, the Producer Price Index (PPI) is not the target. In the context of establishing a common language with the public, it is considered useful to reiterate this fact. The record-low level of producer price increases is undoubtedly a favorable development in terms of costs. However, it should not be forgotten that with the introduction of indices with the base year 2003, the PPI has become extremely sensitive to the developments in world raw material prices and exchange rate, whereas the information it contains about future inflation has become limited.

Factors Affecting Inflation

16. The above-mentioned conclusions regarding inflation figures show that the analysis of new data has become essential in order to predict the future inflation trend. The most important data released since the announcement of the inflation and outlook report last month are those concerning Gross National Product (GNP) developments in the first quarter of 2005.

17. According to GNP data for the first quarter of 2005, the rate of increase in economic activity and demand decelerated compared to the first half of 2004. However, the growth process continued. In this period, the consumption of semi-durable and non-durable goods and investments in the construction sector became the expenditure groups that were outstanding in terms of annual growth. Particularly the investment-oriented positive contribution of public expenditures to growth points to a change in the composition of domestic demand.

18. In the first half of last year, high increases were observed in domestic demand due to stimulated deferred investment and consumption demands. The base effect created by this development played a significant role in the decrease of the annual growth figures in the first quarter of 2005. The said effect will be more evident in the second quarter of 2005. Hence, even though the recovery in economic activity continues in the second quarter of the year,

lower annual growth figures will not come as a surprise due to the above-mentioned base effect.

19. It would be more appropriate to use seasonally adjusted figures in the evaluation of GNP data in order to be able to reach meaningful conclusions. Analyzing by seasonally adjusted values of private consumption expenditures, economic activity sharply decreased in the third quarter of 2004, followed by a marked recovery in the successive two quarters. In particular, it is a general misconception that demand for durable consumption goods decreased in the first quarter of the year. Seasonally adjusted data indicate that the demand for durable consumption goods rose significantly in the first quarter of the year compared to the previous quarter. Furthermore, the leading indicators show that this trend also continues in the second quarter. It is anticipated that, as the high base effect observed in the first half of the previous year disappears in the third quarter of 2005, annual growth rates will exceed program projections in the last two quarters of 2005 and overall growth will be close to those projections.

20. To sum up, GNP figures pertaining to the first quarter of the year do not point to stagnation in economic activity. On the contrary, the revival of demand is expected to continue in the second half of the year due to the decline in real interest rates in the first half of the year. Considering the current trend and the inflation target for 2006, close monitoring of domestic demand developments and a prudent approach to medium-term targets are gaining importance.

21. The evaluations made above of the importance of adjusting data for seasonality are also valid for the data pertaining to investments. The development, which stands out in the analysis of investment data, is the low annual rate of increase in machinery-equipment investments made by the private sector. It will not be surprising if machinery-equipment investments made by the private sector turns out to decline on an annual basis, in the second quarter of the year. Thus, the production of machinery-equipment, which decreased on an annual basis in April as well as in March, indicates that the base effect mentioned above became stronger in the second quarter of the year. However, the seasonally adjusted figures show that the production of machinery-equipment increased in the first quarter of the year compared to the previous quarter. This trend is anticipated to continue in the second quarter of the year. Moreover, the rapid rise in construction investments underpins the rise in total fixed capital investments. As long as construction investments focus on industrial buildings, they will increase the production capacity of the economy and create new employment opportunities. When the data pertaining to construction permits are analyzed

according to their utilization purpose, it is seen that industrial construction permits displayed a high rate of increase in the last quarter of 2004 compared to the same period of the previous year. This development points to the establishment of new production units and provides positive signals for economic activity in the upcoming period.

22. Meanwhile, the upward trend in total employment continues in the first quarter of 2005. The effects of this development on real wages in the overall economy cannot be analyzed properly due to the lack of data. According to the data pertaining to the private manufacturing industry, the employment index for this sector increased by 2.7 percent in the first quarter of 2005 compared to the same period of the previous year. Moreover, real wages per hour and productivity in the private manufacturing industry rose by 3.9 and 6.4 percent, respectively, in the same period. In this context, real unit wages of the private manufacturing industry decreased in the first quarter of 2005 compared to the same period of the previous year due to the fact that the increases in productivity were realized above those of real wages. The analysis of real unit wages with respect to the sub-sectors indicates that sectors excluding leather products and clothing did not display significant increases. Therefore, as of the first quarter of 2005, it is observed that the developments in unit wages of the manufacturing industry continue to affect inflation favorably. Overall, in 2005, unit labor costs in this sector are expected to maintain their low levels. However, at present, unit labor costs and total disposable income for the economy in general are more important than the developments in unit wages of the manufacturing industry. Accordingly, taking also into account the recent increase in employment, the necessity of being prudent within a medium term perspective manifests itself.

23. Credit developments provide important clues about domestic demand. Although the slowdown in the annual rate of increase in vehicle credits persisted in the first half of 2005, the increase still continues on a monthly basis. Meanwhile, housing credits retain their high rates of growth. In the first half of 2005, the downward trend in real interest rates is expected to underpin the upward trend of credits in the upcoming period. The Central Bank closely monitors the said developments with respect to both domestic demand and financial stability.

24. Indicators for foreign demand display a stable trend. While the share of consumption goods in the composition of imports continues to decline, the strong level of the share of imports of intermediary goods shows that the rise in production is significantly supported by foreign demand. As a consequence of global economic growth, the rapid rise in import prices persists. At the same time, the unpredictable fluctuations in oil prices present a risk factor for

inflation in all periods. Oil prices rank first among the factors, which started to affect our economy as of the second half of 2004 and halted the downward trend in inflation. The recent increases observed in crude oil prices are expected to manifest their effects on the July inflation figures. There is no doubt that external shocks such as oil price developments will have a limited effect on inflation in the medium term as long as such shocks do not continue for long periods. However, medium and long-term inflation expectations may deteriorate, should these shocks persist for a long time. It should be kept in mind that in the event of this happening, the Central Bank would take the necessary measures.

25. Meanwhile, the relatively stable course of imported input costs excluding oil, slightly curbs further pressure on the inflation exerted by oil prices and presents a favorable outlook for the end-year inflation target. In addition, reflections of this favorable outlook are observed in producer prices. However, when the end-2006 inflation target of 5 percent is taken into account with a medium-term perspective, it is obvious that the current inflation trend is not enough and this target can only be achieved if domestic demand is controlled.

26. Lastly, it seems as though international liquidity conditions will probably continue to in favor developing countries for a while. However, the balances we are referring to are prone to rapid change and any projections based on the assumption that the current conditions will be permanent would be very risky. Therefore, it is very important to reinforce the resistance of the economy against such shocks, in other words ensuring sustained activity in structural reforms.

27. The Central Bank will continue to play its part in ensuring that the achievements in the fight against inflation recorded so far will not reverse. It is clear that one of the prerequisites of maintaining these achievements is continued fiscal discipline. The fact that budget and income policies of the public sector are implemented in line with the targets has been the major reason behind the consistency of inflation expectations and inflation targets in the last years. It is a fact that single-digit inflation figures have been achieved, however it is also a fact that price stability has not yet been established. Attaining price stability would only be possible provided that steadfast implementation of economic program is sustained, no concessions are made about fiscal discipline and the structural reforms that will secure the quality of the fiscal discipline in the long run are continued.

28. Another important point worth mentioning is that the significant contribution made by the recovery phase of the economic crisis to economic growth started to come to an end towards the end of 2004. This should not be misinterpreted as stagnation, on the contrary, it should be perceived as the economy converging to its potential growth rate. It should be

kept in mind that the short and medium-term target of macroeconomic policies is to keep the level of economic growth close to the potential growth rates. Meanwhile, as is repeated in the presentations prepared by the Central Bank on sustainable growth, long-term policies should be focused on expanding this potential. Therefore, the structural reforms of social security, financial institutions and tax structure, which have been on the agenda lately, would help decrease the inefficiencies in the economy and contribute to social welfare by increasing the potential growth rate of the economy. Evidently, not only passing the laws themselves but also the resolute implementation and institutionalization of these reforms are critically important in this respect.

29. There is one last point to be reiterated. The Turkish economy has undergone a drastic transformation in the last few years and giant leaps have been taken towards “normalization” process. Successful implementation of the economic program has led to a remarkable trend of continuous decline in the share of public debt to national income and thus various economic dynamics stemming from “sustainability” concerns have become less important. This transformation has helped the effects of monetary policy to occur via channels that are more familiar and comprehensible to the public. The successful economic program, which changed the transmission mechanism significantly, has also reinforced the economy’s resistance to external shocks and brought about the ability to think with a “medium-term perspective”. In fact, once the Central Bank was convinced that the normalization process of the economy was getting stronger (please refer to the announcement “Monetary and Exchange Rate Policy for 2005” dated December 20, 2004), Central Bank started to draw attention to medium-term trends and attach greater importance to factors affecting the medium-term inflation outlook such as employment, productivity and demand developments while making monetary policy decisions.

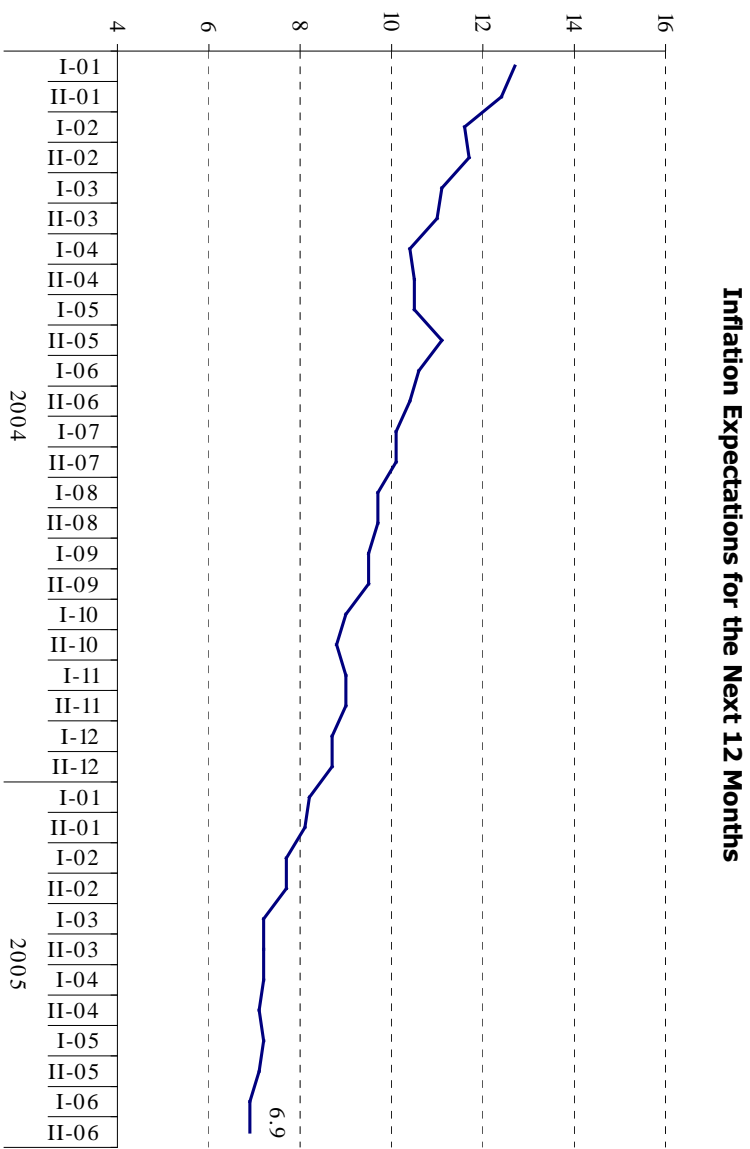
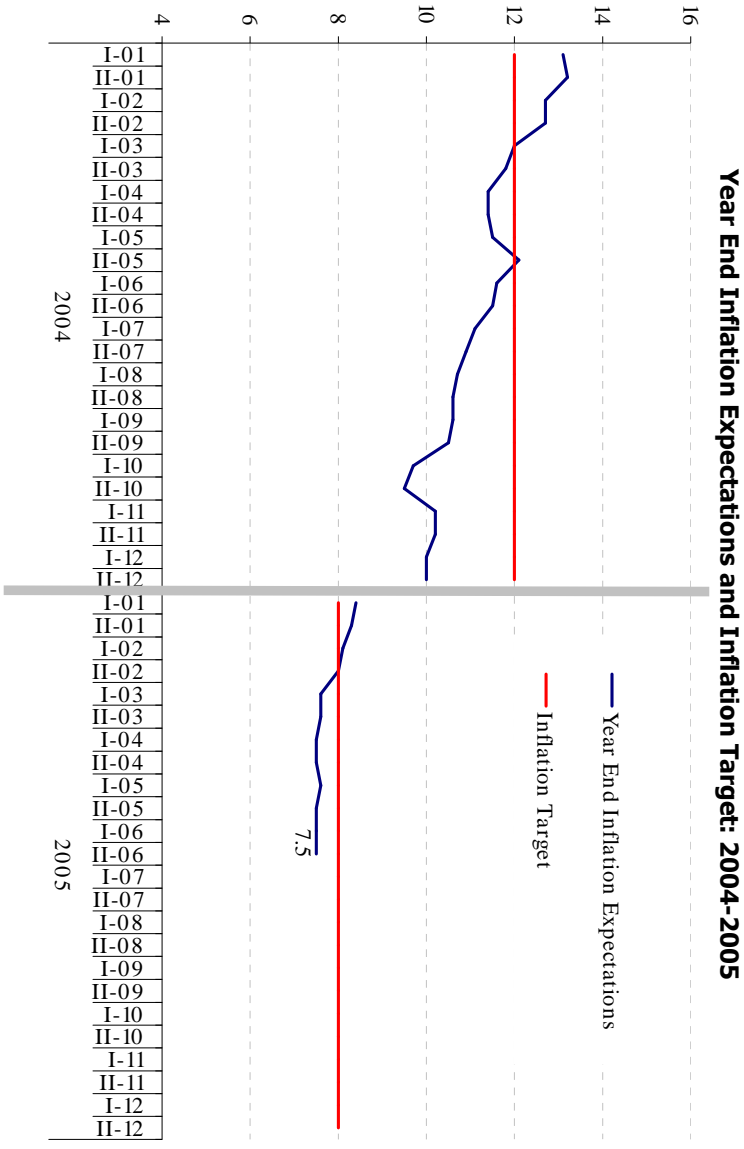
Conclusion

30. Within the framework of the main scenario in which fiscal discipline is sustained, structural reforms are continued at this pace, oil prices follow a reasonable course, and the economy is not exposed to any significant exogenous shocks, it is foreseen that the annual inflation rate will start a downward trend, again, in the upcoming months and end-year figures will be consistent with the target. In fact, taking into account the lagged effects, the importance of projections pertaining to 2005 targets is becoming less significant in monetary policy decisions, whereas those pertaining to 2006 are becoming more significant. As a matter of fact, the Central Bank has specifically underlined the risks in the medium term and clearly emphasized the importance of being cautious in the medium term in the last two

“Inflation and Outlook” reports. In light of the data released throughout the last month, our concerns about the downward inflation trend continue in a way to lead us think that demand has started to recover and the acceleration in the downward trend in inflation has slowed down.

31. To conclude, in light of the above evaluations, which also take into account the opinions presented at the Monetary Policy Committee meeting dated July 8, 2005, it has been decided to keep the level of the short-term interest rates applied on the CBRT Interbank Money Market and the Istanbul Stock Exchange Repo-Reverse Repo Market unchanged. With currently available data, it can be asserted that the likelihood of short-term interest rates following a downward trend in the upcoming months is lower compared to the previous period. Undoubtedly, any new data that involve information about the medium-term trend of inflation and any signal about the future would necessitate the revision of these projections and will be taken into account while making monetary policy decisions.

Figure 4: Inflation Expectations according to the CBRT Expectations Survey



Source: CBRT Expectations Survey