

September Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with base year 2003, the CPI increased by 1.02 percent and the PPI by 0.78 in September 2005. Annual inflation in the CPI and PPI became 7.99 percent and 4.38 percent, respectively (Graph 1).

2. In September, the special CPI aggregate F, which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices, and indirect taxes, increased in monthly terms by 0.92 percent, while the G index, obtained by excluding unprocessed food from the F index, displayed a 0.57 percent-increase (Table 1, Graph 2). The year-on-year rise in September for these indices became 6.73 percent and 6.86 percent, respectively (Graph 1).

3. In September, agricultural prices increased by 1.53 percent, whereas the PPI excluding agriculture (industrial prices) rose by 0.58 percent (Table 1).

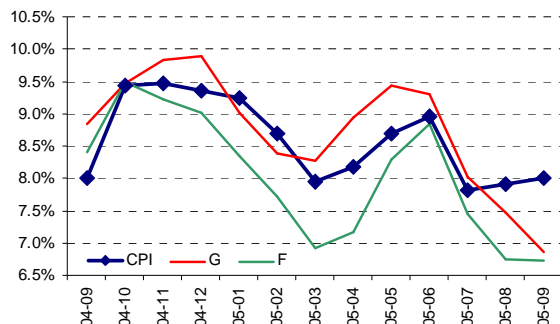
Table 1: General CPI, PPI and Sub-groups

	2005 September	2004 Dec - 2005 Sep	2004 Sep- 2005 Sep
CPI	1.02	3.93	7.99
Special CPI Aggregates			
A. CPI Excl. Seasonal Goods	0.68	6.81	9.10
B. CPI Excl. Unprocessed Food	0.82	4.96	8.39
C. CPI Excl. Energy	0.82	3.54	7.43
D. CPI Excl. Unprocessed Food and Energy	0.52	4.72	7.79
E. CPI Excl. Energy and Alcoholic Beverages	0.89	2.48	6.55
F. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes	0.92	2.20	6.73
G. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food	0.57	3.26	6.86
PPI	0.78	2.98	4.38
Agriculture	1.53	-2.62	1.58
Industry	0.58	4.55	5.14
Mining	3.10	13.40	11.82
Manufacturing	1.54	5.32	6.15
Energy	-14.34	-9.68	-11.53

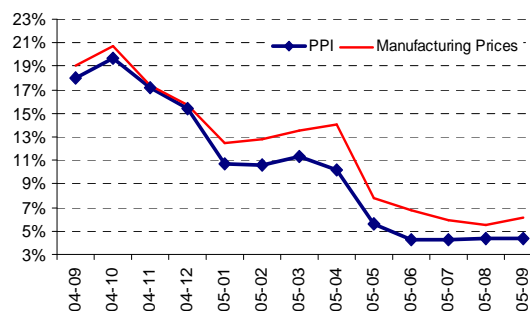
Source: SIS (2003=100)

Graph 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 main determinants of the CPI increase in September are (i) developments in the prices of food and non-alcoholic beverages, (ii) high increases in housing and transportation groups, (iii) price increases in restaurant and hotel groups and (iv) the rise in prices of education services. The decline in the prices of household equipment, and entertainment and culture groups restrained the increase in the CPI.

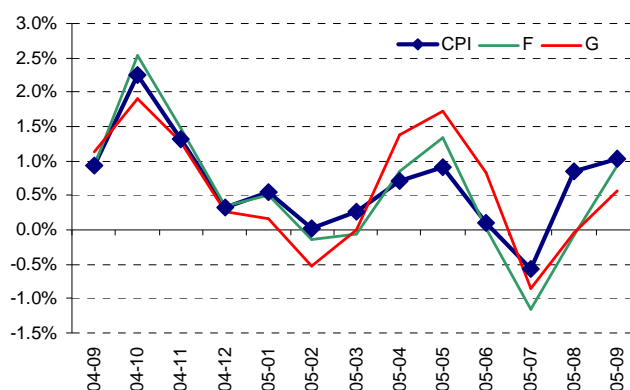
5. The monthly price increase in food and non-alcoholic beverages group is 1.34 percent. Two factors may help explain the high increase in this group. The first one is the seasonal increase in prices of fresh vegetables. The second factor is that some of the price adjustments to be made for Ramadan, which starts in October, were already implemented in September. The actual effect of Ramadan on food prices is predicted to be reflected in October inflation.

6. High monthly price increases continue in the housing group. This rise stems from both the seasonal increases in rents and the increase in prices of petroleum products.

7. Similar to the housing group, the 1.76 percent-increase observed in prices of the transportation group was also derived from the rise in the prices of petroleum

products. The main determinants in this group were especially the high price increases in bus transportation to schools in big cities.

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



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

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

Source: SIS (2003=100)

8. The rise in university fees was the determining factor in the education group. The adjustment made to dormitory prices contributed to price increases in the restaurant and hotel groups. Furthermore, significant adjustments are expected to the prices of restaurant services throughout Ramadan.

9. The 1.40 percent-decline in the prices of the household goods group resulted especially from the decrease in prices of durable household goods. The decline in the entertainment and culture groups mainly stemmed from the fall in tour prices. Although prices of the said groups are expected to drop in October as well, small increases are likely to occur afterwards.

10. New price indices and changing pricing behavior make it difficult to predict the seasonal effects on clothing prices. The price increases of the fall-winter season that were observed during September and October in previous periods are likely to concentrate around October 2005, as in the previous year. In this context, it will not be surprising if there is a high increase in the clothing group in October.

11. Special CPI Aggregates A and B displayed a higher annual increase compared to the CPI, whereas annual increases of other special aggregates remained below

CPI inflation. The main information provided by the special CPI aggregates shows that the inflation trend is consistent with the end-year target.

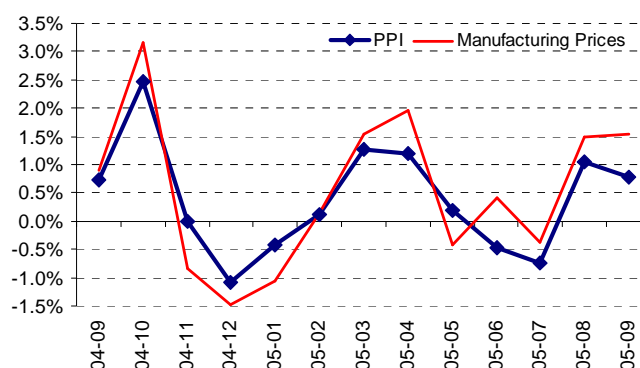
Developments in Producer Prices

12. Along with the 0.78 percent increase in producer prices in September, the cumulative increase in the PPI was realized as 2.98 percent during the first nine months of the year.

13. In the first three quarters of 2005, agricultural prices dropped by 2.6 percent and had a favorable impact on the PPI. After the decline in summer, agricultural prices started to climb in September. Price increases in the agriculture sector are expected to continue in the last quarter of the year.

14. Manufacturing industry prices increased by 1.54 percent in September (Graph 3). As predicted, prices of coke and refined petroleum products led to an increase in manufacturing industry prices due to the direct impact of oil prices. In addition, price increases in the sectors, which are susceptible to oil prices, such as chemical goods and plastic and rubber production, continue.

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



Source: SIS (2003=100)

II. OUTLOOK

Inflation Developments

15. Alcoholic beverages and tobacco, housing, transportation and restaurant-hotels are the sub-items that put the brakes on the downward trend of inflation during the last twelve months. The prices of the alcoholic beverages and tobacco groups were basically influenced by high tax increments. The dramatic increase of oil prices in the last period was conducive to price increases in the transportation group. Meanwhile, price increases in the restaurant and hotels group can be attributed to the buoyancy of tourism and the structural inflation rigidity in the services group. Price increases in the housing group are mainly reflected on services inflation, as in rents, while the increases in oil prices have had primary effects on this sector via fuel prices. To sum up, the observed slowdown in the downward trend of inflation can be explained by the rigidity of the services inflation hand-in-hand with soaring oil prices.

16. Excluding groups such as transportation services that are sensitive to oil prices, it is observed that the downward trend of inflation in the services sector continues, despite persistent rigidity in services sector inflation. Nevertheless, since this trend is still above 10 percent and price increases in the services sector alone are expected to make a contribution of almost three-points to 2006 inflation, price developments in this sector should continue to be monitored carefully in terms of future inflation.

17. The cumulative price increase of 3.93 percent observed in the first nine months of the year indicates that the annual inflation figures will be consistent with the end-2005 target under the baseline scenario, in which oil prices follow a reasonable course and the economy is not exposed to significant exogenous shocks. Food prices are likely to rise more than usual in October due to Ramadan. Moreover, clothing prices may also display a high seasonal elevation during the same period. Nevertheless, it should be noted that seasonal increases in prices of clothing and food groups will be temporary, and will not derail the general trend of inflation.

18. Undoubtedly, the medium-term course of inflation is the main concern for the Central Bank. The evaluation of this trend requires the use of figures that exclude temporary and exogenous impacts as much as possible. In this context, among the

special CPI aggregates the annual increases in (E) which excludes energy, alcoholic beverages and tobacco products; in (F) which other goods in E with administered prices, and indirect taxes; and in the G index, which is obtained by excluding unprocessed food from the F index, remained below 7 percent. These figures provide a considerable amount of information for the future.

19. Another piece of information in terms of future inflation is the course of the increase in the producer prices. It is observed that the strong position of the New Turkish Lira, which results from macroeconomic stability and favorable expectations, has eased the cost pressures created by rapid increases in world raw material prices. In fact, price increases in industrial products, which are calculated by excluding coke and refined petroleum products, are maintaining extremely low levels. However, it should be noted that since the PPI is being measured by excluding taxes, according to indices with a base year 2003, it responds to cost shocks more rapidly compared to the past. Consequently, the course of producers' prices should be evaluated cautiously.

Factors Affecting Inflation

20. Unfavorable developments in oil prices that are one of the main factors that have recently exerted pressures on the costs continue. In the last twelve months, the primary effects of oil price increases on inflation approached to 1.5 percentage points. In other words, if oil prices had remained unchanged in the last twelve months, annual inflation would have been roughly estimated at around 6.5 percent. From this standpoint, it can be said that the main trend of inflation is a downward one. As of today, the impacts of oil price increases on inflation have mostly remained at primary level. In other words, oil price increases have been limited to those sectors in which petroleum products are used as primary inputs. The continuation of falling inflation expectations for the next year indicates that the secondary effects of oil prices have remained limited up to now.

21. However, the unpredictable course of oil prices continues to lead to uncertainties around 2006 inflation. In this context, the continuation of oil price increases is considered as one of the main risk factors in forecasting the future

course of inflation. As a matter of fact, if the high levels of oil prices persist, it is likely that secondary effects would be observed after a certain point. In other words, expectations, wages and prices in the overall economy would be affected. Such a risk necessitates taking a cautious stance with regard to medium-term developments. Within this framework, the Central Bank will continue to monitor pricing behaviors and inflation expectations, and will not react to oil-related price increases unless any secondary effects become evident. In order for the secondary effects of oil prices to remain limited in the coming period as well and the course of inflation to be consistent with the targets for 2006, domestic demand should be modest and favorable expectations should be maintained. In this perspective, preserving the momentum of fiscal discipline and structural reforms continues to be of critical importance.

22. In a period of persistent uncertainties in oil prices, developments in demand, productivity, employment and unit labor costs gain more importance in terms of the predictability of the inflation trend in the medium-term. Both the related data regarding these factors announced in the last month and the GNP developments in the second quarter of 2005 provide significant information about future prospects.

23. According to seasonally adjusted data, the aggregate domestic demand increased by 5.2 percent compared to the previous period. Seasonally adjusted domestic sales of automobile and white goods pertaining to the July-August period show that the demand for durable goods has also maintained its upward trend in the third quarter of the year. During the same period, stable increases in industrial production continued. In other words, there is no stagnation in domestic demand and general economic activity as of the third quarter of the year. On the contrary, a balanced growth trend has been achieved in the economy throughout 2005. All these developments support the forecasts in the Inflation and Outlook Report issued following the announcement of GNP figures for the first quarter of the year.

24. Undoubtedly, it is important to know which subgroups have led to economic growth, from the standpoint of supply and demand equilibrium and productivity. In this framework, the resumption of the upward trend in investment expenditures stands as the most outstanding development of the second quarter of the year. In

the second quarter of 2005, the contribution of investment expenditures to GNP growth was significantly high compared with that of total consumption expenditures. The rapid growth trend in investment demand is also supported by seasonally adjusted data.

25. The 1.6 percentage-point rise in imports of capital goods and 17.6 percentage-point increase in imports of electrical machinery in July compared to the same month last year are attributable to the fact that the demand for machinery-equipment investments has continued in the third quarter. Meanwhile, the investment tendency in the CBRT Business Tendency Survey, which had displayed a downward trend since March, turned upwards in July and maintained its historic high level. This is a very salutary indicator with respect to investor confidence. The rapid rise in sales of commercial vehicles in July and August also supports the strong investment tendency.

26. Based on the information given so far it can be seen that share of investments have increased in the composition of aggregate domestic demand in the second quarter, and that trend is continuing in the third quarter, as well. These developments are very important in order to avoid the capacity pressure that might be triggered by the high production level. Moreover, the strong investment tendency provides a favorable outlook with respect to the labor productivity-unit cost-inflation relationship and reduces concerns about the risk of a slowdown in the increase of productivity.

27. The increases in manufacturing industry production and productivity have continued in the third quarter. In other words, while the risks concerning the upward trend in imported raw material prices persist, which is one of the two main factors affecting costs, the risks imposed by real unit wages on prices have decreased. Although it has been estimated that the contribution of unit labor costs to the downward trend in inflation would be less than that of the past three years, it is expected that the rise in productivity would persist and the rise in labor supply would continue to keep real wages under control; therefore no significant pressure is expected on production costs in this regard. This forecast is certainly based on the

assumption that the incomes policy of the public sector is consistent with the inflation target.

28. Credit developments are another factor that should be evaluated with respect to their impacts on the inflation outlook. Growth of both consumer and commercial credits seems to have relatively stabilized. However, it is believed that the decline in long-term interest rates will support credit growth in the coming period. Moreover, as financial deepening becomes more rooted and fiscal dominance is reduced during the normalization process of the economy, the continuation of growth in credit volume would not come as a surprise.

29. What is important here is the information provided by credit growth with respect to the future trend of inflation. Credits extended to firms boost production by supporting investments; therefore, their effect on inflation will remain relatively limited. Although an expansion in consumer credits is generally associated with a rise in demand and pressure on inflation, it would probably have a demand-dampening effect, as household debt grows bigger. Currently, it is not feasible to predict precisely which effect will dominate. The Central Bank closely monitors rapid credit expansion with respect to the risks it may pose to price as well as financial stability.

30. Probable fluctuations in international liquidity conditions can be considered as an all-time risk factor. 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 determined economic policies. Moreover, the start of Turkey's EU accession negotiation process is a favorable development, as it would help to further reduce volatility in the economy and to increase resilience to external shocks.

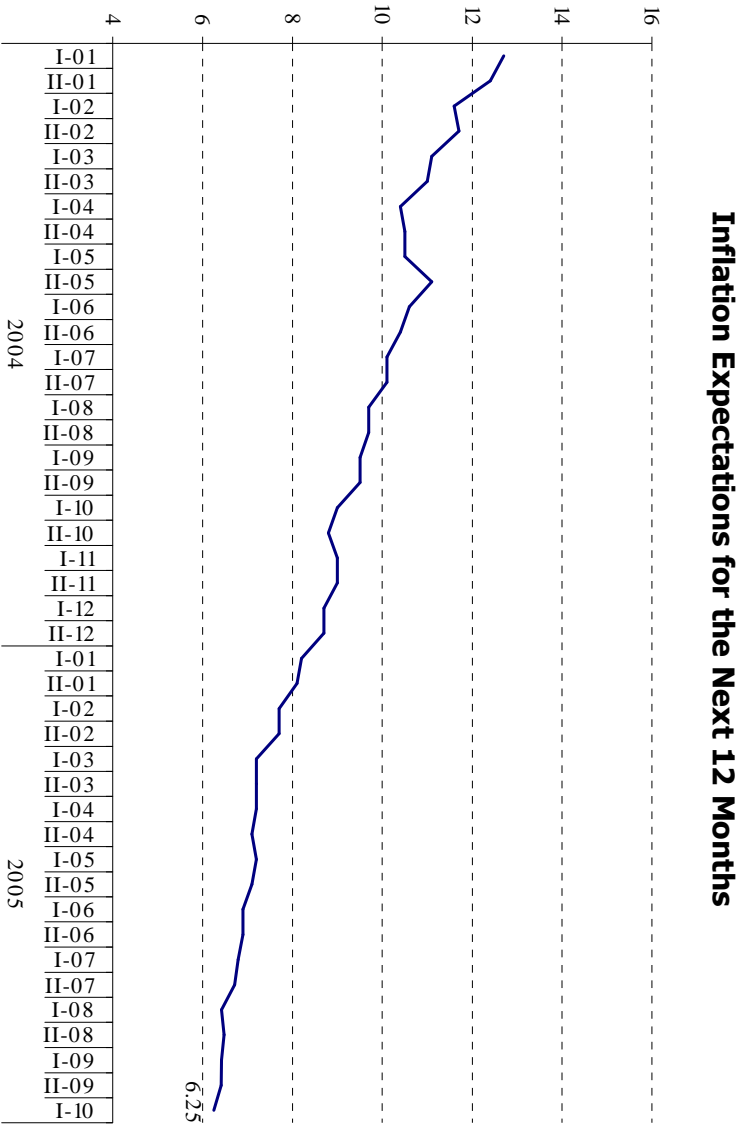
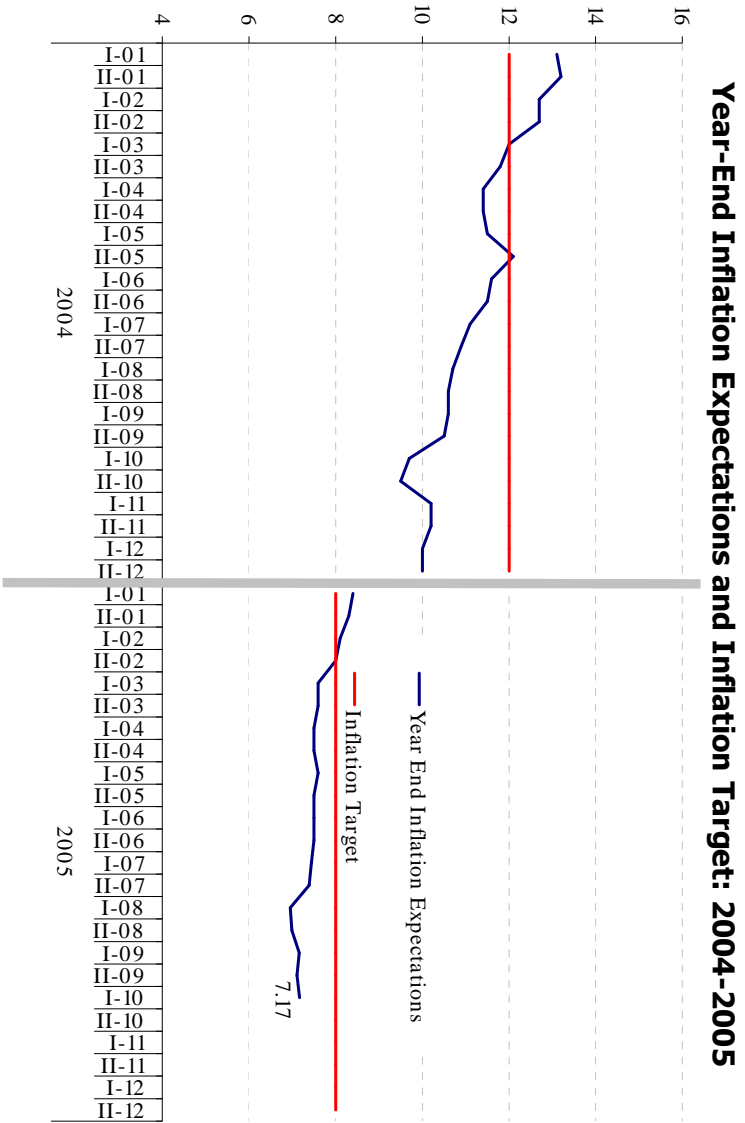
31. Obviously, sustainable growth and price stability can be achieved through reinforcing economic fundamentals, rather than being achieved through external factors. Significant steps have been taken towards reducing fiscal dominance and ensuring financial deepening in the last couple of years. Meanwhile, the current initiative for privatization will help reduce the public borrowing requirement and contribute to extending maturities. All these steps are important for overcoming the hurdles on the way to price stability, as these developments will make the monetary

transmission mechanism more evident and thus increase the effectiveness of monetary policy. Clearly, it is crucial that privatization revenues do not form an excuse for deviating from the budget discipline. These resources must be used primarily for reducing the debt stock in order to ensure the continuation of the decline in inflation and to keep the current account deficit under control.

Conclusion

32. In the light of the above evaluations that also take into account the views put forward at the Monetary Policy Committee meeting dated 10 October 2005, it has been decided to cut short-term interest rates applied at the CBRT Interbank Money Market and at the Istanbul Stock Exchange Repo-Reverse Repo Market by 0.25 percentage points. According to recently announced data, concerns about the continuation of rises in productivity are reduced and the pressure exerted by aggregate demand on inflation is increasingly likely to remain limited. Moreover, the removal of uncertainties regarding the start of the EU accession negotiation process supports the favorable trend in inflation expectations. By considering the information provided by these developments for the course of inflation in 2006, although it can be asserted that the probability of short-term interest rates going downwards is higher than the probability of them going upwards in the upcoming period, it is not possible to make a clear-cut statement about the future trend of short-term interest rates because of the high inflationary trend still in existence, the persistence of rigidity in services inflation and the uncertainties about the secondary effects of the rise in 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 CBT Expectations Survey



Source: CBRT Expectations Survey