December Inflation and Outlook

I. GENERAL EVALUATION

1. In December 2004, the CPI rose by 0.45 percent and the WPI by 0.13. As of December 2004, annual CPI and WPI inflation declined to 9.32 percent and 13.84 percent, respectively.

2. Seasonally adjusted monthly price increases were realized as 0.67 and 0.24 percent in the CPI and WPI, respectively. While the CPI, was 0.83 percent, excluding food, the WPI, became –0.32 percent, excluding agriculture.

Table 1: General CPI, WPI and Sub-items

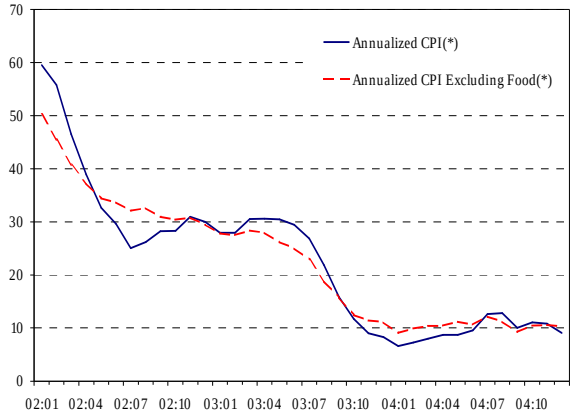
	Annual % Change		Monthly % Change			
	2003 Dec.	**2004 Dec.**	**2004 Oct.**	**2004 Nov.**	**2003 Dec.**	**2004 Dec.**
CPI	18.4	9.3	2.2	1.5	0.9	0.4
Goods	15.5	6.1	2.7	1.8	0.7	0.2
Services	24.0	15.3	1.5	1.1	1.1	0.8
Excluding food	17.9	10.4	1.8	1.3	0.7	0.3
Food	19.9	5.6	3.6	2.3	1.4	0.9
WPI	13.9	13.8	3.2	0.8	0.6	0.1
Public	11.4	19.5	3.9	1.2	0.4	-1.1
Private	14.9	11.7	3.0	0.6	0.7	0.6
Public man.	13.2	24.3	4.8	0.9	0.4	-0.3
Private man.	12.3	10.6	1.4	0.2	0.9	0.2
Agriculture	20.0	14.1	6.1	1.2	0.3	1.6
Excluding agr.	12.1	13.8	2.4	0.6	0.7	-0.3
Excl.agr.&energy	12.7	14.6	2.5	0.6	0.8	-0.4

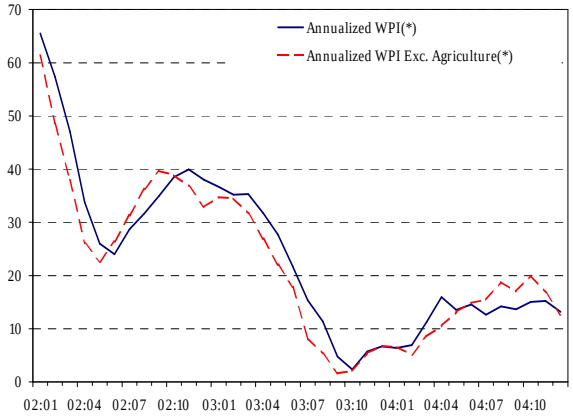
Kaynak: TCMB, DİE.

3. The last six-month average of seasonally adjusted inflation was 1.04 percent in the WPI and 0.73 percent in the CPI. The average rates of increase correspond to 13.15 percent and 9.07 percent in annual terms. During the same period, the average rate of increase in the seasonally adjusted CPI became 0.82 percent, excluding food. This figure corresponds to 10.33 percent in annual terms (Figure 1).

Figure 1: Annual Percentage Change and Six-month Moving Averages*

CPI and CPI Excluding Food **WPI and WPI Excluding Agriculture**





(*) Six-month moving average (Annualized, Seasonally Adjusted)
TRAMO/SEATS method is used for the seasonal adjustment.
Source: CBRT, SIS.

4. During the last month of 2004, a slowdown was observed in the rate of increase in all the main sub–items of the CPI compared to the October–November 2004 period. The appreciation of the Turkish Lira by 6.8 percent in terms of the U.S. dollar and by 2.5 percent in terms of the foreign exchange basket comprising of 0.5 Euro+0.5 U.S. dollars along with the lack of significant price adjustment in public prices became determining factors in the slowdown of the CPI in December 2004. Seasonally adjusted monthly consumer prices inflation was realized as 0.7 percent with a decline of 0.2 points compared to November 2004. Thus, annual inflation dropped to 9.3 percent.

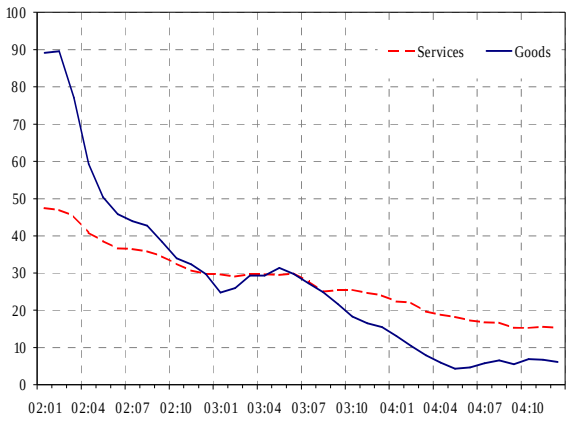
5. While the increase in food prices slowed down in the goods group as expected after Ramadan, seasonal sales started in the clothing–shoes group. Along with the slowdown in the food and clothing group, the prices of transportation vehicles, which increased by 7.1 percent due to last month's tax adjustments, was adjusted in December. Hence, prices in this group declined by 3.2 percent. Moreover, the household appliances group displayed a slight increase in December, not conflicting with their general tendency throughout the year. Within this framework, seasonally adjusted price increases in the goods group were realized at 0.1 percent and annual inflation of the goods group remained at quite a low level of 6.1 percent (Figure. 2).

6. Despite a slowdown in the rate of price increases in the services group, seasonally adjusted price increases were realized as 1.2 percent in this group, remaining high above the price increases of goods group (Figure 2). In the rents

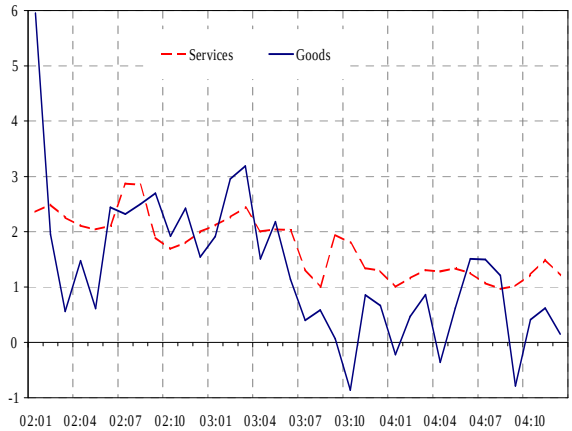
group, seasonally adjusted price increases that rose to 1.5 percent in November, dropped to 1 percent in December. Thus, the annual price increase in the services sector became 15.3 percent (Figure 2).

Figure 2: Goods and Services Group Prices

Annual Percentage Change



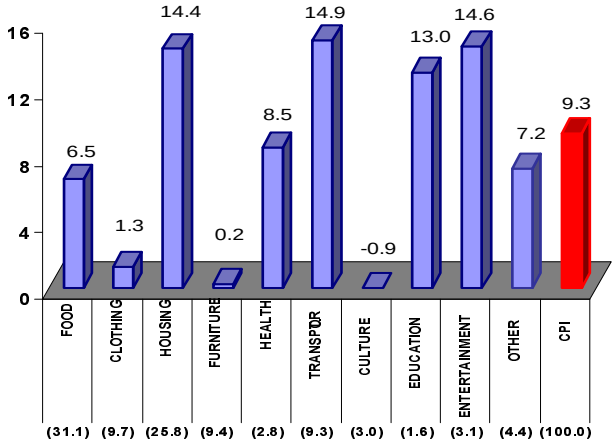
Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.
* TRAMO/SEATS method is used for the seasonal adjustment.

7. The striking difference between the growth rates of the prices of goods and services is also quite evident, when compared to the increases in the main sub-groups of the CPI in 2004. All groups, which displayed price increases above the general CPI and the 2004 target, (namely that of restaurant, hotel and cafes, housing, and education groups with the exception of the transportation group) are service sector-weighted (Figure 3). Meanwhile rents, which constitute the bulk of the housing group, increased by 19 percent, as one of the items which recorded the highest increase among CPI sub-items in 2004.

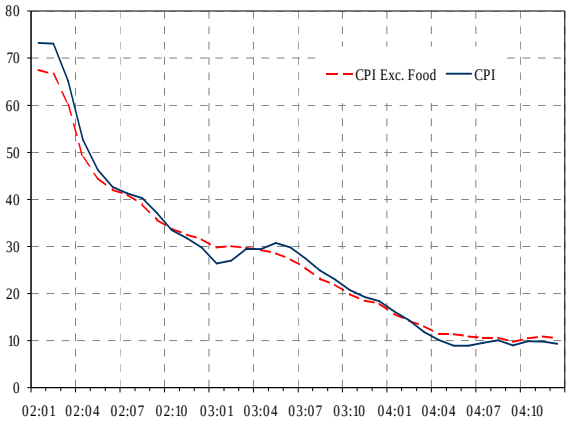
Figure 3: Rates of Increase in the CPI and its Subgroups in 2004, %



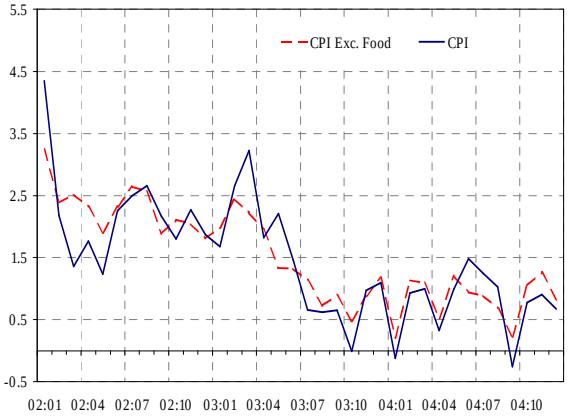
8. Consequently, the seasonally adjusted CPI and CPI excluding food, slowed down compared to the October-November period. Thus, annual inflation began to roll back after a two month-period and was realized as 9.32 percent and 10.45 percent respectively, for the CPI and CPI excluding food (Figure 4). Food prices that rose by 5.62 percent in 2004 assisted the fall in inflation.

Figure 4: CPI and CPI Excluding Food

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.

* TRAMO/SEATS method is used for the seasonal adjustment.

9. Starting next month, the SIS will publish the CPI with the 2003 base year along with the CPI with the 1994 base year. One of the significant changes in the new index is the inclusion of technological innovations (mobile phones, DVDs, the Internet, computers, etc.). A comparison of the weights in the old and new indices reveals that the weights of certain sectors such as food, alcoholic beverages and transportation were increased in relative terms. Alternatively, the relative weights of housing and furniture went down. The decline in the housing sector stemmed from omitting implicit rent from of the index. Implicit rent, which showed how much rent the house-owners/landlords would have paid if they had been tenants in their own apartments, used to constitute the bulk of the rent item in the CPI with 1994 base year. With the exclusion of the implicit rent, the rent item in the new index will only reflect the real amount of rent paid by the households.

Developments in Wholesale Prices

10. 0.36 point of the 0.13 percent monthly WPI inflation resulted from private sector price increases, while -0.23 percent from price reductions in the public sector. Seasonally adjusted WPI inflation dropped by 0.4 point in December compared to November and became 0.24 percent.

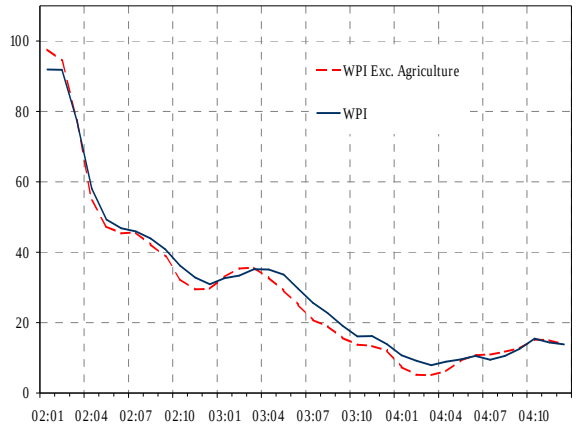
11. Having increased by 1.6 percent, agricultural sector prices were the determinant of the WPI in December, with a 0.3-point contribution. The seasonally adjusted agricultural price increase was 1.2 percent. Meanwhile, the rate of increase of the seasonally adjusted WPI excluding agriculture, was realized as -0.3 percent.

12. In December, prices in the public manufacturing industry declined by 0.3 percent. The decline in the prices of manufacturing industries producing basic metal and chemical products were instrumental in this development. In addition, prices in the petroleum products industry, which rose by 1.8 percent in November, decreased by 0.1 percent in December. As for private manufacturing industry prices, they went up by 0.2 percent in December. In order to ease cost pressures on the CPI in the coming period, it is crucial that price increases in the public private manufacturing industries remain at moderate levels.

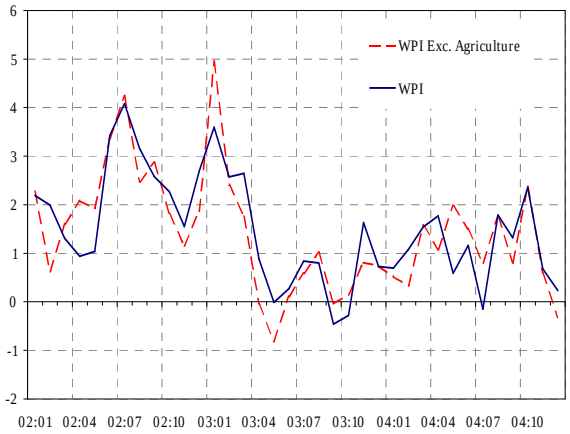
13. Energy prices within the WPI group maintained their current trend and rose by 0.4 percent. Moreover, energy prices are continuing to decline on an annual basis.

Figure 5: WPI and WPI Excluding Agriculture

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.

* TRAMO/SEATS method is used for the seasonal adjustment.

14. Accordingly, the annual WPI and WPI excluding agriculture dropped to 13.8 percent in December (Figure 5). Annual price increases in public and private

manufacturing industries differed significantly due to fluctuations in international commodity prices, namely oil, throughout the year. In 2004, annual price increases in the public and private manufacturing industries were 24.3 percent and 10.6 percent, respectively.

15. Starting the next month, the SIS is going to issue Producer Price Index (PPI) with the 2003 base year. The new index will introduce a number of changes in method and content. One of the significant changes in the PPI is the elimination of the private-public distinction. Another crucial point is that, unlike the WPI, value added tax will not be included in the scope of the PPI. Moreover, a comparison between the 1994 Base Year WPI and 2003 Base Year PPI reveals that relative weight of manufacturing and energy sectors in the new index will increase, while those of the agriculture and mining sectors will fall.

II. OUTLOOK

General Evaluation

16. The downward trend in inflation, which has been going on for the last three years, continued throughout 2004 as well. By the end of 2004, inflation become 9.3 percent and remained below the targeted level. Coherent implementation of strict monetary and fiscal policies, as well as ongoing comprehensive structural adjustments lay behind the reason inflation has not exceeded the targeted level, despite rapid increases in world commodity prices and fluctuations in the financial markets during April and May.

17. As a matter of fact, subsequent steps taken on the way to macroeconomic stability have also influenced inflation expectations. By December 2004, expectations for the coming year converged to 8 percent, which was the year-end target for 2005. This convergence, which can be seen as a favorable development in terms of the formal inflation-targeting regime to be adopted at the start of 2006, highlights the fact that inflation targets have now assumed the role of a nominal anchor. It can be deemed as a remarkable development that, the general trend of inflation did not take an obviously upward course in the second half of 2004 and moreover, inflation expectations about the forthcoming year remained stable, despite cost pressures that emerged, especially after the first quarter of 2004. With the removal of the cost pressures towards the end of the year, inflation has resumed its downward trend.

18. The downward trend in inflation has changed the pricing behavior. Starting from the next period, prices in many sectors are expected to be set annually or six-monthly rather than monthly, as was the case in the chronic inflation period. In this context, inflation might rise seasonally in January, which is a period of price adjustments in many sectors. However, this will not necessarily point to an increase in the medium term trend of inflation. Another factor regarding January inflation will be the uncertainty about the incidence level of VAT cuts on prices of such sectors as education, health and food. Nevertheless, it is estimated that VAT cuts will positively contribute to inflation in terms of price adjustments to be made in 2005. On the other hand, the effect of process of transition to the New Turkish Lira on the prices is expected to be modest. However, it is hard to make an assessment about the overall effect of all these factors before the inflation figures for January have been announced.

19. Starting from the first couple of months, the inflation trend is believed to follow a course consistent with the end-year target of 8 percent. However, some movements may also occur that do not reflect the general inflation trend and that can be mainly attributed to the base effect. Therefore, the downward trend of inflation could come to a halt in the first four months of the year, however it is predicted that inflation will start to fall again in May and reach the targeted level by the end of the year.

20. Evidently, all these projections are based on the current inflation basket; in other words, the base year index of 1994. However, as price indices and inflation figures will be calculated on the 2003 base year with a new goods-services basket employing a new scope and method in 2005, we should be cautious about inflation projections. Within this context, it is not advisable to draw early conclusions before having adequate information about the course of the new index.

Factors Affecting Inflation

21. As we have reiterated in our past reports and press releases, the determinants of the inflation trend in 2004 were; (i) high level of raw material costs; (ii) controlled recovery in domestic demand; (iii) sustained increase in productivity; (iv) short-lived deterioration in international liquidity conditions; (v) rigidity in services prices; (vi) relative stability of exchange rates. The future course of the listed factors is of crucial importance to inflation in 2005. It is projected that developments in raw material

costs will be more favorable compared to 2004. Meanwhile, the persistent rise in productivity will depend on steadfast implementation of structural reforms and determined steps to be taken towards clearing the barriers to investment and production. It should be borne in mind that global liquidity conditions are at all times considered to be a risk factor. Although unit labor costs will not contribute to the decrease in inflation as much as they have done in the last three years, it is projected that compared to 2004, cost conditions will be more favorable in 2005, due to stability in exchange rates coupled with a slowdown in the rise in prices of goods. Meanwhile, it is estimated that the rise in prices of services will continue to gradually slow down, even if it still remains above the general inflation level in 2005.

22. The rapid growth in economic activity observed in the first half of 2004 lost its momentum, giving way to more controlled growth in the third quarter. Currently, there is not yet evident pressure on the demand side. As of the second half of 2004, recovery in demand shifted to semi-durable and non-durable consumption goods. Meanwhile, the level of final demand components, excluding consumer durables, and private machinery-equipment recorded in the third quarter of 2004 still falls below the level recorded in Q3 in 1997. Undoubtedly, according to economic theory, the low level of fluctuations in the mentioned consumer goods is only natural. However, the 10 percent rise in the population since 1997 should not be ignored.

23. At the end of the first half of the year, the rise in interest rates of consumer credits, the decrease in the credits granted by public banks, the reduction in discount rates for scrap vehicles and the increase of the Resource Utilization Support Fund to be levied on consumer credit interests have all caused the demand of durable goods to fall in the third quarter of 2004. In fact, several recent factors including the slow-down observed in industrial production, imports of intermediary goods, money demand and credits, the decline in excess liquidity and the stability of consumer tendency and consumer confidence indices indicate that domestic demand is unlikely to exert inflationary pressure in the short term. However, it is expected that the consumption tendency may display an upward trend along with the probable improvement of consumer confidence as of the first quarter of 2005. Furthermore, the investment tendency, which started to slow down in the second half of 2004, is expected to improve in the first quarter of 2005. Along with the stable course of exports, it is foreseen that the growth figures of 2005 will maintain a trend consistent with the program projections.

24. Although it is predicted that the general supply-demand balance of the economy will not contribute to the decrease in inflation in 2005 as much as it did in past years, the decline in inflation is likely to continue in the medium term. During this period when significant steps are being taken towards economic stability and the medium-term point of view is gaining importance, it should be remembered that the crucial indicators for the monetary policy will be the medium-term tendencies, rather than the swings in the short-term. With this aim, the Central Bank will continue to focus on the structural tendency of the inflation in the medium-term in 2005, rather than temporary factors such as short-term fluctuations in the financial markets or exogenous cost shocks. The continuation of the decline in medium-term inflation will depend on monetary and fiscal discipline as well as structural regulations that will enhance competitiveness and productivity. For this reason, the importance of structural reforms will be continuously emphasized in the upcoming period.

25. Both the commitments included in the three-year program and the works to be achieved during the EU membership process will necessitate significant steps to be taken towards structural reforms in the medium-term. Especially the social security and tax reforms that would contribute to the sustainability of the fiscal discipline, and the rapid adoption of banking regulations that would support the soundness of the financial system and enhance the monetary transmission mechanism bear significance. In addition, the continuation of the removal of bureaucratic barriers against investment and production is of critical importance.

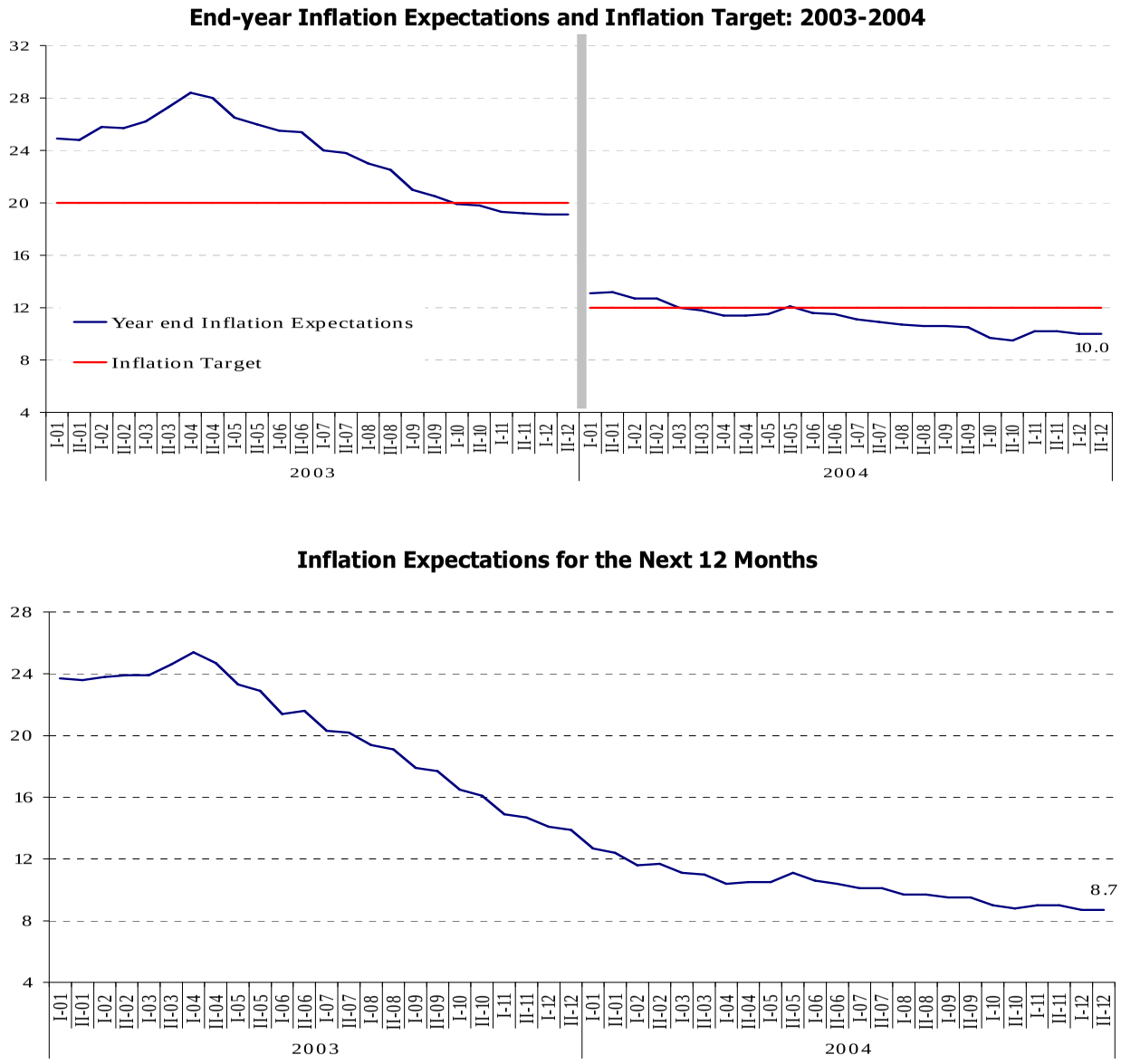
26. As a result, it is projected that inflation will maintain its downward course and the inflation target would be attained, as in the past three years, in 2005, on condition that the afore-mentioned regulations and reforms are maintained.

27. It is inevitable that there will always be some external shocks, outside the control of economic policies. As has occurred in other countries, a number of developments may cause inflation to deviate from its target. These developments may be; rising world energy prices, fluctuations in exchange rates triggered by adverse developments in global liquidity conditions, supply-side shocks affecting the unprocessed food products, or adjustments in indirect taxes. However, at this point, it should once again be emphasized that the Central Bank of Turkey will not, and should not, be taking action vis-à-vis shocks which are perceived as temporary. As a matter of fact, having anticipated that the main tendency of inflation would be "downward", the Central Bank has preferred not to take action against temporary

shocks and, on a number of occasions in recent years, has focused on medium-term trends. This approach will continue. However, in case of disharmony between medium-term forecasts and targets, or in case of deterioration in the pricing behavior, the Central Bank will not hesitate to take the necessary actions.

28. As mentioned in the press release dated December 20, 2004, the Monetary Policy Committee (MPC) will serve as an advisory body in 2005, which is the transition period to the formal inflation regime to be launched in 2006. Interest rates will be determined by the Governor's Office, taking into account the evaluations of the MPC. The first MPC meeting of 2005 convened on January 10, 2005 to discuss the developments in inflation and the economy. In light of the above-mentioned evaluations that take into consideration the discussions held in this meeting regarding the general outlook, a decision was taken to drop short-term interest rates implemented on the CBRT Interbank Money Market and at the Istanbul Stock Exchange Repurchase-Reverse Repurchase Market by one point as of January 11, 2005.

Figure 6: Inflation Expectations According to CBRT Expectations Survey



Source: CBRT Expectations Survey