July Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with base year 2003, the CPI decreased by 0.57 percent and the PPI by 0.74 percent in July 2005. Annual inflation in the CPI and PPI became 7.82 percent and 4.26 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, decreased by 1.16 percentage points in July in monthly terms; while the G index, which is obtained by excluding unprocessed food from the F index, decreased by 0.85 percent. (Table 1), (Graph 2). The year-on-year rise in July for these indices became 7.45 and 8.02 percent, respectively (Graph 1).

3. In July, agricultural prices decreased by 2.47 percent and the PPI excluding agriculture (industrial prices) declined by 0.28 percentage points (Table 1).

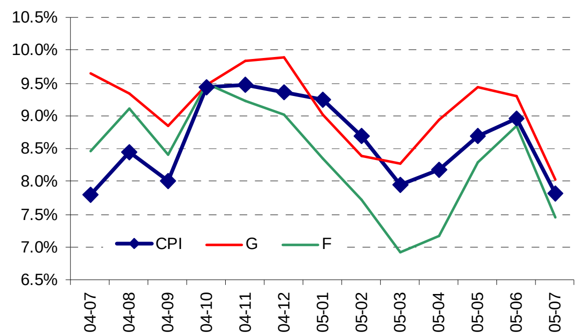
Table 1: General CPI, PPI and Sub-groups

	2005 July	2004 Dec - 2005 July	2004 July-2005 July
CPI	**-0,57**	**2,00**	**7,82**
Special CPI Aggregates			
A. *CPI Excl. Seasonal Goods*	0,48	4,45	9,07
B. *CPI Excl. Unprocessed Food*	-0,27	3,05	8,30
C. *CPI Excl. Energy*	-0,81	1,80	7,32
D. *CPI Excl. Unprocessed Food and Energy*	-0,49	3,03	7,81
E. *CPI Excl. Energy and Alcoholic Beverages*	-0,97	1,66	7,46
F. *CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes*	-1,16	1,35	7,45
G. *CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food*	-0,85	2,70	8,02
PPI	**-0,74**	**1,14**	**4,26**
Agriculture	-2,47	-3,58	-1,45
Industry	-0,28	2,46	5,87
Mining	2,87	7,73	12,87
Manufacturing	-0,36	2,20	5,93
Energy	0,00	4,68	3,11

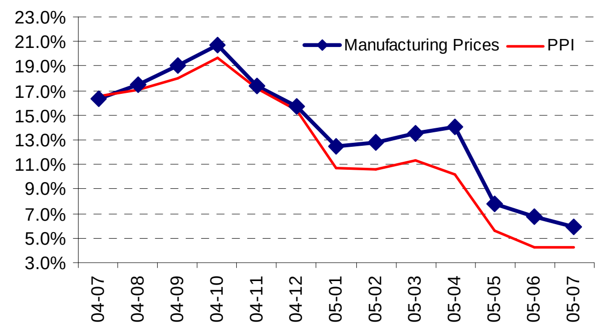
Source: SIS, (2003=100)

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. The most important sub-item developments affecting the decline in the CPI in July were: i) the decline in the prices of clothing and footwear group and ii) the decline in food prices. The contribution of the prices of the clothing-footwear group and the food-non-alcoholic beverages group to the increase in the CPI in July was minus 0.94 percentage points. Food and non-alcoholic beverages prices displayed a monthly decline of 1.15 percent with the effect of the seasonal downward trend observed during the summer in unprocessed food prices. Meanwhile, the monthly decrease in the prices of the clothing and footwear group became 7.45 percent. This development partly helped reduce the uncertainties that emerged from sharp price increments in April and May. The price increases, which exceeded the seasonal tendency in April and May, necessitated much closer monitoring of demand developments in the clothing sector. However, the said increases were partly compensated by a high rate of decrease in July and this points to the fact that the rise was mostly due to changing seasonal patterns. Indeed, an overview of the year shows that the volatility in seasonal price developments has increased in the clothing and footwear group.

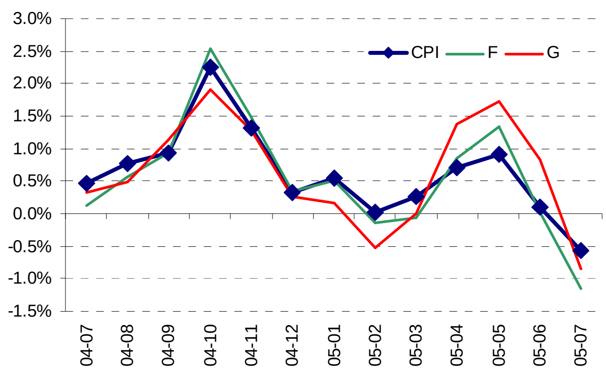
5. In accordance with the Ministry of Finance's decree (*issue 25889 of the Official Gazette dated July 28, 2005),* an *ad valorem* tax of 58 percent and a *specific* tax of YTL 0.06 shall be levied on tobacco products and products like cigarettes. The 1.97 percent rise in prices of alcoholic drinks and the tobacco products group shows the day-weighted effects of the new tax regulation and the actual impact of the arrangement will be more clearly captured in August inflation. Meanwhile, as it is a one-off arrangement, it would not affect the medium-term trend of inflation.

6. The price increases in July in housing and transportation groups are mostly due to the rise in oil prices. The upward trend in the prices of these groups might continue in line with developments in oil prices in the upcoming period. Also continuing is the rapid rise in rents, which is an important component of the housing group.

7. It is observed that the 8.33 percent price-cut (due to the course of the Euro exchange rate) in medicine prices, which took effect on July the 15th contributed to the 1.38 percent decline in health sector prices. Meanwhile, the rise in health services prices, which is another important component of health sector prices, is being closely monitored.

8. The realizations for the special CPI aggregates provide information that the inflation tendency is consistent with the end-2005 inflation target, these realizations further highlight the significance of energy prices and tax arrangements for the end-year CPI inflation figures.

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)

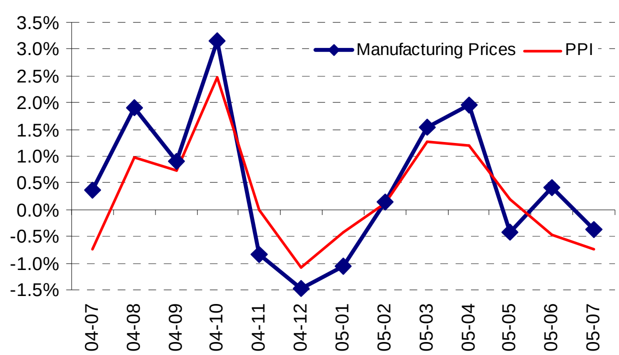
Developments in Producer Prices

9. The Producer Prices Index declined in July, as in June. The rate of increase in the PPI since the beginning of the year has been a mere 1.14 percent (it was 12 percent in the same period last year).

10. Agricultural prices dropped by 2.47 percent in July. The negative year-on-year inflation figures in agricultural prices observed in the last 3 months as well as the annual decline in the same sub-item point to the fact that the recent downward trend in agricultural prices cannot be solely attributed to seasonal effects.

11. In July, industrial prices declined along with the drop in agriculture prices. This decline stemmed from the 0.36 percent drop in the manufacturing industry prices (Figure 3). The general decrease, which is observed in the prices of the sub-groups of the manufacturing industry excluding coke and refined petroleum products, is an important development. In this framework, the appreciation of the Turkish lira observed in the last two months, is deemed to be influential on producer prices. Price decreases in the mentioned sub-groups will contribute favorably to the CPI in the upcoming period.

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



Source: SIS (2003=100)

12. Consequent to the introduction of new price indices, the increases in the exchange rate and raw material prices became more influential on the PPI compared to the past. According to PPI realizations in July, the strong trend of the Turkish lira compensated the negative effect of oil prices. This situation can be clearly seen in the price-decline in the manufacturing industry. In this regard, the developments in exchange rates and international raw material prices will continue to affect the course of the PPI in the upcoming period as well. Possible concurrent increases in the said factors constitute a basic risk for the PPI.

13. The annual rate of the price increases in the production and distribution of electricity and gas, which are included in the energy group that constitutes another part of the industrial sector, maintain a trend above annual inflation in the general PPI. Energy prices, which are mainly affected by external factors, may pose a risk to producer prices through input costs in the upcoming period.

OUTLOOK

Developments in Inflation

14. In the first seven months of 2005 inflation was realized as 2.0 percent. Meanwhile, this increase does not provide accurate information about the general inflation trend since it has not been seasonally adjusted. Although not functioning precisely like seasonal adjustment, the special CPI aggregate excluding seasonal products (A) shows that the cumulative rate of increase became 4.45 percent in the first seven months of the year. Even this figure seems to be consistent with end-year targets. Provided that there is no big surprise in the next five months, end-year inflation is expected to be in line with the target.

15. The July inflation developments should be analyzed with a medium-term perspective. What is important here is an accurate analysis of the reason why figures pertaining to July inflation were realized below general expectations. One of the main reasons behind this development is the difficulty in the predictability of the seasonal effects of prices in the clothing and footwear group. Both the increases in April and May and the decrease in July had proved to be smoother in previous years. Hence, this development made it difficult to forecast monthly inflation figures and caused fluctuations in annual inflation rates.

16. Another main factor leading to low inflation figures in July was the direct or indirect impact of the strong course of the New Turkish Lira on prices. There is no doubt that the pass-through effect from the exchange rate to inflation has eased remarkably compared to the pre-2001 period. However, the effects of the exchange rate on inflation should not be underestimated in economies where imported inputs are extensively used. Furthermore, the inflation basket with the base year 2003 became a little more sensitive to the exchange rate, as the share of technology-intensive goods increased while that of rents decreased in the basket.

17. Since the third month of the year, the Central Bank has made announcements to the public that inflation in 2005 is likely to remain below the end-year target. In a medium-term strategical framework, these predictions were mainly taken into consideration regarding past monetary policy decisions. Analyzing the lagged effects of monetary policy, it should be borne in mind that the information provided by the data for future inflation is more important than the realizations. The rigidity in services sector inflation is still at high levels despite its relative decline compared to previous periods. Hence it is an important risk factor for the achievement of price stability. As of July 2005, year-on-year price increases in the subgroups of services items such as education and restaurant-hotels, and especially in rents were realized above the general inflation trend. Therefore, they continue to pose a risk on inflation in the upcoming period.

18. The historically low levels of producer price increases are considered to be favorable for the course of inflation. Nevertheless, it should be kept in mind that along with indices with the base year 2003, the said index became extremely sensitive to world raw material prices and to the developments in exchange rates, and it might display considerable fluctuation in the event of a probable high volatility in exchange rates. However, considering the cost-push factors, developments in producer prices are emitting positive signals for future inflation, at least in the short term.

Outlook of the Factors Affecting Inflation

19. Strong economic fundamentals and the gradual decrease of volatilities in the risk premium during the "normalization" process of the economy have increased the relative importance of medium-term tendencies for monetary policy and inflation. In other words, once macroeconomic stability has been achieved, factors such as employment, productivity and demand developments that affect medium-term inflation are started to be attributed a greater weight in the formation of the monetary policy decisions.

20. Although the data disseminated since the release of the inflation and outlook report last month do not point to any remarkable changes in domestic demand, the downward movement in consumer confidence indices and the decrease in domestic sales expectations in the Business Tendency Survey are being carefully monitored. Meanwhile, it is observed that domestic sales of durable goods are maintaining their high level.

21. In the meantime, the upward trend in total employment continued in the first quarter of 2005. Business Tendency Survey data indicate that employment continues to follow a stably increasing path. It is expected that the impact of these developments on real wages shall remain limited due to the ongoing rapid increase in labor force participation. However, it is anticipated that the significant contribution of unit labor costs to the downward trend in inflation will disappear in the upcoming period.

22. Another factor issuing signals about domestic demand is the credit developments. In the first half of 2005, consumer credits increased rapidly, in a way to urge the Central Bank to wear on a more cautious stance. Credit developments will also be carefully monitored in the upcoming period.

23. To sum up, although last month's data pertaining to domestic demand developments do not allow us to give up the cautious stance, they nevertheless provide signals that the increase in demand could occur in a controlled manner. There is no doubt that domestic demand is not the only variable that is significant for inflation in the medium-term. Developments in foreign demand are also very important in terms of evaluating the total demand for goods in the economy. The data released in the last month particularly indicate a slowdown in foreign demand. Obviously, it is impossible to make a conclusive evaluation with data covering a very short period of time. Despite the strong course of economic activity all over the world, it is significant that growth projections about the economy of our biggest trade partner, i.e. the European Union, have been revised downward. Moreover, the world is facing a period of intense competition due to the increased openness of the Chinese economy. This constitutes the main factor leading to the substitution of domestic value added with imported goods in our economy. The ongoing strong course of imports of intermediary goods despite the relative slowdown in industrial production lends support to this view. In an environment of increasing openness, the slowdown in foreign demand and developments in imports of intermediary goods are being closely monitored in terms of the total demand for domestic goods.

24. Obviously, the important point for the Central Bank is the meaning of export and import developments in terms of future inflation, rather than the actual variables. In case of a marked slowdown in foreign demand, total demand will be adversely affected. Since such a development will partially remove the pressures on future inflation, it bears significance in terms of monetary policy and is being closely monitored.

25. In line with the growth process in the US and Chinese economies, import prices continue to increase at high rates. Crude oil prices, the metal prices index and the unit value index of imports are still at significantly high levels compared to the averages of the previous year. Although exogenous cost factors are anticipated to have temporary impacts on inflation, medium and long-term inflation expectations may be affected unfavorably in the event of persistence of the said increases. It should be borne in mind that the Central Bank will take the proper action in the event of such a development.

26. From time to time, volatility in oil prices is influential on inflation. Although the strong position of the New Turkish lira diminishes the impact of the increase in input prices, it is not at a level to compensate for the recent high rate of increase in oil prices. Identification of the effects of exogenous shocks on inflation is important in terms of deciding when and what to respond to. According to calculations, the primary effects of the increase in oil prices on annual inflation (via sub-items such as petroleum products, natural gas, transportation, tours) vary between 1 percent and 2 percent. Therefore, oil prices were one of the leading factors that slowed down the disinflation process starting from the second half of 2004.

27. As mentioned before, the Central Bank will react to the permanent repercussions of oil prices on the long-term expectations and pricing behaviors, not to the direct effects of oil prices. Thus, the current favorable course of expectations is a positive development. Even though the downward track of annual inflation was hampered recently, the expectations are favorably falling. This shows that economic agents consider the effects of cost shocks on inflation to be temporary, and that when these shocks disappear inflation will follow a course in line with the target. Undoubtedly cost-push factors such as oil prices continue to pose a risk in terms of inflation of the upcoming period. However, based on the current data, it is not possible to evaluate whether the high rate of increase in world raw material prices will persist in 2006.

28. International liquidity conditions continue to develop in favor of developing countries. It should be kept in mind that this situation may be subject to rapid change; and that the projections made under the assumption that current conditions could persist, would be risky. What is important for the medium and long term is the continuation of the efforts aiming to increase the resilience of the economy to shocks.

29. It should be borne in mind that in the post-2001 period, attaining high rates of growth in the disinflation process was possible with structural adjustments and high rates of increase in productivity. In this process, important steps were taken for price stability; however to attain absolute price stability, the determined implementation of the economic program in the recent years should be carried on with the same determination and the budget and incomes policy should be in line with the inflation target. At the same time, no deviations should be made in the fiscal discipline and the structural reforms needed to maintain the quality of the fiscal discipline in the long run should continue.

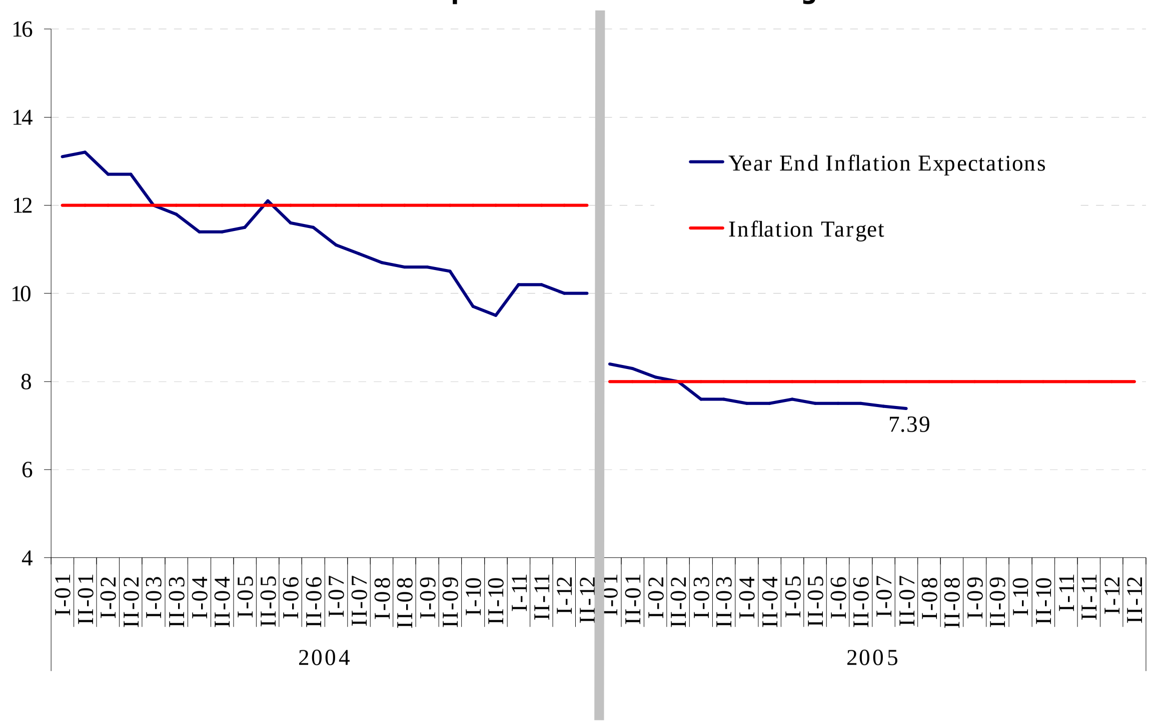
30. Beyond all these factors, one of the main setbacks to the disinflation process in Turkey today is the previous pricing habit. In countries experiencing extended periods of chronic inflation, the tendency for reverting back to previous pricing behavior is very common. Occasionally, price setters can perceive any recovery in demand conditions as an opportunity to increase their profit margins, even in circumstances when domestic demand is under control. Such attitude is mostly observed in the services sector, which is to a great extent closed to foreign competition. Due to increasing foreign competition conditions, past behavior is not influential in goods subject to foreign trade; thus price setters follow a more rational pricing policy. The CBRT will continue to closely monitor the pricing behaviors in the upcoming period.

Conclusion

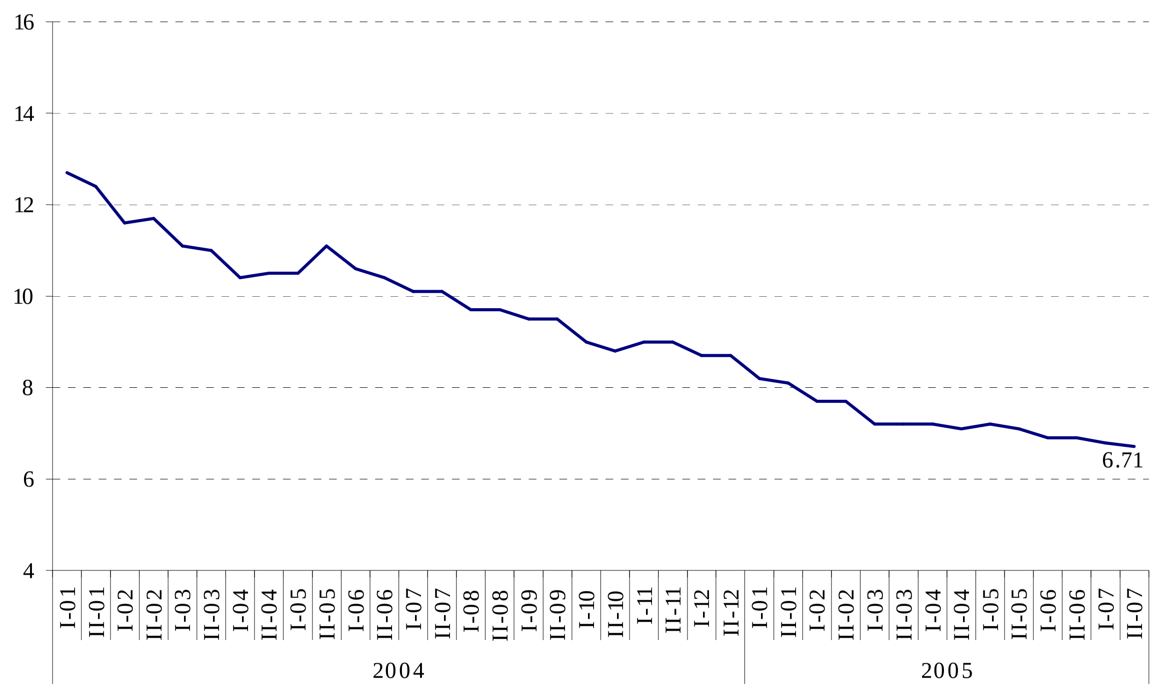
31. In light of the above evaluations, which also take into account the views presented at the Monetary Policy Committee meeting held on 8 August 2005, the Central Bank has decided not to change the short-term interest rates in the CBRT Interbank Money Market the Istanbul Stock Exchange Repo/Reverse Repo Markets. In the baseline scenario, where fiscal discipline is not interrupted, the incomes policy is in line with the target, structural reforms do not lose pace, there is no upsurge in oil prices, and the economy would not face a sizable exogenous shock, it is foreseen that the rate of annual inflation, which started to decline again in July, will continue to gradually decline in the last quarter of 2005, achieving the end-year target. According to the data in hand, although the necessity of being cautious in terms of the medium-term continues, the concerns related to the effects of possible developments in the total demand on future inflation tend to ease relative to previous month, with the data announced in the last month. Assuming that no severe exogenous shock occurs, should this tendency continue in the upcoming period, likelihood of short-term interest rate cuts will increase. Undoubtedly, any new data involving information about the medium-term trend of inflation and any signal about the future would necessitate the revision of these assessments and would be taken into account while making monetary policy decisions.

Figure 4: Inflation Expectations according to the CBRT Expectations Survey

Year End Inflation Expectations and Inflation Target: 2004-2005



Inflation Expectations for the Next 12 Months



Source: CBRT Expectations Survey