January Inflation and Outlook

I. GENERAL EVALUATION

1. The State Institute of Statistics announced consumer and producer price indices with base year 2003 on 3 February 2005. The CPI rose by 0.55 percent, while the PPI declined by 0.41 percent in January 2005. Respective annual CPI and PPI inflation rates are 9.23 and 10.70 percent.

2. According to the index with 1994 base year, which has been extended by the adaptation of the prices compiled for the index with 2003 base year to former goods and services basket, the CPI and the WPI increased by 9.47 percent and 9.92 percent, respectively, compared to the same month of the previous year.

3. When the indices with 1994 and 2003 base years are compared for the February-December 2004 period, during which a different basket of goods and services was sampled for each index, it is seen that there is only a slight difference between the two indices in terms of cumulative rates of increase. The cumulative rate of increase of CPI in the February-December 2004 period became 8.52 percent according to the index with base year 1994, while it was calculated as 8.63 percent based on the index with base year 2003. During the same period, the WPI with 1994 base year increased by 10.92 percent, while the PPI with base year 2003 rose by 11.16 percent.

Table 1: General CPI, PPI and subgroups (2003=100*)

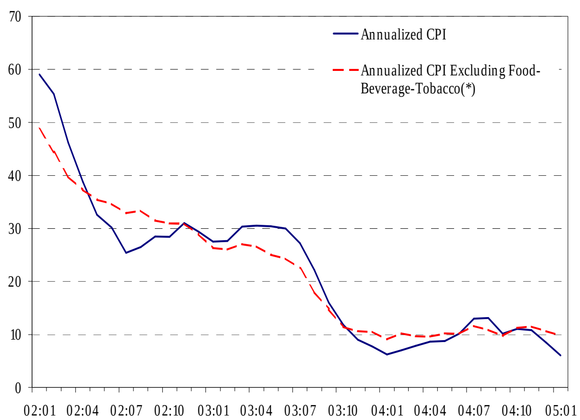
	2005 Jan.	2004 Jan.-2005 Jan.
CPI	**0.55**	**9.23**
Special CPI Aggregates		
A. CPI Excl. Seasonal Goods	0.85	10.43
B. CPI Excl. Unprocessed Food	0.29	10.02
***D.** CPI Excl. Unprocessed Food and Energy*	0.32	9.37
C. CPI Excl. Energy	0.61	8.76
***E**. CPI Excl. Energy and Alcoholic Beverages*	0.59	8.53
***F.** CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes*	0.47	8.10
***G.** CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food*	0.15	8.77
PPI	**-0.41**	**10.70**
Agriculture	0.97	7.32
Industry	-0.80	11.70
Mining	-3.40	11.16
Man. Industry	-1.06	12.47
Energy	3.90	2.01

(*) Details on CPI, PPI and Special CPI Aggregates can be found at the SIS web page.
Source: SIS

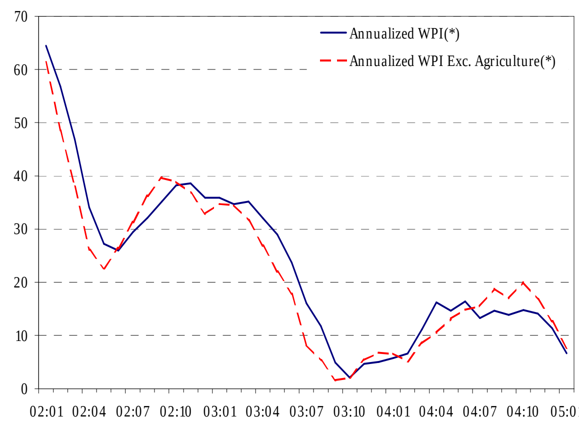
4. The Central Bank of Turkey will primarily monitor the developments of the index with base year 2003, which is more up-to-date. Undoubtedly, with the announcement of the index figures with base year 2003, breaks will quite probably be observed in the price series, which constitute the basis of inflation assessments. The impacts of these breaks on the results of statistical analysis will be more explicit with the increase of available observations. Graphs will utilize the former price indices until the new indices reach a certain number of usable observations, where data continuity to be achieved.

Figure 1: Annual Percentage Change and Six-month Moving Averages* (1994=100)

CPI and CPI Excluding Food



WPI and WPI Excluding Agriculture



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

Developments in Consumer Prices

5. Despite the fact that January is one of the months during which price increases in goods items (such as food and consumer durables) as well as in services groups (such as rents, health, transportation, financial services and restaurant services) gain a seasonal pace, general consumer prices displayed a limited increase of 0.55 percent.

6. Item-by-item analysis reveals that transportation, entertainment-culture and households displayed the highest rates of increase in January. Transportation prices rose by 2.85 percent due to the price increases in the municipal and other public transportation services at the beginning of the year. Moreover, a relatively high rate of increase, 1.92 percent, in prices of technology-intensive goods such as televisions, computers as well as DVDs and service-intensive products such as cinema, theatre and tours chiefly stemmed from seasonal price adjustments. The 1.51 percent price increase in the group of household goods, which mainly consists of furniture and consumer durables, remained quite above the general inflation rate.

7. Meanwhile, the price increase in the food and beverages group became 1.19 percent. When strong upward seasonal factors affecting this group in January are taken into account, the said rate of increase is considered to be fairly limited. Besides, this development mainly stemmed from favorable weather conditions as well as the VAT cut in the food sector. Winter sales as well as the 5.05 percent decline in clothing and shoe prices due to the appreciation of the New Turkish Lira had a compensating role in the seasonal increases in other sub-items, too.

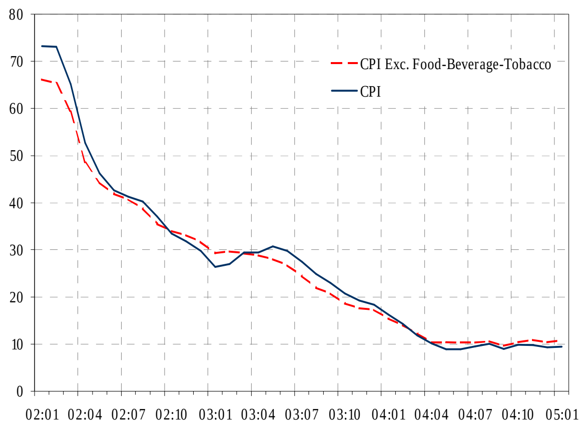
8. Prices in the housing group, which has lower weight in the new price index after exclusion of imputed rent, displayed a slight increase of 0.67 percent. On the other hand, rent increases are still maintaining their pace. In January 2005, rents increased by 1.90 percent. Furthermore, restaurant and hotel services, one of the items in services, recorded the highest rate of increase within the CPI in January, which is 1.27 percent.

9. Annual price increases in food and beverages, clothing and shoes remained below the general inflation tendency and inflation target, whereas annual price increases in the groups of housing, health transportation, education, restaurants and hotels pursued a course higher than the general trend. This observation is valid for the index with base year 1994, as well.

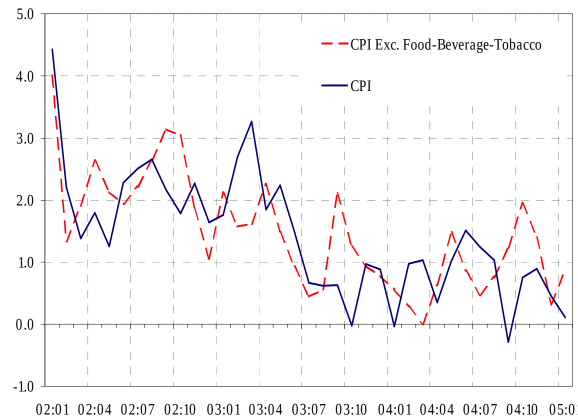
10. Along with the CPI with base year 2003, special CPI aggregates have started to be announced. These indicators are of great importance with regard to distinguishing different shocks to inflation and understanding the basic tendency of inflation better. The annual rate of increase in the index (G), which is compiled with the exclusion of energy, alcoholic drinks, tobacco, other products the prices of which are managed, indirect taxes and unprocessed food, turned out to be 8.77 percent (Table 1). Remaining below the 12-month average inflation rate of 9.28 percent, this figure shows a downward-tending annual inflation.

Figure 2: CPI and CPI Excluding Food-Beverage-Tobacco (1994=100)

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.
* TRAMO/SEATS method has been used in seasonal adjustment.

Developments in Producer Prices

11. The PPI declined by 0.41 percent in January. This corresponds to 10.7 percent in annual terms.

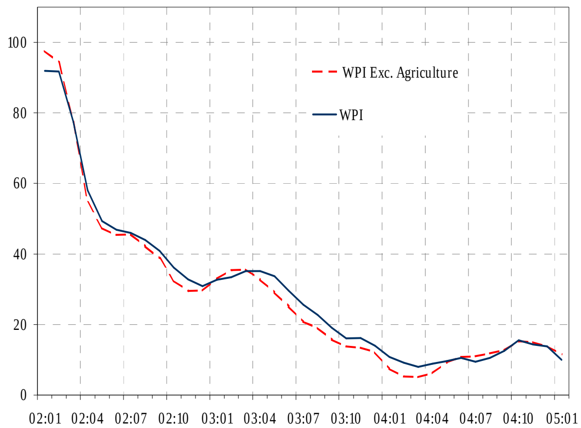
12. Agricultural prices increased by 0.97 percent in January, while the prices for the PPI excluding agriculture (industrial sector) dropped by 0.80 percent. Fresh vegetable and fruit prices, which reflect seasonality, were influential in the upsurge in agricultural sector prices. In annual terms, agricultural sector prices rose by 7.32 percent, while the PPI excluding agriculture rose by 11.7 percent.

13. Manufacturing industry prices declined by 1.06 percent in January. Prices of coke and the refined oil products sector, which dropped by 7.44 percent, were key determinants of this development. This is largely attributable to developments in crude oil prices and the appreciation of the Turkish lira. Having said that, prices for the oil products sector may follow a fluctuating course in the upcoming period, depending on the fluctuations in international crude oil prices and exchange rates.

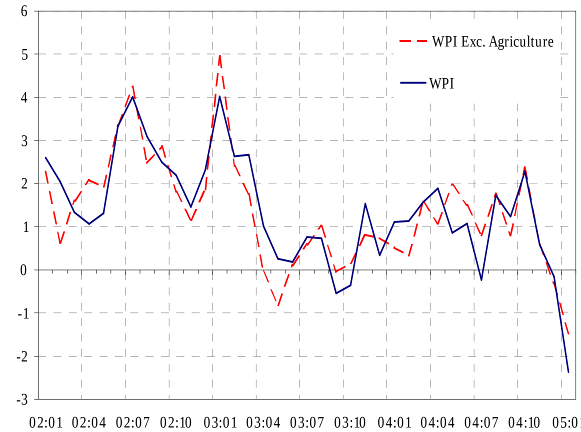
14. Energy (electricity, gas, water) prices of the PPI increased by 3.9 percent. Energy prices have risen by 2.01 percent in annual terms.

Figure 3: WPI and WPI Excluding Agriculture (1994=100)

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.

* TRAMO/SEATS method is used for the seasonal adjustment. As the data is not sufficient to analyze the seasonality of PPI with base year 2003, seasonal factor estimates derived from index figures with base year 1994 were used in the seasonal adjustment of the figures for January 2004.

15. A radical change in the PPI (as compared to the former WPI) is the elimination of the differentiation between the private and public sectors. Besides, the relative weights of sectors in the index have changed. However, the effects of these changes on measured inflation and the inflation tendency will be closely monitored.

II. OUTLOOK

New Indices and Inflation

16. The State Institute of Statistics began to publish monthly and yearly inflation figures based on the price indices with base year 2003. At the very beginning, it is deemed useful to correct a misperception with regard to the comparison of former and new indices in terms of the measurement of inflation. For a reliable comparison, it is necessary to consider the increase *in the same time span* in both indices. The figures announced by the SIS allow a comparison of data covering the last 11 months of 2004 for both indices. When the new index value for January 2004 (calculated by using the annual increase) and the new index value for December 2004 (calculated by using the monthly increase) are used to measure inflation for the last eleven months of 2004, both the CPI and the PPI are seen to have increased at a *higher* rate, though not too high, compared to the old indices. Therefore, it should be pointed out that the public opinion that "the new basket measures inflation lower" might not be correct, taking into account at least the previous year's data.

17. The interpretation of the information contained in the figures announced, with respect to future inflation is crucial, as usual. Within this context, the significant decline in the industry prices, which is a sub-item of the producer price index is deemed to be a favorable development with respect to inflation in the upcoming period. Accordingly, the risk arising from cost increases of the first 10 months of 2004 to be reflected in the consumer prices diminished. Whether this risk will continue diminishing in the coming period depends on developments of raw material and other input costs.

18. Meanwhile, a number of special CPI aggregates, candidates for use in the calculation of core inflation together with the new indices, have started to be published. One of the issues triggering public curiosity regards which of them is to be used as core inflation. The answer to this question may differ depending on cyclical changes. For example, during periods of intense oil price movements, inflation excluding energy may convey important information, whereas in case of a change in relative prices due to radical tax arrangements in the public sector, prices adjusted for indirect taxes may come to the forefront.

19. Taking into account the fact that public goods- and petroleum products-related external factors have had an unfavorable effect on inflation in recent months, it would be reasonable to assert that figures excluding those pertaining to the aforementioned factors incorporate very important information in terms of the main trend in inflation. Supporting the view that the downward trend in inflation continues, annualized figures of special CPI aggregates (indicated in the SIS bulletin with codes C, D, F and G) have remained below the changes recorded according to 12-month averages.

20. As stated in our previous inflation and outlook report, inflation figures for January 2005 certainly contain some information about future inflation; however, this information can be hard to interpret. For example, it is impossible to have a final evaluation of the incidence level of VAT cuts on prices of such sectors as health, education and food in January. Factors such as the change in index coverage, the increase in the role of technology-intense goods or the exclusion from the index of some important items such as imputed rent are likely to lead to a structural break in the time-series pattern of price series. Accordingly, it will be hard to make forward-looking analysis by utilizing past inflation data. The changes in the expenditure coverage and the price compilation period enriched the set of available information, as well as influencing the course of seasonal fluctuations of the indices.

General Factors Affecting the Monetary Policy

21. The above-mentioned factors are valid in all circumstances. However, it should be kept in mind that, in making predictions about the future course of inflation, the Central Bank is concerned about the near-to-medium term course of the variables affecting inflation rather than past inflation data. Central Bank's primary goal is to establish and maintain price stability via sustaining the downward trend in inflation. Meanwhile, the course of inflation in the medium and long-term will ultimately be determined by the general economic equilibrium at macro level and the structural reforms at micro level.

22. Important steps have been taken on the way to macroeconomic stability thanks to the monetary and fiscal policies implemented for the last three years as well as the ongoing structural arrangements. As a natural consequence of this process, policy makers and other economic agents will start to act in line with a medium-term perspective rather than a short-term one. Undoubtedly, the Central Bank is also part of this process of change and making its monetary policy decisions by taking the medium-term conditions into account. Moreover, price stability, by definition, necessitates adopting a medium- and long-term perspective.

23. Considering this approach, it is clear that the revision made in the method of measuring inflation should not lead to a change in the view of the Central Bank about the medium-term economic outlook. In the medium and long-term, factors that might jeopardize price stability will stand as factors that will affect the monetary policy stance. As a natural consequence, these factors will be determined by macroeconomic and structural elements rather than temporary factors such as change in index, indirect taxes or oil price increases. For example, medium-term monetary policy outlook may be affected by a non-transitory deceleration in productivity rise, deterioration of the general supply-demand equilibrium in favor of the latter, or a serious halt to the process of structural reforms which aim at increasing the quality of fiscal discipline.

Macroeconomic Outlook

24. Taking into account the achievements obtained in macroeconomic stability, it is anticipated that the investment trend will pursue a strong course in the coming period and the increase in productivity will continue though not at such a high pace as in recent years. Meanwhile, under the assumption that the public wages policy will be consistent with inflation targets, rises in real wages are not estimated to reach a level to exert pressure on inflation. In addition to these, taking into consideration the falling financing costs and the course of exchange rates, it is predicted that there will not be a marked pressure on unit costs in 2005, as well.

25. In the second half of the year, the upward trend in the expenditure on durable goods lost pace and capacity utilization rates in the said sectors dropped as a result of the decrease in conjunctural effects arising from delayed demand, a series of selective measures and the rise in interest rates on consumer credits. Moreover, there has been a slowdown in the rate of increase in industrial production, intermediary goods imports, money demand and credits while at the same time the amount of excess liquidity has decreased and consumer tendency and consumer confidence tendency index has stabilized. As a result, all these developments and the other leading indicators about economic activity show that growth lost pace in the third quarter and this relative slowdown will continue in the last quarter of the year as well. On the other hand, 2004 budget indicators and the figures announced for 2005 denote that fiscal discipline will be sustained in the upcoming period and this supports our projection about the sustainability of the recovery in domestic demand in a controlled manner. In conclusion, the view that domestic dynamics will continue to support the downward trend in inflation is strengthening.

26. CPI inflation excluding energy, one of the special CPI aggregates, is well below the general CPI inflation and this points to the negative effect of the cumulative contribution of external factors on the 2004 inflation. Undoubtedly, most of the external developments are unpredictable. For instance, it is not possible to foresee oil prices, probable course of the negotiations with the EU or if the international liquidity conditions will continue to be in favor of developing countries. However, as usually emphasized by the Central Bank, an increase in the economy's resistance to unfavorable developments in the said circumstances is much more important in terms of medium and long-term inflation dynamics compared to the developments themselves. In an environment where inefficiency in the public sector is diminished, tax policy is regulated in order to strengthen the quality of fiscal discipline, bureaucratic obstacles to investment and production are removed and institutional governance is improved, external factors could not threaten inflation and macroeconomic stability. In other words, if the structural reforms that were launched three years ago are carried out with determination, the external shocks mentioned above will surely have a temporary effect on our economy.

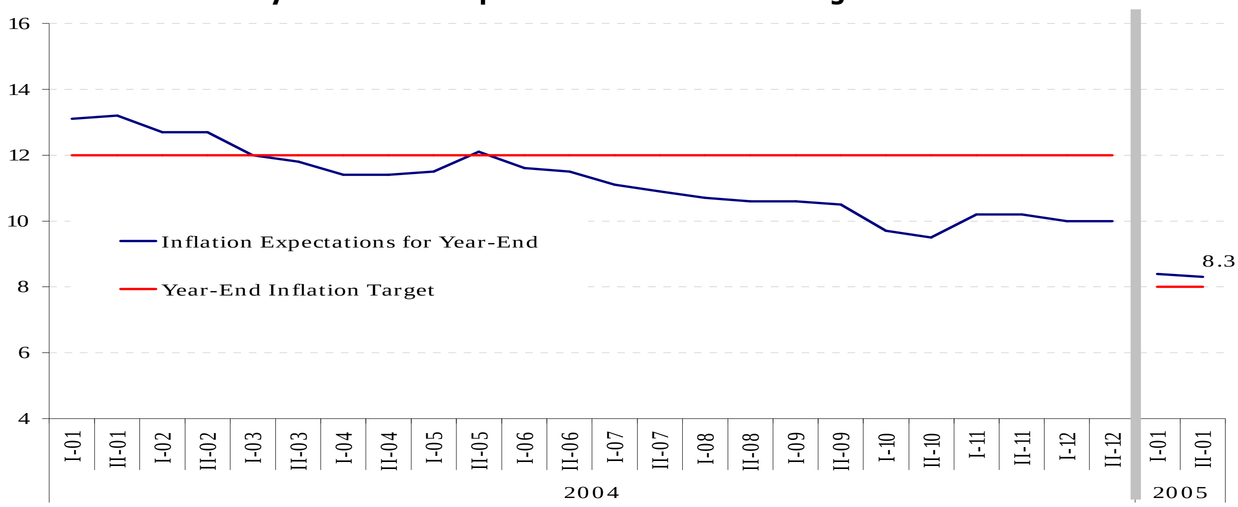
27. The Central Bank makes its monetary policy decisions according to inflation in the upcoming period, that is to say, to its predictions concerning the continuation of the downward trend in inflation and the magnitude of this decline. It should be underlined once again that maintenance of fiscal discipline and structural reforms are prerequisites for the continuation of the decline in inflation. In the light of the above evaluations and under the assumption that policies, which are based on fiscal discipline and structural reforms and are explained in detail in the three-year Pre-accession Economic Program, are carried out with determination, inflation will continue to decrease. However, in case of a temporary slow-down in maintaining budgetary discipline and structural reforms, the downward trend of inflation may lose momentum although it is not expected to rise. For this reason, it is very important that the favorable environment created by the improvement of future expectations does not slow down the budgetary discipline and structural reform process but gives an impetus to the efforts to stabilize these acquisitions.

28. Indeed, the duration of the decline bears some significance here. A long period would not be a favorable development for the end-year inflation target. At this point, the Central Bank does not foresee a risk for the end-year inflation target, which can arise from the length of this period. Nevertheless, it is clear that the Central Bank does not have control or authority over the timing of these efforts. Every step to be made towards this aim will put an end to the precautions against temporary uncertainties, while it will contribute to the gradual decline in short-term interests in the upcoming period.

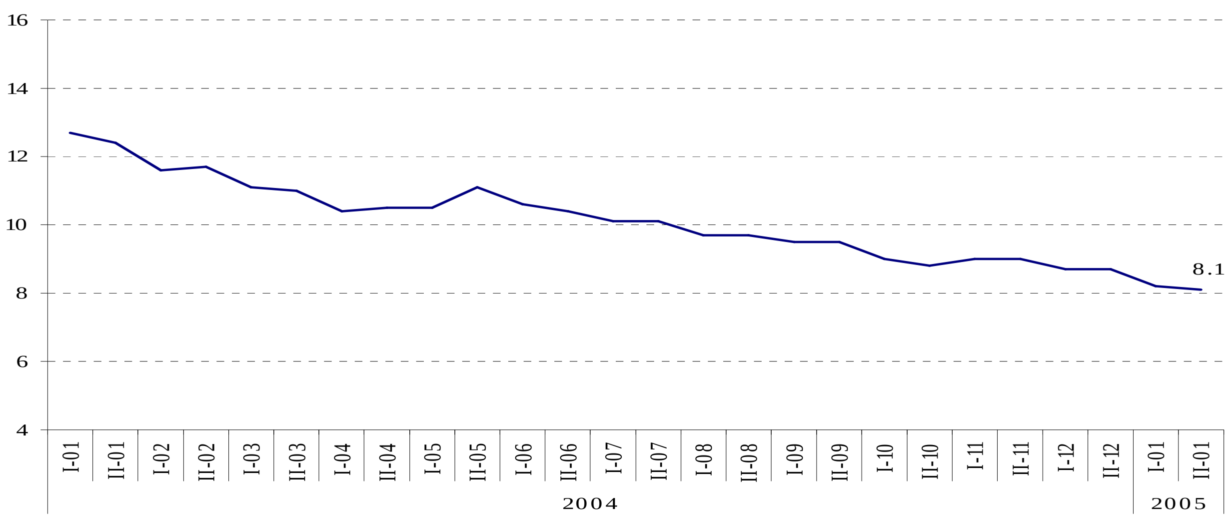
29. In the light of this information, overnight interest rate is cut by 0.50 points, by also taking account of the evaluations made at the meeting of Monetary Policy Board held on 8 February 2005.

Figure 4: Inflation Expectations According to the CBRT Expectations Survey

End-year Inflation Expectations and Inflation Target: 2004-2005



Inflation Expectations for the Next 12 Months



Resource: CBRT Expectations Survey