February Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with base year 2003, in February 2005, the CPI rose by 0.02 percent and the PPI by 0.11 percent. The annual rates of increase in the CPI and PPI declined to 8.69 percent and 10.58 percent, respectively.

2. CPI excluding unprocessed food, energy, alcoholic beverages, tobacco products, administered prices and indirect taxes, which is one of the special CPI aggregates, dropped by 0.18 percent (Table 1). The annual rate of increase for the afore-mentioned aggregate, which was 8.77 percent in January 2005, declined to 8.58 percent in February (Figure 1). All the special CPI aggregates in the SIS bulletin, underline a lower rate of annual inflation.

3. In February 2005, the PPI excluding agriculture rose by 0.17 percent (Table 1). The same index increased by 12.12 percent annually (Figure 1).

4. Within this framework, in February, the decline in consumer inflation relatively gained pace and February 2005 has become a favorable month in terms of inflation developments.

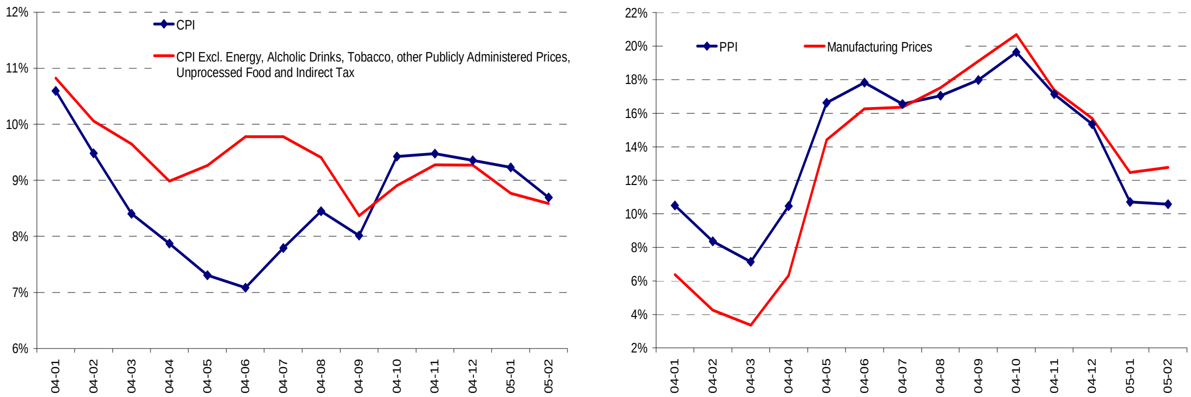
Table 1: General CPI, PPI and subgroups

	2005 Jan.	2005 Feb.	2004 Feb. 2005 Feb.
CPI	**0,55**	**0,02**	**8,69**
Special CPI Aggregates			
A. CPI Excl. Seasonal Goods	0,85	0,85	10,33
B. CPI Excl. Unprocessed Food	0,29	0,09	9,50
D. *CPI Excl. Unprocessed Food and Energy*	0,32	0,05	8,77
C. CPI Excl. Energy	0,61	0,43	8,28
E. *CPI Excl. Energy and Alcoholic Beverages*	0,59	0,27	7,84
F. *CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes*	0,47	0,24	7,89
G. *CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food*	0,15	-0,18	8,58
PPI	**-0,41**	**0,11**	**10,58**
Agriculture	0,97	-0,12	5,49
Industry	-0,80	0,17	12,12
Mining	-3,40	2,07	12,88
Man. Industry	-1,06	0,14	12,78
Energy	3,90	0,12	3,32

Source: SIS, (2003=100)

Figure 1: Annual Percentage Change

CPI and Special CPI Aggregates (G) **PPI and Manufacturing Industry**



Source: SIS, (2003=100)

Developments in Consumer Prices

5. The main factors determining consumer inflation in February 2005 are i) the increase in Special Consumption Tax (SCT) of cigarettes and alcohol, ii) the cut in VAT at the beginning of the year iii) the appreciation of the New Turkish Lira.

6. The increase in the SCT of cigarettes and alcohol, caused increases in the prices of alcoholic beverages in rates varying between 17.6 percent and 23.5 percent at the beginning of the month. In the days that followed, the SCT increases led to a 4-5 percent rise in some foreign cigarettes. Accordingly, in February 2005, the item with the highest rate of increase within the CPI became alcoholic beverages and tobacco products with 1.95 percent.

7. The fact that the share of alcoholic beverages and tobacco group, whose prices are determined mostly by the public, has risen remarkably according to the index with 2003 base year compared to the index with 1994 base year, indicates that lump-sum tax increases will be more influential on inflation compared to the previous period. That is why it is important to make these increases compatible with the end-year target and spread them throughout the year.

8. Besides the increase in the SCT, another tax issue affecting February inflation was a 10 percent cut in the VAT on food, education and health. The impact of the cut was not very visible in the food and non-alcoholic beverages group due to seasonal price increases. However, price increases having realized below seasonal averages in this group in January and February, highlight the fact that the decline in

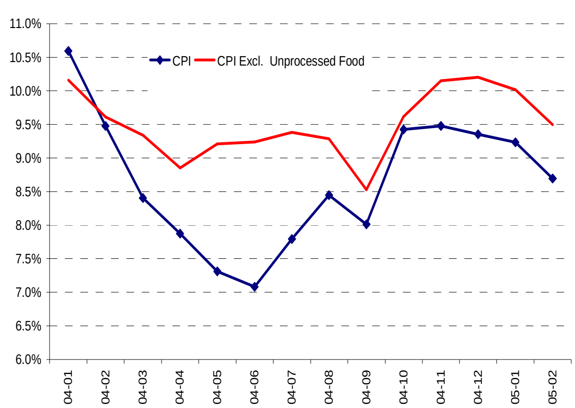
VAT might have been effective. On the other hand, in the education and health groups, the influence of VAT cut is more apparent: prices of education services have dropped by 0.69 percent in the last two months. During this period, in which prices of health services are generally adjusted for the next six months, the price increases in the health services group, were recorded at historically low levels. Health group prices which had risen 7.26 percent in the January-February period of the previous year, increased by only 0.17 percent in the same period this year. Thus, the annual price increase in the health group that stood at 11.70 percent by the end of 2004, declined to 4.31 percent, as of February.

9. Along with this, in the November 2004 and February 2005 period, the appreciation of the New Turkish lira in terms of the US dollar with the average value of 10.4 percent limited the price increase in most of the goods items. Indeed, according to the series obtained using the three-digit classification of the index with 2003 base year, prices of the goods group declined by 0.29 percent in February 2005. In addition to this, exchange rate developments were also influential on the 0.27 percent decline in the entertainment and culture group (in the new index, technological goods like DVD players and laptops are included in this group).

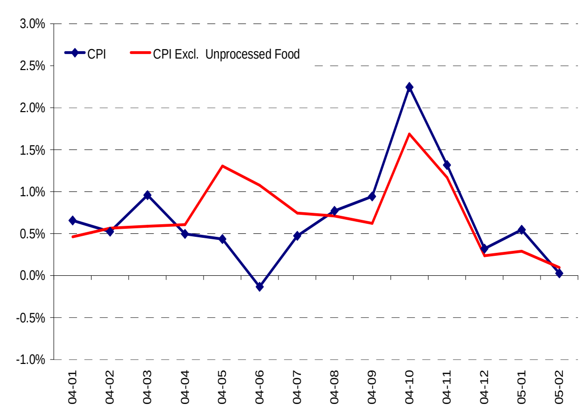
10. On the other hand, prices of the services group rose by 0.51 percent in February. Though this rate is above the increases in the general CPI and goods prices, it is considerably below the February increases of previous years. While prices of restaurant-hotel services and rents rose by 1.48 percent and 1.24 percent, respectively, the decline in the prices of education and health services by 0.43 percent and 0.29 percent partially compensated for these increases.

Figure 2: CPI and CPI Excl. Unprocessed Food

Annual Percentage Change



Monthly Percentage Change



Source: SIS, (2003=100)

Developments in Producer Prices

11. In February, the PPI increased by 0.11 percent. Compared to December 2003, the PPI decreased by 0.30 percent and compared to the same month last year, it increased by 10.58 percent.

12. While monthly agricultural prices dropped by 0.12 percent, the PPI, excluding agriculture, (the industrial sector) increased by 0.17 percent. In year-on-year terms, the former increased by 5.49 percent and the latter by 12.12 percent. In the light of these figures, it can be asserted that the relative prices have developed cyclically in favor of the industrial sector.

13. Manufacturing industry prices increased by 0.14 percent in February. The 4.3 percent rise in coke coal and refined oil prices, which stemmed from the developments in international oil prices, became the primary determinants of this increase. As the unfavorable impact of international energy prices on manufacturing industry prices is expected to persist in the upcoming period, it is important that oil prices are closely followed.

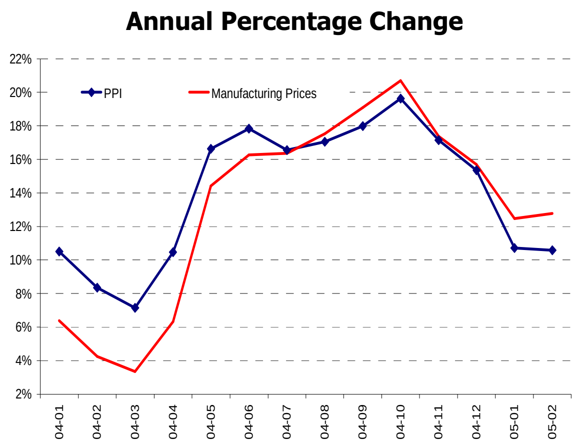
14. Energy prices (electricity, gas, water) within the PPI increased by 0.12 percent. The year-on-year rise in energy prices has reached 3.32 percent.

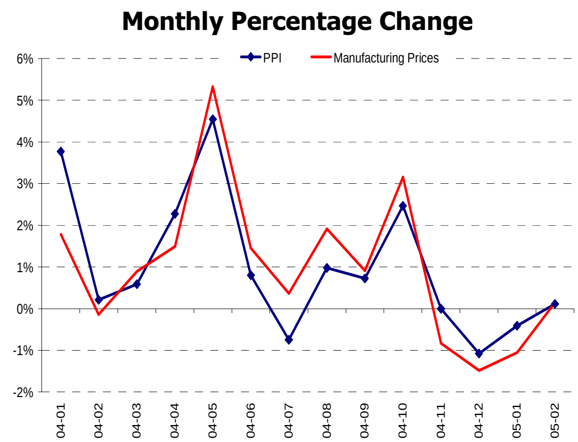
15. Tobacco products prices within the manufacturing sector have decreased by a significant 22.70 percent, which can be accepted as the effect of the rise in SCT on tobacco products. As taxes are not included in the calculation of the production prices, any rise in SCT exerts a downward pressure on prices excluding tax. While this implies a decline in profit margins, it is believed that a direct correspondence cannot be established between the decline in tobacco products prices and production costs.

16. In the manufacturing industry sector, prices in the basic metal industry decreased by 1.96 percent in February. Meanwhile, prices of metal products increased by 0.72 percent and machinery-equipment by 0.56 percent. It is expected that the decline in the basic metal industry prices will be reflected in the prices of metal products and machinery-equipment. However, the downward effect might be rather limited as international basic metal prices are on the rise.

17. The 12 percent decline in the prices of office machines manufacturing is also a development worth noting. However, the subject decline is believed to be caused by the annual price adjustments and no further downward pricing is expected. On the contrary, the prices in this sector are likely to display a gradual but limited rise due to input costs and demand developments throughout the year.

Figure 3: PPI and Manufacturing Industry Prices





Source: SIS, (2003=100)

II. OUTLOOK

Inflation Developments

18. Towards the end of 2004, there has been a downward movement in the inflation trend due to a slowdown in the rise in costs. Inflation figures of February support a favorable outlook. It is expected that the historically low accumulated inflation figures recorded in February would push the inflation expectations down. This will contribute to the easing of the rigidity created by services sector prices and the inertia in inflation.

19. It would be useful to exclude the CPI from the effects of some exogenous factors for a better evaluation of the inflation figures. For instance, unexpected changes in raw material prices, prices affected by weather conditions and public prices may affect indices and lead to misinterpretation of main inflation trend. Moreover, the absence of well-established fiscal discipline and structural changes that the economy undergoes can lead to frequent changes in taxes. The special CPI aggregates (F and G), which have been developed with the aim of isolating inflation from such external factors, have displayed a declining trend since October 2004. Therefore, it can be asserted that the downward trend in overall inflation continues.

20. Meanwhile, developments in producer prices sub-items emit positive signals as to the future inflation trend. As the PPI has started to be constructed from pre-tax producer prices with the new index, the information contained in producer prices for consumer prices has weakened. However, the accumulated decline in the PPI in the first two months of the year would help limit the rise in consumer prices through the cost channel. As a result, inflation figures recorded in the first two months are promising.

21. While analyzing inflation, the Central Bank takes into account the medium-term outlook and makes use of past inflation figures for information that they provide about the future inflation trend. Any downward/upward movement in inflation in a given month does not mean an overall upward/downward movement in inflation. Therefore, opting for a medium-term point of view is very important while making such an analysis. Seasonal conditions, public price adjustments, changes in tax rates and oil prices can easily lead to lower/higher rates in inflation in any month. For instance, in August 2004, the current inflation figures were higher-than-expected, however the Central Bank interpreted the information contained in these figures correctly and lowered interest rates by projecting that the future inflation trend would be downward. The Bank's projections proved to be true as the favorable trend in inflation continued. We would like to underline that closely monitoring the Bank's future inflation trend projections would assist and enhance comprehension of the Bank's decisions and discourage negative critics that could undermine the credibility of monetary polices.

22. Likewise, another false evaluation is made about "deflation danger." Deflation is described as a persistent decrease in the general price level. The drop observed in inflation in recent months should not be perceived as an ongoing decline in the general level of prices. Considering the trend of the CPI and the special CPI aggregates, it is clear that the Turkish economy is far from deflation, contrary to some statements made in public. Furthermore, such a risk is out of question in the medium term given that economic reforms are continuously carried out. In the harmonization process to the EU, the increasing productivity in sectors subject to foreign trade will bolster real wages. This increase in real wages will raise wages in the services sector and continue to exert pressure on prices in the overall economy. This situation, which is also referred to as the Balassa-Samuelson effect, is frequently seen in the economies of developing countries. For this reason, deflation is out of question and it is almost inevitable that inflation figures will continue to remain above the EU average during the convergence process of these economies. Undoubtedly, these predictions are made in the main scenario, in which structural adjustments are being carried out and bureaucratic barriers against investment and production are being removed.

Macroeconomic Outlook

23. The outlook report of September 2004, when the Central Bank lowered interest rates, drew attention to the fact that both the growth rate of the economy and the domestic demand would slow-down, due to the developments in money demand, credits, automobile sales and liquidity. In fact, the rise in industrial production held back in the last quarter of 2004. In addition to these developments, domestic sales of automobiles and commercial vehicles dropped in January compared to the previous year. This, along with the fact that deferred demand is fulfilled to a great extent, indicate that the relative slow-down in the rate of increase of demand in the second half of 2004 continues in January 2005.

24. Meanwhile, investments are expected to recover in the second quarter of the year owing to the increase in the real sector confidence index. Recently, imports of intermediary goods have continued to grow and new orders made by the domestic market for the next three-month period, published in the Business Tendency Survey, display a significant rise. Moreover, the same survey point to positive expectations for financing costs. Industrial production data for January shows that the increases in production are converging to program projections. In light of these data, the revival in production is predicted to continue and a relative revival in economic activity is expected in the first quarter of the year, compared to the previous quarter on seasonally adjusted terms.

25. Labor market developments in the last quarter of 2004; indicate an ongoing rise in total employment. Considering the latest developments in employment and production, the increase in labor efficiency lost momentum as it was expected in our previous reports. Taking into account the upward trend of real wages, this situation supports our expectation that real unit wages will not affect cost conditions as favorably as they had done in previous periods. Meanwhile, the appreciation of YTL against foreign currencies on both nominal and real basis in the previous period has had a favorable effect on unit costs.

26. In light of supply and demand developments, domestic demand is expected to be below the potential production level of the economy. The slow recovery of the consumer confidence index observed as of August 2004 and low capacity utilization ratios, which have not reached a level to exert pressure on prices, support this prediction. Moreover, as a result of the current incomes policy, the consumption composition is expected to continue contributing to the decline in inflation. However, credit utilization has increased in consumption financing parallel to the rise in installment sales and expectations for a drop in interest rates. This situation is being closely monitored in terms of both domestic demand and financial stability. The legal regulations regarding credit card utilization are expected to diminish related potential risks.

27. In short, supply-demand conditions maintain their favorable course in terms of their direct and indirect effects on prices. It is foreseen that the growth rate will be converging to program projections as of the second half of the year owing to increasing consumer and producer confidence and sustainable performance of exports. Predictions for the year 2005 indicate that the said growth will not threaten the decline in inflation. In conclusion, domestic demand developments will maintain their modest course in the short term and the increase in labor productivity is expected to continue, although at a slower pace.

28. Nevertheless, the analysis mentioned above gives a short-term outlook. In the medium term, the course of favorable developments in inflation is based on the medium term trend followed by the macroeconomic variables affecting inflation. The main factors are the developments in productivity and the supply-demand balance. The outlook of productivity and the general balance depends on external factors and current and future macroeconomic policies.

29. At this point, it is useful to emphasize once again the support given to the disinflation process by current economic policies: The budgetary discipline and the inflation-focused monetary policy that have been implemented with strict determination for the last three years has kept inflationary pressures under control by preventing domestic demand from exceeding sustainable growth rates. In addition to these factors and with the contribution of a series of structural arrangements reducing the inefficiencies in the economy, as well as steps taken in the area of Central Bank independence, a significant achievement has been obtained in terms of expectation management and the credibility of economic policies. Thus, the disinflation process and the high growth rates could be sustained at the same time. Factors such as the implementation of structural reforms, higher integration to the world, keeping domestic demand under control and the floating exchange rate regime also enhanced domestic competition and resulted in productivity increases.

The Relation Between Inflation and the Exchange Rates

30. It was mentioned in sections where developments in the sub-items of inflation were analyzed that exchange rate developments contributed to the low inflation figures in the first two months of the year. At this point, it will be useful to re-emphasize certain points which are believed not yet to have been properly understood regarding the inflation-exchange rate relationship: Studies have revealed that the pass-through from exchange rates to inflation was extremely strong in Turkey *before 2001*. However, the same studies also point to an evident break, *after the 2001 crisis*, in the exchange rate pass-through to prices. The main reasons of this break can be listed as; decline in the duration and persistence of exchange rate movements following the adoption of the floating exchange rate regime, increased domestic competition on account of changing economic conditions, inflation targets acting more as a nominal anchor, owing to increasing credibility of economic policies, and changing pricing behavior of firms as a result of the fall in inflation.

31. However, independent of the monetary and exchange rate policies, the fact that Turkey is an open economy, unable to set prices in international markets, makes it inevitable that inflation will be influenced by fluctuations in the exchange rate. This also has to do with the fact that the goods basket covered by the CPI consists mostly of traded goods, as well as the high share of imported intermediate goods in the composition of the input costs of the economy in general. However, what needs to be emphasized here is that, under the current regime, the influence of the exchange rate on inflation *decreased in an obvious manner, compared to the pre-2001 period,* and that the exchange rate is no more the main determinant of inflation, but *only one of the determinants*. Besides, the exchange rate developments under the floating exchange rate regime are the results of the current economic policies. It is possible that there might be fluctuations stemming from external shocks in the coming period, as was the case in the past. What needs to be emphasized here is that as long as the necessary steps are taken on the road to macroeconomic stability, such shocks will be bound to be temporary deviations from the main trend; otherwise, they may pose serious risks to inflation, causing deterioration in expectations.

32. Another issue that needs to be discussed is how the price index change affected the inflation-exchange rate relationship. The answer to this question can be reached by looking from two different angles. The first angle considers the content of the index. Compared to the CPI index with a 1994 base year, the CPI index with a 2003 base year contains more goods groups, with prices susceptible to the exchange rate. This causes the reflections of exchange rate movements on the general index to appear slightly higher (in either direction). However, in spite of the influence caused by the new price index, the exchange rate-inflation relationship is estimated to be much weaker compared to the pre-2001 period. As for the PPI, the announcement of producer prices, which exclude taxes, together with the index with 2003 as the base year, increased the susceptibility of this index to the exchange rate. In conclusion, it can be asserted that, independent of the composition of the index, the relationship between inflation and the exchange rate has weakened in the structural sense.

33. The second angle is one of time . It is quite difficult to make comparisons between the old and the new price indices, with regard to the course of the pass-through in time. The main source of this difficulty is that the new index series does not have sufficient number of observations to secure the reliability of the statistical analysis yet. In this case, although the known statistical techniques seem to be applicable from a solely-numerical perspective, the results produced by these techniques provide evidence which is far from reliable enough.

Monetary and Exchange Rate Policy

34. Needless to say, it is impossible to foresee the future course of exchange rates of the upcoming period. The Central Bank does not act with a certain exchange level in mind while implementing its exchange rate policy; it mainly focuses on keeping the potential volatility in exchange rates at low levels in order to ensure financial market stability. Recently, developments about European Union negotiations have boosted the capital inflow via reinforcing favorable expectations about the future. At this point, it is crucial to be cautious against the perceptions that all problems have been overcome. As a matter of fact, Turkey has just started to overcome the economic collapse brought about by the crisis in 2001 and the actions initiated to fully establish macroeconomic stability have not yet been completed. It should be always kept in mind that only through macroeconomic stability would it be possible to keep the volatility of asset prices to a minimum level in the medium-term. Accordingly, stimulating the structural arrangements bears great importance for increasing the resilience to exogenous shocks and reducing the potential volatility brought about by the likelihood of a reversal in global liquidity conditions.

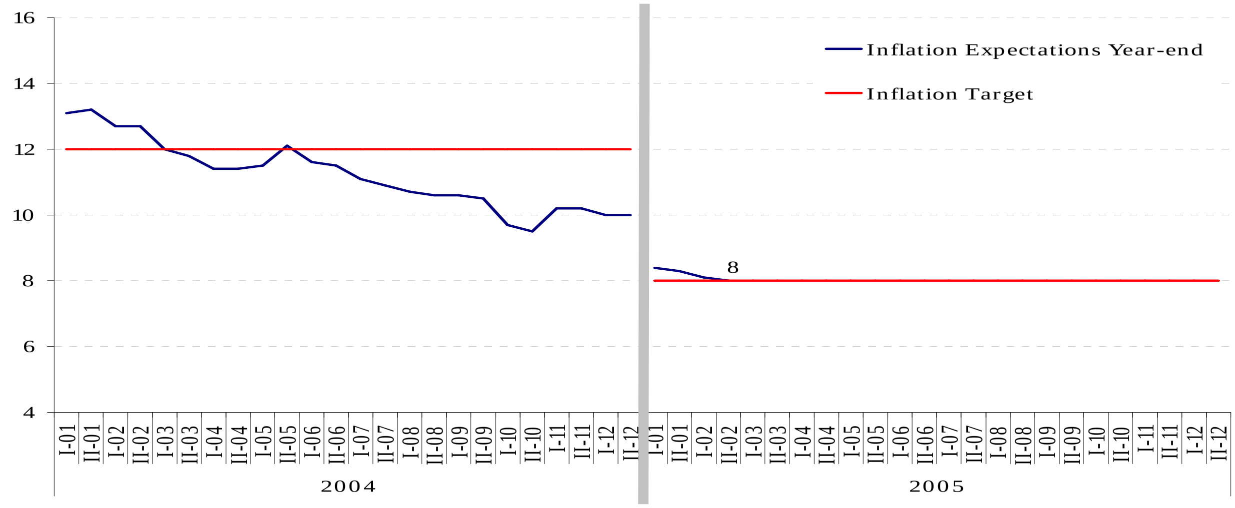
35. Another important development in terms of the monetary policy of the upcoming period is the increase in New Turkish lira-denominated long-term bond issues of international institutions. For these institutions will try to close their positions, creating a demand for domestic bond markets. This demand will extend the borrowing maturity as well as reduce the borrowing cost; and this, in turn, will increase the relative effectiveness of the monetary policy via alleviating fiscal dominance. These developments bode well for the inflation targeting policy to be adopted in 2006. With the extension of maturities and the decline in risk premium, not only the current but also the future stance of monetary policy will have gained importance and this will provide the market players with a medium-term perspective.

36. In conclusion, there seem to be no obvious risks to the inflation target in the short-term other than significant exogenous shocks; however, we are in a period where the medium-term outlook is shaped by structural reforms. In light of the above mentioned analyses as well as the other developments in the previous month and taking into account the evaluations made at the Monetary Policy Board meeting held on March 8, 2005, the Central Bank decided to cut the short-term interest rates applicable on the CBRT Interbank Money Market and Istanbul Stock Exchange Repo-Reverse Repo Market by 1 point to be effective as of March 9, 2005. The Central Bank is maintaining its cautiously optimistic stance for the upcoming period. The above mentioned points indicate that fiscal discipline and structural arrangements are essential for sustaining the downward trend in inflation in the medium-term and establishing macroeconomic stability permanently. For this reason, while following a policy focused on future inflation, the Central Bank is trying to anticipate the inflation outlook on the one hand, and monitoring the developments in social security and restructuring in income management that will increase the quality of primary surplus, on the other hand. It is also closely monitoring the other developments in banking draft law and fiscal policy, and is taking into account the potential risks while making its monetary policy decisions. In this context, any arrangement to be made with the aim of improving the quality of fiscal discipline, reinforcing macroeconomic stability and reducing inefficiencies in the economy will increase the likelihood of decline in interest rates.

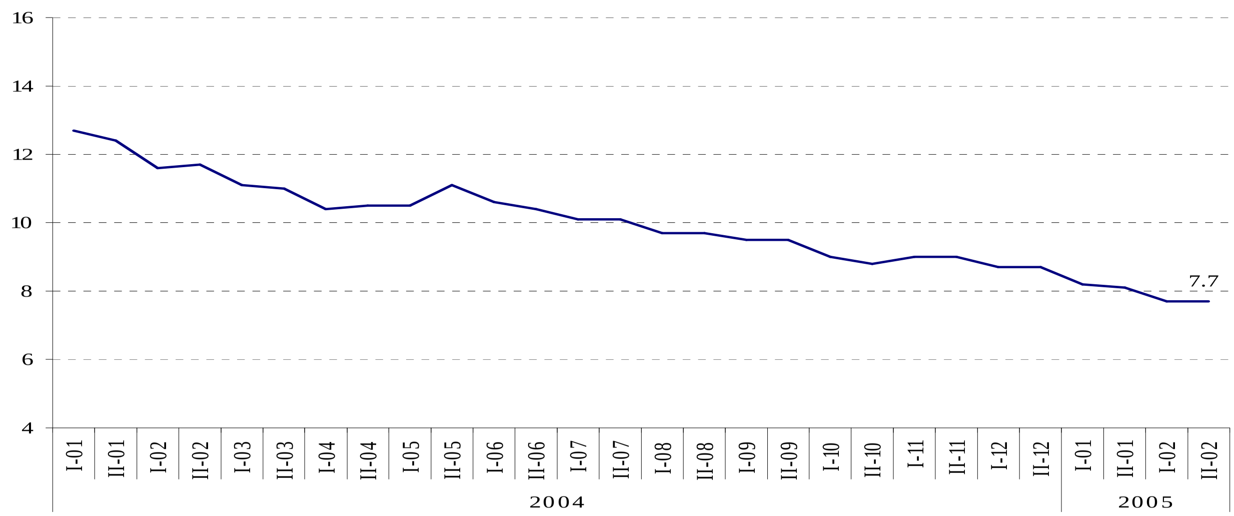
37. The first point worth emphasizing here is that the current account deficit or exchange rate or any other variable is included in the decision-making process *not directly but indirectly, only to the extent that they contain information for future inflation.* In other words, the interest rate decisions of the Central Bank are never aimed at directly affecting other variables but future inflation. The second point is that the fall in short-term interest rates is not a sufficient condition for a fall in long-term interest rates. It is the improvement in the quality of fiscal discipline as well as the permanent reduction in risk premium, rather than an artificial cut in short-term interest rates, that will assure a permanent fall in long-term nominal and real interest rates. Within this framework, the pace of implementation and continuation of the steps to be taken in the restructuring of revenue administration, social security reforms, banking draft law and corporate governance are of critical importance.

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



Source: CBRT Expectations Survey