

November Inflation and Outlook

I. GENERAL EVALUATION

1. According to the indices with base year 2003, the CPI increased by 1.40 percent, while the PPI dropped by 0.95 in November. Annual inflation in the CPI and PPI became 7.61 percent and 1.60 percent, respectively (Graph 1).
2. In November, the special CPI aggregate F, which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes, increased by 1.93 percent in monthly terms, while the G index, obtained by excluding unprocessed food from the F index, displayed a 0.88 percent-increase (Table 1). The year-on-year increase in November for these indices became 6.87 percent and 6.27 percent, respectively.
3. In November, agricultural prices increased by 2.11 percent, whereas the PPI excluding agriculture (industrial prices) fell by 1.74 percent (Table 1).

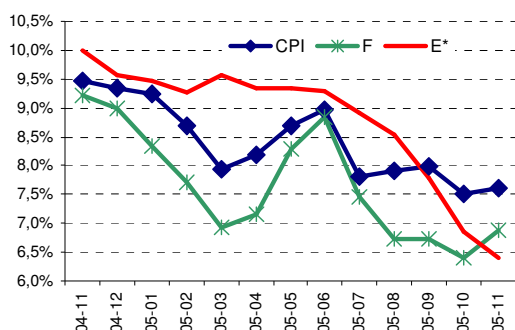
Table 1: General CPI, PPI and Sub-groups

	2005 November	2004 Dec.- 2005 Nov.	2004 Nov.- 2005 Nov.
CPI	1,40	7,27	7,61
Special CPI Aggregates			
A. CPI Excl. Seasonal Goods	0,05	7,44	7,46
B. CPI Excl. Unprocessed Food	0,61	7,07	7,36
C. CPI Excl. Energy	1,65	7,24	7,51
D. CPI Excl. Unprocessed Food and Energy	0,74	6,99	7,20
E. CPI Excl. Energy, Alcoholic Beverages and Tobacco	1,76	6,39	6,68
F. CPI Excl. Energy, Alcoholic Beverages and Tobacco, Other Administered Prices and Indirect Taxes	1,93	6,49	6,87
G. CPI Excl. Energy, Alcoholic Beverages and Tobacco, Other Administered Prices, Indirect Taxes and Unprocessed Food	0,88	6,00	6,27
PPI	-0,95	2,71	1,60
Agriculture	2,11	1,28	1,56
Industry	-1,74	3,11	1,62
Mining	-2,68	10,53	4,28
Manufacturing	-1,86	3,75	2,22
Energy	0,67	-8,78	-8,44

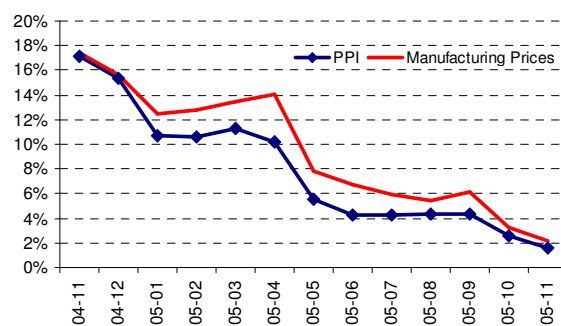
Source: Turkish Statistics Institute (TSI), (2003=100)

Graph 1: Inflation (Annual Percentage Change)

CPI and Selected Aggregates



PPI and Manufacturing Industry



E*: CPI excluding energy, alcoholic beverages, tobacco and seasonal products.

F: CPI excluding energy, alcoholic beverages, tobacco, other goods with administered prices and indirect taxes.

Source: TSI (2003=100), CBRT

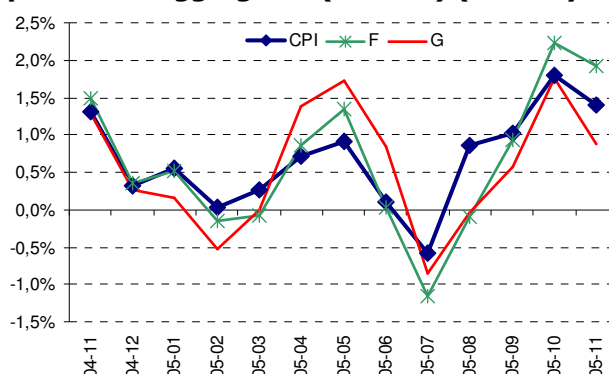
Developments in Consumer Prices

4. The monthly price increase in food and non-alcoholic beverages became 3.27 percent. The main determinant in this development was the increases in fresh fruit and vegetables, which were realized significantly above the seasonal tendencies.

5. The prices in the clothing and footwear group, which increased at a high rate in October due to the effect of new season products, rose by 3.53 percent in November, maintaining their seasonal tendency. The year-end rate of increase of the group prices, which displayed a 0.46 percent increase in the first eleven months of the year, is expected to be realized considerably below the general inflation target.

6. The monthly price increase in the housing group became 1.05 percent. The main determinants of the increase in housing prices were the increases in rent and natural gas prices that rose by 1.17 percent and 4.34 percent, respectively.

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



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

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

Source: TSI (2003=100)

7. In November, prices of household goods rose by 0.85 percent mainly due to the increase by 2.26 percent in furniture prices, which had substantially risen in the previous month as well. The high-rated increases in furniture manufacturing, which can be an indicator for the demand for consumption goods, should particularly be noted. It is believed that the domestic demand-price relationship is stronger in this sector due to the facts that this sector is relatively closed to foreign competition and it utilizes low imported input. In this framework, the increase in the furniture manufacturing sector by 32.1 percent in nine months of the year, compared to same period last year, and the fact that furniture prices remained above the general inflation level rising by a high rate of 13.4 percent cumulatively, in the January-November period, point to a decline in the contribution of domestic demand to the falling inflation.

8. Prices in the transportation group declined by 0.82 percent in November. This drop mainly stemmed from the decline in items that were directly influenced by oil prices.

9. It is observed that prices in restaurants and hotels still maintain their upward trend in November and that the eleven-month cumulative increase of 14.40 percent in the said group in 2005 is above its level of 2004.

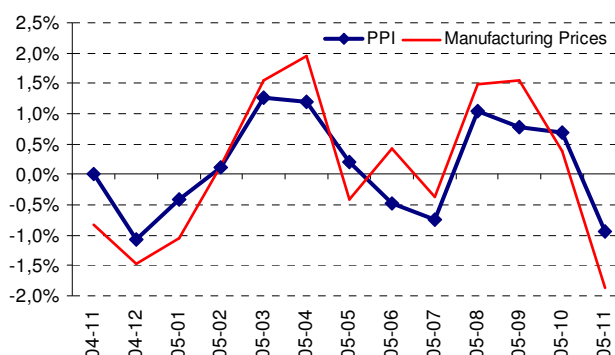
Developments in Producer Prices

10. Along with the 0.95 percent decrease in producer prices in November, the cumulative increase in the PPI was realized as 2.71 percent during the first eleven months of the year.

11. Agricultural prices maintain their upward trend due to seasonal effects. With the 2.11 percent increase in November, the annual price increase in the agriculture sector was realized as 1.56 percent. The increase in agricultural prices is expected to continue in the coming months.

12. Manufacturing industry prices decreased by 1.86 percent in November. The main determinant in this decrease was the 12.02 decline in prices of petroleum products, especially in line with developments in international markets. Moreover, annual increase in the manufacturing industry prices, excluding petroleum products, maintained its downward trend in November. As to the energy group, the upsurge in natural gas prices is considerable.

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



Source: TSI (2003=100)

II. OUTLOOK

Inflation Developments

13. November inflation was realized above market expectations due to high increases in food prices resulting from seasonal movements. The increase in fruit and vegetables, which were realized about nine points above the November 2004 figures, became the main determinant in this development. Nearly 3.13 percent of the 3.27 percent increase in the food and non-alcoholic beverages item stemmed from the high increase in fruit and vegetables prices. The increase in the said sub-items (fruit and vegetables) consisted of about 1.22 points of November inflation. Excluding seasonal factors, it is clear that November price developments do not seem to impair the general inflation outlook expressed in the previous report.

14. In the new period, in which the inflation-targeting regime will be implemented, it is crucial that all Central Bank reports to be read carefully in order to fully understand the future stance of monetary policy. Monetary policy implemented by the Central Bank should be related to future inflation, not to the realized figure. Although this issue was repeatedly emphasized through reports, presentations and assessments in the last four years, it is evident that it was not fully understood by the public. The existence of questions such as "How can the 2006 target be achieved when the inflation figure of the last four months is 5.17 percent?" compels this issue to be emphasized over and over. The Central Bank has repeatedly announced that factors, such as indirect taxes, oil effect and seasonality have been the determinants in inflation developments of the last four months.

15. Another point, which is not fully understood by the public, is that producer prices are not the target. Taking the PPI increase as a target in the fight against inflation is out of the question, because the producer prices do not measure the daily cost of living of economic agents. It should be repeated once more that the Central Bank's definition of inflation is the inflation rate, which is calculated by the percentage change of the Consumer Price Index with base year 2003. Comprehension of this definition by the public during the inflation-targeting period is of great importance in order for them to accurately understand the Central Bank's

messages. Undoubtedly, producer prices may contain information about the inflation of the coming period, since they are cost indicators for the retail sector. Therefore, the course of producer price increases at historically low levels during the last period gives favorable signals for inflation in the upcoming period. Nevertheless, it should be borne in mind that producer prices may change rapidly due to cost conditions and hence, the value of information it contains about the future tendency of inflation is limited. While evaluating the realized inflation figures as regards inflation in the upcoming period, the CPI indicators that are calculated by excluding temporary and external effects contain much more helpful information.

16. It should not be overlooked the November inflation that excluding seasonal products (various food and clothing products having variable weight within the index), was realized as merely 0.05 percent and that the said increase was the lowest monthly increase throughout 2005. Undoubtedly, the relatively low increases in services prices and the effect of the slackening oil prices have assisted inflation in November. However, the decline of the index, which excludes energy, services and seasonal products, on monthly basis, indicates that the November figures do not point to a rise in inflation, but signal a decline in inflation.

17. It is observed that the annual rates of increase of the special CPI aggregate F, which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes and the G index obtained by excluding unprocessed food from the F index shift between 6 percent and 7 percent. The index (E*) obtained by excluding seasonal products from the E index, which excludes energy, alcoholic beverages and tobacco products, dropped to 6.40 percent, maintaining its gradual decrease in the last period (Graph 1), These figures point to a decline in the short-term tendency of inflation.

Factors Affecting Inflation

18. The medium-term trend of inflation is shaped by expectations, supply-demand balance, costs and developments in pricing behaviors. Recently, developments in consumer confidence indices and data on white goods – automobile sales show that consumption demand is following a stable path. Analyzing foreign trade data, it is

observed that imports of consumption goods increased in seasonally adjusted terms in the third quarter of the year, but re-stabilized afterwards. Similar trends apply to domestic sales of automobiles and white goods. In seasonally adjusted terms, white goods sales and domestic sales of automobiles, which had lost its pace but nevertheless continued to increase in the third quarter of the year compared to the previous period, declined in September and October. Hence, data for October signal that the recovery in consumption expenditures will not accelerate and remain at its current level in the last quarter. However, data pertaining to the last two months of the year will be particularly significant in order to be able to assess the course of domestic demand more clearly, since the effect of Ramadan on demand has not been thoroughly assessed. In short, no marked increase has been observed in consumption demand, excluding the household goods sector, recently. On the other hand, increase in the household sector is believed to be related to the recovery in the housing market.

19. Meanwhile, the continuance of investment-oriented growth is deemed to be a favorable development in terms of future inflation. Current indicators show that machinery-equipment investments accelerated, especially in the second half of the year, compared to the first half. In seasonally adjusted terms, machinery-equipment manufacturing and imports of capital goods increased in the third quarter of the year compared to the previous period, and the favorable course of investment expenditures for the next twelve-month period continued in November. These developments are perceived to indicate that the above-mentioned tendency will continue.

20. Recently announced data on employment and unemployment is also significant in terms of demand and inflation in the medium term. What should be noted in the first place is that the annual decline in total employment observed in the third quarter of the year does not indicate a deterioration in the employment trend. Structural transformation, which has led to a change in the shares of employment sectors to the detriment of the agriculture sector, has reduced employment in the agriculture sector and restrained the increase in total employment, accordingly. However, the continuance of high increases in employment, excluding agriculture, on

a year-on-year basis shows that the recovery in economic activity supports employment. Private sector employment, excluding agriculture, has been increasing at an accelerated pace since the second quarter of 2004 in a stable manner, which is a desired development in terms of the potential of the economy to create employment. Meanwhile, medium-term effects of this development on demand and inflation developments should also be carefully evaluated.

21. There has not been any development in foreign demand indicators that would change the outlook of previous months. It is observed that annual increases in exports of textile and clothing sectors, which have been adversely affected by increased foreign competition, continue at a lower pace. Rapid increases in exports of machinery-equipment also continue. It is anticipated that the increases in exports will continue in the short run, but ongoing increases in imports will restrain the contribution of net foreign demand to growth. It is likely that increases in imports will lose pace in the medium term as both investment and consumption will be saturated and the effect of high increases in prices of imported raw materials will decrease. It is foreseen that the increased openness observed during this process will keep inflation under control, particularly in the goods group.

22. Another factor that has been closely monitored is credit developments. Both on the consumer and corporation sides, credits have displayed a relatively stable trend in the last period. A certain level of saturation reached in automobile demand is considered to have contributed to this development. Meanwhile, the high increases in housing credits are continuing. As a reflection of the economic normalization process, credit interest rates fell remarkably and maturities gradually started to be extended. These developments encouraged credit utilization. Therefore, there has been a significant increase in housing credits, especially in 2005. The reduction of fiscal dominance and the belief that financial deepening and economic stability will continue has supported the supply side. As a result of these developments, the share of housing credits in consumer credits, which was 14 percent at the beginning of 2004, reached 41 percent as of October 2005 and exceeded automobile and other credits. Housing credits are expected to continue to increase in the upcoming period. At this point, the Central Bank continues to consider the rapid credit extension as a

development requiring careful observation due to the risks that it may pose to both price stability and financial stability.

23. On the cost side, there is a relatively stable trend in the last period stemming from both the strong course of the New Turkish lira and the slackening oil prices. On the wage side, limited nominal increases are observed in the last period and unit labor costs remain at their historically low level as a result of the continuation of the increases in productivity. The continuation of investments is predicted to support partial labor productivity in the upcoming period, as well.

24. In conclusion, although the current conditions in supply-demand and labor markets do not exert pressure on inflation, it is necessary to carefully monitor domestic demand and cost conditions for inflation to be consistent with the 5-percent target set for 2006.

25. There is no doubt that attributing high importance to inflation figures or demand developments of a single month may lead to false judgments. For this reason, most central banks publish their inflation reports on a quarterly basis. In the upcoming period where the Central Bank of the Republic of Turkey will adopt the inflation-targeting regime, the Bank will update its detailed inflation analysis and predictions regarding inflation on a quarterly basis, as well.

Monetary Policy and Risks

26. Crude oil prices, which had exerted pressure on inflation in the last two years, are observed to contribute positively to the decline in inflation in the recent period. Provided that the same trend continues in the medium-term, the concerns about the secondary effects are likely to ease. However, considering the unpredictable price movements in this sector, risk scenarios should still be based according the developments in oil prices. In other words, oil prices continue to pose a risk to monetary policy today. There is no doubt that a further decline in oil prices would directly affect the forward-looking attitude of the Central Bank.

27. Another main factor that might pose risk to the future inflation trend is prospective changes in international liquidity conditions and developments in global

risk perceptions against developing countries. In such a case, fluctuations in foreign exchange markets might emerge that could push inflation up through costs; however, simultaneously, interest rates would go up and lead to a decrease in demand, and inflation would again be under control in the medium-term. Obviously, if such risks are materialized, uninterrupted progress in structural reforms will become crucial to have these fluctuations temporary.

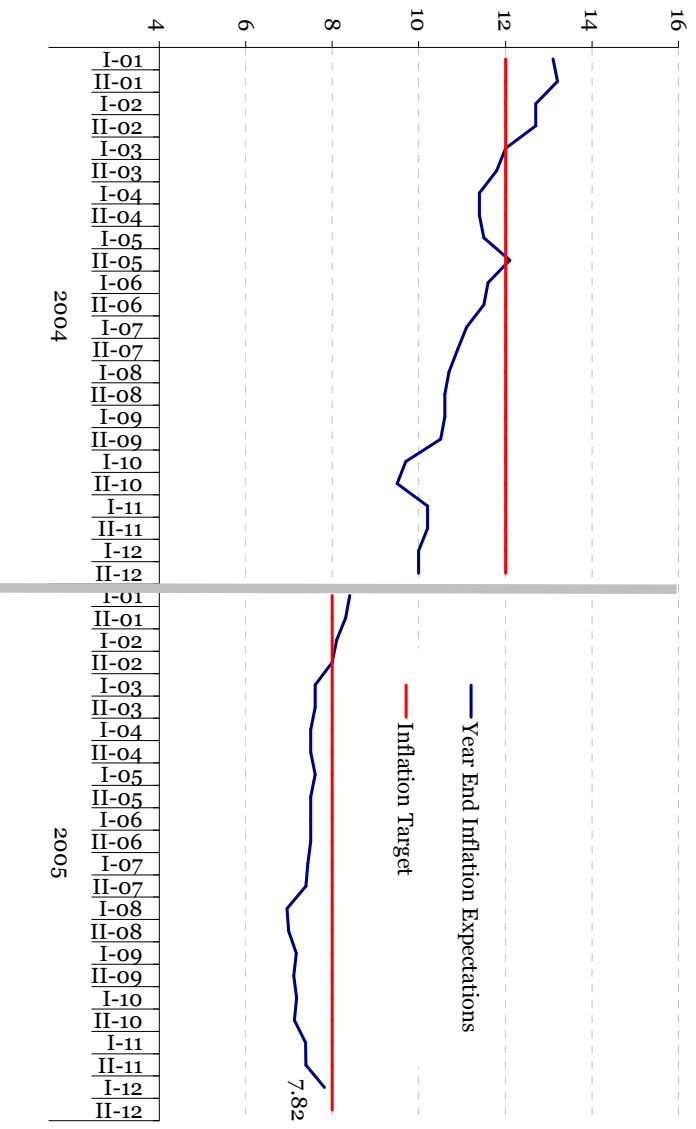
28. Another risk pertaining to the 2006 inflation is the high price increases in the services group. Annual inflation in this group has gradually decreased in the last one-year period and converged to 12 percent level. However, this level is not yet enough for the Central Bank to abandon its cautious stance about services inflation. Even the services prices index that excludes items sensitive to oil prices cruises well above the general inflation trend. It is natural for services group inflation to be over the general inflation trend in an economy where the increase in productivity in tradable goods is high. However, currently, services group inflation is 6 percentage points higher than the inflation in the prices of goods and this fact still raises concerns about the possibility of attaining the 2006 target. Even if it is projected that the rise in the prices of services would gradually slow down through 2006, the contribution of this group to the year end inflation is calculated to be 2.5 percentage points, which urges the Central Bank to continue its cautious stance.

Conclusion

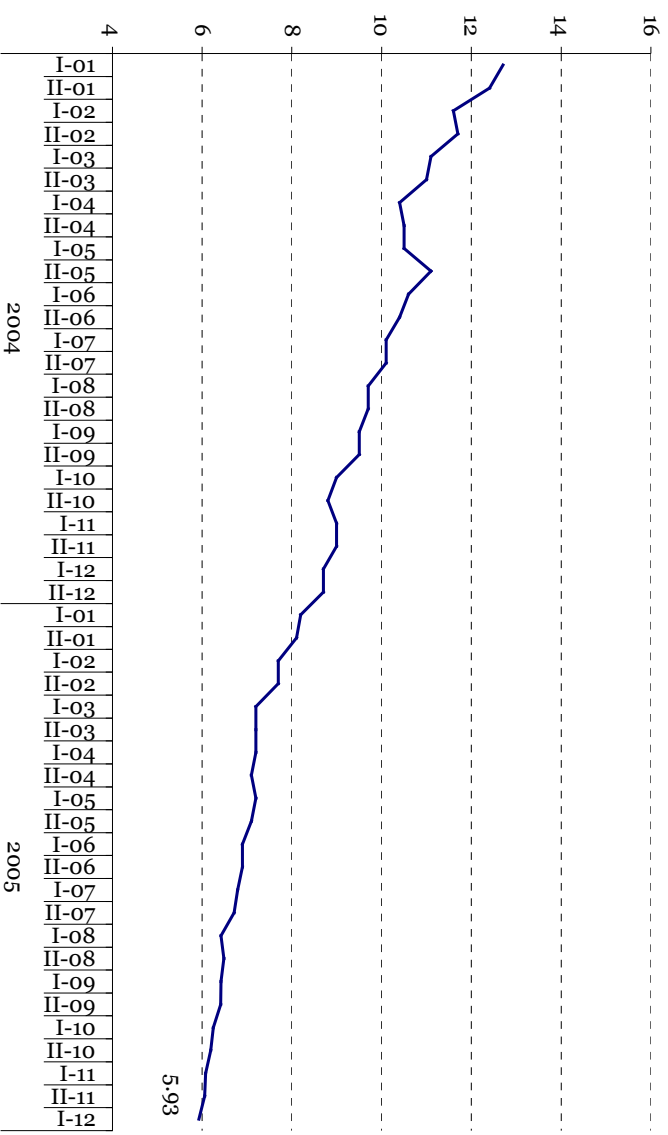
29. In the light of the above evaluations that also take into account the views put forward at the Monetary Policy Committee meeting, dated 8 December 2005, it has been decided to cut short-term interest rates applied at the CBRT Interbank Money Market and Istanbul Stock Exchange Repo-Reverse Repo Market by 0.25 percentage points. In case there is no extraordinary development in the last month of the year, it is expected that end-2005 inflation will remain under the targeted level. According to the medium-term forecasts of the Central Bank, which are based on the assumptions that oil prices in 2006 would remain slightly below the 2005 level, there would be no substantial change in international liquidity conditions, fiscal policy would be conducted in line with the end-year target and monetary policy would be

conducted prudently, end-2006 inflation would be close to the targeted level of 5 percent. It should be underlined here that the cautious stance of monetary policy should be maintained in order to achieve the inflation target. In the light of currently available data, the short-term interest rates are less likely to move upward than to move downward or to remain stable in the medium term. However in the short term, the likelihood of the short-term interest rates to remain stable is gradually increasing compared to previous periods. It is not possible to make a clear-cut statement about the future direction of this trend due to several factors: the main trend of inflation is proceeding above the medium-term targets; the positive contribution of favorable demand conditions to the downward trend in inflation has become less significant compared to the last three years; the rigidity of services prices inflation persists; the uncertainties about liquidity conditions and oil prices continue. In this context, it should be underlined that any new data and information associated with the inflation outlook over the next period would urge Central Bank to revise its stance about the future.

Graph 4: Inflation Expectations According to CBRT Expectations Survey
Year-End Inflation Expectations and Inflation Target: 2004-2005



Inflation Expectations for the Next 12 Months



Source: CBRT Expectations Survey