April 11, 2005

# March Inflation and Outlook

## *I. GENERAL EVALUATION*

**1.** According to the indices with 2003 base year, the CPI rose by 0.26 percent and the PPI by 1.26 percent in March 2005. The annual rates of increase of the indices were 7.94 percent and 11.33 percent, respectively.

**2.** The special CPI aggregate (G), which excludes energy, alcoholic beverages, other goods and services with administered prices, indirect taxes and unprocessed food, decreased by 0.38 percent in the January – March 2005 period. The rate of annual increase dropped to 8.27 percent in March with a persistent decline starting from October 2004 (Table 1, Figure 1). A similar decline is observed in the annual rate of increase in other special CPI aggregates as well.

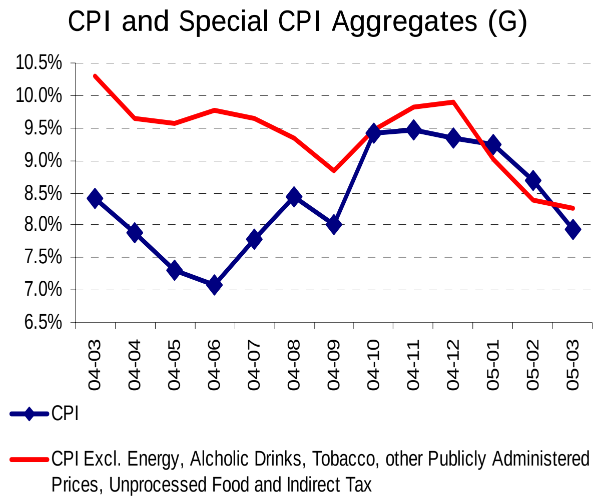
**3.** The PPI excluding agriculture (industrial sector) rose by 1.39 percent. The determining factor in this increase was the 1.54 percent upsurge in the manufacturing industry. The annual increase in the PPI, excluding agriculture, is 12.78 percent (Table 1, Figure 1).

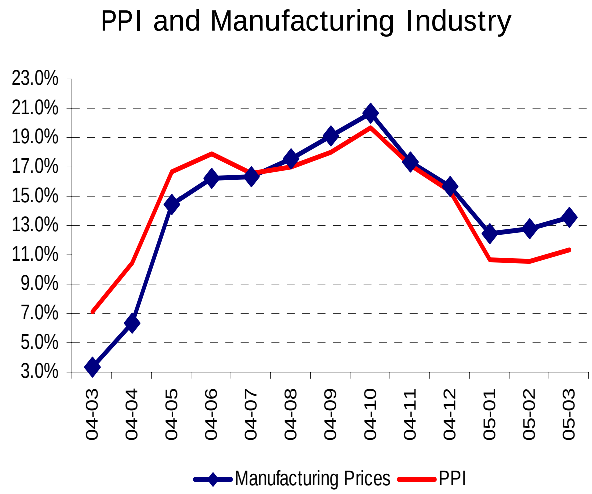
Table 1: General CPI, PPI and subgroups

| | 2005 Mar. | 2004 Dec. 2005 Mar. | 2004 Mar.- 2005 Mar. |
|---|---|---|---|
| **CPI** | **0,26** | **0,83** | **7,94** |
| **Special CPI Aggregates** | | | |
| *A. CPI Excl. Seasonal Goods* | 0,65 | 2,06 | 9,86 |
| *B. CPI Excl. Unprocessed food* | 0,29 | 0,37 | 9,00 |
| *C. CPI Excl. Energy* | 0,07 | 0,67 | 6,95 |
| *D. CPI Excl. Unprocessed Food and Energy* | 0,08 | 0,09 | 8,01 |
| *E. CPI Excl. Energy and Alcoholic Beverages* | 0,07 | 0,59 | 7,18 |
| *F. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes* | -0,07 | 0,30 | 6,92 |
| *G. CPI Excl. Energy, Alcoholic Beverages, Other Administered Price, Indirect Taxes and Unprocessed Food* | 0,00 | -0,38 | 8,27 |
| **PPI** | **1,26** | **0,96** | **11,33** |
| Agriculture | 0,79 | 1,65 | 6,45 |
| Industry | 1,39 | 0,76 | 12,78 |
| Mining | -0,89 | -2,28 | 12,86 |
| Man. Industry | 1,54 | 0,61 | 13,50 |
| Energy | -0,05 | 3,98 | 3,34 |

Source: SIS (2003=100), CBRT

Figure 1: Annual Percentage Change




Source: SIS (2003=100)

### *Developments in Consumer Prices*

**4.** The factors influencing the consumer price increase in March 2005 can be summarized as i) the course of oil prices, ii) rigidity in services inflation, and iii) delayed effects of the appreciation of the New Turkish Lira.

**5.** In March 2005, the increase in natural gas, heating oil, petroleum, and diesel oil prices, resulting from the developments in international crude oil prices, became the determinant factor in inflation, reflecting on the housing and transportation group prices. Nevertheless, due to the timing of the rise in petroleum and diesel oil prices, the upward effects are most likely to be observed in the April inflation figures.

**6.** Meanwhile, the continuing rigidity in services prices is noticed. When compared to the previous month, the increase in prices of restaurant and hotel services was way above the average inflation level at 2.36 percent. The cumulative increase of 5.19 percent in restaurant – hotel service prices, against the 0.83 percent in the CPI, in the first quarter of 2005, points to a probable high demand for these services.

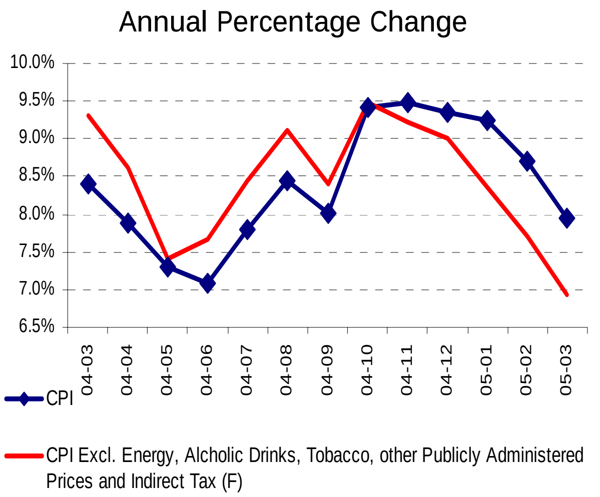
**7.** Moreover, prices in the health sector, which displayed an increase in the first two months of the year, below the seasonal trend, as a result of the VAT discount, rose by 0.89 percent in March 2005. Even though it can be said that prices in the health sector are still in a process of seasonal adjustment, it is difficult to predict the course of prices in this sector for the upcoming period. Especially after the legal adjustments that have united different hospitals linked to various social security institutions under the same organization, the patterns of economic behavior in the public health sector and its repercussions on the private health sector are being closely monitored.

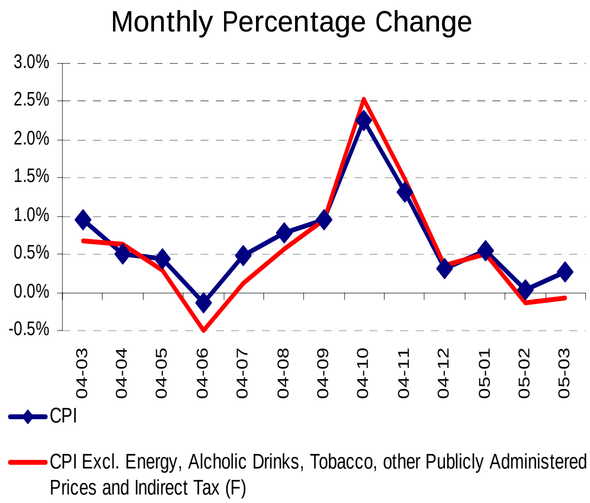
**8.** Meanwhile, delayed effects of the appreciation of the New Turkish Lira on the prices of durable goods such as household appliances, private transportation vehicles and entertainment-culture instruments were observed. Hence, the prices of household appliances and entertainment-culture groups, which include these items, declined.

**9.** One of the sub-groups that restrained the increase of CPI in March is clothing-shoes, as it was in January and February. In the January-March period, the total decline in prices of the clothing-shoes group reached 14.55 percent. As of April, the beginning of the new season in the clothing sector, an upsurge is expected in the prices of this group.

**10.** The decline in inflation measured by the special CPI aggregates (F) (the CPI excluding energy, alcoholic beverages, other goods and services with administered prices and indirect taxes) and (G) (the CPI excluding energy, alcoholic beverages, other goods and services with administered prices, indirect taxes and unprocessed food) indices is remarkable (Figure 1 and Figure 2).

Figure 2: CPI and Special CPI Aggregate (F)




Source: SIS (2003=100)

### *Developments in Producer Prices*

**11.** In March 2005, the PPI rose by 1.26 percent compared to the previous month. The increase mainly stemmed from the increase in the PPI excluding agriculture (1.39 percent). Under the index with 2003 base year, fluctuations in the prices of the agriculture sector were expected to ease with the utilization of geometric mean to calculate the prices in this sector. Hence, the historically high rates of increase in agriculture prices during March, according to the indices with 1994 base year, was recorded as a mere 0.79 percent under the new indices in 2005.

**12.** Manufacturing industry prices, which have a significant share of the industrial sector, rose by 1.54 percent in March 2005. The rise in manufacturing industry prices resulted from coke coal and refined oil products, whose prices increased by 11.81 percent due to changing circumstances in international oil prices in that period. The annual increase in the sector by 43.24 percent, which was well above the rate of increase in the PPI, points to the negative effects of oil prices on inflation. Furthermore, the rising tendency in crude oil prices, a significant input in the manufacturing industry, is of great importance. If this increase in international crude oil prices persists, the negative effects on manufacturer prices might linger.

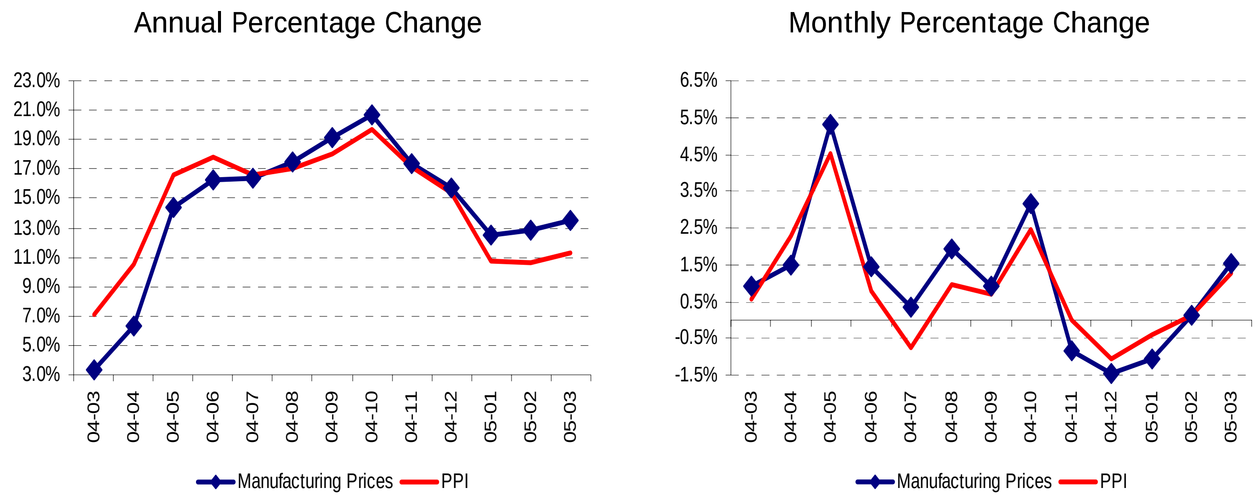
**13.** Moreover, limited increases in energy prices, another determinant of production costs, continued. In March 2005, energy (electricity, gas, and water) prices fell by 0.05 percent compared to the previous month. However, it should be kept in mind that the sensitivity of natural gas and electricity prices to crude oil prices may lead to price adjustments in the said sectors in the coming period.

**14.** When March PPI realizations are analyzed in terms of sub-sectors, though there is no apparent change in input costs, price movements in opposite directions are observed in some sectors, in consecutive months. For example, in the manufacturing industry, the increase in prices of tobacco products by 3.84 percent, which dropped by 22.70 percent in the previous month is quite remarkable. Furthermore, the prices of office supplies production fell by 12 percent in February 2005 and increased by 8.23 percent in March. This development indicates that the said price developments mainly stem from adjustments made in the profit margin after tax increases rather than production costs.

**15.** The appreciation of the New Turkish lira in the first quarter restricted the pass-through effect of the increase in primary metal prices on the manufacturing industry. Hence, prices in the primary metal industry under the PPI fell by 0.64 percent in March 2005. As of the beginning of the year, the cumulative decrease in the prices in primary metal industry reached 3.16 percent. However, production costs in this sector might be negatively affected by world commodity prices, which may increase due to the raw material demands of industrializing economies such as China and India.

**16.** Finally, in March 2005, the PPI increased by 11.33 percent compared to the same month of the previous year. In the same period, the PPI, excluding agriculture, rose by 12.78 percent, while agriculture prices increased by 6.45 percent.

Figure 3: PPI and Manufacturing Industry Prices




Source: SIS (2003=100)

## *II. OUTLOOK*

### *Inflation Developments*

**17.** Inflation stayed on a downward track also in March. The cumulative inflation of the first quarter of 2005 being 0.83 percent, which is even lower than the inflation figure of March 2004 for a single month, underlines the remarkable decline in inflation. As of April 2005, year-end inflation expectations were realized at 0.5 points below the target.

**18.** In the first months of 2005, the favorable outlook especially for tradable goods prices continued and the rigidity in the growth rate of the services sector prices eased compared to previous periods, despite the persistence of the earlier trend in rents and the restaurant-hotel group. In order to be able to evaluate inflation developments accurately, the adjustment of the CPI trend for external variables can provide significant forward-looking information. This is because a sudden hike in oil prices and unexpected developments in natural conditions or public price adjustments may lead to unforeseen fluctuations in inflation. Adjustment of the general price index for such factors bears much significance for the accurate setting of response timing of monetary policy through analyzing the main trends in inflation. Special CPI aggregates were derived to serve this purpose. The tendency displayed by the special CPI aggregates since October 2004 confirms the downward course of the main trend.

**19.** After going through a change in context and method of measurement, and owing especially to the fact that prices are calculated excluding taxes, the PPI became more susceptible to raw material prices and exchange rate developments. The most affected sector in this sense is petroleum products sector, which is subject to high special consumption taxes. In fact, the refinery output prices of petroleum products were observed to be the main determinant of the general PPI index in March; this may cause producer prices to display unforeseen fluctuations. Interpretation of these producer price fluctuations as “inflation fluctuations” would be a misinterpretation. It is obvious that for better evaluation of the medium-term inflation outlook, consumer prices should be in the forefront rather than producer prices. It should be emphasized once more that the word “inflation” should be used as a synonym of the increase in the consumer price index, which is an accurate indicator in terms of price stability and purchasing power, and that a common language should be formed in the public in this respect. At this point, it should also be remembered that inflation targets are expressed with increases in the consumer price index, whereas producer prices are considered solely with respect to the information they contain regarding inflation in the upcoming period and are not considered as targets by any means.

## *Factors Affecting Inflation*

**20.** Growth data pertaining to the fourth quarter of 2004 was announced. As suggested by the Central Bank, not only in its reports, but also in presentations from the second half of 2004 onwards, acceleration in both economic growth and domestic demand slowed down. In the last quarter of 2004, the annual growth rates of private consumption and investment expenditures displayed a considerable decline compared to the first nine months of the year. Contrary to the developments in the first nine months of 2004, the contribution of private expenditures to economic growth remained below GDP growth. Furthermore, according to seasonally adjusted data, private consumption expenditures and total final domestic demand declined in the last quarter of 2004, compared to the previous quarter.

**21.** The composition of the developments in private consumption in the last quarter of 2004 differs from developments in previous periods. In the first nine months of 2004, growth mainly originated from durable consumption goods. The high levels of productivity increases achieved in these sectors, as well as the low costs of imported input items prevented the downward trend in inflation to be hampered by the demand side. Excluding the durable consumption goods sector, the revival in domestic demand was very limited. However, recently announced data shows that expenditures on durable consumption goods declined in the last quarter of the year compared to the same period of the previous year, while expenditures on semi-durable consumption goods maintained their high level, despite the slowdown in their rate of growth compared to the previous period. Meanwhile, the high increase in public consumption expenditures in the last quarter of 2004 is a development which has captured attention. Although, these data show that the relative recovery in domestic demand has been spreading to sectors other than the consumption of durables, when the historical consumption levels are taken into account, no demand-side risk to inflation has yet been perceived in the short term.

**22.** Consumer confidence indices, imports of intermediate goods, automobile sales and other demand-related developments indicate that economic activity is likely to be more vigorous in the upcoming period compared to the last quarter of 2004, but more controlled compared to the first half of 2004. Hence, total demand is forecasted to follow a parallel course to program projections in 2005. The relative slowdown observed in comparison with the first half of 2004 should not be perceived as “stagnation”, but rather as a healthy development showing that long-term sustainable growth rates have been resumed. Undoubtedly, the adjustment process created by the rapid transformation of our economy is reflected in a different way in every sector. However, the point that should be underlined here is that the

Turkish economy reached high growth rates in the last three years and that this growth process continues in 2005, as well.

**23.** In the last period, the ongoing decline in credit interest rates, the rise observed in the demand for money and the briskness in consumer credits point to a possible rebound in domestic demand from the second half of the year onwards. However, data available as of today does not allow for a clear-cut assessment. At this point, it should be stressed once again that maintaining the discipline in the fiscal and monetary policies is essential for the gains achieved in the fight against inflation to be lasting ones.

**24.** The Central Bank indicated in its "Inflation and Outlook" reports from the second half of 2004 onwards that productivity increases would slow down and that rises in real wages might adopt a relative acceleration. In fact, the slowdown observed in productivity in the last quarter along with the upward trend in employment and real wages led to a rise in real unit wages in the private manufacturing industry for the first time since 1999. Considering the developments in the last four years, it is clear that productivity increases have kept labor costs under control and, to a large extent, accounted for the historical decline in inflation. The current level of unit wages does not constitute a significant risk to the 2005 inflation target. However, the slowdown or in some cases the decline recently observed in growth rates of productivity in some sub-sectors is a development that should be followed closely.

**25.** Projections about the output gap, which is one of the indicators of resource utilization in the economy and the pressures on inflation, show that the production level reached during the last quarter of 2004 does not create any pressure on inflation. Developments in machinery-equipment production and imports of investment goods as well as the business tendency survey data as of early-2005 indicate that investments continue, albeit at a slower pace compared to previous periods. Increased capacity owing to higher investment expenditures in recent periods, the controlled increase of domestic demand and the continuing rise in investment expenditures rule out the possibility in the short run of a pressure on prices led by the supply-demand conditions.

**26.** To sum up, employment, productivity and wage developments pertaining to the last quarter of 2004 support our prediction that labor costs will not contribute to the disinflation process as much as they had done in the previous periods. Still, it is anticipated that investment expenditures, which recorded a high rate of increase throughout 2004, will continue to foster productivity increases, particularly in technology intensive sectors. Meanwhile, taking into account the current unemployment rate and considering the likelihood that additions to the labor force originating from demographic factors will be high in the coming years, increases in average labor costs are projected to remain limited, under the assumption that the public wage policy will be consistent with inflation targets. At this point, however, it should be once again underlined that rapid removal of the barriers to investment and production and the development of corporate governance are of critical importance for the continuity of productivity increases. It should be kept in mind that the attainment of the historical disinflation process and the concurrent high growth figures were possible owing to macroeconomic stability and high productivity increases. In order to establish macroeconomic stability permanently, a similar process needs to continue from now on as well. This in turn necessitates that the structural reforms of the last three years be broadened and continued.

**27.** Although there seem to be no significant risks to inflation in terms of the supply-demand conditions, developments in international liquidity and oil prices, as well as the course of unit wages signal that costs will not make an extra contribution to the downward trend in inflation in the coming period, and that monthly inflation figures may be realized higher in the rest of 2005 compared to the first quarter of the year. The downward trend of the first quarter and the favorable course of expectations still render the 2005 inflation target attainable despite recent cost developments.

**28.** Recent exchange rate movements were shaped to a large extent by international liquidity conditions and changes in global risk perception. In order to ensure that the effects of the said developments on the economy are temporary in the medium-term, the process of reinforcement in macroeconomic foundations must be sustained. For this reason, draft laws currently pending including those about social security, financial institutions and revenue administration are highly significant.

**29.** Recently, a lot of attention has been focused on the question regarding to what extent the exchange rate movements can affect inflation. It has been occasionally emphasized in previous reports that the relationship between exchange rate developments and inflation has weakened. Undoubtedly, the exchange rate will continue to be an important determinant of inflation in Turkey, a country on the path to becoming an increasingly open economy. However, there is a crucial point about exchange rate-inflation relation that should be clarified: In the floating exchange rate regime, developments in exchange rate movements affect inflation as long as these movements occur in the same direction for several consecutive months and are perceived as permanent. Hence, the effects of a sudden depreciation in the New Turkish lira following a sudden rise in inflation will remain limited to a certain extent. Therefore, the current level of exchange rates does not constitute any risks to inflation.

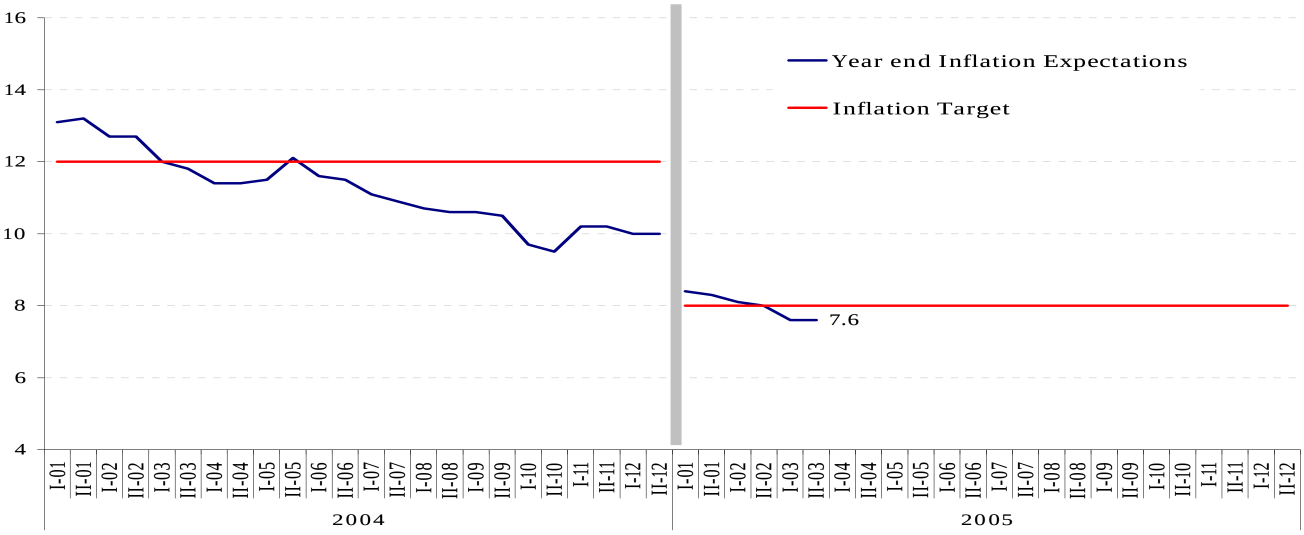
## *Monetary Policy*

**30.** In typical monetary transmission mechanisms, the impact of interest rate changes on demand and the repercussions of demand movements on inflation occur with a time lag. Although it may not be possible to say that the said transmission mechanisms started to operate properly in our country due to fiscal dominance, it is clear that we are on route to having a similar mechanism following the achievements attained in macroeconomic stability in recent years. These developments enable the Central Bank to focus on future inflation rather than current inflation and to focus increasingly more attention on the medium-term. Needless to say, in line with the rapid transformation that our economy has undergone in its normalization process, monetary transmission mechanisms will also be in a process of continuous change. The more macroeconomic stability is established, the more uncertainties in monetary transmission mechanisms will decrease. With the transition to the inflation-targeting regime next year, the said mechanisms will become more significant.

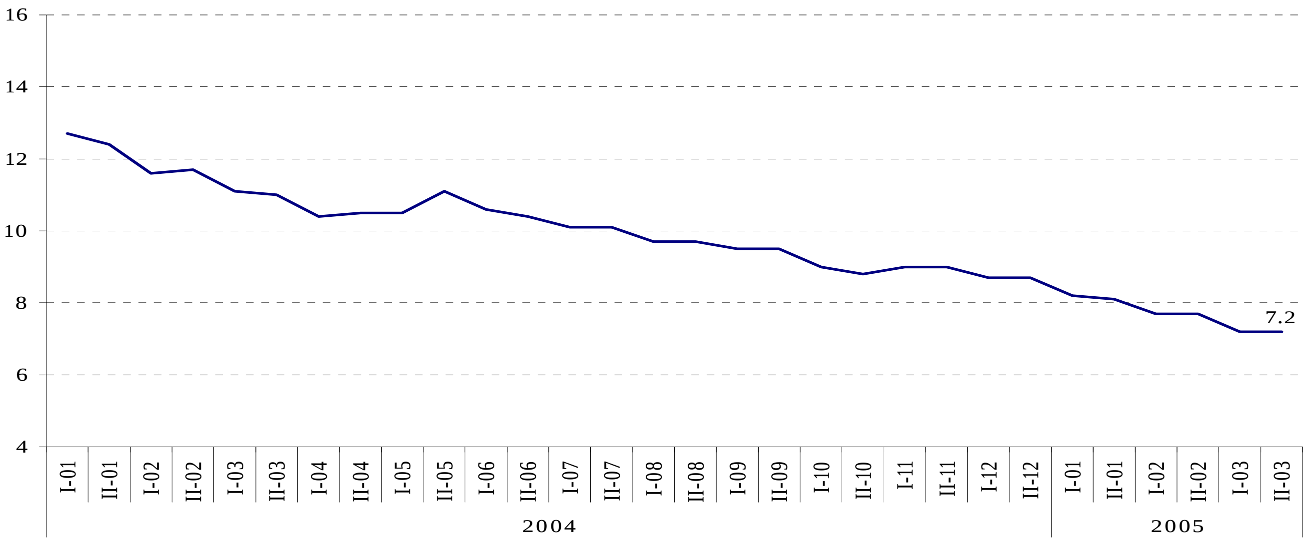
**31.** In light of current data, the above-mentioned cost developments are estimated to lead to at least a small amount of increase in inflation figures in the upcoming period. However, it is anticipated that the said increase would not change the main inflation trend and inflation will re-enter a downward trend as soon as temporary conditions are removed. Considering the cost, production, demand, and productivity conditions, and in an overall scenario in which structural reforms would not lose pace and the economy would not be exposed to a great exogenous shock, 2005 inflation is expected to realize in line with the targets. In accordance with the above-mentioned analyses and taking into account the evaluations made at the Monetary Policy Board meeting held on April 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 0.5 point to be effective as of April 11, 2005. While the Central Bank is maintaining its cautiously optimistic stance for 2005 year-end inflation, it emphasizes that this cautious stance should also be sustained in the medium-term, considering the data pertaining to last month and the developments in the world. In this framework, besides structural reforms the course of unit costs, domestic demand and international liquidity conditions will be closely monitored in terms of monetary policy decisions.

**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