

May Inflation and Outlook

I. DEVELOPMENTS IN PRICES

1. According to the indices with base year 2003, the CPI rose by 0.92 percent and the PPI by 0.20 percent in May 2005. The annual rates of increase of the indices were 8.70 percent and 5.59 percent, respectively.

2. The special CPI aggregate (F), which excludes energy, alcoholic beverages, tobacco products, other goods with administered prices and indirect taxes, increased by 1.34 percent in May 2005. Meanwhile, another special CPI aggregate (G), which is obtained by excluding unprocessed food from (F), increased by 1.73 percent in the same month (Table 1). The annual rates of increase in the mentioned aggregates were recorded as 8.28 percent and 9.43 percent, respectively (Figure 1).

3. The PPI excluding agriculture (industrial sector), decreased by 0.28 in May 2005. The annual increase in the PPI, excluding agriculture, was 7.67 percent (Figure 1).

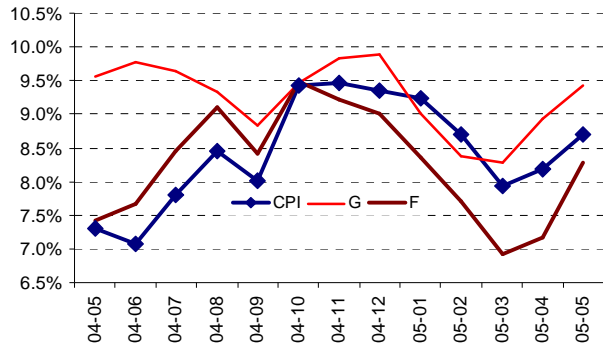
Table 1: General CPI, PPI and Sub-groups

| | 2005 May | 2004 Dec - 2005 May | 2004 May- 2005 May |
|---|---------------------|--------------------------------|-------------------------------|
| CPI | 0.92 | 2.49 | 8.70 |
| Special CPI Aggregates | | | |
| A. CPI Excl. Seasonal Goods | 0.43 | 3.14 | 9.59 |
| B. CPI Excl. Unprocessed Food | 1.07 | 2.63 | 9.60 |
| C. CPI Excl. Energy | 1.26 | 2.59 | 8.00 |
| D. CPI Excl. Unprocessed Food and Energy | 1.53 | 2.79 | 8.94 |
| E. CPI Excl. Energy and Alcoholic Beverages | 1.33 | 2.61 | 8.28 |
| F. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices and Indirect Taxes | 1.34 | 2.51 | 8.28 |
| G. CPI Excl. Energy, Alcoholic Beverages, Other Administered Prices, Indirect Taxes and Unprocessed Food | 1.73 | 2.73 | 9.43 |
| PPI | 0.20 | 2.38 | 5.59 |
| Agriculture | 1.96 | 2.31 | -1.23 |
| Industry | -0.28 | 2.40 | 7.67 |
| Mining | 4.13 | 7.14 | 16.22 |
| Manufacturing | -0.42 | 2.14 | 7.80 |
| Energy | 0.38 | 4.71 | 3.43 |

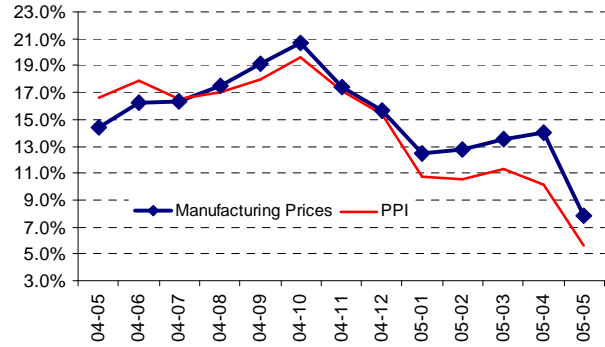
Source: SIS, (2003=100)

Figure 1: Inflation (Annual Percentage Change)

CPI and Special CPI Aggregates (F and G)



PPI and Manufacturing Industry



Source: SIS (2003=100)

Developments in Consumer Prices

4. Price developments in clothing-footwear and entertainment-culture groups have been effective on the CPI inflation in May.

5. In May 2005, the monthly increase in the clothing and footwear prices rose by 8.83 percent and was realized beyond expectations. 0.71 points of the 0.92 percent CPI inflation came from this group. Although, it is yet early to consider this development as an indicator of a demand-push pressure on prices, developments in this sector will be followed closely in the upcoming months.

6. The 4.06 percent rise in entertainment-culture prices was derived mainly from the prices of short and long tours and books (novels). The hike in tour prices is deemed to be related to the demand on the local tours in the week corresponding to the national holiday on May 19, i.e. Atatürk Commemoration and Youth and Sport Day.

7. Monthly inflation in food, non-alcoholic/alcoholic beverages and tobacco groups realized as zero. When analyzed in detail, seasonal drops in the prices of fresh vegetables limited the rise in food prices.

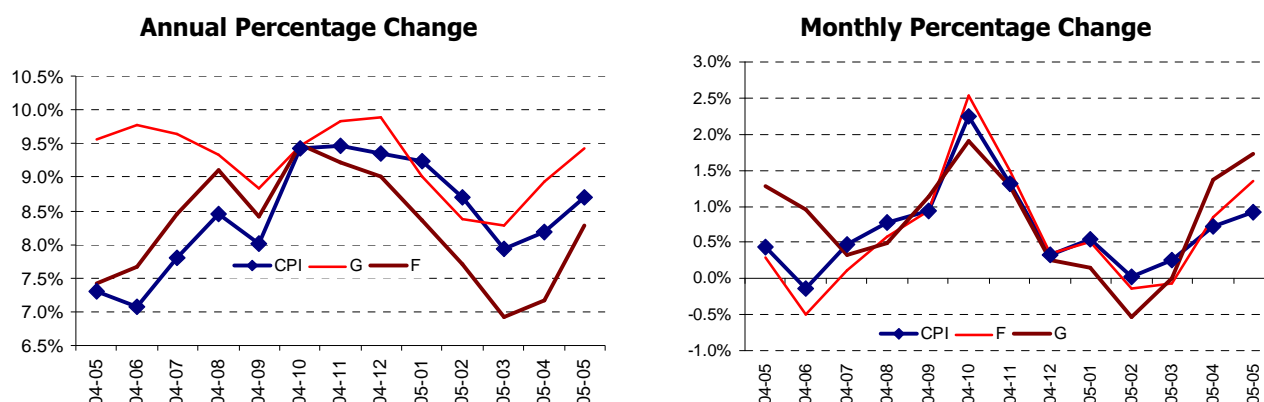
8. The price increase in the household appliances group realized below the general level of inflation due to the limited increase in durables. However, as a result of seasonal factors, the prices of dining and occasional furniture included in the furniture group increased by 5.39 and 2.13 percent, respectively.

9. Housing prices dropped by 0.30 percent compared to April 2005. This decline, which occurred despite the 1.22 percent rise in rents, was derived from the decline in home heating prices (central heating oil, etc.). In other words, the fall in oil products prices affected housing prices.

10. According to the May indices announced by the SIS on June 3, 2005, special CPI aggregates (F) and (G) of April 2005 were revised. As a matter of fact, the figures mentioned above in article 2 are calculated on the basis of the revised indices. Accordingly, the following figures were obtained for April 2005:

| | Index | F | | | G | |
|-------------------|--------|---------|--------|--------|---------|--------|
| | | Monthly | Annual | | Monthly | Annual |
| Before adjustment | 114.60 | -0.01 | 6.25 | 115.91 | 0.84 | 8.36 |
| After adjustment | 115.59 | 0.86 | 7.17 | 116.52 | 1.37 | 8.94 |

Figure 2: CPI and Special CPI Aggregates (F and G)



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

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

Source: SIS (2003=100)

Developments in Producer Prices

11. The PPI rose by 0.20 percent in May 2005. Hence, the increase in the PPI was realized as 2.38 percent in the first five months of the year and remained very limited compared to previous years. In May 2005, agricultural prices increased while industrial prices decreased. In the scope of the new index, the upsurge in agricultural prices remains below the increase

rates pertaining to the same period of the last two years. Moreover, agricultural prices are expected to decrease in the upcoming months due to seasonal factors.

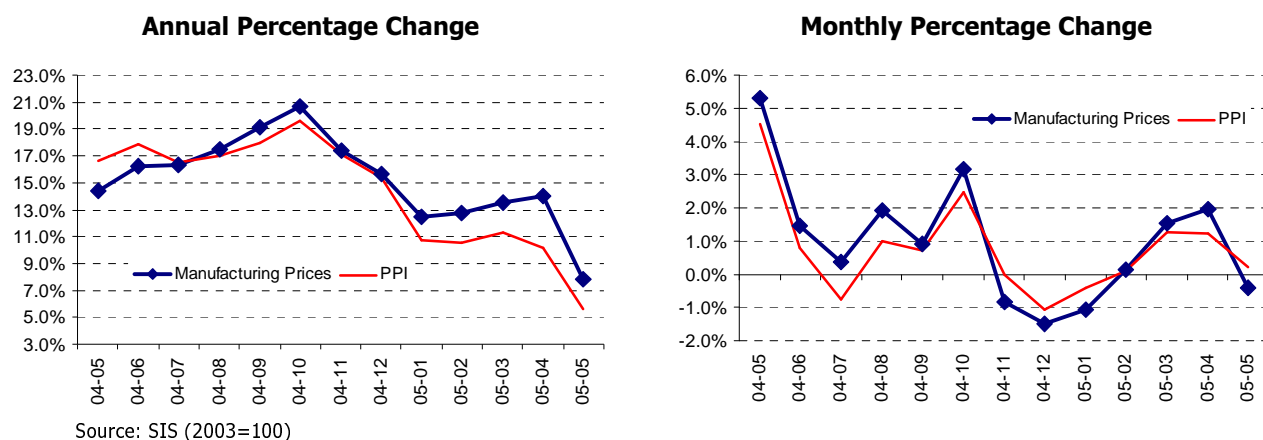
12. Along with the stable course of exchange rates, the recent decline in international oil prices brought about a 6.02 percent decline in coke coal and refined oil products. This development is the main determinant of the decline observed in the prices of the manufacturing sector in May 2005.

13. Meanwhile, primary metal industry prices decreased in May 2005. In this context, it should be underlined that the manufacturing industry and therefore the PPI will continue to display a volatile trend based primarily on oil prices, raw material prices and the volatility of exchange rates. In fact, in light of the new index, it is seen that exchange rates, oil prices and raw material prices are influential on the PPI.

14. Another point in the figures pertaining to PPI in May 2005 that attracts attention is the rise in the prices of clothing and leather products manufacturing sectors, which affect the clothing sector prices in the CPI. It should be noted that the rates of increase in these sectors since the beginning of the year, have been among the highest rates of increase in the manufacturing industry sector. In this context of these developments, cost factors can be considered responsible for the rise in clothing and footwear prices under the CPI.

15. To conclude, input prices and exchange rates are considered to be the major risk factors with respect to the course of the PPI for the coming period. Meanwhile, on account of the existing demand conditions and the non-tax calculation of the PPI, it should be emphasized once more that the reflection of the fluctuations in the PPI to the CPI is only limited.

Figure 3: PPI and Manufacturing Industry Prices



II. OUTLOOK

Inflation Tendency in the Short-Term

16. Seasonal increases in clothing and shoes group prices contributed significantly to the rise in the annual inflation figures in the months of April and May. As a matter of fact, the inflation figure for May excluding the clothing and shoes group was 0.28 percent. The fact that the price indices with base year 2003 were adopted only recently complicates the forecast of seasonal movements in the clothing group. While the weight of some items under clothing prices change seasonally, some items do not show up in the index (which has a weight of zero in the index) in certain months. The latter type of products is called “seasonal goods”. These goods appear under the food and clothing-shoes sectors in the CPI with base year 2003, the same as the CPI with base year 1994. However, together with the new indices, the weight and content of these goods changed, which in turn led to an increase in the volatility caused by seasonality. In the light of these explanations, although there is a probability that sharp drops might occur in clothing prices in July and August, the uncertainty caused by the change in the context and method of the indices, accompanied by the difficulty in making a clear breakdown of cost factors call for caution in making forecasts for this area.

17. Together with the new indices, the State Institute of Statistics also began to publish certain special CPI aggregates. These aggregates were developed to facilitate a more transparent analysis of inflation developments. Correct interpretation of these special CPI aggregates is extremely important in providing a healthy forward-looking assessment of inflation figures. It is not possible to statistically adjust inflation, calculated from the indices with base year 2003, for seasonality. Therefore, the special CPI aggregate excluding seasonal goods, (A), gives somewhat more accurate information, during the periods when the sub-items record sharp seasonal movements (as was the case in the last two months). The special CPI aggregate excluding seasonal goods, (A), rose by 0.43 percent in May.

18. The Central Bank attaches great importance to those aggregates, which exclude most of the items that are beyond the control of monetary policy and which provide information with respect to inflation in the coming period. These aggregates could be referred to as a kind of “core inflation”. Namely, they are the special CPI aggregate (F) that excludes energy, alcoholic beverages, tobacco products, other goods with administered prices, and indirect taxes and the special CPI aggregate (G) that is obtained by the exclusion of unprocessed food from the index (F). However, it should be kept in mind that these aggregates also have

some seasonality and that the interpretation of the unfiltered monthly figures may yield unfavorable results. For instance, seasonal fluctuations in clothing prices cause similar fluctuations in the special CPI aggregates. That is why the special CPI aggregates, F and G, which are closer to the definition of core inflation, should be evaluated not in monthly terms but annually, or based on the tendency. Accordingly, the cumulative figures for the first five months of this year are better indicators. The fact that, in the face of an end-year target of 8 percent, the F and G aggregates rose only by 2.51 and 2.73 percent respectively in the first five months of the year shows that the inflation tendency is consistent with the end-year target. Yet, the rise in the annual increases of these aggregates for the last two months that came about with the revision of the figures announced last month calls for caution.

19. In conclusion, as of the month of May, the inflation tendency is coherent with the end-year target. However, an assessment of the sub-items shows that there are some risks for the upcoming period. For example, the VAT reduction in early 2005, in the clothing, health and education sectors limited price increases in these sectors considerably. However, it should be kept in mind that these are one-time consequences and that they have no informative value with respect to inflation forecasts for the coming period. Furthermore, the ongoing high tendency of price increases in the services sector continues to be a risk factor for inflation in the coming period.

Outlook of the Factors Affecting Inflation in the Medium-Term

20. The evaluation of supply-demand developments, as well as the unit costs is of great importance for the course of inflation in the medium-term. The inflation figures of the last two months give rise to the perception that the disinflation process might have been interrupted. Accurate analysis of supply-demand factors is crucial to be able to assess whether or not this interruption is a temporary one. One of the factors that come to the forefront in this respect is the rate of capacity utilization. In 2005, the rate of capacity utilization is at lower levels compared to last year's averages. This stems from the increase in the total capacity following robust investments in machinery and equipment in 2004. Despite the fact that capacity utilization ratios are lower on average compared to those of last year, industrial production continued in a balanced manner in the first four months of the year. Naturally, the course of investments in the coming period is also significant for the production increases so as not to put pressure on the capacity. The analysis of the manufacturing sector with respect to the sub-sectors points to ongoing demand for investment goods. Besides, the strong tendency in the import of capital goods continued in

the first four months of the year. All these developments show that the average rate of capacity utilization for the private sector for 2005 might remain below last year's, and that the capacity utilization ratios will not be putting pressure on the prices.

21. Another important factor that influences pricing behavior is the unit labor cost. The unit labor costs have remained low as of the last quarter of 2004. Unfortunately, it is not possible to comment on the current situation, as the data is announced with a time lag. However, developments in the labor market provide some hints about it. Investments in the last two years mainly concentrated on expansion of the existing capacity, which in return led to a rapid rise in labor productivity. However, this became less common in 2005 as investments shifted from the expansion of existing capacity to the construction of new premises and the establishment of new production units, which fuels the rise in employment in return. Actually, total employment increased by 4.7 percent in Q1-2005 compared to the same period last year. In light of these developments, it is predicted that unit labor costs, which have been decreasing for the last four years, would start to increase in 2005 and the rise would become more evident by 2006.

22. Domestic demand developments are believed to be important factors that would affect the future trend of inflation. Although current data falls short of giving a clear signal pertaining to demand, it is believed that moderate growth in domestic demand persists. In January-April 2005, domestic automobile sales dropped by 25.4 percent, compared to the same period last year. In the same period again, domestic consumer durables sales inched up by a mere 1.3 percent. Meanwhile, the sustained decline in the share of consumption goods in overall imports affirms that the relative slowdown in the rate of increase in private consumption expenditure continues. However, these developments should not be interpreted as a lack of demand in these sectors, and the base effect created by deferred demand last year should be kept in mind. When last year's historic highs are taken into account, it can be asserted that, albeit a relative slowdown, domestic demand for consumer durables is stable in 2005. Moreover, when the reasons for working under capacity stated in the manufacturing industry expectations survey pertaining to April 2005 are analyzed, it is observed that the share of the deficient domestic demand has decreased substantially compared to the same month last year.

23. Credit developments provide important hints about domestic demand. Although the slowdown in the annual rate of increase in vehicle credits persisted in the first five months of 2005, growth still continues. Meanwhile housing credits retain their high rates of growth. The liquidity that exceeded the expected level due to the Central Bank's foreign exchange

purchases, coupled with real interest rates, which are lower than the rates of previous years, suggest that the growth trend in credits would continue. Meanwhile, it should be borne in mind that the period ahead, which will be marked by financial deepening and convergence with European Union economy, will bring a gradual increase in the ratio of total domestic credits to national income. All these factors point to the fact that we are nearing a period where a careful stance should be taken regarding the domestic demand and credits in the medium term.

24. Indicators for foreign demand display a stable trend. Although rapid growth in the world economy persists, general evaluations point to the fact that expansion in global economic activity would start slowing down by next year. However, our economy is becoming more integrated to international markets every day and the market share of exporting companies is growing rapidly, which suggests that for a while demand for goods produced domestically would continue to be supported by foreign demand. While the decline in the share of consumption goods in imports composition continues, the increase in the share of imports of intermediary goods persists, which means the rise in production is supported by foreign demand rather than domestic demand. According to data issued by the Turkish Automotive Manufacturers Association, domestic sales decreased by 18.4 percent annually in the first four months of 2005, however the 33.3 percent rise in exports led to an 11.3 percent increase in total automobile manufacturing.

25. As a consequence of global economic growth, the rapid rise in imports prices persists. Meanwhile, any sudden changes in global liquidity or prospective fluctuations in raw material prices still present a risk factor for inflation. However, the favorable course of producer prices is expected to keep cost-push inflation under control in the short run.

26. Lastly, the accord between inflation expectations and the target is expected to continue to support the downward trend in inflation. However, taking into account the 5 percent end-year target in 2006, it is evident that managing expectations will become more important in the period ahead. At this point, continuance of the consistent monetary and fiscal policies implemented in the last four years will become crucial. In particular, the implementation of public pricing and income policies concurrent with the inflation target, which contributes to molding expectations, will become more important than ever for achieving price stability. It should be borne in mind that it is not possible to make inflation targets credible unless they are backed by fiscal policies.

Monetary Policy

27. It was repeatedly emphasized in the recent inflation and outlook reports that the critical variables for inflation in the medium term are fundamental economic variables such as the course of domestic demand and unit labor costs, rather than temporary exogenous shocks. International crude oil prices and the volatility in exchange rates undoubtedly influence inflation via their impacts on the subgroups of housing and transportation. However, monetary policies are not sufficiently equipped with the measures to fight against the short-term (primary) effects of such adverse shocks. So, the main responsibility of the monetary authorities is to provide a proper response to the lasting (secondary) effects of the above-mentioned developments on pricing behavior and inflation expectations. The Central Bank of Turkey has concentrated on medium-term inflation trends rather than temporary factors, which explains the reason for its interest rate cuts despite the ongoing increases in world raw material prices.

28. Following the conclusion by the Central Bank that the presence of fiscal dominance was alleviated, the resistance to exogenous shocks has increased; in other words, the normalization process in the economy has gained strength (see the press release on “Monetary and Exchange Rate Policy in 2005 dated 20 December 2004) the Bank has started to draw attention to medium-term trends in its inflation and monetary policy reports. At this point, in terms of the monetary policy, the notion of “medium term” needs to be more clearly defined. The medium term refers to the time period in which the delayed effects of monetary policy on inflation are most evident. Such a definition is highly necessary, since the effects of monetary policy on real economy and inflation occur with a time lag.

29. Studies made by the Central Bank point out that the effects of change in interest rates on the economic activity of Turkey has strengthened, and the said relationship occurs with a longer time lag than previously. This relationship has not yet been fully established, due to the chronic inflation period in the past; nevertheless, it is more apparent compared to previous periods. In light of current data, it can be said that it takes three to nine months for the effects of the change in interest rates to become apparent on the general course of economic activity, while the same effects on inflation materialize in nine to eighteen months. In this context, as of today, the definition of “medium-term” should be interpreted as a time period exceeding one year. Hence, the time period referred to in the monetary policy decision-making process regarding future inflation corresponds to more than one year, in transition from the short term to the medium term.

30. The extension of this period may change in time. In fact, monetary transmission mechanisms also undergo constant changes due to the transformation observed in the normalization process of our economy. As long as economic stability continues to increase, change is inevitable. Considering the fact that the effects of the interest rates on inflation occurred only in three months in the 1990's leads to a better understanding of the changes observed in the transmission mechanisms throughout time. This process has now taken a year, which shows that the reaction time of economic agents to macroeconomic developments has increased. This extension is an inherent part of the normalization process in the Turkish economy, and should be perceived as a favorable development. The transition to inflation targeting in 2006 will help monetary transmission mechanism become more apparent, and the Central Bank be able to act with an improved medium-term perspective.

31. It is clear that monetary policy will have an influence on inflation as long as it can affect medium and long-term interest rates. As of today, the said relationship has not been fully established yet, despite the distance covered in the last three years. Although the dominance of risk perception changes on the interest rates has decreased significantly, it is still high compared to developed countries. At this point, it should be borne in mind that macroeconomic stability and structural reforms are critical in terms of the crystallization of the relationship between short-term and medium/long-term interest rates.

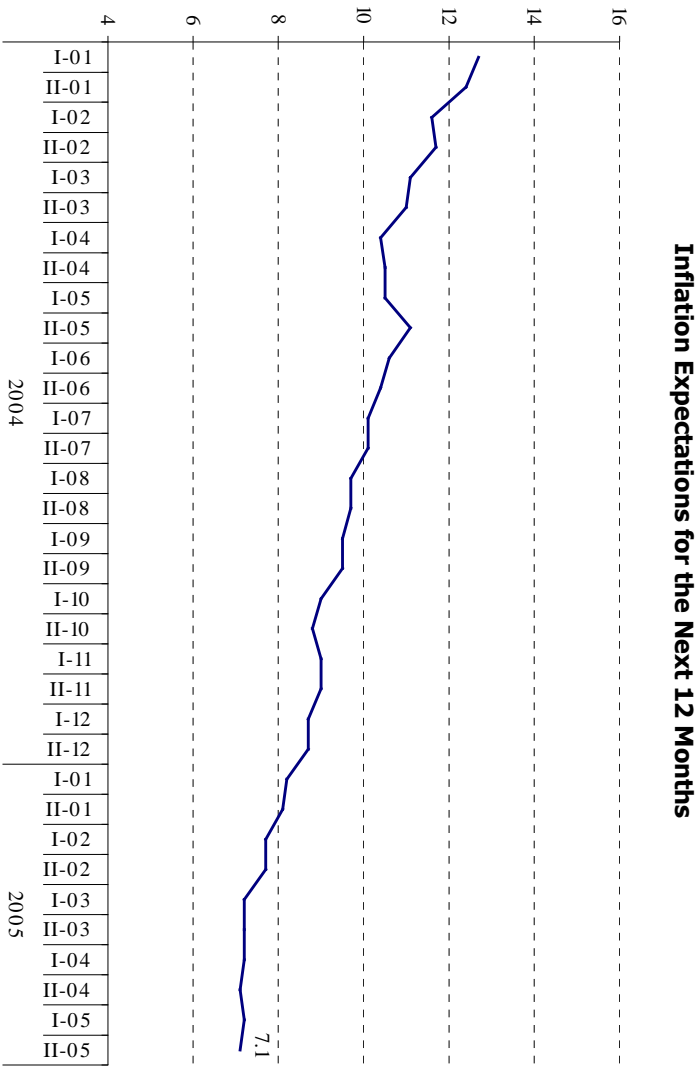
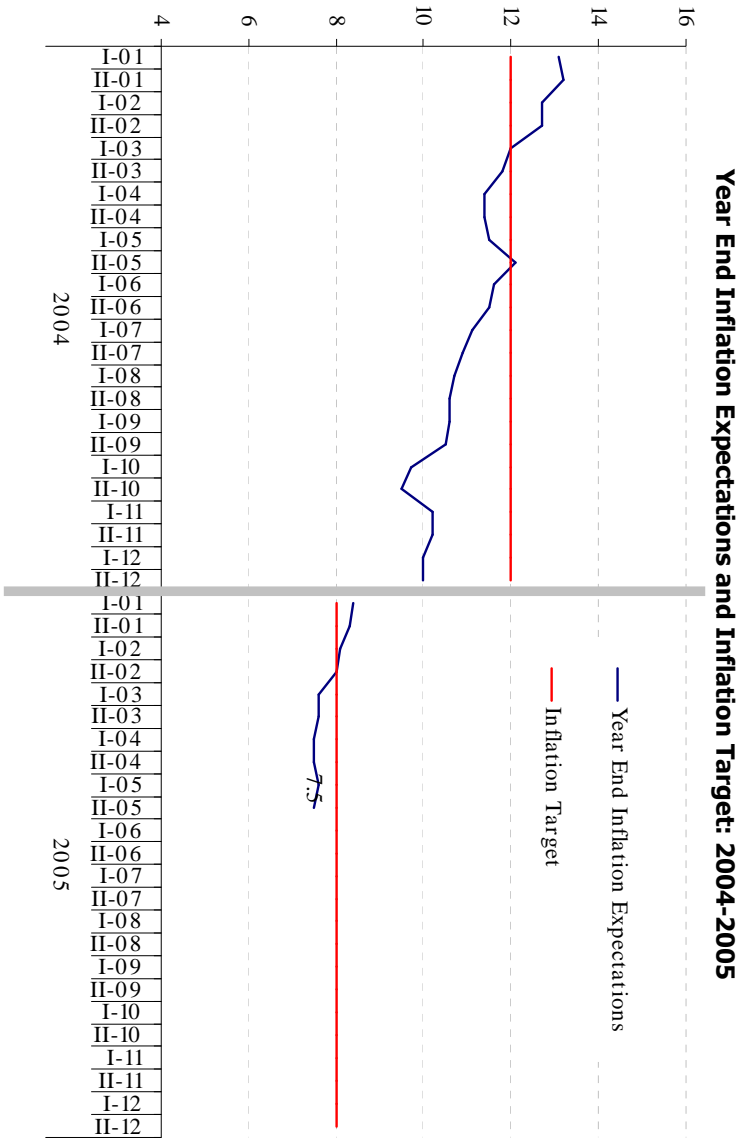
Conclusion

32. In summary, within the framework of the overall scenario, in which fiscal discipline is sustained, structural reforms will not lose pace and the economy will not be exposed to any significant exogenous shocks, annual inflation is expected to decrease in the upcoming months and end-year figures are anticipated to be consistent with the targets. However, as the delayed effects are analyzed, it is a fact that we are nearing a period where the 2006 inflation target should also be taken into account in monetary policy decisions. As a matter of fact, the Central Bank emphasized the necessity of "being cautious in the medium term" in its "April Inflation and Outlook" report released in May, and has started to underline the significance of the medium term in its recent announcements.

33. In conclusion, factors affecting the inflation outlook point to the adoption of an optimistic stance in the short term and a cautious stance in the medium term. In accordance with the above-mentioned analyses which take into account the evaluations made at the Monetary Policy Committee meeting held on June 8, 2005, the Central Bank decided to cut

short-term interest rates applicable to the CBRT Interbank Money Market and the Istanbul Stock Exchange Repo-Reverse Repo Market by 0.25 point. The current set of information highlights the belief that the general trend of short-term interest rates is more likely to follow a downward course than an upward one in the upcoming months. Any data containing information regarding the medium-term course of inflation and signals about the future will affect above probabilities, and therefore will be taken into account in monetary policy decisions. In this framework, the course of domestic demand, unit costs, secondary effects of raw material price increases, services sector prices and international liquidity conditions will become increasingly important in the coming period.

Graph 4: Inflation Expectations according to the CBRT Expectations Survey



Source: CBRT Expectations Survey