PRESS RELEASE

6 February 2002

BASIC CHARACTERISTICS OF THE INFLATIONARY PROCESS, THE INFLATION IN JANUARY, AND FUTURE EXPECTATIONS

I. INTRODUCTION

It has already been announced in the Statement of January 2nd, 2002 titled "Monetary Policy and Exchange Rate Policy in 2002 and Prospective Developments" that the Central Bank would share its evaluations on inflation outlook with the public opinion according to the principle of transparency. We are putting this into practice by publishing the first report, which evaluates the inflation of January announced on February 3rd, 2002, and the Central Bank's expectations. Being the first report, the following section sheds light on the basic characteristics of inflationary process in Turkey. In the third section, some technical aspects regarding price indexes are elaborated. The fourth section dwells on the inflation of January 2002 and the future expectations on inflation.

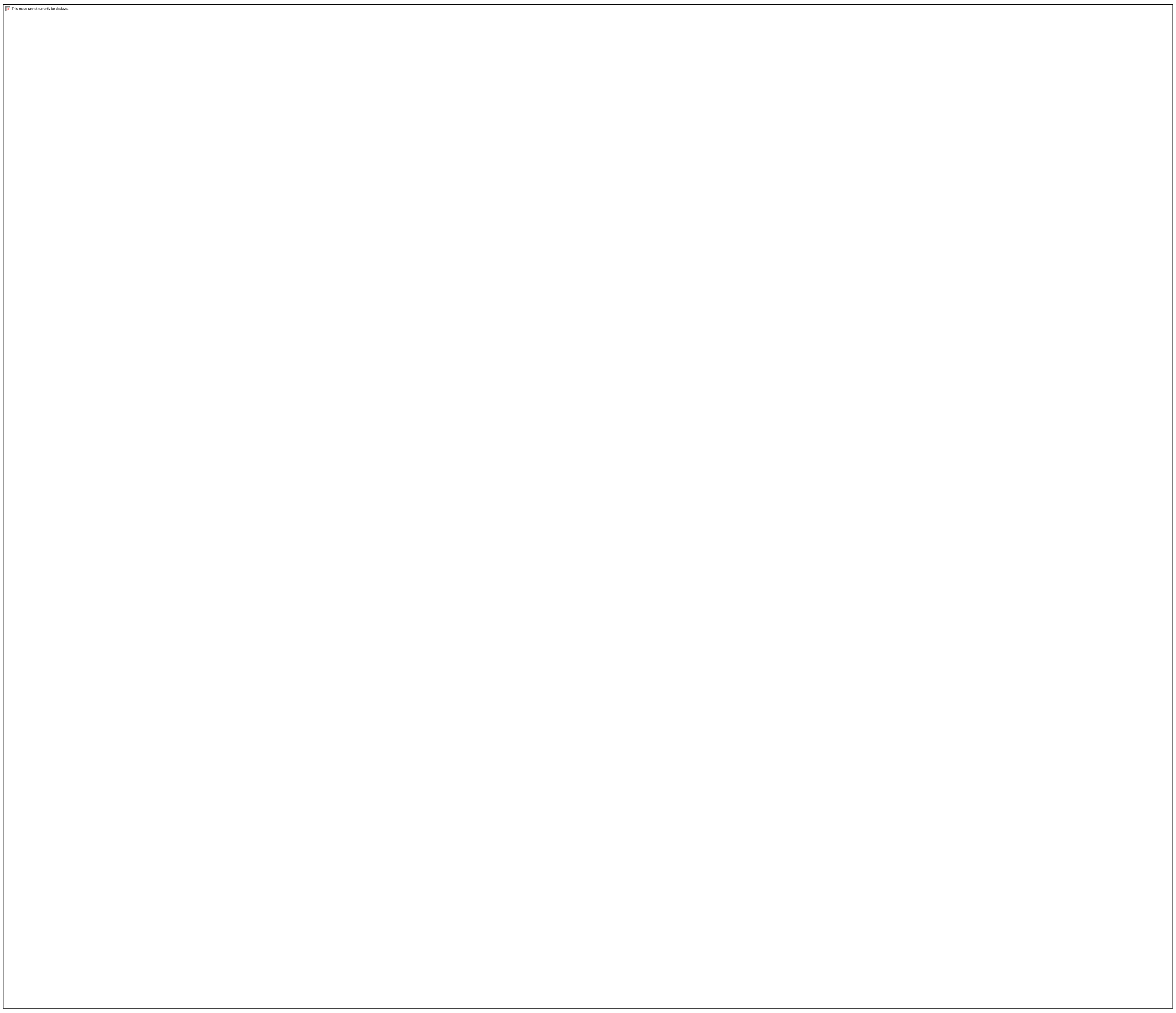
II. A BRIEF EVALUATION ON INFLATIONARY PROCESS IN TURKEY

1. The following graphic shows the annual inflation rates in the period between January 1988 and December 2001.[1] There are three underlying characteristics of the inflation process that started in the mid-Seventies: By international standards, Turkey suffers from a quite high inflation. More importantly, the inflation process has been going on for a quarter century. Therefore, Turkey has suffered from a high and persistent inflation. Secondly, there have been periods when the average inflation rate followed a steady course and remained relatively stable. For example, between early-1989 and end-1993, mid-1995 and mid-1997, and early-1999 and May 2000 can be regarded as periods with high but stable inflation. This reality denotes that a persistent inertia could occur in inflation. Thirdly, the inertia may as well disappear suddenly and inflation rate can move sharply either up or down.

2. Understanding the causes of these three peculiarities is vital in the fight against inflation. At the outset, the main causes of the long-standing and high inflation process were high budget deficits and the financing of these deficits through the Central Bank. Particularly, the second half of 1970's and the early 1980's

[1] "Annual inflation rate" is the percentage rate of increase realized in each month's index values according to the same month of the previous year.

are worth mentioning in this respect. Over time, inflation keeps up its momentum, although budget deficits are no longer covered by the Central Bank, as it has been the case in most of the 1990's. Behind this reality are several reasons. However, two of them are extremely important.



3. First, economic agents end up developing some mechanisms to protect themselves from long-standing inflation, seeing that past disinflation programs have often been interrupted or turned out to be unsuccessful. Generally, these mechanisms emerge as a result of backward indexation behavior in which desired future income is increased in line with the past inflation. Thus, past inflation rate is mirrored into the future.

4. Second, the budget deficits, standing at high levels by any international standards, or even widening progressively as it was the case in the 1990's, had to be financed increasingly through domestic borrowing considering that external support was limited and the Central Bank was no longer in a position to extend credits to the Treasury. Therefore, financial markets should grow in the amount of actual inflation

rate at least in order to keep the increment in real interest rates under control. In other words, past inflation rate was among the factors determining the monetary expansion at times when no stabilization program is implemented.

5. In this process, inflation gets established and develops inertia due to cost increases linked to past inflation. Besides backward-looking policies, the widespread habits of using foreign currency as an index in setting prices, writing contracts, holding savings and borrowing may account for this inertia. Thus, rate of increase of exchange rate becomes an important factor determining inflation.

6. Another aspect of this process is that the correlation between budget deficits and inflation seems to have been weakened, or even disappeared at all. Table-1 shows the public sector borrowing requirement to national income ratio, and the consumer inflation in the period 1989-2000. The public sector borrowing requirement to national income ratio is also calculated by taken the duty losses of state banks into account. Whatever criterion of public deficit is taken, it can be clearly seen that the relationship between public deficits and inflation has disappeared. Really, is there no relationship at all between public deficit and inflation rate?

7. The answer is "yes, there is no relationship" if we consider the realized inflation rates. Yet, the answer turns to "no, there is a relationship" if we consider the potential inflation. In economies where budget deficits soar at high level, if there exists no policy in place to cut down these deficits and if they are progressively financed through domestic borrowing, there is always a risk for inflation to go up. In other words, we may speak of"potential" high inflation equilibrium in such economies. For, they become extremely sensitive to sustainability of financing their domestic debts, which help reduce the actual inflation rate below its potential level. Failure to roll over the domestic debt compels such economies to resort to monetization, and the actual inflation level may soon reach its potential level. To put it differently, we can assert that such economies may become fragile and have a tendency to experience crises.

8. In general, an abrupt rise in inflation rate can materialize simultaneously or right after the increase in exchange rate and interest rate. As a matter of fact, shortly before the inertia was broken and the inflation rose suddenly (in the first half of 1994 and in the wake of the February 2001 crisis) the exchange rate had gone up abruptly. It is also interesting to note that, among the underlying reasons why the inflation rose rapidly (end-1987, early-1988, after April 1994 and in July 1997) are huge increments in prices of public goods and services.

Table-1: The Percentage of Public Sector Borrowing Requirement Within the National Income (PSBRNI) and the Consumer Inflation (%)

YEARS	PSBRNI	PSBRNI including Duty Losses	Consumer Inflation
1989	5,3		64,3
1990	7,4		60,4
1991	10,2		71,1
1992	10,6		66,9
1993	12,0		71,1
1994	7,9		120,3
1995	5,0		76,0
1996	8,6		79,8
1997	7,7	13,1	99,1
1998	9,4	15,9	69,7
1999	15,6	24,2	68,8
2000	12,5	19,6	39,0

9. In the light of the above-mentioned characteristics, we may conclude that the following points are of vital importance for the fight against inflation in Turkey. Pursuing tight fiscal and monetary policy will eliminate the risk of an abrupt increase in inflation, by making the economy less sensitive to crises and by turning expectations into positive. The fiscal discipline will also constrain the growth in total demand and thus contribute to the success in reducing the actual inflation rate. Therefore, achieving fiscal and monetary discipline is essential in the fight against inflation. The belief that the same discipline will continue in the future will also help fight inflation. For this reason, the realization of ongoing structural reforms is of great importance in order to keep up this discipline.

10. However, in an economy like Turkey's, where inflation has a long history, expectations and inertia play important roles in the inflationary dynamics, the fight against inflation should not be based solely on tight fiscal and monetary policies. The more backward-looking behaviors indexed to past inflation is abandoned; the easier the fight against inflation can be won. The price setting mechanisms of some public goods and services do increase the inertia in the inflation. Such mechanisms must be eliminated over time.

11. As mentioned above, the inertia stems mainly from the fact that economic agents base their decisions on the past inflation. Avoiding such behaviors depends on the success of disinflation programs unless a particular incomes policy is implemented. We deem it useful to underline an important point here by giving an example. Let us assume two different "cases" in an economy growing below its potential growth rate. In both cases let the inflation target and the economic policies pursued towards this target be the same and let these policies be "sound and realistic." However, let us assume in the first case that economic agents demand wage increases, set prices for their goods and services, and determine the size of corporate balance sheets with the expectation that the future inflation will be no different from the past inflation, despite sound policies. In the second case, let decisions be taken in the belief that the inflation target would be hit. It is obvious that, in the second case the growth rate and employment will materialize at a higher level than those in the first case, under the assumption that authorities will do whatever it takes in order to reach the targeted inflation.

12. Since sudden hikes in public prices will spur inflation, such increments must absolutely be avoided.

III. SOME TECHNICAL ASPECTS REGARDING PRICE INDEXES

1. Monthly fluctuations of some prices are based much more upon seasonal factors than upon economic causes. Therefore, it is useful to pay attention to the seasonal ups and downs before evaluating the movements in such indexes. In the wholesale price index, it is in the agricultural sector that we see the most intensive seasonal movements. However, in the private manufacturing industry price index and in the public sector price index there is no such an obvious seasonal fluctuation. The seasonal movements in the consumer price index are also important. These movements are greater than those in the wholesale price index, but at the same time are lesser than those in the agricultural price index. The importance of seasonal fluctuations may vary in the sub-groups of the consumer price index.

2. The fact that the price indexes move sometimes freely from economic causes cannot be attributed to the seasonal fluctuations alone. Movements in the public sector prices within the wholesale price index may sometimes occur independently from economic foundations. Three examples for such movements have already been given above. However, considering the long-term averages we may see that the price movements of public sector and private sector are in agreement.

3. Fluctuations in the consumer price index occur in a narrower band in comparison with those in the wholesale and the private manufacturing industry price indexes. This reality shows, in a sense, that there is more rigidity in the consumer

inflation. In addition, the movements in the consumer price index bear more importance than the other indexes for the people at large.

4. Basically for these reasons, the movements in the private manufacturing industry price index and in the consumer price index are significant. The rate of increase in the private manufacturing industry price index is sometimes called as "core inflation." Movements in this index approximately indicate the fluctuations in the core inflation. Likewise, it is also possible to produce a series of "core consumer inflation" excluding some of the sub-groups in the consumer price index.

IV. INFLATION IN JANUARY 2002 AND FORWARD-LOOKING EXPECTATIONS

IV.1 Inflation in January 2002

1. Starting from mid-October 2001, the prospects of achieving fiscal discipline in 2002, the persistence in structural reforms and the impending additional external financing from the IMF have eliminated the concerns about the sustainability of domestic debts and have changed economic expectations into positive. As a result of the change in expectations, interest rates declined substantially and the bubble in the exchange rate, emerged during the summer 2001, has burst.

2. The positive development in the exchange rates and interest rates has slowed down monthly price increases. Both increases in the consumer price index and in the private manufacturing industry price index in January are below the average of the same month in the last years.

3. In particular, the slowing trend in the private manufacturing industry inflation is remarkable. The present level of inflation in the private manufacturing industry, which has been decreasing for the last four months, and the forward-looking expectations are in conformity with the year-end program targets. Apart from the increase of 1,7 percent in January 2001, which was influenced by the currency peg system initiated in 2000, the minimum January realizations in the private manufacturing industry inflation between 1988 and 2000 was materialized at 3,1 percent. The average rate of increase in the private manufacturing industry prices in the months of January in this period is 6,2 percent. Therefore, the rate of increase of 2,1 percent in the private manufacturing industry prices seems to be low and in compliance with the economic fundamentals.

4. However, the January CPI, which increased by 5,3 percent, seems to be above the market expectations and the year-end program target, although being below the average of the past period. The average rate of increase in the CPI in the

months of January between 1994 and 2000 is 6,1 percent. Yet, the average between 1988 and 1993 stood higher.

5. An analysis of the CPI reveals that the price increases turn out to be very different in the sub-groups. For example, the inflation rates in foods and private transportation vehicles have materialized well above the past average inflation rates. However, the slowing-down trend observed in the inflation rate in clothing, housing, health, entertainment, and restaurant services seem to be satisfactory, when seasonal factors are taken into account. Such difference shows that behind the January consumer price inflation, realized at an unjustifiably higher level, might not be a revival in demand. Price increments in agricultural and food sectors resulting from adverse weather conditions, and raising the VAT ratios in some sectors and the supplemental vehicle purchasing tax ratios, which were reduced in November 2001, to their former levels may account for this development in the CPI. However, it is observed that the habit of backward-looking price setting still persists both in the public and private sector.

IV.2 Expectations

6. If the future course of inflation were determined by the economic fundamentals alone, we could easily state for at least three reasons that there would not be any problem in reaching the level of 35 percent, which is the consumer inflation target for 2002. Firstly, the monetary discipline achieved in 2001 is envisaged to continue in 2002 as well, and the growth rate of monetary base is targeted to be in line with the increase in nominal national income. Secondly, a very ambitious budget performance was achieved in 2001 by every international standards and it is planned that this performance should continue in 2002. Thirdly, the Turkish Lira has appreciated nominally after the bubble in exchange rate had burst in October 2001. As we have announced previously, in the framework of the program implemented we expect that the exchange rate will, from now on, tend to move along in harmony with the long-term equilibrium. In short, we expect that the encouraging climate we have observed recently on the inflation front will continue in the near future, bringing the inflation down drastically.

7. However, as emphasized in the second section, one of the basic characteristics of Turkey's inflation is its inertia. In other words, economic decisions, which are taken under the influence of backward-looking policies based on past inflation, will play an important role in determining the future inflation. The significance of this role can be matched with the weight of the economic fundamentals.

8. An important standoff could occur from the standpoint of success in economic policies and public welfare. Past failures in reaching the targets will raise

question marks such as "Why should this time be different from the previous ones?" In fact, economic agents might make their decisions based on past inflation in preparing budget for the next period, in demanding wage increases, or in setting prices for goods and services. However, it is the "soundness" of economic policies against inflation that will make the difference "this time" and convince the public opinion that the history would not repeat itself. If economic fundamentals, the main determinant of inflation, work upon a substantial slowdown in inflation, "backward-looking" pricing behaviors will distort the relationship between the inflation tendency and the economic fundamentals. In other words, although it is possible to obtain much better economic results for the society as a whole, it will be difficult to achieve the desired results because of enduring "backward-looking expectations."

9. As a matter of fact, despite some signs of considerable improvement in recent months, expected inflation level is still well above the targeted level in the program. The Central Bank conducts two separate surveys with the aim of measuring the inflation expectations of economic agents. The first one is the Business Tendency Survey, which has been analyzing 500 large-scale firms since December 1987. Conducted on a monthly basis, this survey concluded in the second half of January that "the expected wholesale inflation rate for the next 12 month-period" stands at 58,3 percent. The second survey, which has been conducting once in a two weeks since 3 August 2001, is related to financial sector. According to the results of this survey for January, "the expected consumer inflation rate for the next 12 month-period" is 45 percent. This rate signals a substantial decline compared to last four surveys. Two surveys conducted in November 2001 showed that the average expected consumer inflation rate for the next 12 month-period was 51,5 percent, while those conducted in December resulted in 49,5 percent.[2]

10. It is expected that rational economic agents will change their attitudes that do not comply with the economic fundamentals. There are two elements that will improve inflation expectations in the near future.

11. The first element is the inflation rates that will realize in the first months of 2002. Nominal appreciation of the Turkish Lira since October 2001 will play an important role in keeping the inflation at lower levels in the period ahead. As already mentioned, we have begun observing a favorable trend in the private manufacturing industry prices. We expect positive developments to occur in the CPI, once the temporary effects of adverse weather conditions and raising the VAT and the supplemental vehicle purchasing tax ratios to their former levels are disappeared, and when the domestic demand dynamics are taken into consideration.

---

[2] The results of this survey also will be published soon and regularly, as it is the case in the Business Tendency Survey.

12. The second element that will reinforce expectations is the approval of two laws by the President, which are extremely important for the program. The "Law on the Restructuring of Debts to the Financial Sector and on the Amendment of Certain Laws" numbered 4743, and the "Law on the Tariffs of Goods and Services Produced by the Public Enterprises and Institutions and on the Amendment of Certain Laws" numbered 4736, which will facilitate to obtain a primary surplus planned for 2002, have been put into effect. Moreover, the IMF Executive Board has ratified the credit to be extended to Turkey. In the meantime, the Turkey's credit rating has been revised upward.

14. The Central Bank announced at the beginning of 2002 that some assumptions on the economic environment had been made in designing the monetary and exchange rate policy. These developments have increased the likelihood that the said assumptions will materialize. In this context, we would like to state that the Central Bank is in the mood for a cautious optimism for the future inflation.