

FEBRUARY INFLATION AND OUTLOOK

I. GENERAL EVALUATION

1. Downward trend in annual inflation rates continued in February 2004 at an accelerating rate. Annual inflation figures dropped to 14.3 percent in CPI and 9.1 percent in WPI. Decline in annual inflation rates of CPI excluding food and WPI excluding agriculture continued as well, realizing as 14.3 percent and 5.2 percent, respectively.
2. In February, monthly price increases became 1.6 percent in WPI and 0.6 percent in CPI. Seasonally adjusted CPI inflation realized as 0.9 percent, while WPI inflation was 1.1 percent.

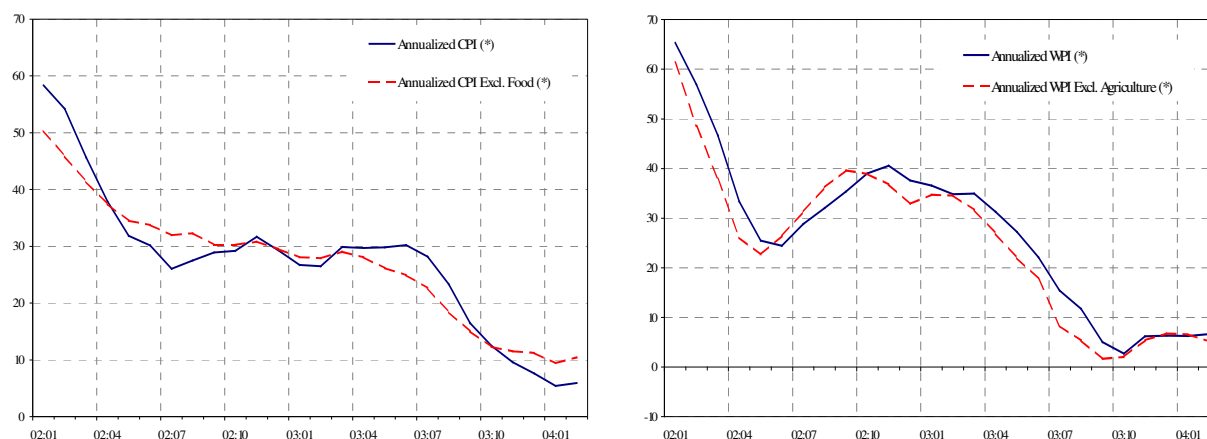
Table 1: General CPI, WPI and Sub-items

	Annual % Change		Monthly % Change			
	2003	2004	2003	2004	2003	2004
	February	February	December	January	February	February
CPI	27.0	14.3	0.9	0.7	2.3	0.6
Goods	26.0	10.4	0.7	0.2	2.5	0.0
Services	29.1	22.0	1.1	1.8	1.8	1.5
Excl. Food	30.0	14.3	0.7	0.5	1.5	0.3
Food	18.1	14.3	1.4	1.4	4.8	1.5
WPI	33.4	9.1	0.6	2.6	3.1	1.6
Public	42.9	1.1	0.4	0.3	3.8	0.7
Private	29.9	12.4	0.7	3.5	2.9	2.0
Public Man.	48.8	2.1	0.4	0.7	4.1	1.1
Private Man.	30.5	7.7	0.9	0.6	1.5	0.1
Agriculture	27.4	21.6	0.3	9.3	5.6	5.4
Excl. Agriculture	35.4	5.2	0.7	0.5	2.4	0.3
Excl. Agr. and Energy	36.7	5.5	0.8	0.6	2.5	0.4

Source: CBRT, SIS.

3. The six-month average of seasonally adjusted inflation became 0.54 percent in WPI and 0.48 percent in CPI. Annualized figures correspond to 6.7 percent and 5.9 percent, respectively. During the same period, the average rate of increase in seasonally adjusted CPI excluding food realized as 0.83 percent. This figure corresponds to 10.4 percent in annual terms. (Figure 1).

Figure 1: Annual Percentage Change and Quarterly Moving Averages
CPI and CPI Excluding Food **WPI and WPI Excluding Agriculture**



(*)Quarterly Moving Averages (Annualized, Seasonally Adjusted).

Source: CBRT, SIS

Developments in Consumer Prices

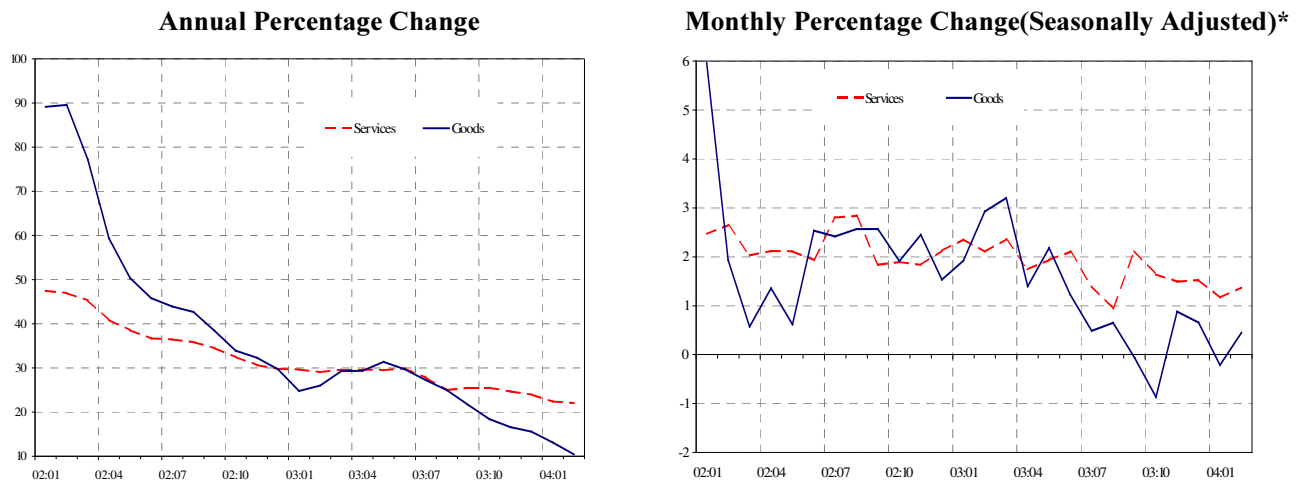
4. Although price increases in CPI, both in food group and groups excluding food in general, pursued a course consistent with the end-year target, relative rigidity in services persisted. Despite high increases in agriculture group, price increases in food group realized as 1.5 percent in February. Prices in this group merely increased by 0.4 percent in seasonally adjusted terms. In summary, food prices pursued a course that supported the downward trend in CPI inflation in the first two months of the year.

5. Durable goods showed a slight increase compared to January. Especially prices of entertainment and culture devices (this group mainly includes goods such as televisions and audio devices) dropped by 5.8 percent and the two-month price decline reached 6.8 percent. This drop stemmed mainly from the appreciation of Turkish lira.

6. Rent increases became one of the most remarkable developments in February. Also the rigidity in rents is continuing as it is in the services group in general. The total increase, which has reached 3.6 percent in the first two months, is far from consistent with the end-year target.

7. Following January, price adjustments in health services continued by losing some momentum in February. Moreover, considering the first two- month rise, the increase of rate in prices slowed down compared to 2003.

Figure 2: Prices of Goods and Services

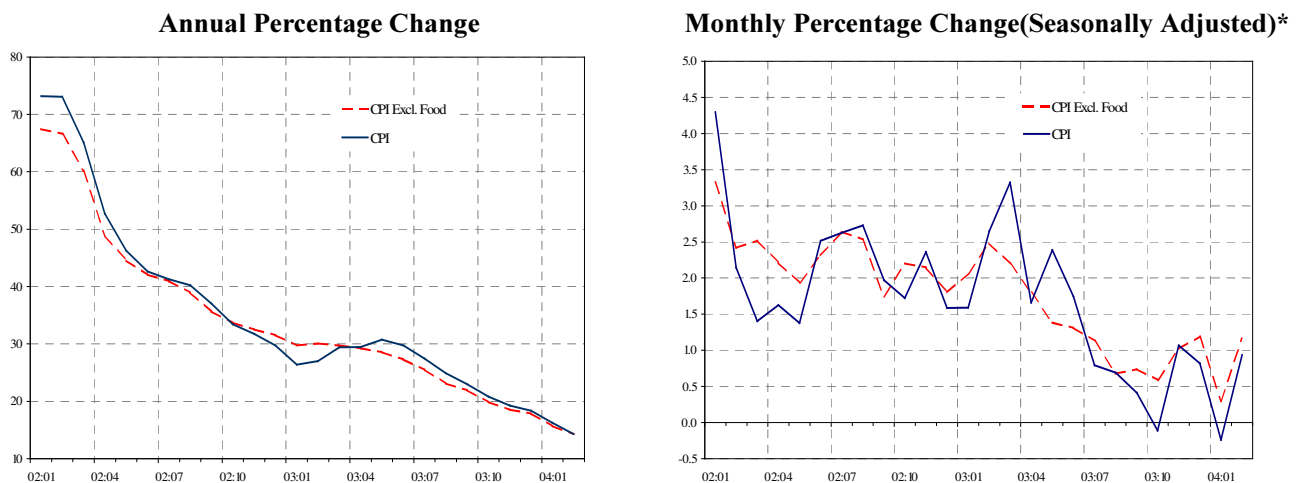


Source:CBRT, SIS.

* TRAMO/SEATS method has been used for deseasonalization.

8. In February, the differentiation between prices of goods and services groups continued similar to the previous months. Prices in rent, restaurant and health groups rose above the general CPI inflation. Both low increase in food and durable goods and the decline in clothing group had a favorable effect on price increases in goods group. Prices in services group have been displaying a regular and significant increase above prices of goods group since mid-2003 (Figure 2).

Figure 3: CPI and CPI Excluding Food



Source:CBRT, SIS.

* TRAMO/SEATS method has been used for deseasonalization.

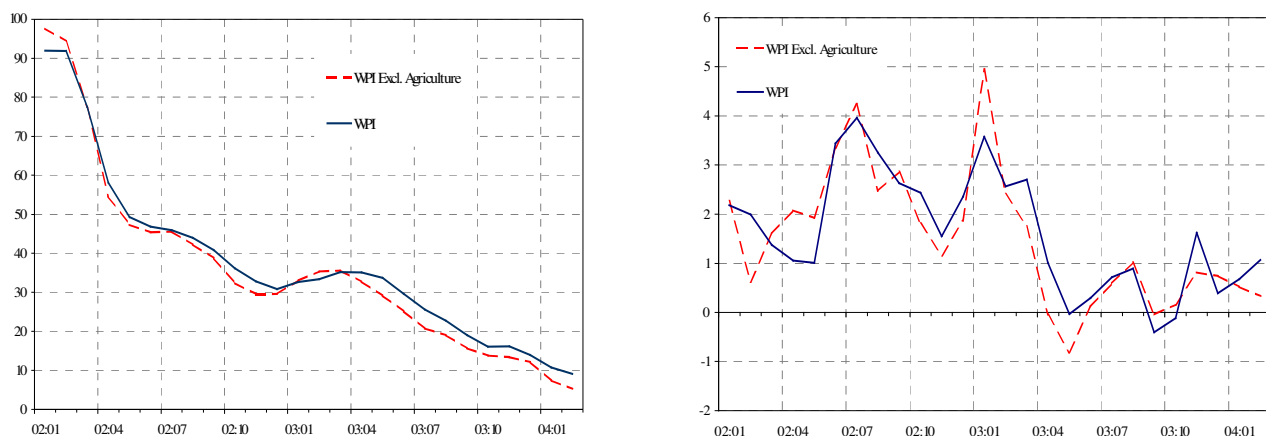
Developments in Wholesale Prices

9. In February 2004, WPI increased by 1.6 percent. The rate of increase of seasonally adjusted WPI rose by 0.4 point and became 1.1 percent. On the other hand, with 0.3 percent, WPI inflation excluding agriculture maintained its downward course, which has been continuing since April 2003 (Figure 4).

10. In February, agricultural prices, which rose by 5.4 percent, contributed the most to the increase in WPI. On the other hand, the seasonally adjusted rate of increase in agriculture prices declined by 2.9 percent compared to January and realized as 1.2 percent. In other words, the price- push effect of agricultural prices on WPI mainly resulted from fresh vegetable and fruit prices that increased due to weather conditions as seen in January. However, as expected, this impact has weakened compared to January.

11. Meanwhile, the increase in WPI excluding agriculture maintained its low trend of recent months. WPI inflation excluding agriculture, which rose by 0.5 percent in January, realized as 0.3 percent in February. Prices in private manufacturing industry and public manufacturing industry increased by 0.1 percent and 1.1 percent, respectively. Moreover, prices in electricity, gas and water groups declined by 0.9 percent.

Figure 4: WPI and WPI Excluding Agriculture
Annual Percentage Change **Monthly Percentage Change(Seasonally Adjusted)***



Source:CBRT, SIS.

* TRAMO/SEATS method has been used for deseasonalization.

12. In line with the developments mentioned above, annual WPI inflation and WPI inflation excluding agriculture declined to 9.1 percent and 5.2 percent, respectively. High rates of increase in these indices in the first months of 2003 owing to the developments in Iraqi War have played a role in stimulating the drop in annual inflation figures as of February 2004.

II. OUTLOOK

13. Enhanced market confidence as a consequence of the economic program has helped expectations to improve, and the change in price-setting behavior and the TL appreciation have reduced the inflation even further by getting annual inflation closer to single digit figures. During this process, real unit costs have decreased significantly thanks to the restructuring of the economic dynamics, and as a consequence, Turkey has witnessed a downward trend in inflation unprecedented in the last 30 years.

The inflation figures in the first two months of 2004 are pointing to a change in expectations and pricing behavior. Meanwhile, the rapid rise in agricultural prices is not expected to jeopardize the inflation target and it is believed that due to the correction in agricultural prices negative inflation figures might be observed in summer.

14. It is believed that the end-year inflation target for 2004 is within reach unless there arises an exogenous shock. However, some important risks that might endanger attaining price stability still prevail:

i) The rigidity in the price increases in services has not yet been completely broken and this poses a risk to inflation for the coming period. Taking into account of the targeted inflation rate instead of the past inflation rate, especially in house rent contracts, is crucially important for breaking this rigidity. Certainly, such a pricing behavior can become widespread only if positive expectations persist and there is no development that might put inflation at risk. Within this framework, it should be underlined that the importance of managing expectations appropriately and keeping domestic demand under control has become more critical than ever, in order to cause the inflation in services to converge to the rate of price increase in goods sector.

ii) In February, possible ways of meeting the fiscal gap in the budget occupied a significant part in the economic agenda. Within the scope of the supplementary budget prepared for this purpose, public sector prices rose at the end of February due to adjustments made in Private Consumption Tax (PCT). Although the extent of the additional funding remained unclear, PCT adjustments have been carried out only in petroleum products and cigarettes until now. The actual impact of these adjustments occurred at the end of the month will be seen on March inflation. Despite this, the prices of pharmaceuticals were adjusted in line with the exchange rates, and along with the reductions in Value Added Tax (VAT) and they will compensate other negative impacts to some extent. The overall impact of finalized measures on inflation is expected to be limited. However, considering that a significant contribution to the recent downward trend in inflation has come from the modest rise in administered prices, the course of those prices will become crucial in the next period as to whether it will be different or not. Especially price increases in those products that affect input costs directly such as electricity, natural gas and petroleum are instrumental on inflation by means of costs and expectations. Consequently, price adjustments that might occur in the said groups after a probable deviation from fiscal discipline will continue to constitute a risk for inflation in the medium-term.

iii) Considering that the rise in employment would pick up in the following period, the need for maintaining the productivity increase backed by structural reforms will become crucial. Accordingly, good corporate governance, and structural arrangements intended to encourage foreign direct capital investments will bear much significance.

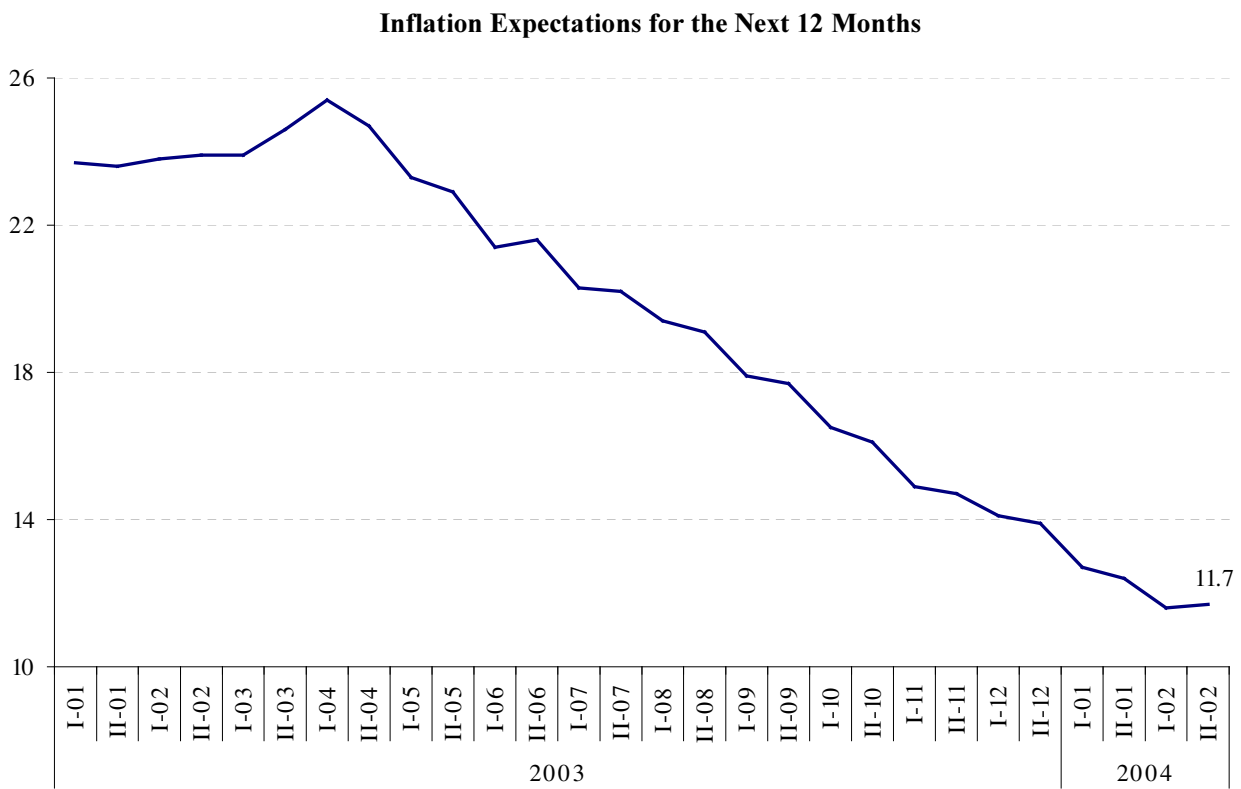
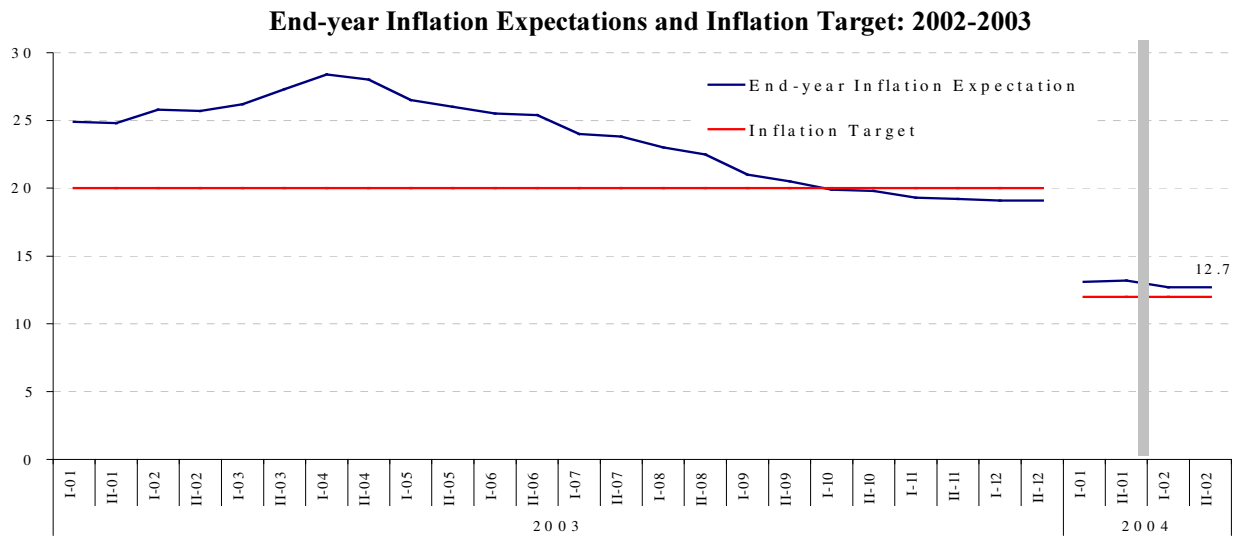
iv) Exchange-rate volatility always creates a risk for inflation. Such a risk has started to diminish relatively, due to the increasing confidence and the removal of concerns over the sustainability of public debt. However, in order to be able to reduce this risk even further in the course of time, the banking reform must be carried out, financial pressure must be eased, expectations must be managed correctly, and economic agents should increasingly rely upon forward and future markets. By all means there will always be exchange rate risk in a floating exchange rate regime. However, it will be useful to improve the free market system and competitive environment in order to weaken exchange rate pass-through and minimize the inflation risk originating from exchange rate.

v) In order to support the downward trend in inflation, it is important that the total domestic demand should not exceed the potential production capacity of the economy. At this point, the productivity increase in the public sector, the deepening of financial sector reform, the encouragement of corporate restructuring, the acceleration of privatization and liberalization of markets, and the direct capital investment have come in the forefront. Attaining the expected growth rates during the disinflation process can only be achieved by expanding the output capacity of the economy, as well as supporting the productivity increase.

vi) In the first 5 months of 2003, inflation rates increased due to cost-push factors arising from the Iraqi War, as well as from the price hikes in food and agricultural products owing to adverse weather conditions. With the removal of the said conditions, inflation rates maintained a rather downward trend for the rest of the year. These developments created a significant discrepancy in the inflation trend between the first and the second halves of the year. As a natural consequence of the mentioned effect, also called as the base effect, the downward trend in annual inflation is expected to be significant in the first five months of 2004. However, even though the downward course of inflation would continue during the remaining part of the year, there may occur a standstill in the 12-month cumulative rates of inflation due to base effect. Yet, such a development will be consistent with the inflation target. At this point, it should be emphasized once more that the Central Bank will continue making its monetary policy decisions by taking into account of the future course of inflation only, not the past inflation. Therefore, the economic units should base their decisions on the expected trend of inflation and the coherence of expected price increases with the targeted inflation, rather than the annual inflation rates, which are backward-looking indicators.

15. To sum up, in order to preserve the success achieved in the fight against inflation in the last two years, and to achieve and maintain price stability, it is required that: (i) the expectations are managed properly and the current policies intended for ensuring macroeconomic stability are credible; (ii) public deficits and total public debt stock are reduced, by sticking to the fiscal discipline; (iii) the crowding-out effect due to the dominance of the public sector on the financial markets is decreased to ensure financial deepening in the framework of lowering public debt stock; (iv) the monetary discipline should continue; (v) the price-setting behavior and incomes policy of the public and private sectors are implemented in line with the inflation targets; (vi) the rigidity in the already subdued inflation should be totally removed by putting into practice the structural reforms launched in legal and institutional areas; (vii) the efficiency and quality in the production of goods and services should be improved, by removing the obstacles to production and investment, and thereby raising the competitive edge of the economy. As always, the Central Bank will continue monitoring the applications in the above mentioned areas, and incorporate all possible developments in its monetary policy decisions, adopting a forward-looking perspective.

Figure 5: Inflation Expectations According to CBRT Expectations Survey



Source: CBRT Expectations Survey