

July Inflation and Outlook

I. GENERAL EVALUATION

1. In July 2004, CPI increased by 0.22 percent while WPI dropped by 1.52 percent. Annual CPI and WPI inflation became 9.6 percent and 9.4 percent, respectively.
2. Seasonally adjusted monthly price increases were recorded as 1.4 percent and - 0.3 percent in CPI and WPI respectively, while seasonally adjusted monthly price increases in CPI excluding food and WPI excluding agriculture became 0.9 percent and 0.8 percent.

Table 1: General CPI, WPI and Sub-items

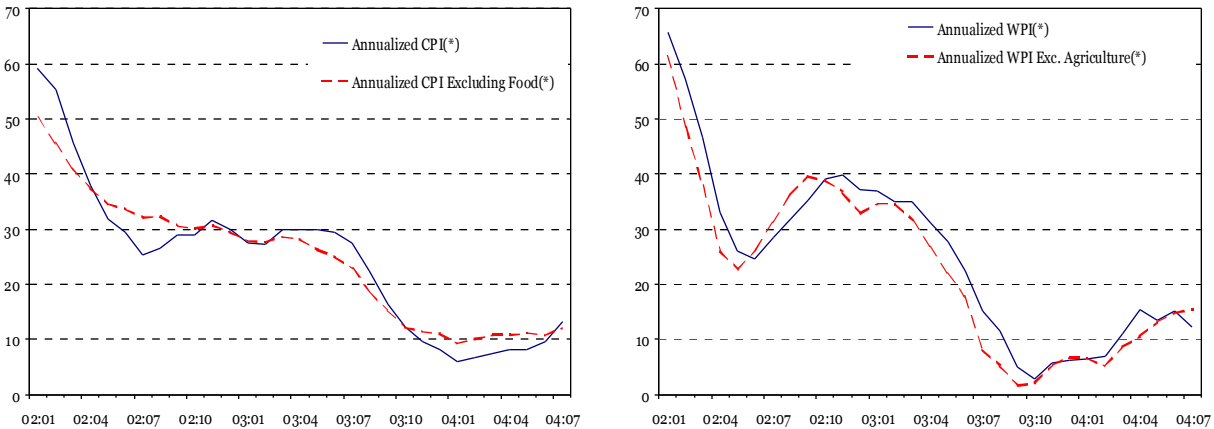
	Annual % Change		Monthly % Change			
	2003 July	2004 July	2004 May	2004 June	2003 July	2004 July
CPI	27.4	9.6	0.4	-0.1	-0.4	0.2
Goods	27.3	5.8	0.1	-0.7	-1.3	-0.2
Services	27.8	16.8	0.9	0.9	1.4	1.0
Excl. Food	25.5	10.6	1.5	0.8	0.7	0.4
Food	34.4	6.0	-3.1	-3.3	-3.8	-0.6
WPI	25.6	9.4	0.0	-1.1	-0.5	-1.5
Public	20.9	12.5	2.3	2.0	0.8	1.8
Private	27.5	8.2	-0.9	-2.2	-1.1	-2.8
Public Manufacture	23.9	15.2	2.6	1.5	1.0	2.7
Private Manufacture	20.3	10.0	1.8	1.2	0.5	0.3
Agriculture	43.7	4.7	-5.2	-8.1	-3.9	-8.6
Excl. Agriculture	20.8	10.9	2.0	1.5	0.6	0.8
Excl. Agr. and Energy	21.3	11.7	2.1	1.6	0.6	0.8

Source: CBRT, SIS.

3. The six-month average of seasonally adjusted inflation was 0.98 percent in WPI and 1.04 in CPI. The mentioned average rates of increase correspond to 12.4 percent and 13.2 percent in annual terms. In the same period again, the average rate of increase in seasonally adjusted CPI excluding food became 0.95 percent, which corresponds to 12.1 percent in annual terms (Figure 1). As illustrated in the figure, a relative increase is observed in the six-month moving average of seasonally adjusted inflation figures in the last couple of months. A significant part of this increase stems from the margin of errors in seasonal coefficients due to the rapid decline in inflation in the last few years. Since seasonal coefficients are estimated by using past data, they include the impact of volatility created by the past period's high inflationary environment and this may lead to misinterpretation especially in the months when seasonality is dominant. For instance, seasonally adjusted figures may look higher than they actually are in June and July; whereas they are lower than they are in January, September and October. Thus, even if the pace of the upward trend in general prices remains stable, the six-month averages of seasonally adjusted inflation seem to be higher in June and July; and lower in September and October again. Therefore, the CBRT reports short-term seasonally adjusted figures,

but does not put emphasis on them in the Outlook section. It is expected that seasonally adjusted figures will be more reliable when sufficient data has been accumulated under the low-inflation environment.

**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. Besides the seasonal decline in food and clothing prices, there were mainly three factors affecting the CPI inflation in July, which are: i) decline in exchange rates, ii) rise in public prices and iii) rigidity in services group prices.

5. In line with the weakening correlation between exchange rates and inflation under floating exchange rate regime, it is observed that the impact of exchange rate movements on inflation has remained limited in April-May period. Moreover, 2.7 percent decline in exchange rates in July helped constraining those lagged effects. One of the sub-items, which displayed a relatively higher rate of increase despite the reversed trend in exchange rates, was electrical and non-electrical house-hold appliances under durable goods group. Despite the limited rise of 0.3 percent in durable goods group, which is known to be the group most severely affected by exchange rate developments, the rise in electrical and non-electrical household appliances prices became 3 percent. Another price group on which the depreciation of the Turkish lira was affective, is the petroleum products and natural gas group. Rise in exchange rates and in crude oil prices caused a 5 percent increment in petroleum products prices first in May and then in June. The rise in petroleum products was followed by a 6.5 percent increase in natural gas prices.

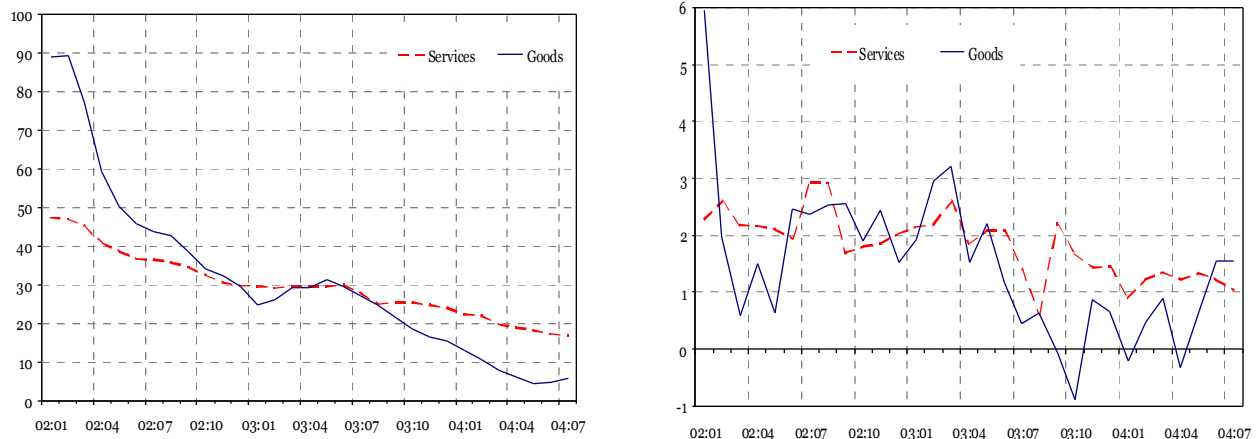
6. Price increases in the housing and transportation groups were influenced by the rise in petroleum products and natural gas prices. Furthermore, the 20 percent increase in the bridge and pay road tolls affected prices of transportation services. Besides, due to the 12 percent increase in

sugar prices, which became effective as of June 18th, crystal sugar prices increased by 6 percent in July, hampering the seasonal decrease in food prices.

7. Apart from the exchange rate and increase in public prices, another determining factor in July CPI inflation is service prices. In the health services group that sets prices twice a year – in January and July –the sub-items of medical services and hospital services prices increased by 1.7 percent and 2.1 percent respectively in July. Thus, in these two groups January-July period cumulative increase realized as 8.3 percent and 15.8 percent, respectively. Even though the increase in the prices of hospital services, which was 46.5 percent by the end of 2003, dropped to 17.5 percent by July 2004, the price adjustments are not yet brought in line with the inflation target and the price rigidity in this group is still continuing.

8. Meanwhile, in July rents rose by 1.1 percent and hotel services prices increased by 2.3 percent due to the seasonal pressure caused by the tourism season. Hence, the hike in the prices of services became 1 percent in July. The seasonally adjusted increase in the prices of services, which was 1.2 percent on average in the first six months of the year, rolled back to 1 percent in July.

Figure 2: Prices of Goods and Services
Annual Percentage Change **Monthly Percentage Change**
(Seasonally Adjusted)*



Source: CBRT, SIS.

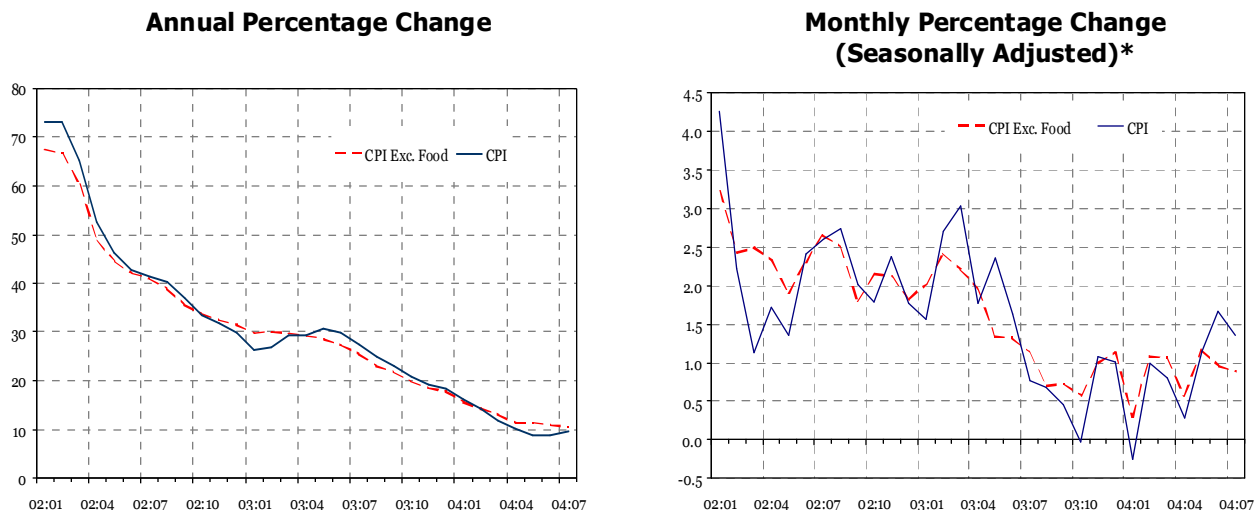
*TRAMO/SEATS method has been used for deseasonalization.

9. Goods prices, which displayed a limited decline of 0.2 percent due to the increase in public prices, rose by 1.5 percent in seasonally adjusted terms. In the first seven months of the year, the seasonally adjusted cumulative price increase became 4.6 and 8.6 percent in goods and services group, respectively.

10. The fact that the food prices, displayed a decline well below seasonal averages, pull up the seasonally adjusted CPI inflation. In fact, analyzing in terms of the seasonally adjusted figures, it is clearly seen that the CPI inflation excluding food (0.9 percent) remained below the general CPI inflation (1.4 percent). Undoubtedly, these figures should be interpreted in line with the hesitations

mentioned in the third paragraph. Besides, the annual CPI inflation rose to 9.6 percent in July from 8.9 percent in June whereas the annual CPI inflation excluding food dropped from 10.9 percent to 10.6 percent.

Figure 3: CPI and CPI Excluding Food



Source: CBRT, SIS.
TRAMO/SEATS method has been used for deseasonalization.

Developments in Wholesale Prices

11. In the first half of the year, due to the demand pressure on the prices of various raw materials used in industrial sector, driven by high growth in China, iron and steel prices increased; thus the basic metal prices in public manufacturing industry were negatively affected. Although stability is observed in iron and steel prices in the recent months, world crude oil prices continue to mount and prices of the petroleum products manufacturing industry display high rates of increase due to the reflection of international oil prices on domestic prices.

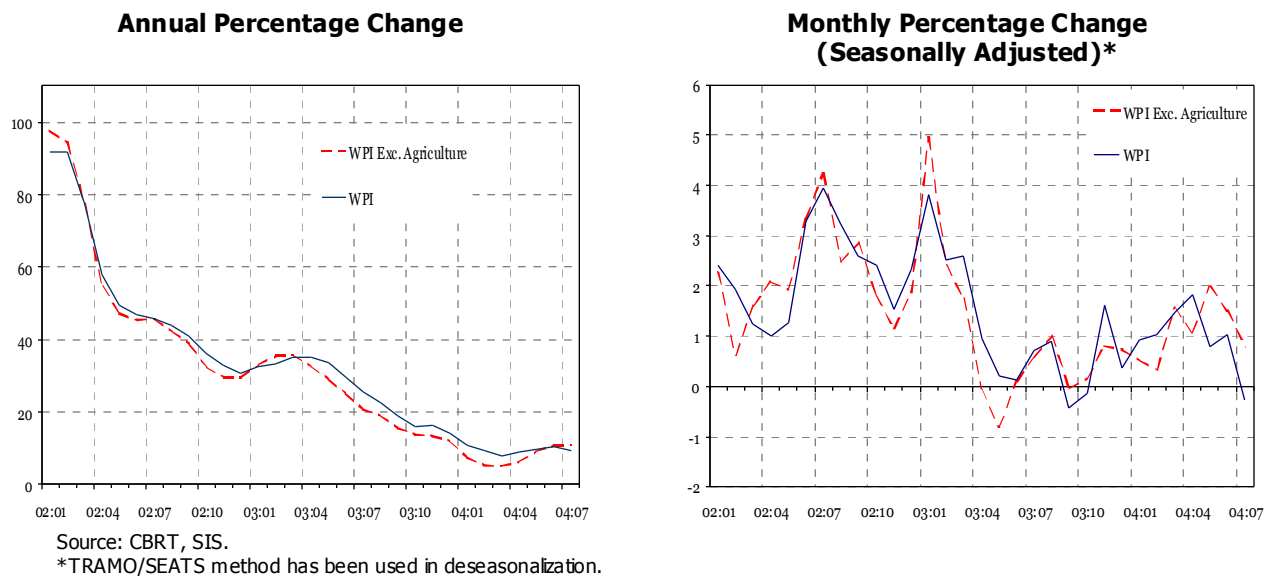
12. In July, 0.61 points of the 1.52 percent monthly decline in the WPI derived from the price hikes in public sector whereas -2.13 points of this decline stemmed from the price drops in private sector. The mentioned contribution of the private sector came from the agricultural prices, which dropped due to seasonal effects. In addition, the seasonally adjusted WPI dropped by 0.3 percent in July.

13. Also in July, agricultural prices decreased by 8.6 percent owing to the fall in fresh fruit and vegetables prices. It is observed that the seasonally adjusted agricultural prices declined by 3.3 percent in July after the drop of 1.3 percent in June. Contrarily, when the agricultural prices, which dropped owing to seasonal effects, are excluded from WPI, WPI excluding agriculture is recorded to increase by 0.8 percent.

14. Public manufacturing industry prices are affected by the price adjustments in petroleum products and sugar. Private manufacturing industry prices slowed down along with the stability of the exchange

rate and are negatively affected by the increases in petroleum prices. However it is observed that the mentioned effects are limited due to the decline in food and textile products prices.

Figure 4: WPI and WPI Excluding Agriculture



15. Energy prices maintained their current course and rose by 0.1 percent. Energy prices continue to decrease by 2.2 percent in annual terms.

16. Hence, the annual WPI increase rolled back to 9.4 percent in July. Meanwhile, WPI excluding agriculture rose to 10.9 percent annually. Considering the fact that high fluctuations in WPI are determined by the agricultural sector and that the agricultural prices display a volatile course, it is predicted that WPI will pursue a fluctuating course in the upcoming period, while WPI excluding agriculture may continue to rise in line with the developments in crude oil prices and exchange rate.

II. OUTLOOK

General Macroeconomic Outlook

17. At this period of the year when the general macroeconomic outlook of 2004 starts to take shape, it is observed that the current economic program implemented with coherence for a long time has yielded much achievements in terms of macroeconomic stability and price stability despite the external uncertainties encountered at times. Achieving a steep decline in inflation in three consecutive years along with high growth rates in national income can be attributed greatly to the current economic program implemented without any compromise. However, it should certainly be kept in mind that much remains to be done, the economic balances have not yet been established permanently and price stability has not yet been achieved completely. Still, much progress has been made in the way of

stabilization, and in terms of macroeconomic indicators; significant changes were made in institutional structure compared to the previous periods.

18. The primary objectives of the current program are to relieve the Turkish economy from its current vicious circles by improving the general macroeconomic environment and expectations, to create an environment in which economic agents are able to make healthy predictions by bringing down inflation and debt burden and to achieve an enduring macroeconomic stability by ensuring a more effective allocation of resources through structural transformations. By the mid-2004, important achievements were made in many areas and the improvement in basic macroeconomic variables surpassed the expectations; however, there is still much to do in terms of achieving absolute price stability as well as permanent macroeconomic stability.

19. Taken in the light of experiences, it is clear that the current program increased immunity to external shocks and as long as the requirements of the program are fulfilled, the main trend has always been towards the better. For instance, the external shocks and uncertainties arising from the Iraq operation in the first months of 2003 had only a limited effect on the economy and the downward trend in inflation and the recovery in economic activities continued in the period following the removal of these factors as it was perceived that the requirements of the program would be fulfilled. It should also be kept in mind that the main trend dominated following the volatility in exchange rate in October 2003 and the downward trend in inflation as well as growth in the economy continued. Finally, the signals given since mid-April by the Federal Reserve Bank of the USA for a likely rise in interest rates in the coming months led to changes in global liquidity and risk trends, thus increasing the fluctuations in the financial markets. Moreover, above-mentioned developments coincided with the periodic uncertainties on foreign policy and the rapid rise in current account deficit. However, fluctuations were rather limited thanks to the signals given for the continuation of the monetary and fiscal discipline and the structural reforms brought on the agenda concerning social security and tax reforms. Thus, the main trend has turned into direction of macroeconomic stability again.

20. The policies implemented within the framework of the stabilization program and a comparison of the program period with the past highlight the importance of concrete, transparent, accountable and comprehensive programs in shaping the future-looking perceptions. The most important economic anchor perceived by public is highly credible commitments with robust arrangements and reforms which sustain the discipline and reduce the structural fragilities in general economic policies, rather than a monetary or a financial variable. In this context, the fact that the macroeconomic framework of the upcoming period was brought to a conclusion phase in a platform involving also the Central Bank, and that this framework envisages the continuation of fiscal discipline and structural reforms is perceived to be a favorable development.

21. In the first half the year, growth originated greatly from private consumption and private investment. It is anticipated that the growth composition of the second quarter of 2004 will follow a course parallel to that of the first quarter. As for the second half of the year, a relative domestic

demand-based slowdown can be observed in growth rate in line with the recently rising interest rates and the fluctuations in exchange rate. However, the upward trend in investments and the strong course of foreign demand are expected to limit this slowdown. Accordingly, under the assumption that no great external shock emerges in the short run, the rate of growth in national income will be higher than the projections of the program pertaining to early 2004. In line with these developments, it is estimated that the imports of intermediary goods and investment goods will be high for the rest of the year and as a result of the rise in imports, which accelerate in accordance with the economic activity, the year-end current account deficit might be higher compared to the previous years despite the strong performance of exports and tourism revenues. Considering the structural dynamics of our country, it should not be deemed a surprise that the current account deficit becomes high where growth is registered to be higher than foreseen.

22. As is the case for the last three years, the Central Bank will continue to shape its monetary policy by taking into consideration the attainment of a consistency between the actual level of inflation for the next period and the inflation target and thus will avoid giving confusing signals to economic agents. It is apparent that the above-mentioned strategy bears an important role in shaping the expectations about inflation, and inflation targets are gradually becoming a more effective anchor. The same monetary policy framework greatly contributes to the efforts for sustaining the fight against inflation and high growth rates concurrently. Therefore, there is no question of a direct intervention to the current account deficit by the Central Bank under the current monetary and exchange rate policy. Above all, in an environment where real interest rates are mostly determined by the volatilities in risk premium and the exchange rate level is set under the market conditions, such a policy reaction is sure to prove ineffective. Besides, it will lead to confusions in the signals to be given and affect the expectations unfavorably.

23. Meanwhile, it is very important to accurately analyze the channels through which the deterioration in current account might affect future inflation. The first channel emerges as the possibility that the deterioration in current account and the expectations thereon might unfavorably affect future inflation through the volatilities they cause in exchange rate. This is not and will not be a strong probability considering the significant steps taken in the way of enacting a new medium-term program under preparation with the support of international institutions. Achievements made in the framework of the current program and the gradually lessening vulnerability of the economy to external shocks set the greatest evidence.

24. The second channel is the correlation between the factors leading to the deterioration in current account and the inflation dynamics. Exchange rate channel, which is one of the factors in this correlation, has already been discussed above. Another important factor to be mentioned is the high rate of growth. The question here is: To what extent is the rapid growth a threat to the downward trend in inflation? In order to be able to give a satisfactory answer to this question, it is necessary to make an accurate analysis of the pressure on inflation exerted by the current production level. Considering the rapid rise in private investment expenditures recently and the persistent rise in

productivity, it can be asserted that the potential production level is increasing. According to the calculations made within the Central Bank, production level did not reach an extent to threaten the downward trend in inflation in the first half of 2004. Moreover, output gap, which is defined as the discrepancy between the potential output level and the actual output, is only one of the variables determining inflation and not the most important one as well.

25. Then again, our thoughts with regard to the impact of current account on the inflationary process should not shadow the fact that we are carefully examining the developments related to the current account. Current account deficit originating mainly from the machinery-equipment imports supports productivity increase through the contribution of investment goods in potential output and thus has its share in the prevailing low inflation and high growth rates. However, the high level of deficit, also in the face of changing global liquidity trends increases the fragility of the domestic economy. For example, the possibility of the Federal Reserve making a more drastic interest rate hike than expected in the coming days should be perceived as a risk factor at present. To emphasize once more, in an economy where structural reforms are sustained uninterruptedly and fiscal policy is on track, such a risk becoming a reality should not be expected to reverse the above-mentioned positive developments with a long-lasting impact.

26. It may prove useful in the coming period to monitor current account deficit developments in a thorough manner together with their sub-items and to take "selected measures" aimed at keeping the increase in consumption goods under control if necessary, without making any compromise in terms of the fiscal discipline, in case a potential problem is foreseen. Because, part of the recovery in tax revenues and budget performance occurred in line with the speeding up of economic activity. Extra tax revenues created by business cycles should not be channeled to expenditures, so that the pressure may be eased on the current account. Beyond all these, for the current account deficit not to be an obstacle to economic growth in the medium term, structural reforms need to be accelerated and the quality of financing must be further enhanced. Within this framework, it should be kept in mind that social security and tax reforms will be very significant policy responses.

Inflation

27. The favorable course continued in July as well and the increase in CPI remained at the level of 3.3 percent in cumulative terms, in the first seven months of 2004, despite the oil price shock and exchange rate fluctuations in the recent period. Turkish lira resuming the tendency of appreciation following the exchange rate fluctuations in April and May was one of the factors restricting the pass-through effect for CPI. Besides, playing significant role in this tendency were the favorable course of expectations, the slow pace of recovery in the domestic demand except for the durable consumption goods, the favorable course of food prices, and the continuing productivity increase in the first half of the year. Moreover, in line with the productivity increases in the manufacturing industry, unit labor costs are predicted to continue making a positive contribution to inflation in overall 2004, though not

as much as the last two years. Proceeding with the arrangements for the removal of obstacles to investments and production is a pre-condition in all cases for the continuity of productivity increases.

28. It has been underlined several times since the beginning of 2004 that annual CPI figures would be on decline up until May, and that they might either assume a standstill or go up from then on, in connection with the very low price increases same month(s) of last year, all of these to be in line with forecasts. Actually, the annual inflation figures that are entirely backward looking variables did go up in July, compared to the previous month. Data for this day suggest that annual inflation figures may also go up in August as a consequence of the fluctuations in oil prices and exchange rates, but will stabilize later on and realize within the end-year target.

29. Certainly, especially recent oil price movements will have reflections on the general inflation level via prices of imported goods and production costs. However compared to the past, these impacts are anticipated to be limited in the short-run. Because, as a consequence of competitive environment getting more widespread and domestic demand being kept under control, firms tends to postpone passing costs on to the prices. Moreover, Central Bank's monetary policy being focused on the harmony of future inflation with targeted inflation, falling inflation and tight fiscal policies of the last two years alter pricing behavior, influence expectations and help weaken the pass-through effect of temporary cost fluctuations on inflation. Besides, the formation of the margin owing to the fact that the increase in consumer prices in the first seven months of the year remained even below the path consistent with the inflation target show that temporary deviations from the basic trend would not jeopardize the year-end target.

30. The Central Bank should act with a forward-looking perspective by considering the lagged effects of monetary policy decisions. As long as tight fiscal policy and incomes policies consistent with the target are sustained, no clear inflationary pressure is anticipated for the rest of the year. However, although the belief that inflation target is achievable for 2004 gained strength, it should be taken into account that there are certain risks for the year 2005. Potential factors and risks that might have an influence on inflation dynamics in the coming term, and especially in 2005 are as follows:

- It is projected that by 2005, neither domestic demand developments, nor unit labor costs would provide as much support as they used to provide in the last three years. Domestic demand started to recover by 2003 and even increased as of the first half of 2004. Therefore, developments in consumer credits as well as the course of domestic demand components will continue to be monitored very closely.
- The 8.7 percent of rise in manufacturing industry prices in the last seven months brings along the risk of an acceleration in the rise in consumer prices in the case of a recovery in domestic demand. The public prices, which supported the decline in inflation throughout 2003, exceeded private manufacturing sector prices by 7.6 percentage points in the first seven months of 2004. The rise in crude oil, main metal and chemical products prices in international markets due to growth observed in global economy as well as the

climb in exchange rates in the second quarter became the factors underlying this increase. Meanwhile, the rise in the prices of other public products such as TEKEL products and sugar played an important role in this rise as well. It is observed that the rise in public prices is still within the tolerable limits for 2004 inflation. However, opting for unforeseen tax and price adjustments for the sake of financing budget in the upcoming period, for which single digit figures are targeted for inflation, would jeopardize the inflation targets. Therefore, it is of crucial importance to reiterate the need for reinforcing the quality of fiscal discipline in the upcoming period.

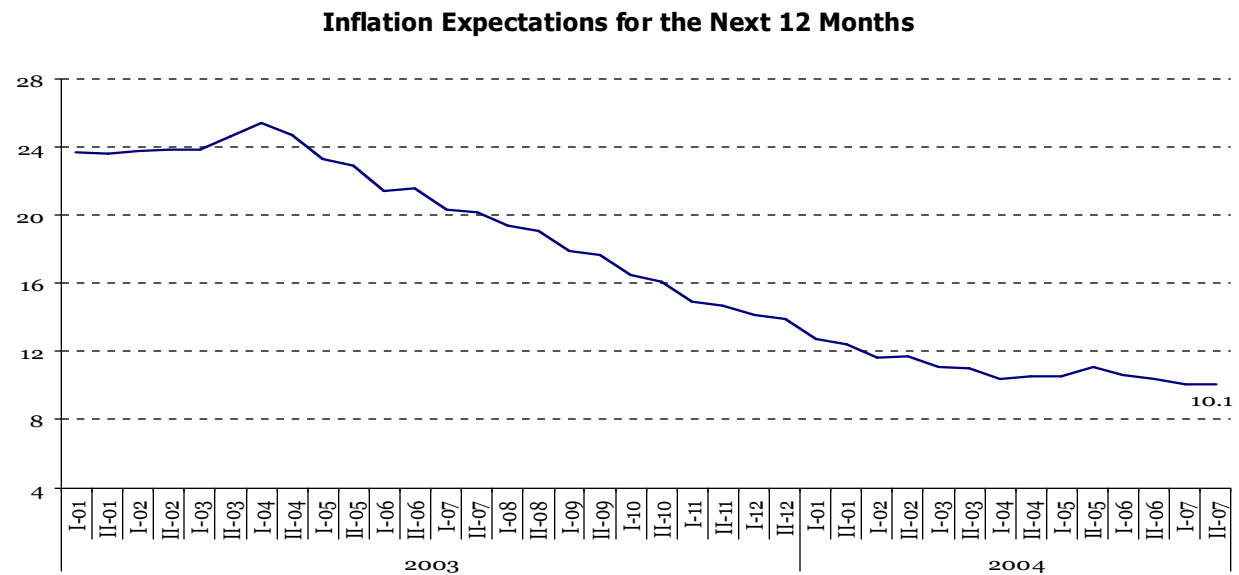
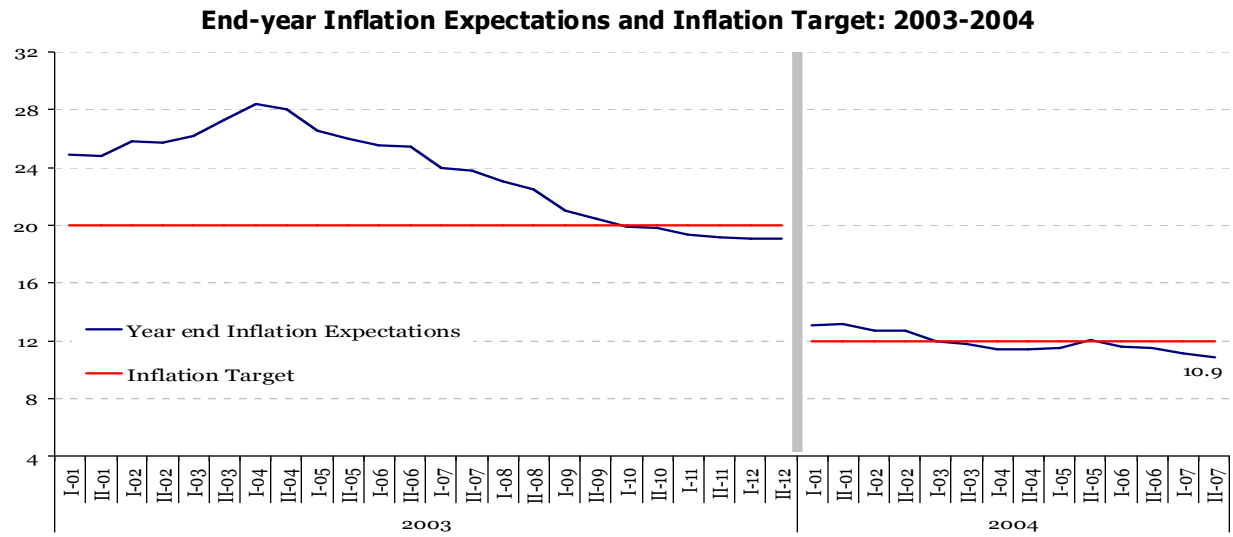
- Unforeseen deviations in energy prices are a risk factor all over the world and Turkey is no exception. The rise in oil prices is not expected to head down in the near future and this upward trend is likely to exert pressure on current account deficit as well as on inflation in the upcoming period. In case the rise in global oil prices continues and budget-financing requirement increases due to exchange rate pressure, making price adjustments in fuel products and oil will become inevitable. The effects of such increases on inflation in the rest of 2004 and 2005 will be very closely monitored.
- Inflation target-based monetary and fiscal policies that have been implemented for the last three years, and the Central Bank's clear opinion-sharing with the public about the course of future inflation trends are playing an important role in molding expectations. At this point, the economic agents perceive the announced inflation target as a strong reference point. Within this framework, it is expected that inflation expectations would display no significant deviation from the target in the rest of 2004 provided that necessary confidence is established in the markets that the program will be strictly adhered to and more efforts will be made to make structural reforms.
- Rigidity in services sector is relatively persisting. The annual inflation rates in lease contracts, education and hospital services exceeding the general inflation trend along with backward-looking indexation method pose risk to 2005 inflation. It should be borne in mind that in the upcoming period when single-digit inflation figures are targeted, any relative price discrepancies owing to a significant deviation in any of the sub-items from the general trend will be more important than it used to be.
- Agricultural prices and food prices have been supporting inflation in 2004. However, the sectors in question are susceptible to weather conditions. Therefore, data pertaining to price developments in those sectors provide very little information for 2005 inflation and can play no important role in monetary policy decision-making process.
- There are certain factors increasing risk perceptions in financial markets, which are: The level of foreign trade deficit is high due to increased economic activity and this in turn increases sensitivity; the Federal Reserve raised interest rates faster than expected; the necessary decisions required for the continuation of the program were delayed and there

is the probability that the uncertainties pertaining to the EU accession negotiations might turn negative. Undoubtedly, even if the mentioned risks become facts, the fluctuations that might emerge subsequently would be weaker and their effect on prices would be more limited compared to the pre-2001 period, provided the monetary and fiscal discipline is maintained and permanent achievements are made about structural reforms. However, it should be borne in mind that under given conditions, developments in other economies and the signals to be given would be very important in the short-run.

31. Consequently, although annual inflation rate is likely to increase in the upcoming months, taking into account the fact that the cumulative inflation rates became rather low in the past 7 months, it can be asserted that chances of surpassing the inflation target is still low unless there emerge some exogenous shocks. Rise in foreign demand, slowdown in the decline in unit costs, relative recovery in domestic consumption expenditures, high ratio of capacity utilization and accelerated public price increases point out to the fact that struggle with inflation will be even harder in 2005. Therefore, sustaining fiscal discipline as well as implementing public wages and revenues policies that are consistent with the inflation target will continue to be a prerequisite for carrying on with struggle with inflation.

32. Moreover, it is critical to put greater effort to making arrangements intended to remove all kinds of obstacles before investment and production to ensure sustainability of the rise in production in the medium and short run, which is important for making sure that stable growth and decline in inflation can continue. It is welcomed that the efforts already initiated and the steps taken about the reforms pertaining to public administration, social security and financial sector. However, it should be borne in mind that maintaining what has been achieved in strengthening economic fundamentals and reducing vulnerabilities in the last three years will only be possible provided the structural transformation is completed.

Figure 5: Inflation Expectations According to CBRT Expectations Survey



Source: CBRT Expectations Survey