

November Inflation and Outlook

I. GENERAL EVALUATION

1. In November 2004, CPI rose by 1.54 percent and WPI by 0.75 percent. Annual CPI and WPI inflation became 9.79 percent and 14.4 percent, respectively.
2. Seasonally adjusted monthly price increases realized as 0.97 percent and 0.72 percent in CPI and WPI, respectively. While CPI excluding food was 1.32 percent, WPI excluding agriculture became 0.60 percent.

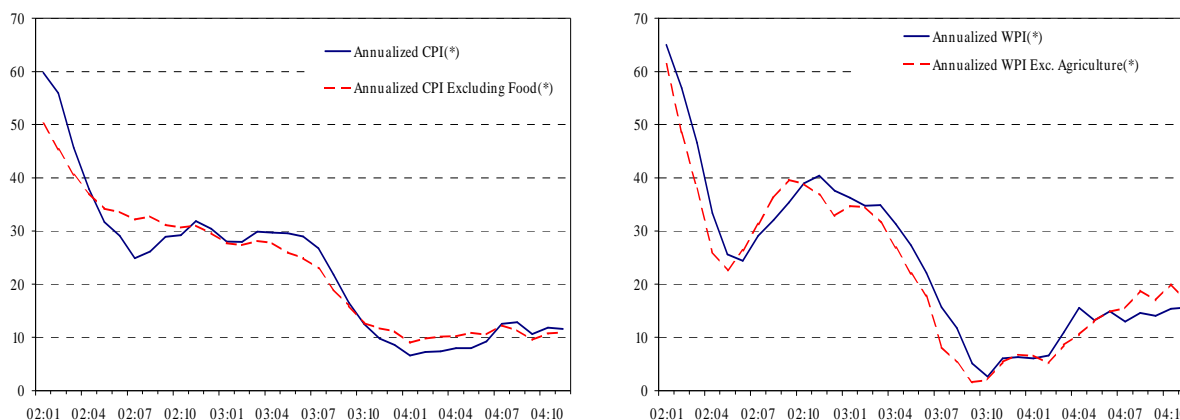
Table 1: General CPI, WPI and Sub-items

	Annual % Change		Monthly % Change			
	2003 Nov.	2004 Nov.	2003 Sep.	2004 Oct.	2003 Nov.	2004 Nov.
CPI	19.3	9.8	0.9	2.2	1.6	1.5
Goods	16.5	6.7	0.4	2.7	2.0	1.8
Services	24.7	15.6	1.8	1.5	0.8	1.1
Excluding food	18.5	10.9	1.2	1.8	0.9	1.3
Food	21.8	6.1	0.1	3.6	4.0	2.3
WPI	16.2	14.4	1.8	3.2	1.7	0.8
Public	12.7	21.3	1.2	3.9	0.6	1.2
Private	17.6	11.8	2.1	3.0	2.1	0.6
Public man.	15.8	25.2	1.1	4.8	0.3	0.9
Private man.	13.6	11.4	0.6	1.4	0.9	0.2
Agriculture	25.9	12.6	5.5	6.1	4.6	1.2
Excluding agr.	13.4	15.0	0.8	2.4	0.8	0.6
Excl.agr.&energy	14.1	15.9	0.8	2.5	0.8	0.6

Source: CBRT, SIS.

3. The last six-month average of seasonally adjusted inflation was 1.22 percent in WPI and 0.92 percent in CPI. The average rates of increase correspond to 15.62 percent and 11.6 percent in annual terms. During the same period, the average rate of increase in seasonally adjusted CPI excluding food became 0.87 percent. This figure corresponds to 11 percent in annual terms (Figure 1).

Figure 1: Annual Percentage Change and Six-month Moving Averages*
CPI and CPI Excluding Food **WPI and WPI Excluding Agriculture**



(*) Six-month moving average (Annualized, Seasonally Adjusted)
 TRAMO/SEATS method has been used in seasonal adjustment.
 Source: CBRT, SIS.

Developments in Consumer Prices

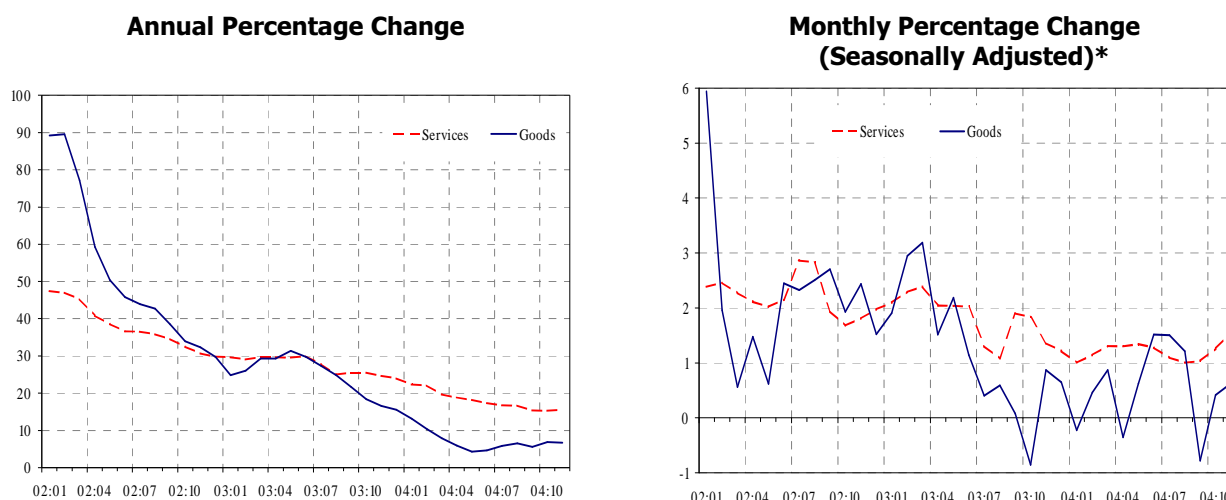
4. Despite a relative slowdown in November, the price increases in food- beverages-tobacco and clothing-shoes, which gained pace in October in line with the seasonal tendency, continued to be a determining factor in CPI inflation. In November, price increases for these two groups realized as 1.9 and 2.2 percent, respectively, thus remaining above CPI. Meanwhile, private transportation vehicle prices, which rose by 7.1 percent due to adjustments in special consumption tax, led to a 4.5 percent price increase in durable goods, the highest level since July 2002. Another item in CPI goods group that displayed a relatively high-rated increase is furniture and flooring prices, which rose by 1.4 percent. In this context, the rate of increase in seasonally adjusted goods prices rose by 0.2 point compared to October and realized as 0.6 percent.

5. Despite the boosting effect of price increases in the food and clothing subgroups on inflation trend for the last two months, the eleven-month cumulative price increases in these two groups realized as 5.7 and 1.8 percent respectively, remaining substantially below the CPI increase of 8.8 percent in the same period. However, the prices of private transportation vehicles, furniture and flooring increased quite above the inflation trend in the January-November period, realizing as 12.9 and 16.6 percent, respectively.

6. Meanwhile, seasonally adjusted price increases in services rose to 1.6 percent from 1.3 percent of October. This development mainly stemmed from the realization of rent increase as 1.4 percent, which is even above the November 2003 figure despite the removal of

unfavorable seasonal factors of the August-October period. Hence, rent increase resumed its upward trend in annual terms after a ten-month period and reached 19.7 percent. Accordingly, the annual price increase in services group rose by 0.3 points compared to October, and reached 15.6 percent. As for the goods group, annual inflation dropped to 6.7 percent from 6.9 percent in October (Figure 2).

Figure 2: Goods and Services Group Prices

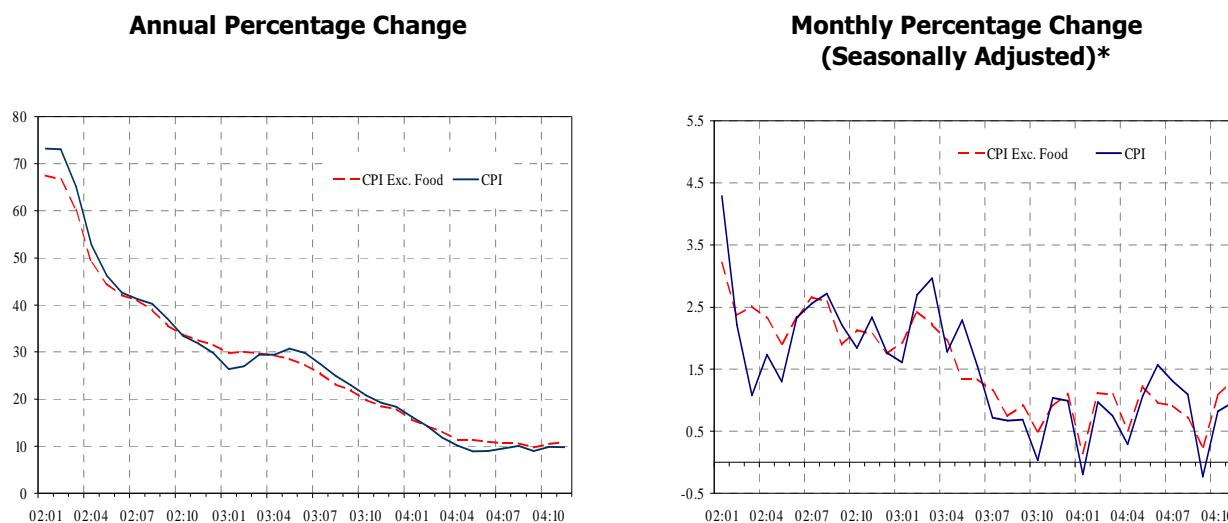


Source: CBRT, SIS.

* TRAMO/SEATS method has been used in seasonal adjustment.

7. Consequently, price increases in seasonally adjusted CPI and CPI excluding food realized 0.2 point and 0.5 point higher than their average values of the first ten months of the year, respectively. While annual CPI inflation declined to 9.79 percent, CPI inflation excluding food prices rose to 10.91 percent (Figure 3). The increases in food, transportation and rents prices stood as the determinants of the rise in CPI inflation excluding food.

Figure 3: CPI and CPI Excluding Food



Source: CBRT, SIS.

* TRAMO/SEATS method has been used in seasonal adjustment.

Developments in Wholesale Prices

8. 0.29 point of the 0.75 percent monthly WPI inflation resulted from public sector price increases and the remaining 0.46 percent from private sector. Seasonally adjusted WPI inflation dropped by 1.7 points in November compared to October and became 0.7 percent.

9. Agricultural prices rose by 1.2 percent in November, whereas seasonally adjusted agricultural price increase declined to 0.7 percent. Considering the increases in seasonally adjusted agricultural prices by 3.6 percent and 2.8 percent in September and October, respectively, it is clear that the agricultural price increase has significantly lost pace in November. Meanwhile, WPI excluding agriculture increased by 0.6 percent. Hence, the cumulative price increase in WPI excluding agriculture reached 14.1 percent since January.

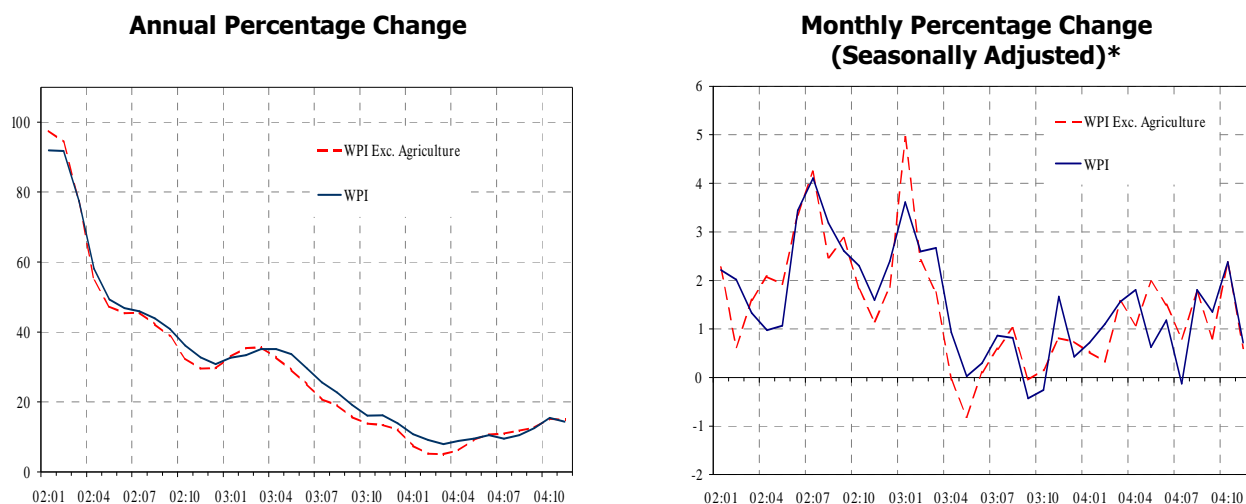
10. In November, prices in public manufacturing industry upped by 0.9 percent. The said upsurge was slight because of the 2.1 percent decline in prices of basic metal industry sector. On the other hand, prices in petroleum products industry, which contributed highly to public manufacturing industry inflation in October, persisted to exert an upward pressure on public manufacturing industry prices with an increase by 1.8 percent in November as well.

11. Private manufacturing industry prices boosted by 0.2 percent. This increase mainly stemmed from the depreciation of US dollar by 3.5 percent in the October-November period and sluggish upward trend in price increases in public manufacturing industry. Meanwhile,

clothing manufacturing prices fell by 9.4 percent in November, after having soared by 14.1 percent in October.

12. Energy prices within the WPI group maintained their current trend and rose by 0.7 percent. On annual basis, however, energy prices contracted by 0.7 percent in November.

Figure 4: WPI and WPI Excluding Agriculture



Source: CBRT, SIS.

* TRAMO/SEATS method is used in the deseasonalization process.

13. In November, annual inflation rates in WPI and WPI excluding agriculture fell to 14.40 percent and 14.96 percent, respectively. Annual price increases in public and private manufacturing industries differed mainly due to volatile international goods prices. Annual price increases in public and private manufacturing industries realized as 25.16 percent and 11.39 percent, respectively.

II. OUTLOOK

14. Consumer prices inflation, which was recorded as 68.5 percent at the end of 2001, dropped to single digits by May 2004 and generally maintained this trend in the second half of the year. Undoubtedly, main factors paving the way for this achievement were the tight fiscal and monetary policies implemented in coherence with each other and a series of structural reforms initiated with the introduction of the program. By the last month of this year, there is no doubt on the attainability of 2004 inflation target and the attention has been directed towards the end-year target for 2005. Having foreseen all these developments beforehand, the Central Bank has already been drawing attention to risks to the inflation target for the next year since March 2004. Meanwhile, the pause being observed recently in the downward trend of annual inflation figures are arising questions whether the downward trend of inflation in the last three years would continue in 2005 as well. At this point, it would be helpful to adopt a forward-looking approach in interpreting the general macroeconomic outlook and the information provided by sub-items of inflation.

Inflation: Sub-Items

15. Following high price increases than expected in October, the interpretation of November inflation figures gains special importance. When seasonally adjusted, the relative increase in food prices seems to be temporary. This supports the findings in our “October inflation and outlook” report. Meanwhile, the shift of seasonality in clothing group to October–November, instead of September–October caused an illusion as if prices increased relatively. When doing the analysis, it should be considered that price increase in clothing sector was only 1.8 percent in the first 11 months of the year.

16. In the first 11 months of 2004, the cumulative increase in prices was recorded as 8.8 percent. Especially rent (17.6%), prices of transportation (15.8%), and furniture-flooring (16.6%) sectors rose remarkably. The contribution of these sub-items to 11-month price increases is 4.75 points. Whether the negative impacts of price developments in the mentioned sectors could continue is crucial for the 2005 inflation. Due to the signs of revival in domestic demand and propensity to compensate relative prices that have remained low, it is thought that high increases in rents and furniture prices may continue in 2005 as well. On the other hand, under the presumption that in 2005, there would not be a need to increase the taxes of vehicles as much as this year, and the surge in oil prices would not continue,

adverse effects of transportation group prices could be removed. Therefore, in 2005, the main sub-groups that may pose risk in terms of inflation are predicted to be furniture-flooring and rent groups.

17. In terms of WPI, November 2004 has been a beneficial period. Agriculture prices, after two consecutive months of extreme upsurges, turned back to its normal tendency. On the other hand, the slowdown of price increases in private manufacturing industry has been a favorable development for the future inflation period. However, the differentiation of wholesale prices between public and private sector evidently continued in November.

18. At this point, it will be useful to put a special emphasis on the general public sector pricing policy. In the 2005 budget, serious hikes are expected in special consumption taxes, which form the bulk of tax revenues. Nevertheless, should the growth rate realize below the expectations in 2005, total tax revenues might stay below the foreseen amount and additional budgetary measures might become necessary. In such a case, even if the oil prices and exchange rate developments could pull down the refinery prices, petroleum prices would not decrease; would even increase. Also, further price adjustments in other goods produced by public can be expected. Such a situation would both deteriorate the relative price structure, disrupting the efficient allocation of resources and challenge the fight against inflation. To avoid similar potential adversities, it appears as a significant fact that the rise in prices of goods and services produced by the public sector should not be perceived as the most important determinant of “fiscal discipline” in state economic enterprises, but the deepening of fiscal adjustment via enhancing productivity in public sector instead.

General Macroeconomic Outlook

19. The main issue that marked the first three quarters of 2004 has been high growth rate and the resulting current account deficit. However, in the second half of the year as a result of the periodic impacts created by the deferred demand, it is observed that the rate of acceleration in durable goods slowed down and the capacity utilization ratios decreased in the mentioned sector owing to some temporary measures taken and the rise in interest rates of consumer credits. Moreover, a slow-down is being observed in industrial production, imports of intermediary goods, money demand and credits, excess liquidity is declining, consumer tendency and consumer confidence indices are becoming stable. Therefore, all these developments and other leading indicators of economic activity point out to a downward trend of growth in the third quarter of 2004 and that this relative deceleration would continue in the last quarter as well.

20. Due to the tight fiscal and monetary policies implemented in the recent years, there is a controlled recovery in domestic demand, which has not yet exerted an obvious pressure on prices. As of the second quarter of 2004, since the recovery in demand for durable goods has spread to wider sub-groups, the supply and demand equilibrium in 2005 should give less support to inflation compared to the previous years. Besides, while going through an unfavorable period in terms of raw material prices, keeping the domestic demand under control is of specific importance for holding the inflation expectations at a low profile. To this end, domestic demand indicators will continue to be closely monitored.

21. It is projected that investment intentions, which have maintained their high level for the last four quarters, would make a positive impact on production and productivity in the upcoming period. Moreover, provided that the fiscal discipline is upheld and the perceptions that its quality would be enhanced become more widespread, real interest rates would further decline, manufacturer confidence would be fostered, recovery in investments and exports would continue, which altogether would be translated into growth resting upon a more solid ground. Thus, rise in productivity would proceed, stable growth and decline in inflation would be maintained simultaneously and favorable course of expectations would support inflation. Evidently, all these projections are based on the assumption that the current economic policy is maintained with a similar approach and the structural reforms that have been already started are deepened.

Inflation and Risks in the Upcoming Term

22. In our recent reports as well as press releases, it was emphasized on the “base effect” that has emerged as a result of the quite favorable course of cost conditions observed since April 2003. We have reiterated that annual inflation figures are completely backward-looking variables and they are determined by the past term’s movements rather than the upcoming term. Actually, annual inflation started to climb in July due to the base year effect and returned back to the downward trend in autumn as part of this effect had ceased. At this point, it is expected that a similar trend could probably be observed in 2005 as well. Increase in prices in the first four months of the year remained subdued due to favorable demand conditions as well as public pricing policy. However, as cost conditions turned unfavorable and budget measures called for some unforeseen price adjustments, rise in prices accelerated relatively as of May. Owing to the mentioned effect, an interruption and even a spurt might be observed in the downward trend in inflation in the first four months of 2005. However, it is anticipated that annual inflation calculated by using the current CPI would head downwards again in May and would reach a level very close to the targeted level by

the end of the year. Evidently, these projections are made within the scope of the main scenario in which the current economy policies are maintained with a similar approach, the structural reforms are implemented steadfastly and there emerges no extraordinary situation domestically or externally. We can summarize the risks that could lead to deviations from our projections as follows:

23. A negative answer, worse-than-expected, pertaining to launching of accession process intended for full membership in the European Union could increase risk perceptions and create fluctuations in financial markets in return. Meanwhile, even if abrupt capital outflow from developing countries seems to be a minor possibility for the time being, any changes in global risk perceptions are accepted as factors that can pose risk to the stability of financial markets. However, it should be once more reiterated that provided the structural reforms are carried out without interruption and fiscal discipline is maintained, the effects of exogenous factors would be limited. In fact, studies are underway for drawing up a new National Economic Program to be implemented in the next three years and perceptions have increased that fiscal and monetary discipline as well as structural reforms would be the core of the new program. As social security reform, tax reform and public governance reform would make a positive impact on productivity in public sector and enhance quality and sustainability of fiscal discipline, they would very much contribute to fostering the fundamentals of economy.

24. Another significant risk factor for 2005 inflation is the likelihood that the differentiation between the goods and services prices might go beyond the predicted limits. Under normal conditions, part of price differentiations between goods and services can be attributed to the facts that; backward-indexation mechanism is quite strong in the services sector, increases in competitiveness and productivity in the sectors subject to foreign trade are in place, and pass-through effect from the exchange rate to domestic consumer prices is felt more strongly in the goods group. However, the annual rent increases at around 20 percent are becoming a phenomenon that is quite remarkable and difficult to explain, especially at a time when we are entering into a period in which the year-end target will be 8 percent. To give an example, if this trend continues in the next period, the rate of increase in rents could likely account for 40 percent of the 2005 inflation figure.

25. The high rate of increase observed in productivity in recent years will undoubtedly provide an impetus to demand for labor force, create new job opportunities later on and lead to a rise in real wages. However, in case where a wage policy focusing on the inflation target is carried on in public sector, private sector is expected to adopt a similar behavior in the

short term and the upsurge in unit labor costs will be limited. Meanwhile, achievement of full macroeconomic stability, removal of bureaucratic barriers against investment and production and enhancement of a competition environment are of critical importance in order for the hike in labor productivity to be permanent in the medium term.

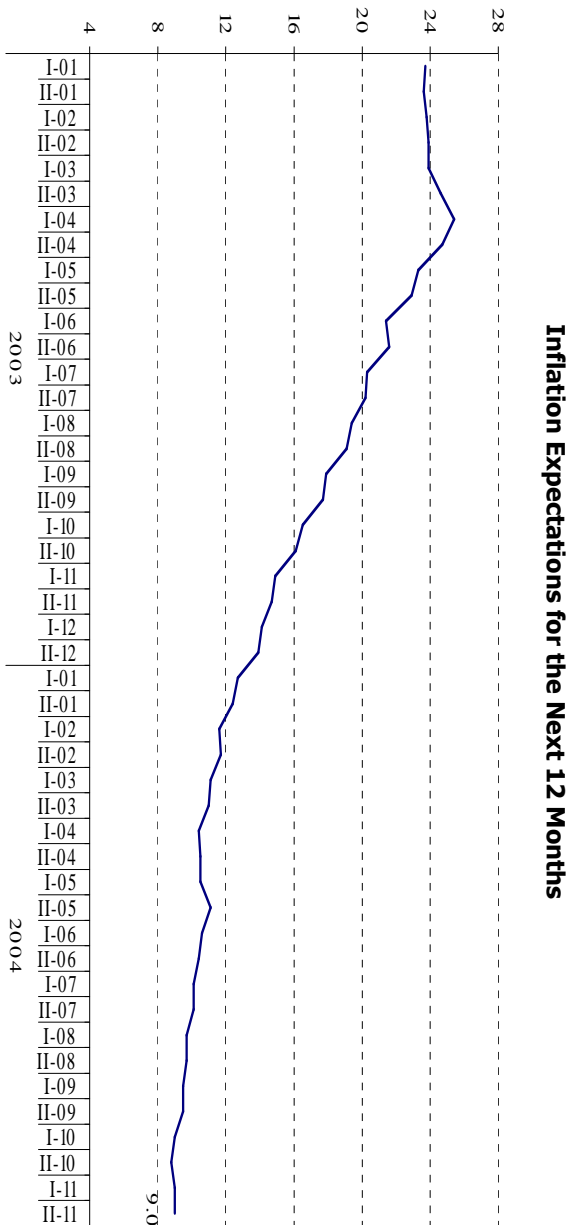
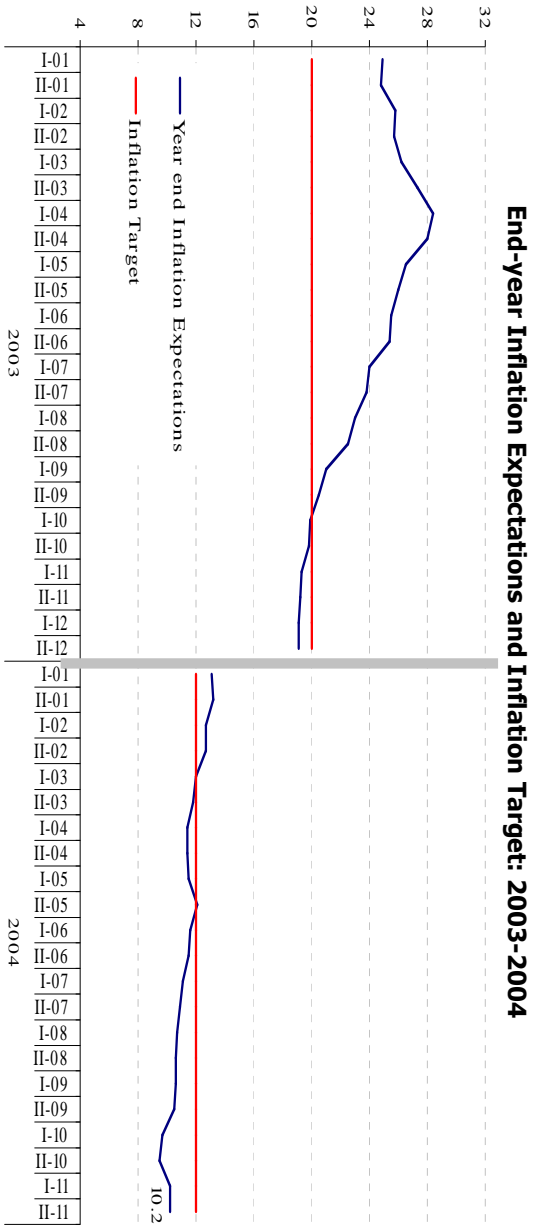
26. Direct effects of the escalating prices of raw material imports on price indices have been recently observed in WPI particularly. In the event that these developments evidently follow an unfavorable course or become more serious, incidence of the hikes in wholesale prices on inflation will be effective in 2005. Although there is no current data that point out to an upturn in medium term-inflation driven by the said developments, close follow-up of the indirect effects of cost pressures on inflation expectations and pricing behavior in the next period is of critical importance.

27. Moreover, the effects of food and agricultural prices on the inflation target are always unpredictable. In December, food prices are expected to support the inflation. However, the favorable course of food prices in overall 2004 does not give clear signals of the continuation of this trend in 2005. The point that should be underlined here is that the monetary policy will act along with the medium and long term-inflation tendencies determined by economic fundamentals rather than temporary shocks in the short term.

28. To conclude, it is clear that inflation will realize in accordance with the end-year inflation target for 2004. In the light of the evaluations above, it is predicted that inflation will continue to fall down despite small periodic fluctuations.

29. Another important factor concerning the inflation figures in the upcoming period is the announcement of inflation figures by SIS in terms of updated baskets as of February 2005. The medium and long term-inflation trends, which will be calculated by using the new basket, are expected to bear similarities to those calculated by using the former basket it is probable that two series may also differentiate from each other. It should be underlined here that new price series will be effective in monetary policy decisions and the Central Bank will continue to focus on CPI. The word “inflation” will refer to the increase in CPI, as always and developments in producer prices will be evaluated according to the hikes in consumer prices in the upcoming period, in other words; in terms of the information about the future inflation.

Figure 5: Inflation Expectations According to CBRT Expectations Survey



Resource: CBRT Expectations Survey