

October Inflation and Outlook

I. GENERAL EVALUATION

1. In October 2004, CPI increased by 2.22 percent and WPI by 3.23 percent. Annual CPI and WPI inflation became 9.9 percent and 15.5 percent, respectively.
2. Seasonally adjusted monthly price increases were recorded as 0.81 percent and 2.42 percent in CPI and WPI respectively; and CPI excluding food and WPI excluding agriculture became 1.05 percent and 2.37 percent.

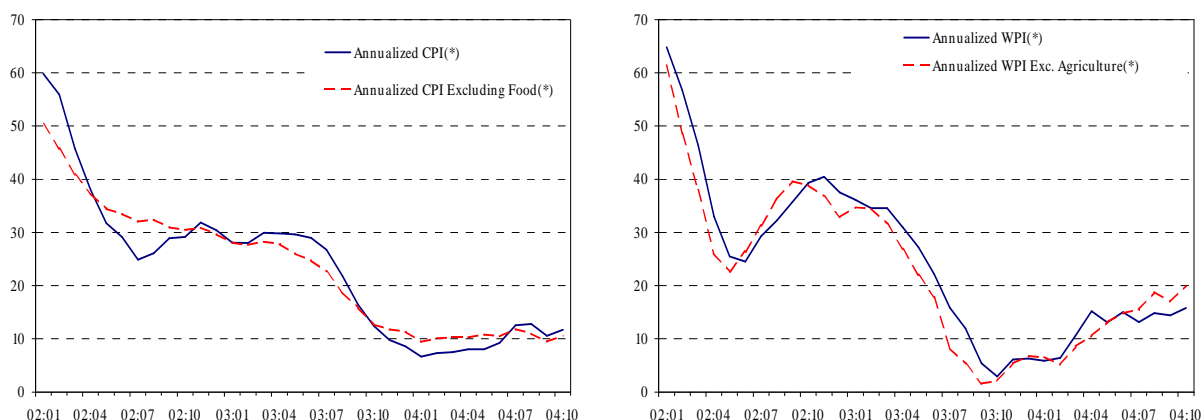
Table 1: General CPI, WPI and Sub-items

	Annual % Change		Monthly % Change			
	2003 October	2004 October	2004 August	2004 September	2003 October	2004 October
CPI	20.8	9.9	0.6	0.9	1.4	2.2
Goods	18.4	6.9	-0.1	0.4	1.4	2.7
Services	25.5	15.3	1.7	1.8	1.5	1.5
Excluding food	19.9	10.4	0.7	1.2	1.2	1.8
Food	24.0	7.9	0.1	0.1	2.2	3.6
WPI	16.1	15.5	0.8	1.8	0.6	3.2
Public	12.4	20.6	2.3	1.2	-0.6	3.9
Private	17.6	13.5	0.2	2.1	1.0	3.0
Public man.	15.5	24.4	2.3	1.1	-0.5	4.8
Private man.	14.4	12.2	1.5	0.6	0.6	1.4
Agriculture	24.3	16.4	-2.5	5.5	1.9	6.1
Excluding agr.	13.8	15.2	1.8	0.8	0.2	2.4
Excl.agr.&energy	14.3	16.2	1.8	0.8	0.2	2.5

Source: CBRT, SIS.

3. The last six-month average of seasonally adjusted inflation was 1.23 percent in WPI and 0.93 in CPI. The average rates of increase correspond to 15.8 percent and 11.7 percent in annual terms. During the same period, the average rate of increase in seasonally adjusted CPI excluding food became 0.84 percent. This figure corresponds to 10.6 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 deseasonalization.
 Source: CBRT, SIS.

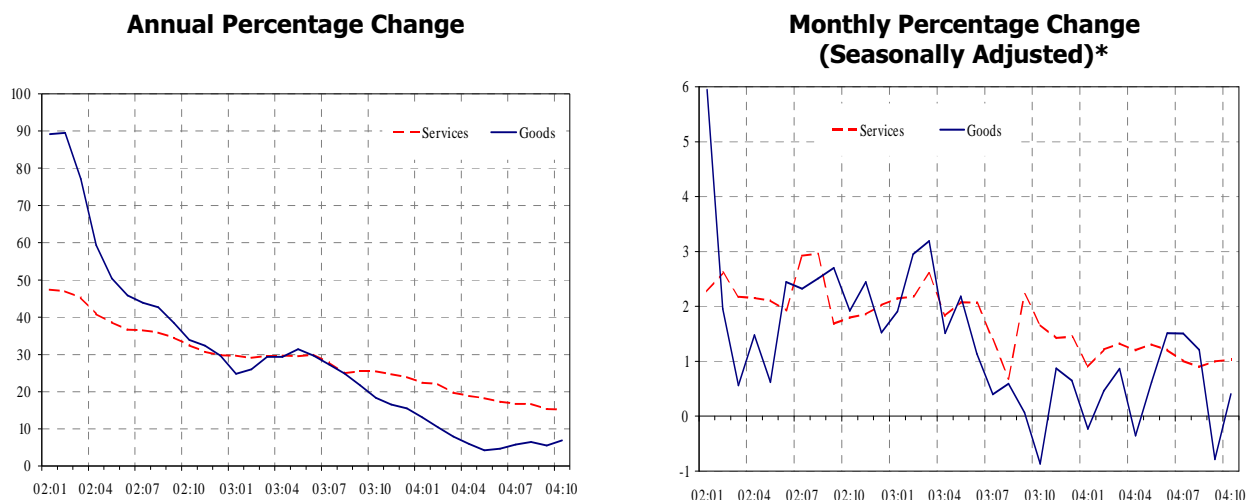
Developments in Consumer Prices

4. Increase in food and clothing prices that were quite below the seasonal tendency in September 2004, gained pace in October 2004 and became a driving factor in CPI inflation. While the prices of food, beverages and tobacco increased by 3.0 in October due to the starting of Ramadan, prices of clothing and shoes rose by 5.7 percent. The decline of seasonally adjusted food, beverages and tobacco prices to 0.2 percent and clothing-shoes prices to -1.1 percent indicates that there is no significant increase beyond seasonal factors in the prices of these sub-groups. Moreover, in the January-October period, the rate of cumulative price increase, which was realized as 3.7 percent in food group and -0.4 percent in clothing-shoes group - quite below the 7.2 percent cumulative price increase in CPI in the same period - points at a consistent increase with the general tendency toward inflation.

5. Apart from food and clothing groups, the largest contribution to the October CPI inflation came from the sub-items of house and transportation. In October 2004, rents, which constitute the bulk of house group, rose by 1.7 percent and hence, cumulative increase in rents in 2004 reached 15.9 as of October. The increases in rents that have accelerated in August-October period due to frequent renewal of lease agreements are expected to slow down relatively in the rest of the year. However, it is inevitable that the increase in rents will be realized quite above CPI inflation at the end of the year.

6. Owing to the 5 percent increases made in prices of petroleum, prices of transportation group twice (in early October and in mid-October), transportation prices rose by 3.7 percent, thus contributing to October CPI inflation by 0.3 points. With the recent price increases, petroleum prices under CPI increased by about 27 percent during the January-October period.

Figure 2: Goods and Services Group Prices



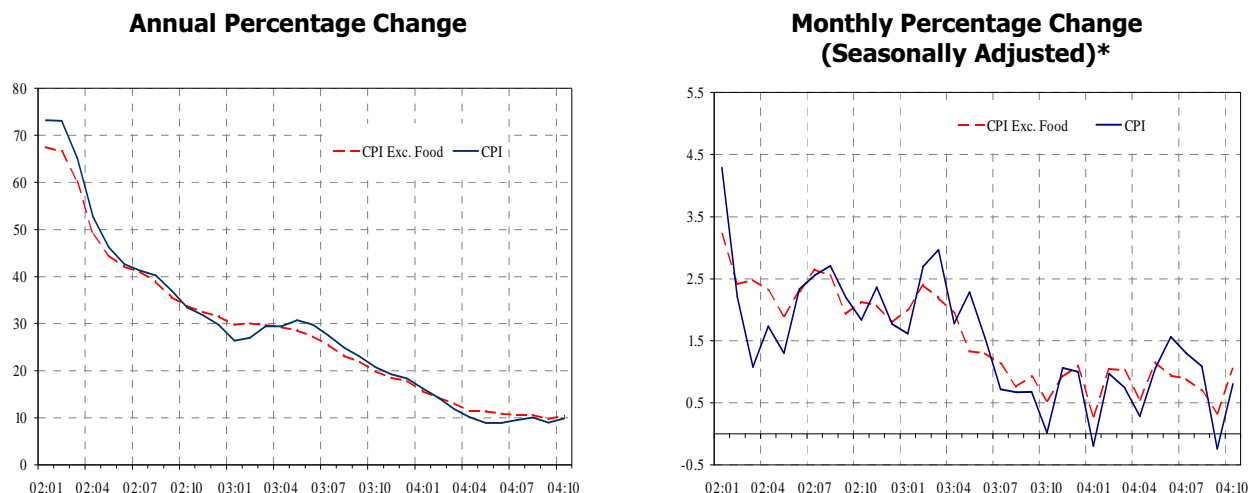
Source: CBRT, SIS.

*TRAMO/SEATS method has been used in deseasonalization.

7. In the meantime, the acceleration of price increases in goods group in October in connection with the food and clothing groups, led to relative narrowing of the gap between annual rates of increase in the groups of goods and services (Figure 2). The annual rate of increase in services group remained the same at 15.3 percent in October, while rising to 6.9 percent from 5.6 percent in the group of goods. Yet, the narrowing gap between the price increases in goods and services groups is considered to be a positive development, to the extent that the services prices get closer to goods prices, and not the other way around. By October, the seasonally adjusted cumulative increase is 5.3 percent for goods group and 11.7 percent for services group.

8. Hence, seasonally adjusted CPI and CPI excluding food prices rose by 0.1 percent and 0.3 percent in October, respectively, compared to the average values recorded in the first nine months of the year. Moreover, annual CPI inflation rose to 9.9 percent and CPI inflation excluding food prices to 10.4 percent in (Figure 3). The rise in annual inflation chiefly stemmed from the intensifying of unfavorable seasonal factors of the September-October period mainly in October. In other words, the October 2004 increase realized higher compared to October 2003, the period during which the seasonal effects were more evenly shared between the two months. The shift in the seasonal factors affecting food and clothing groups stood as the determinant factor in the rise of annual inflation in October.

Figure 3: CPI and CPI Excluding Food



Source: CBRT, SIS.

*TRAMO/SEATS method has been used in deseasonalization.

Developments in the Wholesale Prices

9. The 0.94 points of the 3.23 percent-monthly WPI inflation in October resulted from public sector price increases and the remaining 2.29 points from private sector. Seasonally adjusted WPI increase rose by 1.3 points in October compared to the average value of the first nine months, and realized as 2.4 points.

10. Agricultural sector and the public manufacturing sector were the driving factors of the outstanding increase in wholesale prices. Having risen by 6.1 percent in October following the 5.5 percent increase in September, agricultural prices contributed by 1.4 points to October WPI inflation. Seasonally adjusted agricultural price increase, which realized as 0.6 percent on average during the January-August period, rose to 3.2 percent in the September-October period.

11. In October, price increase in public manufacturing industry became 4.8 percent and reached its highest level since December 2002. The largest contribution to the 4.8 percent-price increase in public manufacturing industry came from petroleum products manufacturing prices, which increased by 8.1 percent due to the 10 percent-increase in petroleum products. Thus, excluding petroleum products, price increase in public manufacturing industry declined by 1.4 percent. The sub-items that displayed the highest price increase excluding petroleum products are chemical products and basic metal industry manufacturing sectors with the 6.2 and 2.7 percent-increases, respectively.

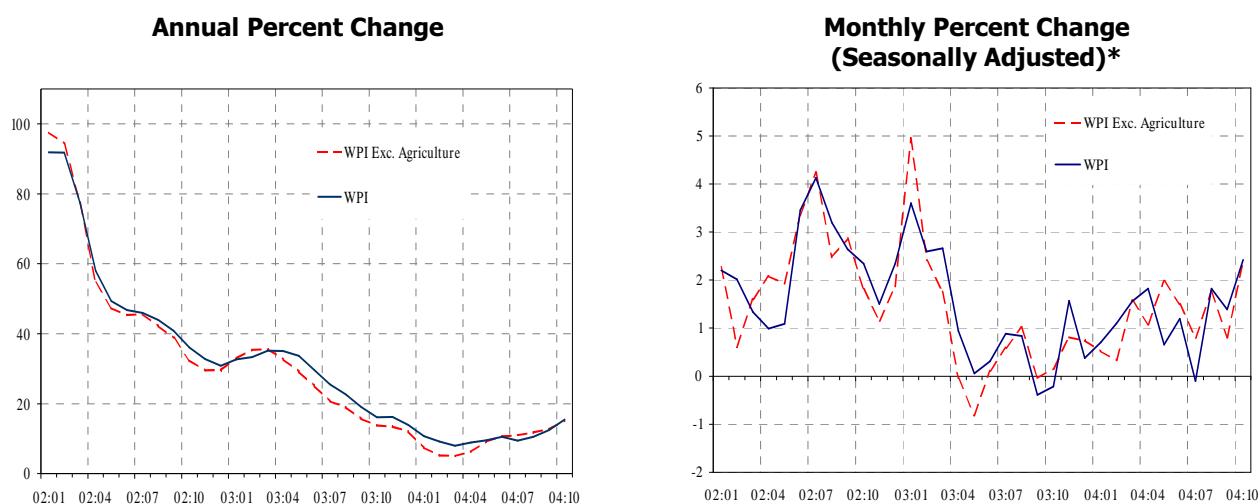
12. In October, the major contribution to the 1.4 percent-price increase in private manufacturing industry came from the 14.1 and 3.6 percent-price increases in clothing manufacturing industry and petroleum products, respectively. In October, clothing prices under CPI pursued an upward course owing to seasonal factors, while the seasonally adjusted 10.6 percent increase in clothing manufacturing prices indicates the effect of the factors other than seasonal factors. Clothing

manufacturing prices gained pace due to the rise in unit labor costs resulting from the increases in real wages, which started at the end of 2002 and became more evident especially in the first quarter of 2004.

13. Meanwhile, energy prices maintained their current trend and rose by 0.3 percent. Energy prices displayed a decline by 1.2 percent on annual basis.

14. In October, annual WPI and WPI inflations excluding agriculture rose to 15.5 percent and 15.2 percent, respectively (Figure 4). Price increases in public and private manufacturing industries differ mainly due to the petroleum products manufacturing sector. Annual price increases in private and public manufacturing industries became 12.2 and 24.4 percent, respectively.

Figure 4: WPI and WPI Excluding Agriculture



Source: CBRT, SIS.

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

II. OUTLOOK

15. To evaluate the inflation trend in the upcoming period, two kinds of analyses come to the forefront: (i) The information provided by developments in the sub-items of prices with regard to the future inflation; (ii) General outlook of macro economy and inflation. To this end, we must first assess the information provided by price developments in October and then evaluate the macroeconomic factors and risks that could be important in terms of inflation dynamics in the next period.

16. In October, no obvious inflationary pressure was observed in the sub-items of CPI excluding food, clothing and transportation. According to a recent research, the revival observed in food prices every year in Ramadan is compensated in the successive months. In October 2004, the contribution of Ramadan to the general CPI index became 0.3 points. Meanwhile, it is noteworthy that despite the boost in October, the prices in clothing sector remained at the same level compared to last year. In other words, excluding seasonal factors, no obvious price acceleration was observed in the clothing sub-group. The price increases in the transportation group are mostly arising from cost pressures such as petroleum products, which is an exogenous factor having temporary effects on inflation. Hence, October inflation figures confirm that there has not been a marked pressure on consumer prices yet.

17. While analyzing the information contained in the inflation figures of October with respect to the future inflation, it is necessary to spare a separate paragraph for the prices of public sector goods. Price increases in imported raw materials since the turn of 2004 made price adjustments inevitable especially in energy sector whose prices are determined by the public sector. Actually, some price adjustments in fuel and other energy prices have recently come to the agenda and some of these adjustments were made in October. It should be underlined that energy sector prices are reflected as input cost in many sectors and therefore deserve utmost care from inflationary point of view. Therefore, while making price adjustments, it would be wise to take into account not only the direct effect, but also the indirect effects generated by input costs and expectations, since the impact of price increases in energy sector on inflation is non-linear. In other words, price adjustments made in time when conditions are ripe have differing impacts on expectations than those adjustments that are delayed even if conditions were ripe, and that are made later on a less frequent basis but at higher rates. Therefore, reflecting the rises in imported oil and natural gas prices on the fuel and natural gas products prices in a very short period toward the end of the year has increased the risks stemming from indirect impacts with regard to next year's inflation. If most of these price increments were done parallel to the rise in oil and natural gas prices without delay, the indirect impact of these increments would be confined to 2004. By this way, an important risk for 2005 inflation target would be eliminated, and the budget revenues would be realized higher by avoiding some of special consumption tax losses. Here it should be borne in mind that the downward trend in inflation will continue, provided that the current program is implemented as stipulated before, and that even if

some short-term deviations might occur due to the impacts of exogenous factors on costs, these deviations will be temporary, which can easily be explained to the general public.

18. Despite all these, even if the direct cost-push effects have been felt in the last few months, the so-called “secondary” or “indirect” effects have not emerged yet, which can be deemed to be a positive development. When the sub-items of consumer prices are analyzed, it is observed that there are no apparent deviations from the general inflation trend and furthermore, a certain degree of slow-down is observed in most of the services group prices. Consequently, in the light of the price data pertaining to sub-items, it is not possible to deduce that there is an upward trend in general inflation in October.

19. The prospective developments and other risks that can affect inflation in the upcoming period are as follows:

- The domestic demand indicators reveal that recovery is not confined to consumer durables anymore and has spread to other sectors as well, and spending on semi-durable and non-durable goods along with other services has been accelerating. However, as most part of the postponed demand has been met and some temporary measures have been taken in the second half of the year, the rate of acceleration in domestic demand is expected to slow down. The slowdown in credit volume and currency demand are factors supporting this assumption. But still, it is predicted that the slowdown will be steady, and high output levels will be preserved with the support of foreign demand that is believed to retain its strong position and with consumer confidence. Although it is estimated that the output level would not exert an evident pressure on inflation by the end of 2004, monitoring demand developments will become even more important in the upcoming period.

- Rise in productivity and higher course of machinery-equipment investments are persisting. These developments are increasing the potential production level and help contain the pressure on prices despite high capacity utilization ratios and relative recovery in domestic demand. However, rise in productivity and high capacity utilization ratios will inevitably create new business opportunities, increase labor demand and lead to rise in real wages in general economy. Therefore, holding onto a public wage and incomes policy that is consistent with the inflation target is critical to ensure that disinflation is continued. Last three years' experience show that adopting a budget policy that is consistent with the targets was one of the primary factors that has helped the inflation target to be regarded as credible. Meanwhile, the upward trend in productivity will continue in the medium and the long run provided that the obstacles to investments and production are wiped away, productivity in public sector is increased and competition environment is improved.

- Another main factor in terms of the inflation in 2005 is exogenous developments. The Federal Reserve Bank has implied that it would not act abruptly in its interest-rate policy and would not be aggressive in raising interest rates. Thus a sudden capital flight from developing countries seems very unlikely for the time being. Certainly, sudden changes in global risk perceptions can always be precarious for stability in financial markets. Moreover, in the process of adaptation to the EU, any piece of information not in line with the expectations may increase risk perceptions in the markets and

may cause volatility. However, what needs to be emphasized once again is that if structural reforms are carried out strictly and fiscal discipline is sustained, unfavorable exogenous developments will only be temporary diversions from the main tendency.

- Although declining a bit, the persistence of price rigidity in services sector poses a risk for future inflation. Backward pricing behavior particularly in such services group sub-items as education, hospital services and rents are slowing the downward trend in inflation. By October 2004, goods prices and services prices increased by 6.9 percent and 15.3 percent, respectively. The fact that the pass-through from exchange rates to prices were faster in goods group and the backward indexation was higher in services group, as well as the increase in competitiveness and productivity in sectors related to foreign trade have determined the said differentiation. That the services prices increase more rapidly compared to goods prices is a worldwide phenomenon, which can be explained partially with structural factors. However, the risk posed by this phenomenon in countries where inflation is in a downward trend is much higher. Moreover, it is difficult to explain with structural factors the reason why the rents increased by 19.4 percent annually as of October, while the end-year inflation target was 12 percent for 2004. Although it is estimated that the said differentiation in price increases in the upcoming period would decline compared to 2004, it is expected that the rises in goods prices would remain below the rises in services group in the medium and long-term, and the rigidity in prices of services group would slow the downward trend in inflation.

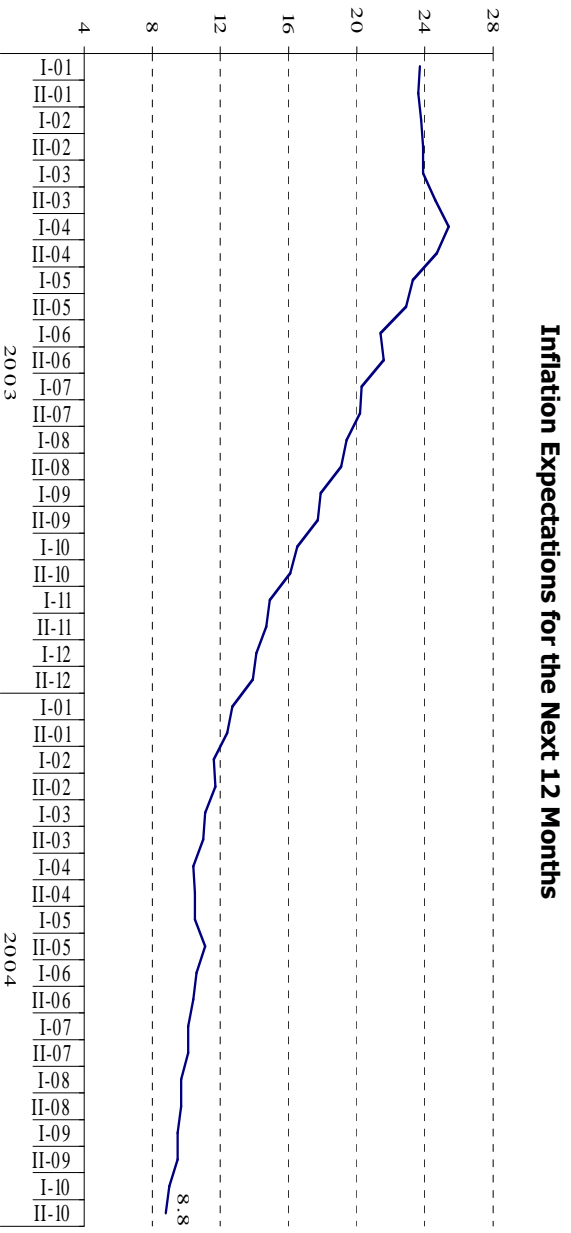
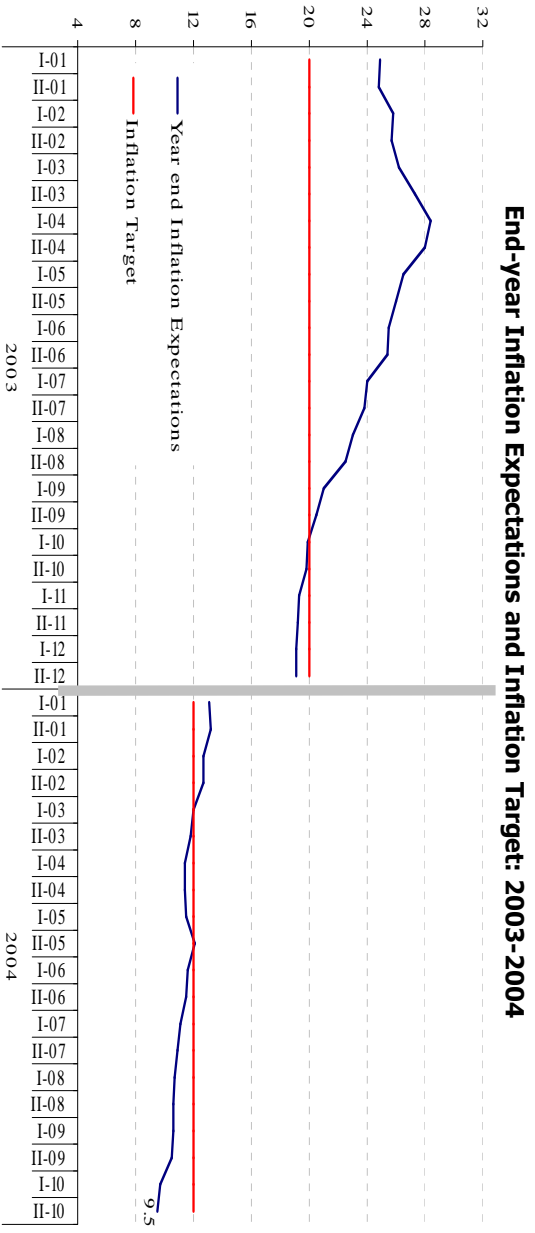
- It is anticipated that one of the most determining factors in 2005 inflation would be the course of international raw material prices. At a time when single-digit inflation is targeted, the impact of relative price changes caused by exogenous shocks will be more critical. The upward trend in crude oil and basic metal prices in international markets has been continuing for a long time and the likelihood of a reversal in this trend seems rather low in the short run, which pose an important risk for 2005 inflation altogether. Although the direct effects of the persistently high levels of crude oil and basic metal import prices on inflation have been felt for a while, these effects were more severe in October due to the above-mentioned public-sector pricing policy. Though not exerting an obvious pressure on general inflation trend in the light of today's data, the indirect effects of the said cost rises on inflation expectations and pricing behaviors in the upcoming period must be monitored closely.

- The course of agriculture and food prices in 2005 is estimated to be one of the determining factors in attaining the inflation target. As mentioned above, the coincidence of October with Ramadan has affected the food prices unfavorably. This effect will probably be offset in the following months. However, it should be kept in mind that the course of fresh vegetable and fruit prices under the food item is mainly shaped by supply factors like natural conditions and the monetary policy has only a limited effect on food prices. Therefore, the favorable course of food prices throughout 2004 contains little information about 2005 inflation.

20. The incidence of the rapid rises in wholesale prices on CPI in the upcoming period will be a determining factor for 2005 inflation. The control of domestic demand and the developments about expectations management will be the critical factors in this issue. In such a period, it is much more important that the structural adjustments foreseen in the three-year national program are immediately enforced, budgetary discipline is preserved without compromise and the quality of fiscal discipline is enhanced. Especially the data pertaining to October once more manifest the importance of structural reforms in disinflation efforts intended for enhancing the quality of fiscal discipline. While a transformation is being observed on the inflation front, unprecedented for the last thirty years, it appears as a significant fact that the most important determinant of “fiscal discipline” in state economic enterprises is not the rise in prices of goods and services produced by the public-sector, but the deepening of fiscal adjustment via enhancing productivity in public sector instead.

21. In conclusion, there is no factor that could jeopardize the attainability of the inflation target for 2004. Under the assumption that tight fiscal policies are sustained and a program that would further deepen the structural reforms is implemented in the upcoming period, it is anticipated that the expectations will not deteriorate and the domestic demand will boost in a controlled manner. Thus, it is foreseen that the main downward trend in inflation will continue, despite expected little fluctuations from time to time. It should be kept in mind that the prices that bear significance in terms of a monetary policy focusing on future inflation will be the prices determined by macroeconomic fundamentals rather than those affected by short-term shocks.

Table 5: Inflation Expectations According to CBRT Expectations Survey



Source: CBRT Expectations Survey