August Inflation Outlook and CBRT Interest Rates

I. *GENERAL EVALUATION*

1. In August 2004, CPI increased by 0.58 percent while WPI surged by 0.79 percent. Annual CPI and WPI inflation became 10 percent and 10.5, respectively.

2. Seasonally adjusted monthly price increases were recorded as 1.1 percent and 1.8 percent in CPI and WPI respectively while seasonally adjusted monthly price increases in CPI excluding food and WPI excluding agriculture became 0.7 percent and 1.8 percent.

Table 1: General CPI, WPI and Sub-items

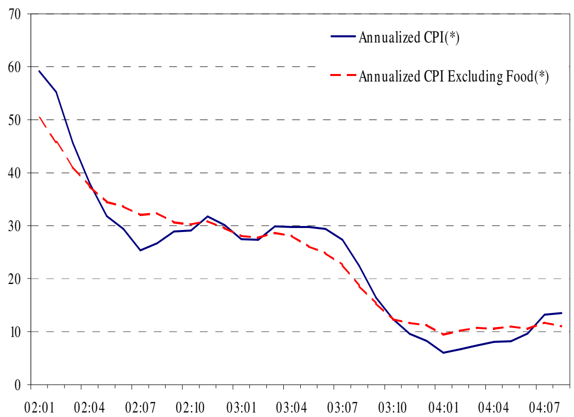
	Annual % Change		Monthly % Change			
	2003 Aug.	2004 Aug.	2004 June	2004 July	2003 Aug.	2004 Aug.
CPI	**24,9**	**10,0**	**-0,1**	**0,2**	**0,2**	**0,6**
Goods	24,9	6,5	-0,7	-0,2	-0,7	-0,1
Services	25,0	16,7	0,9	1,0	1,8	1,7
Excl. Food	23,1	10,6	0,8	0,4	0,7	0,7
Food	31,5	8,0	-3,3	-0,6	-1,7	0,1
WPI	**22,7**	**10,5**	**-1,1**	**-1,5**	**-0,2**	**0,8**
Public	19,4	13,4	2,0	1,8	1,5	2,3
Private	24,1	9,4	-2,2	-2,8	-0,8	0,2
Public Manufacture	22,9	16,0	1,5	2,7	1,6	2,3
Private Manufacture	18,5	10,8	1,2	0,3	0,7	1,5
Agriculture	36,8	6,4	-8,1	-8,6	-4,0	-2,5
Excl. Agriculture	19,0	11,8	1,5	0,8	1,0	1,8
Excl. Agr. and Energy	19,7	12,6	1,6	0,8	1,1	1,8

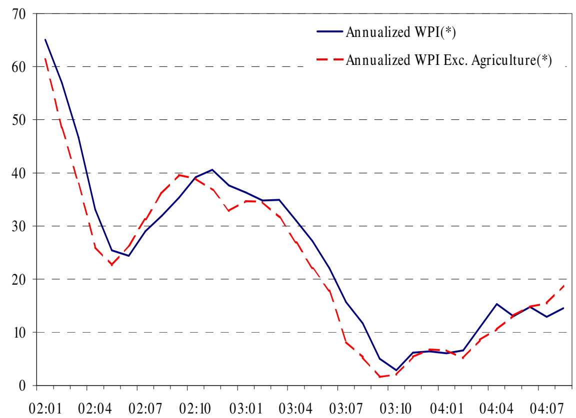
Source: CBRT, SIS

3. The six-month average of seasonally adjusted inflation was 1.14 percent in WPI and 1.06 in CPI. The mentioned average rates of increase correspond to 14.5 percent and 13.5 percent in annual terms. In the same period again, the average rate of increase in seasonally adjusted CPI excluding food became 0.87 percent, which corresponds to 11 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. Despite the relatively high rate of increase in the services group prices in August 2004, seasonal decline in clothing prices, limited increase in food prices, and decrease in durable goods prices restricted the CPI inflation. In August 2004, increase in service group prices was 1.7 percent whereas goods group prices declined by 0.1 percent. Seasonal effects coupled with the absence of demand pressures in semi-durable and non-durable goods had an impact on the favorable course of goods group prices. In the first 8-month period, while seasonally adjusted cumulative price increase was 5.9 percent in goods group, it was 9.4 percent in service group.

5. In the education services sector whose prices are adjusted only in August and September, the tuition fees of private schools and courses increased by 15.7 percent and 12.7 percent respectively, causing the monthly increase in education prices to rise to 9.2 percent. Tuition fees in universities increased almost by 15 percent and this shows that increases in education prices will be effective in pushing up the CPI inflation also in September 2004. The upward trend in rents continues as well. As of August 2004, whereas CPI inflation is 10 percent, the yearly inflation rate of education and rent groups are 21.6 percent and 20.8 percent respectively. This shows the continuation of the price rigidity in services group.

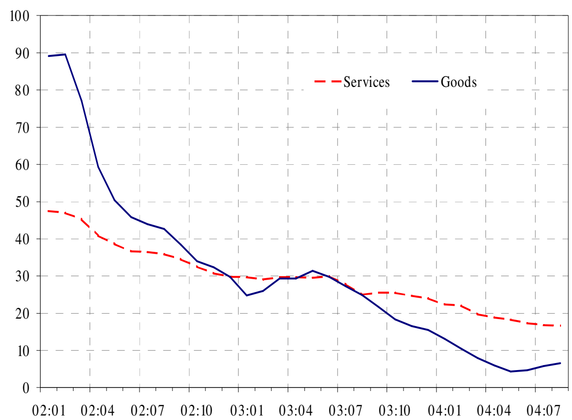
6. In the goods group, food prices had a limited increase of 0.1 percent, whereas clothing and footwear prices decreased by 3.2 percent in August 2004 following the 3.7 percent decline in July 2004. In the first eight months of 2004, cumulative increase in the prices of seasonally adjusted food and clothing prices were 6.3 percent and 4.9 percent, respectively, remaining below the 7.3 percent cumulative increase of seasonally adjusted CPI in the same period. As of September, the favorable seasonal effects in both groups are expected to reverse.

7. Another sub-group affecting the decline of goods group prices was the durable goods prices, decreasing by 2.5 percent in August 2004. Prices of personal transportation vehicles and cultural-recreational instruments within this group, which is known to be sensitive to exchange rate developments and demand conditions, declined by 3.9 percent.

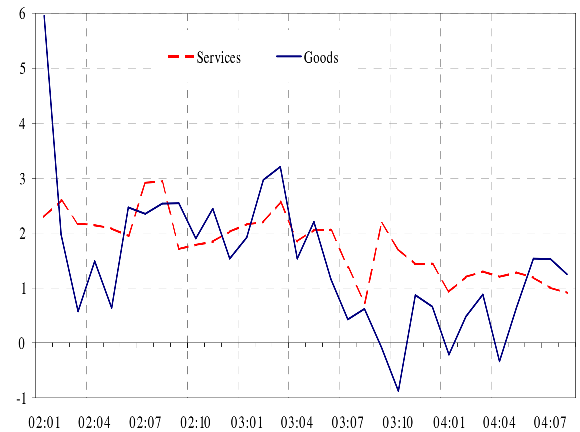
8. It is difficult to distinguish the demand effect on the clothing and durable goods prices due to favorable seasonal effects and cost conditions. Meanwhile, the 3.9 percent increase in furniture and flooring prices that are known to have high demand elasticity and the 12 percent rise observed in cumulative prices as of August are remarkable.

Figure 2: Prices of Goods and Services

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*

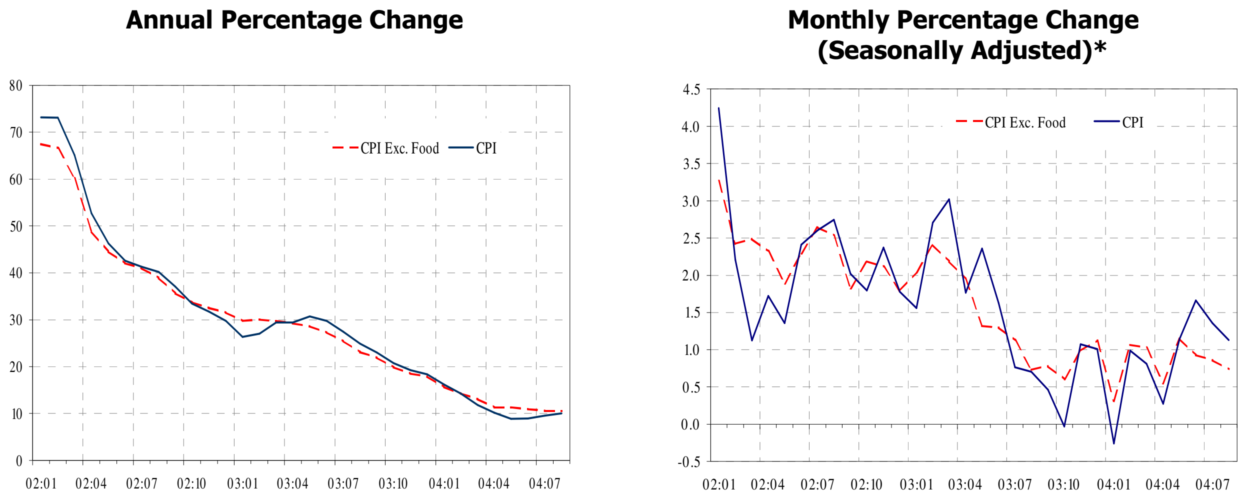


Source: CBRT, SIS.
*TRAMO/SEATS method has been used for deseasonalization.

9. Furthermore, the medicine prices under government control increased by 6.2 percent and therefore health prices remained above CPI inflation with a 1.9 percent increase. Moreover, although house and transportation prices are affected by the 5 percent price increase on petroleum products as of 10 August 2004, it is observed that the price increases in the mentioned groups are partially compensated by other sub-items.

10. In this framework, the seasonally adjusted CPI inflation and CPI excluding food decreased in August compared to their averages in the last three months. In August, annual CPI inflation rose from 9.4 to 10 percent due to the base effect, meanwhile annual CPI inflation excluding food remained at 10.6 percent (Figure 3).

Figure 3: CPI and CPI Excluding Food



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

Developments in Wholesale Prices

11. In August, the manufacturing industry dominated the increase in WPI. In this period, public manufacturing industry prices rose by 2.3 percent on monthly basis. The biggest contribution to this price increase came from petroleum products manufacturing and basic metal industry sectors. Exchange rate changes and the increases in world commodity prices played an important role in this development.

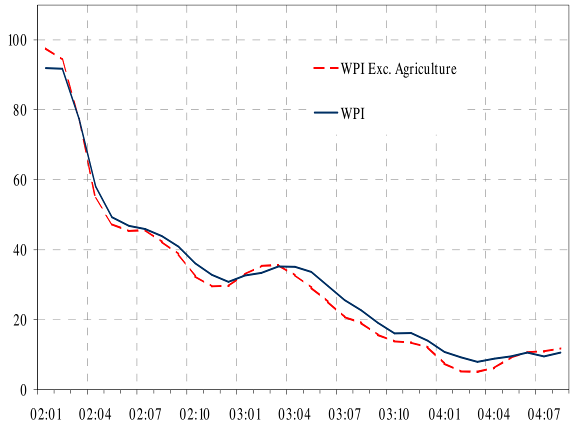
12. Meanwhile, private manufacturing industry prices rose by 1.5 percent in August. Chemicals production and furniture manufacturing sectors made the largest contribution to the mentioned increase. The increase in the chemicals production sector can be explained by the changes in exchange rates and oil prices, stemming from the major usage of petroleum products and imported input in this sector. The high rate of increase in furniture manufacturing sector is considered to reflect the seasonal effects as well as the relative recovery in domestic demand. In August 2004, the annual inflation in furniture manufacturing sector rose from 15.9 percent to 35.3 percent compared to the same month of the previous year.

13. In August, agricultural prices declined by 2.5 percent owing to the fall in fresh fruit and vegetable prices. However, seasonally adjusted agricultural prices increased by 1.1 percent.

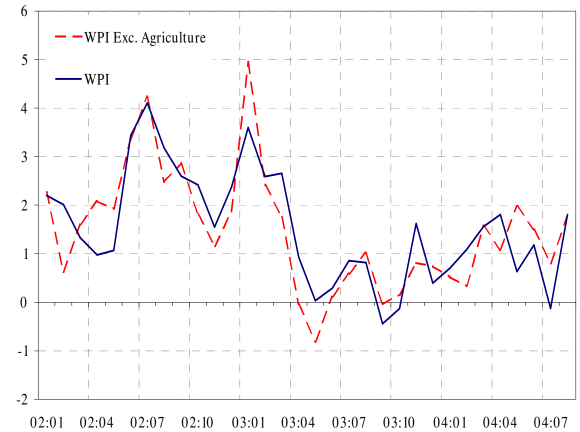
14. Energy prices maintained their current trend and rose by 0.1 percent. It is observed that the energy prices has displayed a downward trend on an annual basis with a 1.8 percent decline.

Figure 4: WPI and WPI Excluding Agriculture

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



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

15. In this respect, the annual WPI and WPI excluding agriculture rose by 10.5 and 11.8 percent respectively in August. In the upcoming period, the developments in international crude oil prices may affect energy prices, especially petroleum products. Furthermore, the seasonal effect of the agriculture sector limiting inflation will be removed.

II. OUTLOOK

Outlook for the General Factors Affecting Inflation

16. While creating an information set about future inflation, it is important that the signals about future prospects given by recent price developments are truly comprehended and the likely course of the factors affecting the general price level in the coming period is well evaluated.

- Despite the high capacity utilization rates and the gradual narrowing in output gap in the recent period, no significant acceleration was observed in consumer prices in the first half of the year. This has resulted mainly from the fact that the relative recovery in domestic demand in the said period did not extend through all sectors as well as from the significant rises in productivity in the sectors where high rates of increase are observed in production – especially in durable goods sector. In the following period, the variables to be monitored in terms of inflation will be domestic demand indicators as well as the rise in productivity and the course of the unit labor costs. In the light of current data, the following points can be specified:
    - Historically high level of capacity utilization rates, lack of a full-competition environment and the signals for a rise in employment are pointing out that the productivity increase may slow down in the coming period compared to the last three years. However, it is estimated that the ongoing investment trend since the last quarter of 2003 would support the productivity boost in the forthcoming period. The support of unit labor costs to the downward trend in inflation might weaken relatively in the following periods. Nevertheless, it is anticipated that the productivity boosts will continue to exert a downward pressure on unit labor costs as long as the adjustments concerning the removal of the obstacles to investment and production are continued.
    - The marked slowdown in money demand, automobile sales and the volume of total credits in recent period and the relative liquidity contraction in the markets are the significant developments in domestic demand. These developments point out that the rise in economic activity ongoing for the last four quarters might lose momentum in the coming period. Related to this issue, developments in consumer credits and leading indicators for domestic demand components are continued to be monitored carefully.
- Consumer prices increased cumulatively by 3.9 percent in the first eight months of 2004. This rise took place regardless of the recent rapid rises in world crude oil prices and the volatility in exchange rate. The margin created by the fact that the increase in consumer prices in the first

eight months of the year remained even below the path consistent with the inflation target indicates that the probability of achieving the year-end target is high even in cases of possible external shocks.

- Thanks to a monetary policy strategy focused on price stability, and the disciplined fiscal policies under the current economic program that has been strictly implemented for a long time, inflation expectations are brought under control, inflation target has gradually reinforced its function as an anchor, and a structural transformation has begun in pricing behaviors. As a consequence, from the point we stand today, announced inflation target is now perceived by economic agents as a strong reference point. In this context, it is anticipated that the inflation expectations would not deviate markedly from the target in the rest of 2004 and the upcoming period as far as the perceptions about the continuation of the current program are reinforced in a similar approach with more emphasis on structural reforms.

- Downward trend in inflation expectations, enhanced competitiveness and the ongoing monetary and fiscal discipline limit the effect of cost increases on prices. Moreover, under the floating exchange rate regime, financial assets denominated in foreign currencies have now become relatively more risky instruments, hence exchange rates can move in either directions. This fact contributes to the breaking of indexation mechanisms and slows down the pass-through effect from exchange rate to inflation– particularly in consumer prices. As long as the fiscal and monetary policies are implemented in consistency with the inflation target and the oligopolistic markets are minimized by enhancing free competition, this change in pricing behavior will become more permanent.

- The rigidity in services prices and the relative price differentiation among commodity-services groups continue. Seasonally adjusted cumulative price increase for the first eight months of the year was 5.9 percent for the commodity group and 9.4 percent for the services group. This can be explained partially by the high productivity increases in the sectors producing commodity groups, and partially by higher sensitivity to the exchange rate of the commodity group prices compared to the services group. However, past pricing habits persist in some sectors in the services group—especially in rental, health and education services—, in a manner difficult to explain the differentiation solely by the two above-mentioned factors. The fact that annual education services prices and rent increases realize above some 20 percent at a period when general price increases occur around 10 percent captures attention. Relative price differentiations that may arise out of a clear deviation of any sub-item from the general trend will be more important than ever in the coming period where lasting price stability is targeted.

- Tax revenues that have surpassed targets owing to the prevailing fiscal discipline and the high growth performance in 2004, enabled that the rise in oil prices that was beyond budgetary forecasts was reflected to the petroleum prices only in a limited manner. It is predicted that the revival in economic activity will slow down in 2005 and growth will realize at a lower level compared to this year. Besides the likelihood that the relative vigor in global economy will continue in 2005 as well, signals that the high levels of commodity prices will not reverse in the short run. In this case, it will be more difficult next year to implement the strategy of partially reflecting the high raw material costs onto the prices, giving up tax revenues. Moreover, such a strategy is not sustainable in the medium term. Lasting solution lies in the deepening of public sector fiscal adjustment. It is important to emphasize once more at this point that the efforts towards backing up fiscal discipline with structural reforms such as social security and tax reforms are perceived as positive developments. Certainly, even if the foundations of these reforms are immediately laid, concrete outcomes for the revenue and expenditure sides will be obtained in the medium and long-term. Yet, the effects of such steps on expectations will make significant contributions to the sustainability of current balances.

- Just like the rest of the world, unforeseeable deviations in oil prices constitute a risk factor for Turkey as well. "Primary effects" of the recent increases in raw material import prices on inflation, directly and also through input costs began to be felt especially in the second half of the year. However, "secondary" effects of such shocks —a deterioration in the medium and long term inflation expectations and the signal for its reflection on prices— have not occurred yet. In other words, if the above-mentioned basic conditions are provided, inflation will resume its downward trend when the external factors increasing input costs disappear. Moreover, ongoing favorable developments as regards the prices of electricity, which is another important input item, are limiting total cost increase. Still, secondary effects of especially the oil price increases will be closely monitored in the coming period.
- The decline in food prices in the said period made a significant contribution to the favorable course of inflation during the first eight months of the year. However, such contribution may vary depending on natural conditions and seasonal trends. Thus, price developments in the said items, independent of their direction, contain very little information regarding future inflation and play hardly any role in the monetary policy decisions.
- The index targeted by the Central Bank within the framework of the current regime is the consumer prices index; WPI does not possess any target nature. The figures given in the economic program for the WPI increase are for projection purposes. Certainly, with a future-looking point of view, wholesale prices are important within the framework of the information they contain as regards the consumer prices. Along the same lines, while manufacturing sector price developments will be closely monitored; in an environment where monetary and fiscal discipline sustains and incomes and wage policy of the public sector designed in harmony with the targets, recent WPI increases are believed to continue having only limited effect on the consumer prices.

17. Finally, certain points as regards the twelve-month cumulative inflation figures should be underlined once again. It was pointed out several times since the beginning of the year in both the monthly inflation analysis and also the quarterly monetary policy reports that annual inflation would decline in the first half of the year, and that while it might go up in the second half of the year, this would be entirely within the framework of the targets. As a matter of fact, annual inflation figures recorded only minor increases in July and August in line with forecasts, compared to previous months. As emphasized before, annual inflation figure is an entirely backward-looking variable, the monthly change of which is linked also to the inflation figure pertaining to the same month of the previous year. This may lead to misinterpretations from time to time. For example, a rise in the annual inflation figure for August might be presented *erroneously* as "inflation being in an upward *trend* in August". On the contrary, with a value of 0.7 percent, seasonally adjusted non-food CPI increase in August displayed a tendency coherent with the inflation target; it even manifested a decline when compared with July. Yet, on account of the extraordinary performance in August last year, the annual inflation figure for August 2004 appears as if it rose compared to the previous month— as a consequence of the base effect.

Current Account Deficit and Inflation

18. It is observed that the arguments around the recent increase in current account deficit are debated within the framework of old habits, not in the context of economic policies and measures to be taken. At this point, it is deemed useful to emphasize the following points once more.

19. First of all, under the ongoing program implemented, the Turkish economy has made great progress on the way of "normalization". It is clear that the continuation of a similar program in the coming period as well, fragilities in the Turkish economy would further diminish and thus the level of sustainable current account deficit would go up, thanks to an environment of macroeconomic stability, strengthening institutional structure and a likely improvement in the quality of the financing resources. Such structural change was experienced by several countries that have passed through a similar process.

20. The second point to be highlighted is that the deterioration in current account recently observed is a "natural" outcome of a period marked by a growth rate surpassing the rate foreseen by the program. The importance attached to monitoring a growth rate in the current account deficit that exceeds program projections should also be attached to monitoring a growth rate in economic activity that exceeds projections. It should be borne in mind that what Turkey needs is not a rapid, unstable growth, but a sustained growth that is consistent with the current program. To this aim, some selective measures shall be taken such as: some incentives provided for certain sectors (for instance the auto scrap discount) should be revised, some limitations on the supply side should be introduced, which would decrease the rapid growth rates in loans to an acceptable level (if these rates are deemed to be conflicting the objective of attaining a healthier financial sector) and would be consistent with the international financial sector norms, the additional tax revenues that emerged as a result of production exceeding the projections should be saved. Some steps to these aims have already been taken. In case of need, some additional measures similar to those might become necessary in the upcoming period.

21. Another point to be highlighted is the role of the monetary policy. It should not be missed that rapid growth and high current account deficit was observed in a period marked by high interest rates in real terms. Therefore, implementing an interest rate policy according to the developments in current account instead of future inflation rate –the method successfully implemented till now- would serve no good, giving confusing signals and affecting expectations adversely. Meanwhile, it should be borne in mind that deterioration in current account emerged in an economy where exchange rates are determined under market conditions. Despite there still exist different views about the ideal exchange rate regime; the floating exchange rate regime has proved to be very beneficial in the period following the 2000-2001 crisis. It is expected that the floating exchange rate regime will be able to play its automatic stabilization role in a more determined way as the structural problems, which cause higher real interest rates and lead to much higher levels occasionally, are settled (such as decreasing the deficits of social security system, reducing underground economy and expanding tax base, achieving an efficiently-operating financial system and profound financial market) and the factors that might lead to expectations about interruption in the implementation of the program are eliminated.

22. At this point, a natural question that should be asked by the Central Bank under the current conditions is "How intensely can the deterioration in current account affect inflation?" As stipulated in the Central Bank Law, the primary objective of the Central bank is to achieve price stability; therefore, it would be wise to re-evaluate the channels through which the deterioration in current account might affect inflation.

a. 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 the 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 backed by international institutions. Achievements made under the current program and the gradually lessening vulnerability of the economy to external shocks set the greatest evidence.

b. The second channel is the correlation between the factors leading to the deterioration in current account and inflation dynamics. As the exchange rate channel, which has already been discussed above, one of the leading factors 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 analyze an important variable, the output gap. Considering the rapid rise in private investment expenditures recently and the persistent rise in productivity, it can asserted that the potential production level is increasing. According to the calculations made by the Central Bank, production level did not reach to an extent to threaten the downward trend in inflation. Moreover, output gap is only one of the variables determining inflation and not the most important one as well. Considering the conditions of the labor market, establishing control over disposable income through the continuation of fiscal discipline, increases in productivity and the other factors mentioned in article 16, there will not be a pressure, which may cause a significant increase in inflation, in the upcoming period.

Conclusion

23. In conclusion, there are no such risk factors that would evidently pose a threat for the attainment of the inflation target for 2004. However, there are certain risks for the year 2005. First of all, neither domestic demand developments nor labor costs would provide as much support to the downward trend in inflation as they used to provide in the last three years. Moreover, high oil prices might push up the energy costs, leading to a pressure on current account and inflation while the likely liquidity contraction and rises in interest rates in the international markets would exert a pressure on exchange rate. However, the important criteria for the inflation trend of the coming period are budget discipline, the quality of the budget discipline, the uninterrupted continuation of the structural reform process consisting of tax and social security reforms that would support the budget discipline in the coming period as well and inflation target-based monetary policy implementations. As long as these policies are carried out effectively, it is clear that the downward trend in inflation will continue even if it might display fluctuations at times due to external shocks. In this framework, the announcements, which focused on the political will about the adherence to the fundamental principles of the current economic program in 2005 and the upcoming periods, helped remove the uncertainties about the new economic program to be adopted and strengthened our belief in the sustainability of *the downward trend in prices of the items excluding the ones such as food and energy which are determined by external factors.* Consequently, under these circumstances and in the light of current data, a cut down in short-term interest rates is deemed appropriate.

24. However, one last point needs to be emphasized again for a better understanding of some aspects of monetary policy: In those countries that have achieved stability or that have attained significant progress in this respect, it is common for a central bank whose primary objective is to achieve price stability to reduce or to raise as well the short-term interest rates, which is the basic policy instrument, depending on the conditions of the economy. It is a basic fact that central banks act as such to maintain the economic stability. In the final analysis, if central banks do not take these steps when the conditions arise, then they should be criticized. Therefore, as has been the case until now, only future inflation will be taken into consideration while shaping the monetary policy; in case of clear signals for an inconsistency between the future course of inflation and the targets coupled with the perceptions that this inconsistency might turn out to be permanent in the medium/long-term, interest rate policies will be used effectively.

III. THE CENTRAL BANK INTEREST RATES

25. In the light of the developments above, the Central Bank (CBRT) has decided to cut short-term interest rates applied at CBRT Interbank Money Market and Repo-Reverse Repo Market at Istanbul Stock Exchange as follows to be effective from September 8, 2004:

a) Overnight Interest Rates: Borrowing interest rate was cut down to **20 percent** from 22 percent and lending interest rate to **24 percent** from 27 percent.

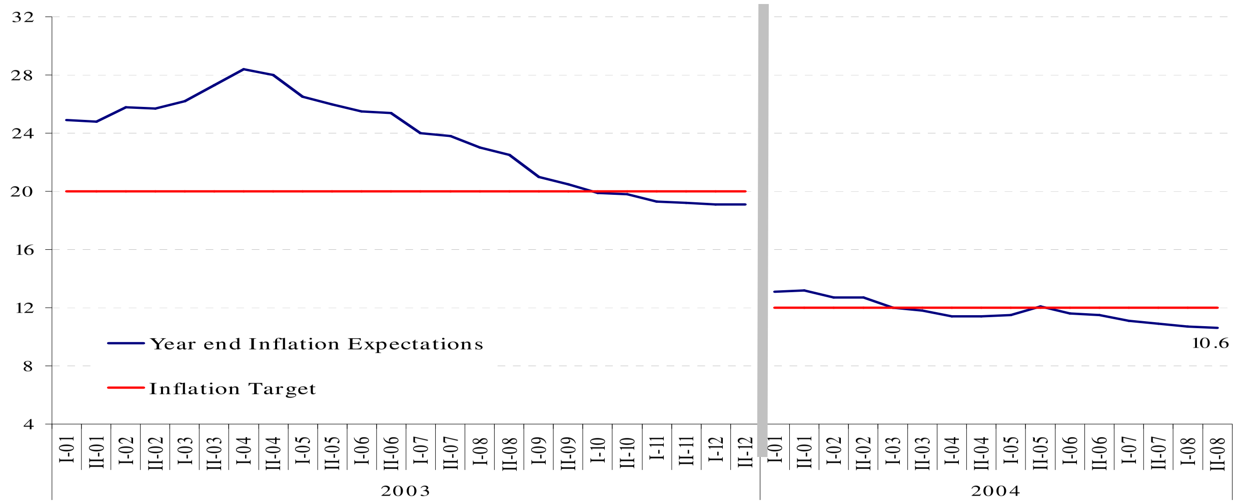
b) Other Maturity: One-week borrowing interest rate was cut down to **20 percent** from 22 percent.

c) Late Liquidity Window Interest Rates: Within the framework of Late Liquidity Window Facility, CBRT overnight borrowing interest rate applicable between 16:00 – 16:30 Hours at Interbank Money Market was cut down to **28 percent** from 32 percent. Borrowing interest rate of **5 percent** remained the same.

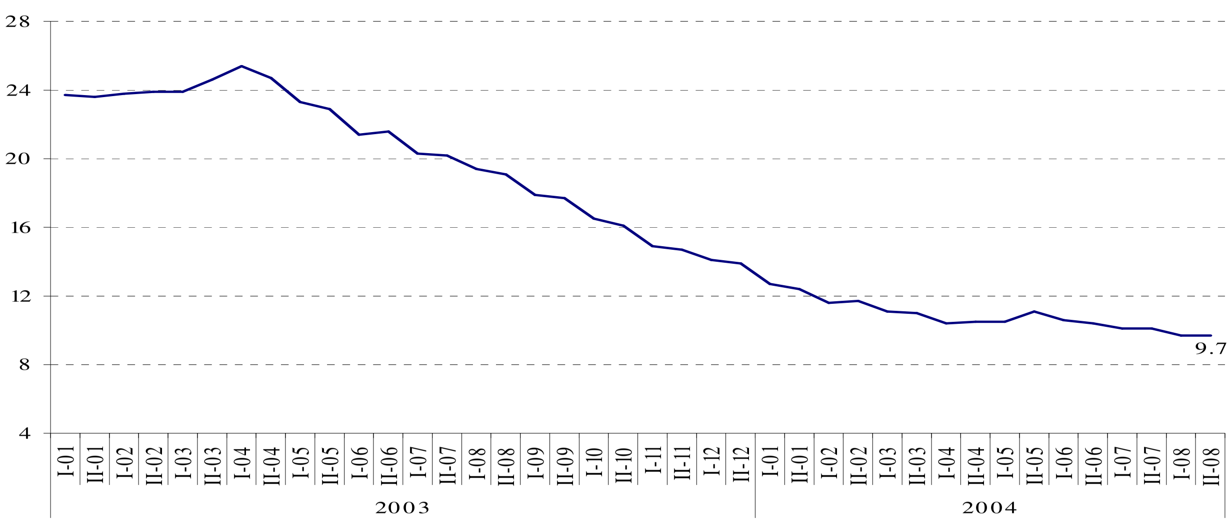
d) The interest rates on overnight and one-week maturity borrowing facilities provided for primary dealer banks via repo transactions within the framework of open market transactions were cut down to **22 percent** from 24 percent.

Figure 5: Inflation Expectations According to CBRT Expectations Survey

End-year Inflation Expectations and Inflation Target: 2003-2004



Inflation Expectations for the Next 12 Months



Source: CBRT Expectations Survey