

# May Inflation and Outlook

## ***I. GENERAL EVALUATION***

1. In May 2004, CPI increased by 0.38 percent while WPI dropped by 0.03 percent. Annual CPI and WPI inflation became 8.9 percent and 9.6 percent, respectively.
2. Seasonally adjusted monthly price increases were recorded as 1.1 percent and 0.8 percent in CPI and WPI respectively while seasonally adjusted monthly price increases in CPI excluding food and WPI excluding agriculture became 1.2 percent and 2.0 percent.

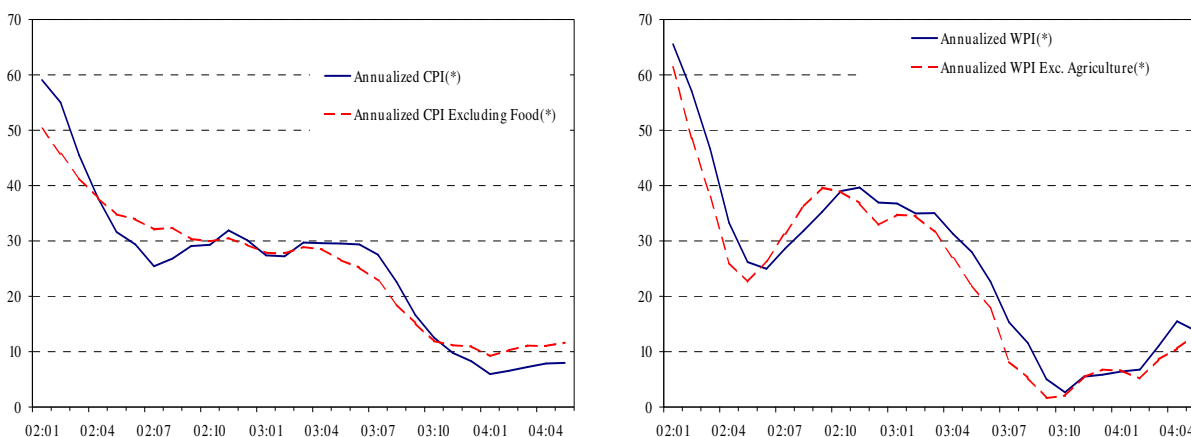
**Table 1: General CPI, WPI and Sub-items**

|                      | Annual % Change |             | Monthly % Change |               |             |             |
|----------------------|-----------------|-------------|------------------|---------------|-------------|-------------|
|                      | 2003<br>May     | 2004<br>May | 2004<br>March    | 2004<br>April | 2003<br>May | 2004<br>May |
| <b>CPI</b>           | <b>30.7</b>     | <b>8.9</b>  | <b>0.9</b>       | <b>0.6</b>    | <b>1.6</b>  | <b>0.4</b>  |
| Goods                | 31.4            | 4.3         | 1.0              | 0.6           | 1.6         | 0.1         |
| Services             | 29.5            | 18.2        | 0.7              | 0.6           | 1.5         | 0.9         |
| Excl. Food           | 28.6            | 11.4        | 0.5              | 0.6           | 1.5         | 1.5         |
| Food                 | 37.8            | 1.4         | 2.2              | 0.6           | 1.9         | -3.1        |
| <b>WPI</b>           | <b>33.7</b>     | <b>9.6</b>  | <b>2.1</b>       | <b>2.6</b>    | <b>-0.6</b> | <b>0.0</b>  |
| Public               | 30.4            | 9.3         | 3.0              | 0.5           | -2.7        | 2.3         |
| Private              | 35.0            | 9.6         | 1.8              | 3.5           | 0.2         | -0.9        |
| Public Man.          | 35.0            | 11.8        | 4.1              | 0.4           | -3.0        | 2.6         |
| Private Man.         | 28.0            | 9.1         | 0.7              | 1.5           | 0.3         | 1.8         |
| Agriculture          | 48.1            | 10.5        | 3.6              | 6.9           | -0.1        | -5.2        |
| Excl. Agriculture    | 29.2            | 9.2         | 1.6              | 1.1           | -0.8        | 2.0         |
| Excl. Agr.and Energy | 30.1            | 9.9         | 1.7              | 1.2           | -0.9        | 2.1         |

Source: CBRT, SIS.

3. The six-month average of seasonally adjusted inflation was 1.1 percent in WPI and 0.6 in CPI. The mentioned average rates of increase correspond to 13.8 percent and 8 percent in annual terms. In the same period again, the average rate of increase in seasonally adjusted CPI excluding food became 0.9 percent, which corresponds to 11.6 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 Averages (Annualized, Seasonally Adjusted).  
TRAMO/SEATS method has been used for deseasonalization.  
Source: CBRT, SIS.

### ***Developments in Consumer Prices***

**4.** In May, there were mainly three factors affecting CPI sub-items. These were: (i) downward trend in food prices, (ii) increase in clothing prices exceeding expectations and (iii) the repercussions of the depreciation of Turkish lira on prices.

**5.** Compensation of rapid increase in agricultural prices in winter ended up in a decline in food prices. With the decline in food prices, inflation remained well below the expected inflation rate of 1.1 percent according to May 2004 results of the CBRT Expectations Survey. In the CPI, especially the fresh vegetable prices declined remarkably. Meanwhile, due to the adjustments made in the prices of tea, beverages group prices increased by 3.4 percent. As a result of this, while the prices in food group declined by 3.1 percent, decline in food-beverages-tobacco group prices remained relatively limited with a 2.3 percent.

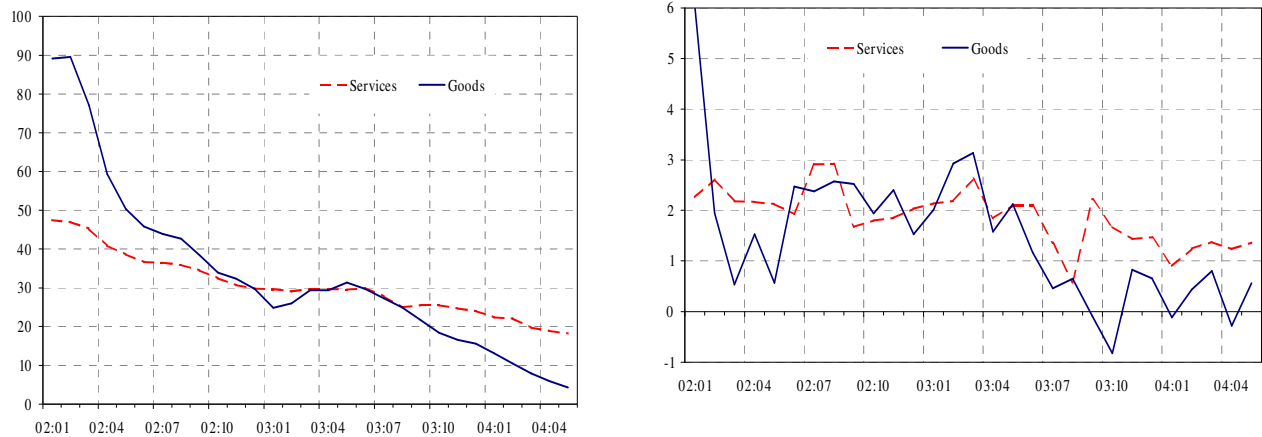
**6.** 5.8 percent of inflation in clothing group indicates that part of the seasonal increase peculiar to April has shifted to May in 2004. The index value of clothing prices is currently 1.8 percent lower than the last season's values (November 2003) and annual rate of increase in clothing is only 2.5 percent, therefore, it can be asserted that increase in clothing prices should not pose a risk to the inflation target.

**7.** In May 2004, the issue of concern in the markets was how the depreciation of Turkish lira would affect the prices. When the developments in CPI sub-items are examined within this framework, it is observed that the pass-through from exchange rates to CPI has been mostly limited to petroleum prices. The increase in durable goods prices, which was expected to be the group most severely affected, was recorded as 1.9 percent. Though exchange rate appreciation had minor effects on private transportation vehicles and cultural and recreational devices, the prices of electrical and

non-electrical household appliances remained intact. In other words, the impact of the depreciation in Turkish lira on durable goods and CPI inflation were limited in May 2004. The extent to which the exchange rate appreciation will be perceived as permanent, and the course of domestic demand in summer is estimated to be the major factors determining the degree of pass-through.

**8.** Apart from the three main points mentioned above, inflation developments in terms of relative price discrepancies are similar to those in the previous months. Displaying a course in line with the first four months of the year, increase in the prices of services groups was recorded as 1.4 percent (seasonally adjusted) and pursued its course, which is inconsistent with the inflation target. When the decline in annual inflation is reflected on the lease agreements, the increase in the prices of services group is expected to slowdown as well.

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

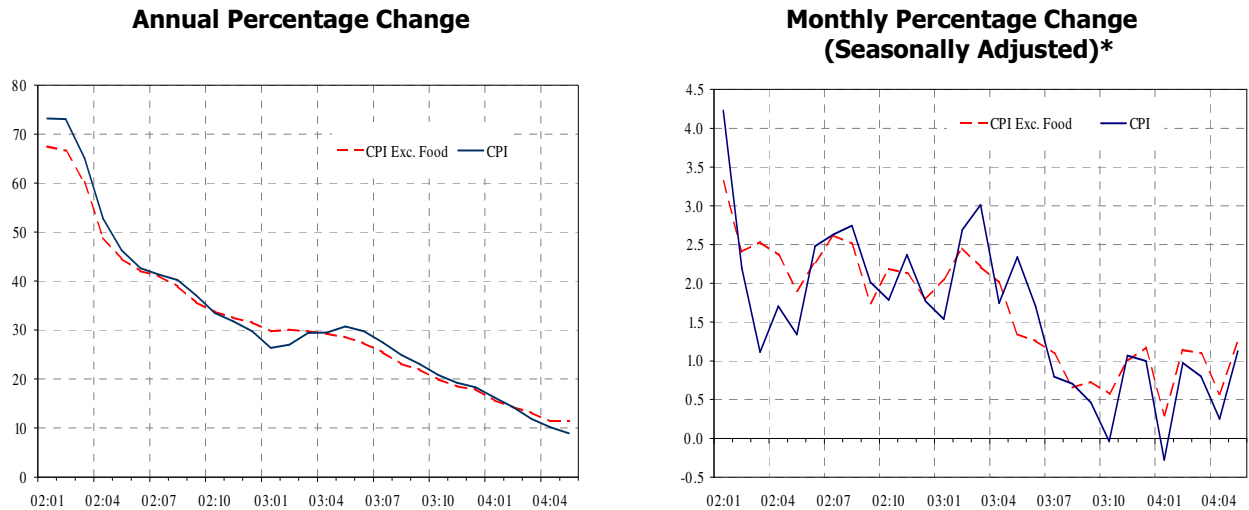


Source: CBRT, SIS.

\*TRAMO/SEATS method has been used for deseasonalization.

**9.** As a result, compared to the past 6 months, seasonally adjusted CPI excluding food slightly increased in May. The average rate of inflation excluding food in the first five months is 0.9 percent, and despite the high rate of increase in the prices of services, it is still compatible with the targeted inflation rate. Meanwhile, in May, seasonally adjusted food prices declined by 1.7 percent compared to January. Considering that annual rate of increase in the prices in this group is 1.4 percent, it can be asserted that chances of posing a risk to end-year inflation target are rather low.

**Figure 3: CPI and CPI Excluding Food**



Source: CBRT, SIS.

\*TRAMO/SEATS method has been used for seasonal adjustment

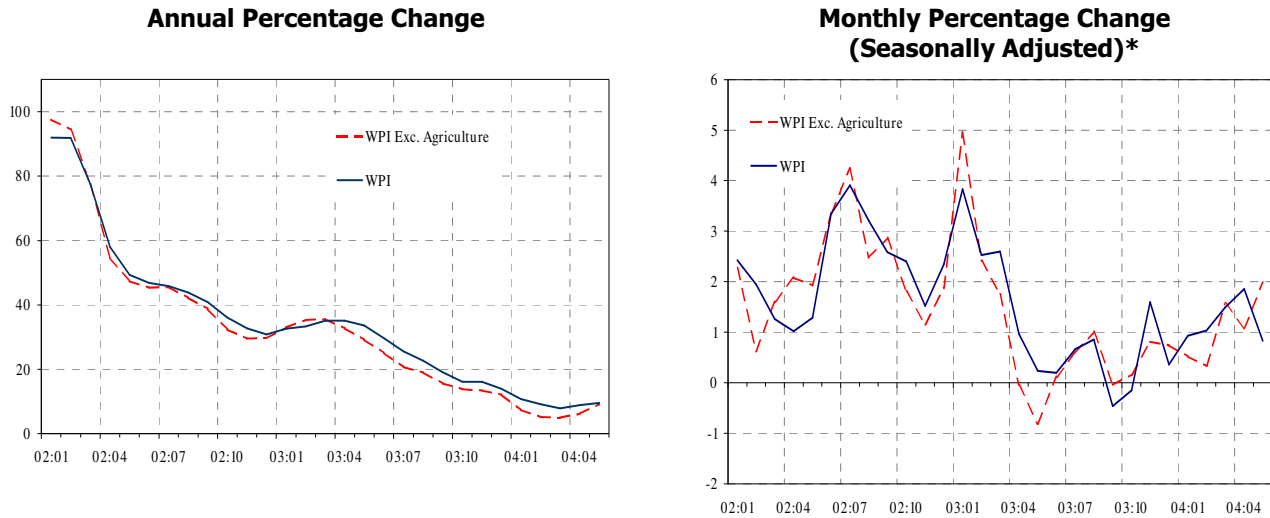
#### ***Developments in Wholesale prices***

**10.** WPI declined by 0.03 percent in May 2004. Rate of increase in seasonally adjusted WPI, came down to 0.8 percent, which is 1.1 points lower than April figure. Whereas, rate of increase in WPI excluding agriculture, increased by 0.9 percent compared to April and was registered as 2.0 percent (Figure 4).

**11.** The decline in WPI in May can be attributed to the 5.2 percent decline in agricultural prices. Seasonally adjusted agricultural prices, which increased by 2.6 percent in January-April period, declined by 2,3 percent in May and diverted mainly from the course it had been following since the turn of the year. While the decline in agricultural prices was reflected in WPI by -1.54 percent, 2.1 percent rise in manufacturing industry prices contributed to WPI inflation by 1.51 percent. In other words, the decline in agricultural prices limited the WPI inflation by compensating the rise in manufacturing industry prices that accelerated due to cost-push pressures.

**12.** The significant rise in monthly rate of increase in WPI excluding agriculture can mostly be attributed to the depreciation of Turkish Lira against US dollars by 2.7 percent and 11.1 percent in April and May, respectively. Monthly rates of increase in private manufacturing industry prices and public manufacturing industry prices rose to 1.8 percent and 2.6 percent, respectively. The rise in the prices of raw materials as well as appreciation in exchange rates became the factors underlying the rise of public manufacturing industry prices. Despite the slowdown in the rate of increase in world metal prices, the prices in the public basic metal sector rose by 9.1 percent. Prices of oil products increased by 5 percent in mid-May due to the rise in international crude oil prices and appreciation in exchange rates. This 5 percent rise caused a 2.3 percent increase in the prices of public petroleum products manufacturing sector.

**Figure 4: WPI and WPI Excluding Agriculture**



Source: CBRT, SIS.

\*TRAMO/SEATS method has been used in deseasonalization.

**13.** An analysis of the sub-sectors of private manufacturing industry reveals that appreciation in exchange rates has had partial effects on most of the sub-items and the highest rates of increase were observed in prices of press-publication, communications equipment manufacturing industry and textile products manufacturing industry. The 5.2 percent rise in the prices of textile products bears importance as this group has a big share in private manufacturing sector and it is likely to have a delayed effect on clothing prices registered under CPI. This group's contribution to overall rate of increase in private manufacturing industry of 1.8 percent became 0.6 percent.

**14.** In May, energy prices increased by 0.6 percent as a result of the 2.1 percent rise in water prices, whereas they dropped by 1.7 percent compared to the same month of the previous year.

**15.** In line with the developments mentioned above, annual WPI inflation and WPI inflation excluding agriculture rose to 9.6 percent and 9.2 percent, respectively.

## **II. OUTLOOK**

**16.** Figures for May inflation constituted a significant reference point in terms of observing the extent to which the raw material costs and the fluctuations in financial markets would effect inflation. In this framework, the 1.5 percent rise in CPI excluding food indicated that the effects of the above-mentioned unfavorable developments on inflation would remain limited and also reaffirmed the belief that the year-end inflation target was attainable. Undoubtedly, cost-push pressures are likely to affect inflation in summer as well; however it is anticipated that these pressures would not reach a level that would jeopardize the end-year target.

**17.** After three successive years of downward trend in inflation, it is observed that the progress achieved so far has started to assume a permanent nature. The change in inflation dynamics undergone by Turkish economy during this process can be summarized under the main headings listed below:

- In line with the current program, worries about the sustainability of borrowing alleviated and the public prices were increased at a rate consistent with the end-year target, both of which weakened the pressure caused by public sector on inflation. However, in order to maintain this condition and ensure permanence of the achievements in inflation in the long run, it is necessary to carry out structural reforms in public sector in full strength.
- As a consequence of the current monetary and fiscal policies consistent with the inflation target as well as the credibility established thanks to the achievements in disinflation efforts, the economic agents have started to take the inflation target as a reference point.
- It is observed that pricing behaviors have become more rational, backward-looking indexation behavior has started to weaken and the effect of the prospective future demand and cost conditions in determining inflation has started to increase.
- With the advent of the floating exchange rate regime, nominal exchange rate-indexation behavior lost intensity, however exchange rates are still effective on inflation through costs and import prices. In this context, floating exchange rate policy is believed to have led to a structural change in the exchange rate-inflation correlation. Moreover, forward-looking inflation policy of the Central Bank, enhanced competitive environment, downward trend in inflation and tight fiscal policies implemented in the last two years are changing the pricing behaviors of firms, affecting the expectations and contributing to the weakening the pass-through from exchange rates to inflation.

**18.** There are certain points that should be emphasized for the sake of reaching an accurate interpretation of the general course of annual inflation figures in the forthcoming months. The lagged effects of cost increases observed as a result of the brisk movements in raw material prices and

exchange rates in the last two months coupled with the hike in oil prices on inflation are expected to continue in June and July as well. Meanwhile, the base effect observed in June, July and August 2003 as a consequence of the inflation figures that were well lower than the normal trend, will start to disappear as of next month. In other words, even if monthly inflation follows a trend consistent with the end-year target, annual inflation figures may be increasing only because of the calculation method during the next three-month period. It is crucial that the above mentioned point, which has been reiterated our inflation reports since early 2004, should be perceived correctly by all economic agents and the course of the annual inflation figures for the following period should not be used as an alibi for changing expectations or leading to speculative movements. It should be emphasized once more that the figures to be paid particular attention in terms of year-end inflation in the following months must be cumulative rates of increase in prices that have been recorded as of the turn of the year and the price increases estimated for the rest of the year rather than the twelve-month (annual) cumulative inflation figures. In this context, it should be noted that the cumulative rate of increase in prices for the first five months of the year became 3.2 percent. Prospective factors and risks that might affect inflation dynamics in the upcoming period are as follows:

- Surveys and leading indicators point out that the rise in consumer credits and production continued in the first five months of 2004 and as a consequence of this fact, capacity utilization was at high rates. However, it is still hard to talk of an overall recovery spread throughout all sectors in economy. Moreover, it is anticipated that the uncertainties sparked by internal and external developments and upward trend in long-term interest rates would reduce the consumption demand relatively. Taking into account these factors coupled with the determined implementation of tight monetary and fiscal policies, it is projected that there would be no prominent domestic demand pressure in the upcoming period. Undoubtedly, the Central Bank will continue to monitor the rise in consumer credits closely in the next period as well and make the necessary warnings in case these developments pose potential risks that may impede the downward trend in inflation or disrupt the stability in financial markets.
- There is a risk that the easing of the fluctuations in the financial markets might be delayed due to aggressive interest rate moves by the Federal Reserve Bank, or to increased external uncertainties. However, the effect of the mentioned prospective fluctuations on prices would be weaker compared to the pre-2001 period because of the above-mentioned reasons.
- Oil prices were raised as a result of the persisting rise in world oil prices and increased budget financing requirement caused by exchange rate pressure. Meeting the additional financing requirement, which might emerge unless the related factors reverse, in a manner consistent with the current economic program bears importance in terms of inflation, domestic demand, current account deficit and expectations.
- The likelihood of a rise in electricity prices is low for the time being, which is accepted as one of the factors that may limit the cost pressure caused by oil products.

- Projecting that the rise in productivity will maintain its rather modest course, though not as fast as in the last two years, and taking into account the current conditions in the labor force market, unit labor costs are predicted to keep contributing to the decline in inflation throughout 2004. However, it should be borne in mind that carrying out public wages and incomes policies in line with the targeted inflation rate is a critical prerequisite for the fight against inflation. Furthermore, the adjustments that focus on the removal of obstacles to investment and production are very important for the continuation of the rise in productivity in the medium and long run and ensuring sustained and lasting downward trend in inflation in the upcoming years. Efforts put forth on this matter are deemed very constructive. However, there is still more to be done about legal arrangement, governance quality and macro-economic stability.
- On the verge of a period of uncertainties in terms of external factors, it is of critical importance that strong signals, stating that the current economic program would not be interrupted, should be given. Clarifying the decisions on the continuation of the economic program will contribute very much to diminishing of the vulnerability to exogenous shocks. It should be borne in mind that, in an economy where inflation is in a downward trend, achieving high growth rates depends on the enforcement of structural transformation in the medium term and on the perception of the commitments made for this transformation process as credible by economic agents in the short term. Therefore, it is crucially important to carry on with a program that aims at ensuring the sustainability of the achievements, focuses on the structural reforms and defines structural criteria within the framework of a general and a medium-term plan.
- Inflation target-oriented monetary and fiscal policies which have been implemented for the last three years and the Central Bank's clear opinion-sharing with the public about the course of the future inflation tendency are playing an important role in molding expectations. In conclusion, at this point, the economic agents perceive the announced inflation target as a strong reference point. Given the current data, expected inflation figures, which have been following a course close to the targeted inflation despite cost-oriented shocks, are projected to maintain a similar trend in the upcoming period.
- Agriculture and food prices should be evaluated separately while evaluating the prospective risks to inflation in the upcoming period. Agricultural prices, which displayed a 27.6 percent hike in the first four months of the year, started to slowdown in May. It is predicted that this trend would continue in the upcoming months and have a restrictive effect on WPI inflation. Undoubtedly, it is necessary to be prudent about food and agricultural prices, as seasonal conditions cannot be foreseen. However, the relative stability in food prices despite fluctuations in agricultural prices reduces the mentioned risks in CPI compared to WPI.
- As of the inception of implicit inflation targeting, the end-year inflation target has been defined in terms of consumer prices; CPI inflation is taken as the focal point of our announcements and reports and the increase in WPI is evaluated in the light of the data that it includes about future



CPI inflation. In this framework, the developments in wholesale prices in May are estimated to affect future CPI inflation adversely in terms of costs, however this effect is expected to be limited in the short run similar to the case in exchange rate-inflation correlation, and the effect in question would not reach level to jeopardize end-year inflation target.

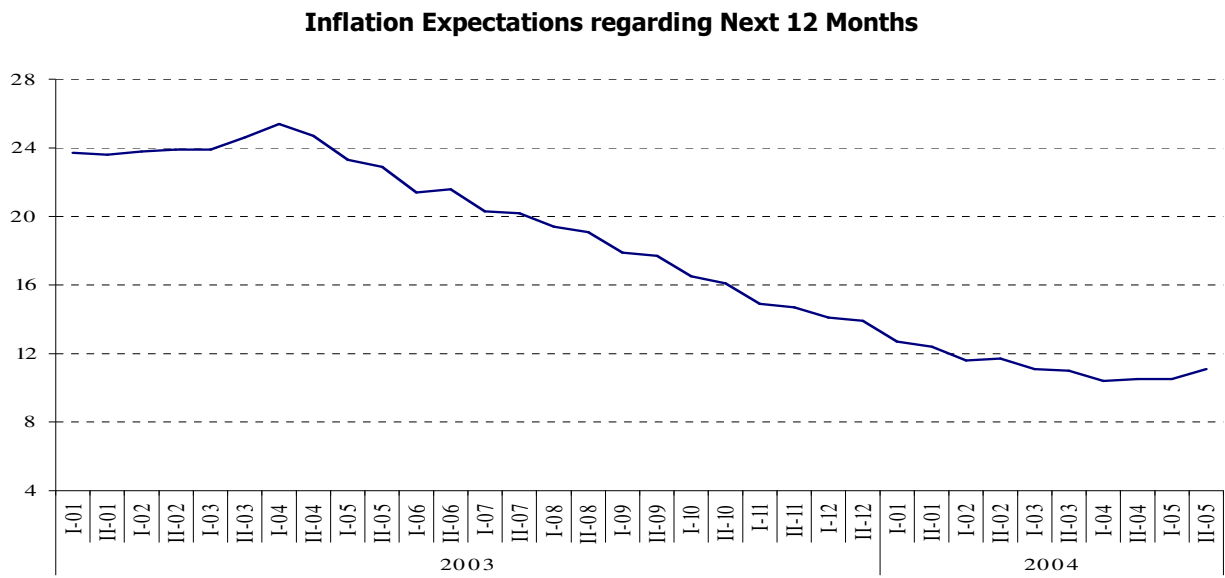
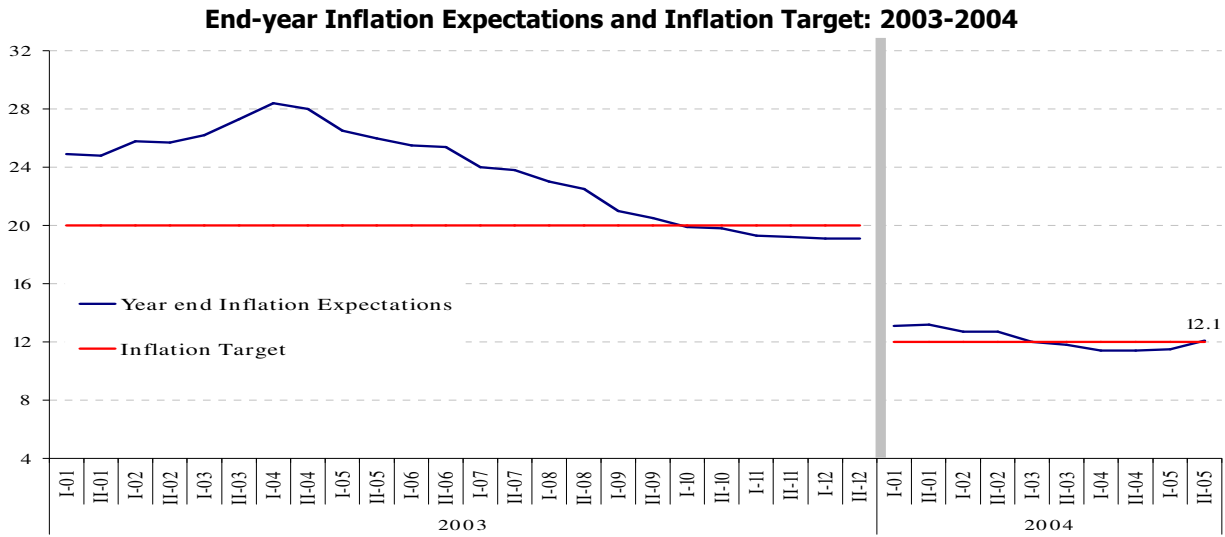
- Albeit slight decline in the last few months, the rigidity in the services sector still persists. In the upcoming months, the prospective vanishing of the compensating effect of goods prices due to cost pressure, might pose a risk to general CPI index.

**19.** In conclusion, effects of the recent increases in costs on inflation are deemed to be temporary and it is predicted that the already low inflation trend would display a further downward trend with the removal of these effects. Undoubtedly, the effects of recent developments on general inflation are temporary, whereas these effects would likely affect the end-year 12-month cumulative inflation figure. However, the point that must be emphasized is that despite all these shocks, the end-year inflation target is certainly attainable. According to the projections made on the assumption that the necessary signals are given about the continuation of fiscal discipline and structural reforms after 2004 and permanence of commitment mechanisms is ensured, it is projected that the annual inflation might slightly accelerate in the next few months mainly due to accounting period and partly to cost pressure, however the end-year inflation target would still be achieved.

**20.** The figures obtained in the first five months of the year point out to the remarkable progress made in the fight against inflation. However, it is evident that economic balances have not yet settled firmly and vulnerability, which was formed over many years, has not been entirely eliminated. The necessity to bolster the steps taken in the last three years towards attaining a permanent macroeconomic stability and price stability with fundamental structural reforms will be more pronounced apparently in the future.

**21.** The steps to be taken towards reforming tax management and social security will be perceived as positive signals with respect to increasing the quality of fiscal adjustment in the medium and the long run. Carrying out the structural reforms in legal and institutional areas is a sine qua non for removing the obstacles before increasing the efficiency of production factors. Establishing a production process, based on market rules and free competition, is necessary for attaining macroeconomic stability as well as for protecting price stability. Accordingly, every step to be taken and every signal to be given towards this goal would contribute to the progress in attaining lasting stability.

**Figure 5: Inflation Expectations according to CBRT Expectations Survey**



Source: CBRT Expectations Survey