April Inflation and Outlook

I. GENERAL EVALUATION

1. The downward trend in consumer inflation rates continued in April 2004 as well and annual inflation rate dropped to 10.2 percent in CPI. A relative acceleration was observed in WPI due to the effect of agriculture prices and annual inflation became 8.9 percent in WPI.

2. Seasonally adjusted monthly price increases realized as 1.7 percent and 0.2 percent in WPI and CPI, respectively. Inflation rates of CPI excluding food and WPI excluding agriculture displayed a slowdown compared to March and became 0.6 and 1.1, respectively.

Table 1: General CPI, WPI and Sub-items

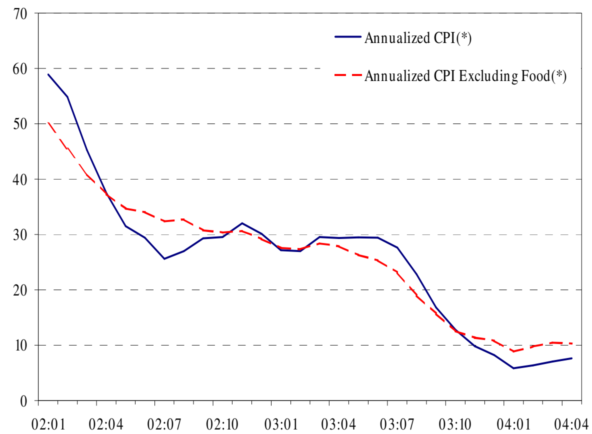
	Annual % Change		Annual % Change			
	2003 April	**2004 April**	**2004 February**	**2004 March**	**2003 April**	**2004 April**
CPI	**29.5**	**10.2**	**0.6**	**0.9**	**2.1**	**0.6**
Goods	29.4	5.9	0.0	1.0	2.5	0.6
Services	29.7	18.8	1.5	0.7	1.3	0.6
Excl. Food	29.3	11.4	0.3	0.5	2.1	0.6
Food	30.0	6.6	1.5	2.2	1.9	0.6
WPI	**35.1**	**8.9**	**1.6**	**2.1**	**1.8**	**2.6**
Public	37.7	3.9	0.7	3.0	-1.2	0.5
Private	34.1	10.8	2.0	1.8	2.9	3.5
Public Man.	43.2	5.7	1.1	4.1	-0.9	0.4
Private Man.	29.4	7.5	0.1	0.7	0.7	1.5
Agriculture	42.1	16.5	5.4	3.6	7.2	6.9
Excl. Agriculture	32.8	6.2	0.3	1.6	0.0	1.1
Excl. Agr.and Energy	33.9	6.7	0.4	1.7	0.0	1.2

Source: CBRT, SIS.

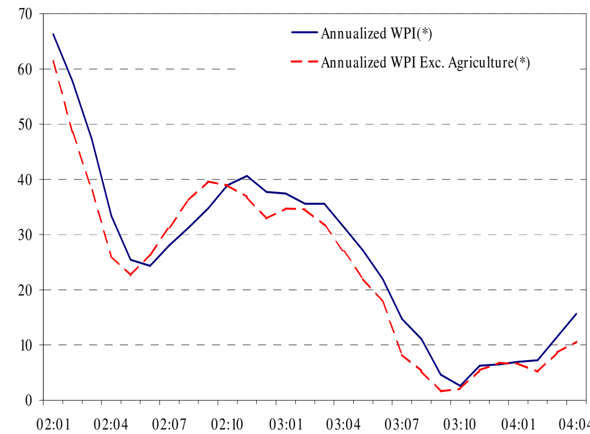
3. The six-month average of seasonally adjusted inflation became 1.2 percent in WPI and 0.6 percent in CPI. Annualized figures correspond to 15.6 percent and 7.6 percent, respectively. During the same period, the average rate of increase in seasonally adjusted CPI excluding food realized as 0.8 percent. This figure corresponds to 10.3 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. The most significant development in terms of sub-items was noted in prices of durable goods group. Especially the decline by 7.9 percent in prices of household electrical-non-electrical devices compared to the previous month is remarkable. Delayed effects of exchange rate along with the sales campaigns are deemed to have contributed to the downward trend in prices of this group. However, it is anticipated that the depreciation of Turkish Lira in the last two weeks of April may exert pressure on the prices in this group.

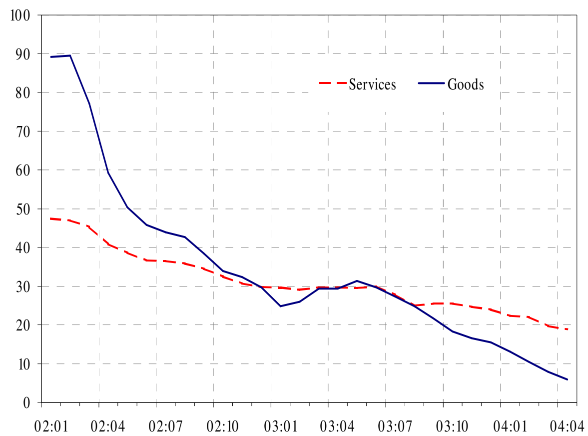
5. Price increases in clothing group were limited by 4.8 percent in April as of which the summer season has opened. This limited rate of increase is considered to be a favorable development. Clothing prices display high rates of increases twice a year with the opening of new seasons in April and October. However, the prices dropped by 5.7 percent in April 2004 compared to the beginning of the previous season (October 2003).

6. As for the general trend in services group, seasonally adjusted inflation maintained its general level of 2004 by 1.2 percent rate of increase. Despite the relative slowdown in rent increases observed in the last two months, no significant breakdown was recorded in the rigidity in services group prices. Services group price increase was 4.6 percent in the first four months of the year, while price increase in goods group was limited by 1.8 percent. Annual rate of price increase as of April is 5.9 percent in goods group and 18.8 percent in services group.

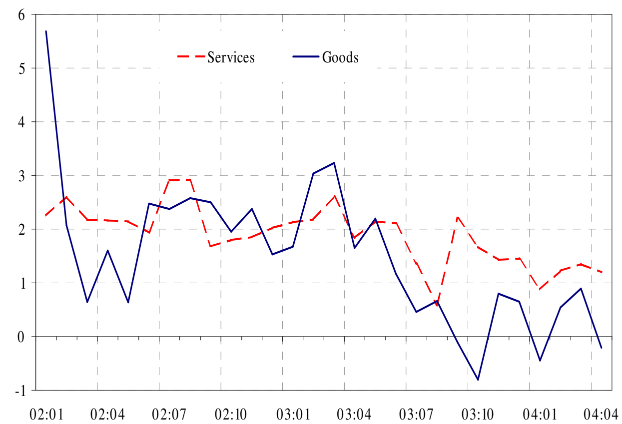
7. Along with the limited rate of increase observed in clothing prices despite high seasonality in April as well as the decline in durable goods prices, price increases in all other CPI sub-groups maintained their downward trend as well. Price increases in all the food-beverages-tobacco, housing, health, transportation and various goods and services groups realized between the range of 0-0.5 percent.

Figure 2: Prices of Goods and Services

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*

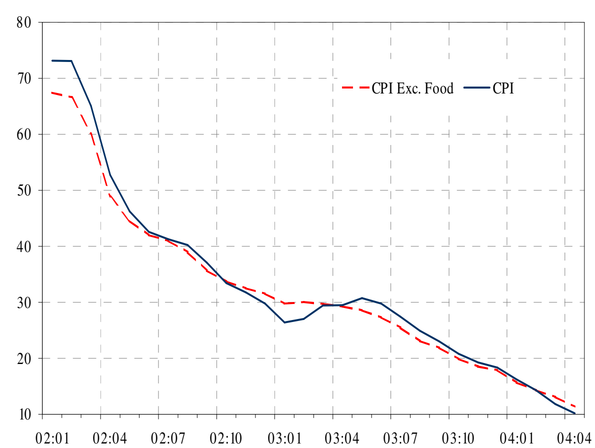


Source: CBRT, SIS.
***TRAMO/SEATS method has been used for deseasonalization.**

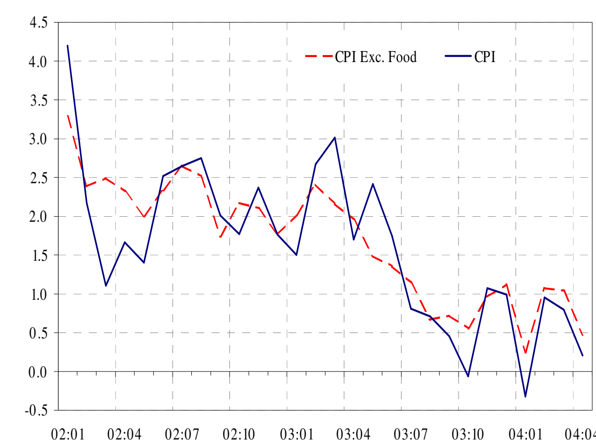
8. Thus, seasonally adjusted CPI inflation became 0.2 percent in April, realizing even below the average inflation rate of 0.5 percent recorded in the first quarter of 2004. The 0.4 percent monthly average inflation for the first 4 months of the year corresponds to 4.9 percent in annual terms.

Figure 3: CPI and CPI Excluding Food

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



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

Developments in Wholesale Prices

9. In April 2004, WPI increased by 2.6 percent. The rate of increase in seasonally adjusted WPI rose by 0.2 point compared to March and became 1.7 percent. On the other hand, WPI inflation excluding agriculture declined by 0.5 point compared to March and realized as 1.1 percent (Figure 4).

10. The largest contribution to WPI increase was made by the food prices (1.6 point) with a rise of 6.9 percent. Additionally, manufacturing industry prices contributed by 0.9 point to April WPI inflation with an increase of 1.1 percent. The increase in agriculture prices resulted partly from the recent inclusion of summer vegetables and fruits within the scope of WPI. Besides, seasonally adjusted rate of increase in agriculture prices rose by 2.8 points compared to March and realized as 4.5 percent.

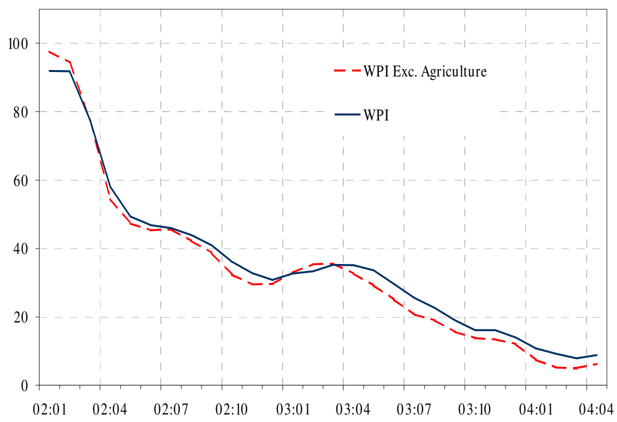
11. The decline in the rate of increase in monthly WPI excluding agriculture stemmed mainly from public manufacturing industry sector. In March, prices in tobacco products manufacturing sector rose with the tax increases imposed on tobacco products within the framework of supplementary budget measures, while prices in oil products manufacturing industry climbed due to the rise in raw material prices. However, prices in these groups increased at low rates with the removal of above-mentioned effects in April. On the other hand, basic metal industry prices, which had increased in line with the upsurge in international raw material prices in January-March period, continued to rise in April as well. Public basic metal industry prices rose by 3.6 percent in April compared to March.

12. The rate of increase in private manufacturing industry prices rose by 0.8 point from March and realized as 1.5 percent. Basic metal industry sector, which was negatively affected by raw material prices like public manufacturing industry, has contributed to this development. The rate of increase in private basic metal industry sector rose by 8 points compared to March and realized as 9.7 percent. As it is known, the recent prices of raw materials used in basic metal industry were affected by the pressure on the markets caused by the high rate of growth in China. However, this effect has started to weaken recently. Furthermore, the aforementioned pressure is likely to maintain its weakening trend in the medium term due to the policies implemented in China to cool the economy as well as the structural transformation of Chinese economy.

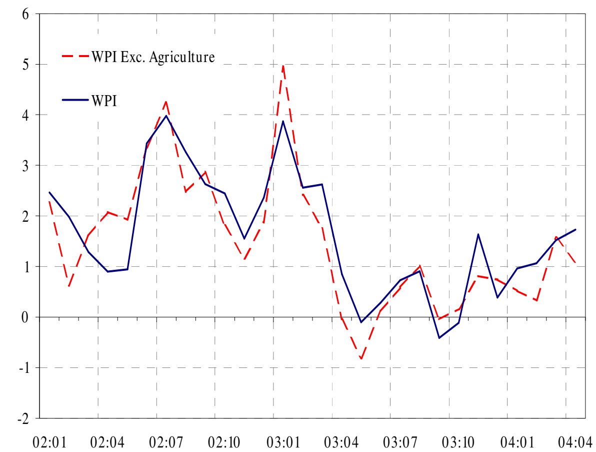
13. As of April, electricity-water-gas prices declined by 1.6 percent in monthly terms and by 1.8 percent on an annual basis. Increase observed in exchange rates in April will unlikely be reflected on electricity and natural gas prices.

Figure 4: WPI and WPI Excluding Agriculture

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



Source: CBRT, SIS.
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14. In line with the developments mentioned above, annual WPI inflation and WPI inflation excluding agriculture rose to 8.9 percent and 6.2 percent, respectively.

II. OUTLOOK

General Macroeconomic Outlook

15. Attributing the favorable developments observed in Turkish economy in recent years merely to external factors means overlooking some basic facts. Important steps were taken towards achieving stability in the last period. While macroeconomic indicators improved rapidly, significant changes were made in institutional structure compared to the previous periods. It is clear that the recovery in the general trend of the economy will continue as long as the same approach is maintained. We should remember that the external shocks and uncertainties arising from Iraqi operation in the first months of 2003, which were much greater, had only limited effects on the economy. Hence, the downward trend in inflation and the recovery process in economic activities continued in the period following the removal of these unfavorable factors. It should also be kept in mind that the general trend dominated following the volatility in exchange rate in October 2003 similar to the volatility observed in recent weeks and the downward trend in inflation as well as growth in the economy continued.

16. The signals given by the Federal Reserve Bank of the USA for a likely rise in interest rates in the coming months lead to changes in global liquidity and risk trends, thus increasing the fluctuations in the financial markets of developing countries despite the fact that there is not an obvious change in basic economic indicators. Turkish economy is affected by a similar trend too, despite the relatively strong course of basic economic indicators in recent years and some periodic uncertainties on foreign policy, and the concurrence of these developments and the increase in current account deficit reinforces this effect. However, the point that should be underlined here is that the unfavorable impact of recent developments are bound to be temporary under the assumption that the current program will be carried out without any compromise. Especially the social security and tax reforms that would ensure a sustainable fiscal discipline must be realized rapidly and determinedly.

17. The last three years of experience under the floating exchange rate regime highlighted the importance of expectations management and future-looking perceptions of economic agents with respect to macroeconomic balances. The most significant lesson to be derived from these developments is that not only nominal anchors but also concrete, transparent and accountable programs are required in order to achieve stability and to shape future-looking perceptions. In other words, the most important economic anchor perceived by public is highly credible stipulation with concrete arrangements and reforms which would sustain the discipline in economic policies and reduce the fragility in general economic policies, rather than monetary or fiscal variables.

18. Current program has made great contributions to the fight against inflation and to the structural reform efforts. Nevertheless, it is clear that these efforts are not adequate. Economic balances have not been established permanently and price stability has not been completely achieved yet. While entering into a period where uncertainties about external factors are increasing, it is of critical importance that strong signals should be given for the continuation of current program, which has proved to be successful in many fronts so far. In other words, the perception of commitments made for the achievement of minimum fragility in the fundamentals of the economy as credible is now much more important than ever. Therefore, the willpower on the continuation of the economic program, which ends in early-2005, will contribute to the achievement of permanent macroeconomic stability in the medium term, while it will be contributing to reduce the fragility in the short term. It should be kept in mind that achieving a sustained and high growth as well as price stability depends on the enforcement of structural transformation process in the medium term and the perception of the commitments made for this transformation process as credible by economic agencies in the short term. Thus, the need for a program focused on structural reforms starting from the next year, which involves structural criteria within the framework of a general and medium-term plan and aims at continuing its achievements, is the most significant fact that should be underlined.

19. Current account deficit started to expand due to the upsurge in imports, which gained momentum owing to the recovery initiated in economic activities in the last period. However, in an economy where fiscal policy is on track, the current account deficit is not expected to display long-term deviations from general tendency. Hence, it is predicted that it should start to shrink in the coming months even though current account deficit is predicted to realize at a high level in the first four months of the year. Despite the three-year experience in the floating exchange rate regime, it is observed that some dynamics with respect to current regime, current account deficit and exchange rates are still not fully comprehended. In the course of the implementation of fixed/managed exchange rate system in the past, a rapid increase in current account deficit was the source of serious concerns, because an increasing current account deficit in economies based on exchange rate anchor, by which the exchange rate is pre-announced, would undermine the committed exchange rate levels after a while. This mechanism is still fresh in minds in our country, where an exchange rate policy, based on level of exchange rates, was implemented for years. Undoubtedly, in a world where capital movements are considerably free and intense, the relationship between exchange rate and current account deficit may be broken off from time to time. However, since the exchange rate reacts against an information set involving all forward-looking information under current exchange rate regime, perceptions for future current account deficits ultimately affect exchange rates and exchange rate gives both lower wavelength and higher frequency-reactions. Hence, these movements are deemed "natural" in floating exchange regime.

20. At this point, the importance of risk management of financial and real sectors in the environment of floating exchange rate regime and declining inflation once more manifests itself. In the banking sector, whose financial structure was strengthened via the restructuring program, banks' interest margins narrowed and their yields arising from the drops in interest rate and exchange rate reduced due to the significant decline in inflation. In this period, it is essential that banks attribute high importance to growth for the sake of better harmonization to the declining inflation environment.

Inflation

21. The increase in CPI pursued its favorable course in April as in the previous months and remained cumulatively at 2.8 percent in the first four months of the year. The decline in inflation resulted especially from the positive course of expectations and the appreciation of TL in the first quarter of the year. The partial recovery of domestic demand limited the impact of agriculture prices on food ongoing positive course of unit labor costs continued to keep the inflation under control.

22. It was repeatedly emphasized since the beginning of 2004 that though annual CPI inflation figures would decline until May and might display an upward trend as of May, this development would completely be in line with the inflation target. It should be once more underlined that the right perception of the significance of the projected course of 12-month cumulative inflation figures in terms of the formation of expectations in the coming months is of vital importance. In the first 5 months of 2003, inflation rates climbed because of price hikes in food and agricultural products arising from cost-push factors caused by Iraq War as well as adverse weather conditions. With the removal of the said conditions, CPI inflation pursued a rather modest trend for the rest of the year. These developments led to an obvious discrepancy in inflation trend between the first and second halves of 2003. As a natural outcome of this effect, the downward trend in annual inflation continued evidently in the first four months of 2004. On the other hand, even though annual inflation rates may display stagnation or rise due to the reverse of this effect or a likely increase in cost pressure in the second half the year, such a development will be temporary and be consistent with the inflation target in view of current data.

23. Undoubtedly, the recent exchange rate movements will have effects on prices via the prices of imported goods and production costs. However, these effects are predicted to be limited compared to the past. In fact, with adoption of the floating exchange rate regime, the policy of making exchange rates artificially predictable has been abandoned and both upward and downward short-term movements have been observed in the exchange rates, therefore, foreign exchange-denominated financial instruments are no more secure investment instruments and the habit of indexation of prices to exchange rates have changed. Within this context, floating exchange rate regime policy is believed to have caused a structural change in the pass-through between exchange rate and inflation. Furthermore, the Central Bank's policy focusing on future course of inflation, a more competitive environment, decline in inflation and tight fiscal policies that have been implemented for the last two years are changing pricing behaviors, affecting expectations and contributing to the weakening of the pass-through from exchange rates to inflation. In fact, the empirical studies show that past inflation is still an important parameter for inflation expectations; however, the effect of the inflation target on expectations has increased significantly in the last period. These studies also indicate that the effect of exchange rates on inflation started to diminish compared to previous terms. In this context, according to the figures pertaining to the first four months of the year, the inflation is expected to display temporary rises in the upcoming period, however, it is predicted that such a rise would not reach a level that would jeopardize the inflation target. Moreover, the margin created as the course of consumer prices inflation in the first four months of the year remained even below the course consistent with the inflation target, indicates that the temporary deviations from the main tendency would not threaten the end-year target.

24. The factors that might affect the inflation dynamics in the upcoming period are as follows:

- As of March, the ratio of capacity utilization has reached historic highs with 82.3 percent, which indicates that unless new investments continue, the supply-demand balance will not support the decline in inflation as much as it did in 2003. However, it is projected that no significant domestic demand pressure would be observed in 2004 as long as the tight fiscal policy and the incomes policy consistent with the target are carried out.
- The increase in metal industry prices, which put pressure on public and private manufacturing industry prices in March and April, respectively, would slow down parallel to the decline in prices around the world as of the upcoming months.
- Exchange rate movements would increase the input costs of imported intermediate goods and affect inflation directly via imported consumption goods as well. However, this effect

would remain rather weak compared to the pre-2001 period due to the reasons mentioned above.

- The budget-financing requirement, which may increase due to the sustained increase in world oil prices and exchange rate pressure, would make increase in the prices of petroleum and oil products inevitable. Moreover, as the exchange rate movements that emerged lately would probably not be reflected to electricity prices, the general cost of energy would continue to be kept under control.
- It is predicted that unit labor costs would continue to contribute positively to inflation throughout 2004 as a result of the increase in productivity in manufacturing industry; however, this contribution would not reach a level observed in the last two years. Nevertheless, taking the necessary measures for enhancing investment and production is a pre-requisite for sustained increase in productivity.
- As a by-product of the increasing credibility of economic policies, the end-year inflation expectations are predicted to remain in the targeted track in the upcoming months.
- The rigidity in services sector inflation continues relatively and therefore, the possibility of the offsetting effect of the prices of goods to disappear (due to the cost pressure) in the upcoming months, is considered as a risk for the general CPI index.

In conclusion, it is predicted that, with the tight monetary and fiscal policies, the relative advantages provided by the unit labor costs would continue to support inflation; inflation might display a periodic rise due to the uncertainty in the exchange rate-inflation pass-through, however, the latest developments would remain as mere temporary deviations from the baseline trend and the end-year inflation target is perceived to be still within reach. Undoubtedly, it should be noted that these predictions are made under the assumption that there would be no deviations from the fiscal discipline, the steadfast implementation of the current program would continue and the structural reforms would not be interrupted.