

FEBRUARY INFLATION AND OUTLOOK

I. GENERAL EVALUATION

1. In February 2003, WPI and CPI increased by 3.1 percent and 2.3 percent, respectively. Compared to February 2002 (WPI 2.6 percent, CPI 1.8 percent), acceleration of monthly increases caused an upward push in the annual WPI and CPI inflation. Annual inflation rose to 33.4 percent in WPI and to 27 percent in CPI. Seasonally adjusted increases are 3.1 percent in WPI and 2.8 percent in CPI.

2. Since no significant revival has yet been seen in consumer demand, the cost increases of the January-February 2003 period have been barely reflected on the consumer prices.

3. Increase in agricultural prices and food prices were instrumental in WPI and CPI inflation. Increases in WPI (excluding agriculture) and CPI (excluding food) realized as 2.4 percent and 1.5 percent, respectively. Rent was the main sub-item that limited the increase of CPI, whereas private manufacturing prices, which slowed down due to TL appreciation, reduced the increase of CPI.

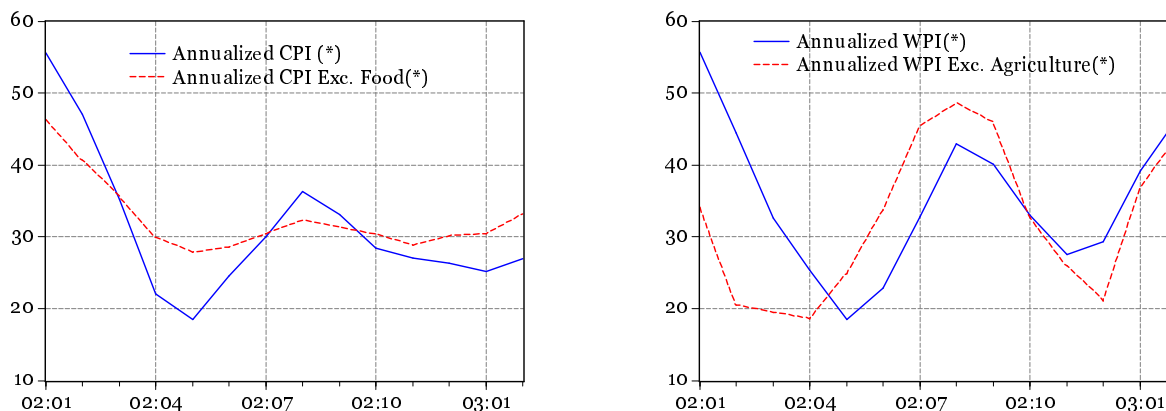
Table 1: CPI, WPI and Sub-items

	Year-on-Year % Change		Monthly % Change			
	2002	2003	2002		2002	2003
	February	February	December	January	February	February
CPI	73,1	27,0	1,6	2,6	1,8	2,3
Goods	89,5	26,0	1,6	2,3	1,5	2,5
Services	47,0	29,1	1,7	3,1	2,3	1,8
Excluding Food	66,6	30,0	1,3	2,5	1,3	1,5
Food	95,2	18,1	2,9	3,0	3,2	4,8
WPI	91,8	33,4	2,6	5,6	2,6	3,1
Public	99,4	42,9	1,6	7,3	0,5	3,8
Private	89,2	29,9	3,0	4,9	3,3	2,9
Public Manufacturing	98,8	48,8	2,8	8,5	0,4	4,1
Private Manufacturing	91,7	30,5	2,0	3,6	0,7	1,5
Agriculture	84,5	27,4	5,2	7,7	8,9	5,6
Excluding Agriculture	94,4	35,4	1,9	5,0	0,6	2,4
Excluding Agriculture and Energy	93,2	36,7	2,0	5,2	0,7	2,5

Source: SIS, CBRT

4. Average of seasonally adjusted inflation during the last three months was 3.2 percent in WPI and 2.0 percent in CPI. These rates correspond to annual average increases of 46.3 percent and 26.9 percent for WPI and CPI, respectively. Thus, annual CPI and WPI inflation calculated by this method rose in February compared to the previous month.

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



(*)Annualized 3 month moving average of seasonally adjusted data

Developments in Consumer Prices

5. The increase in CPI mainly stemmed from the increase in food prices by 4.8 percent. The seasonal rise in food prices, which was expected in January, realized partly in February. It is assumed that the sharp increases in agricultural prices that have been continuing since the last quarter of 2002 also played an important role in the rate of increase in February food prices.

6. While the increase in goods prices realized at 2.5 percent owing to the rise in food prices, the increase in service prices became 1.8 percent due to the low level of rental rise, despite the price adjustments in health services. As to the seasonally adjusted prices, price increases in service sector was 2.1 percent in services and 3.1 percent in goods. As of February, annual prices rose to 26 percent in goods, while dropping to 29.1 percent in services (Figure 2).

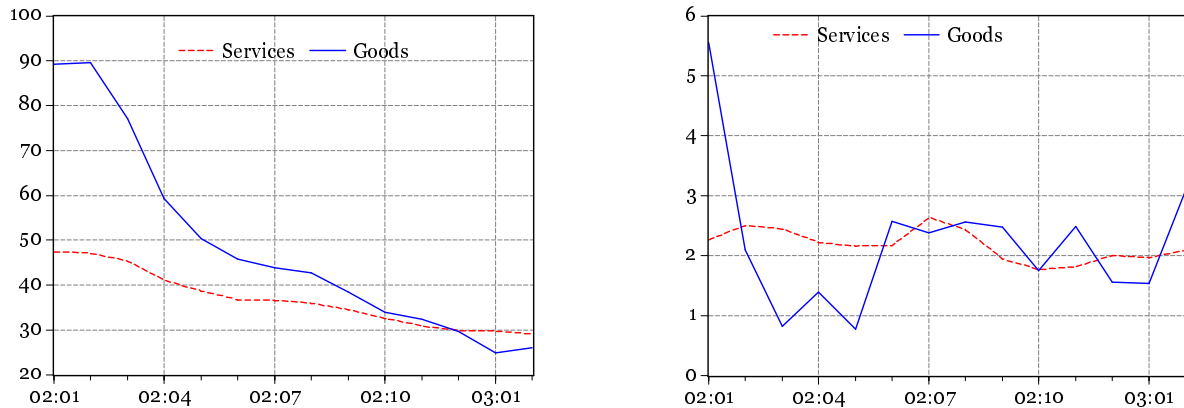
7. Rents became the main sub-item, which limited the increase in February CPI inflation, while housing rents recorded the lowest monthly increase in the January 1994-February 2003 period by 0.9 percent. In February, housing group prices increased by 1.4 percent due to the rises in heating expenses in line with hikes in petroleum prices and the increases in water prices. The course of rent increases in the rest of the year bears great importance to the inflation target.

8. Transportation is another sub-item, which was affected by the rise in petroleum prices. The rise of 4.1 percent in transportation prices in February remained

considerably above the overall CPI increase. Moreover, the increases in petroleum prices, which have accelerated recently due to hikes in international crude oil prices, will likely be reflected on prices in transportation services in the next period.

Figure 2: Prices of Goods and Services

Year-on-Year Change (%) **Monthly Change
(Seasonally Adjusted(*), %)**

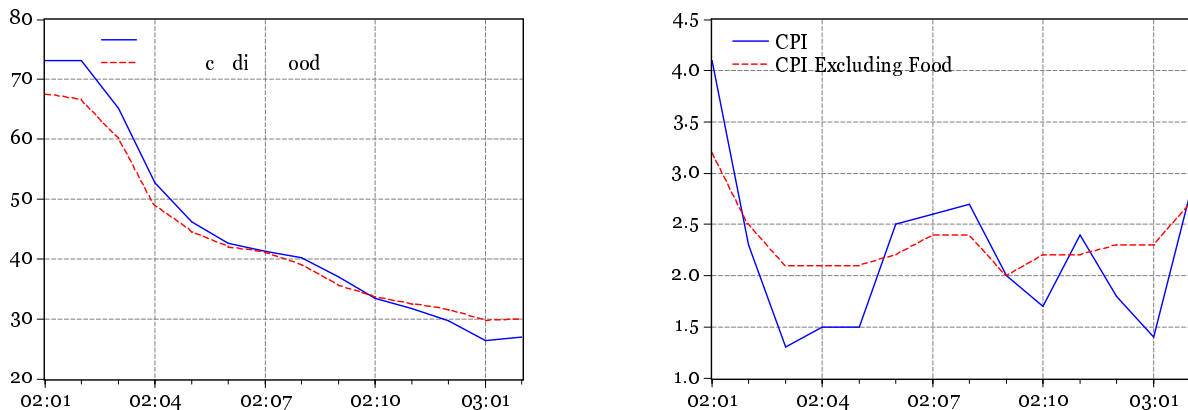


Source: CBRT; SIS
 (*) TRAMO/SEATS methodology is utilized for seasonal adjustment.

9. Seasonally adjusted CPI increase, which was 1.4 percent in January, recorded its highest level of the last 12 months with 2.8 percent in February. This development mainly stemmed from the change in the seasonal behavior of food and health prices.

Figure 3: CPI and CPI Excluding Food

Year-on-Year Change (%) **Monthly Change
(Seasonally Adjusted(*), %)**



Source: CBRT; SIS
 (*) TRAMO/SEATS methodology is utilized for seasonal adjustment.

Developments in Wholesale Prices

10. The increase in the international crude oil prices had a significant effect on the rate of increase of WPI in February. Apart from this, domestic petroleum prices that are adjusted in accordance with the automatic pricing system rose due to the adjustment of special consumption tax according to the inflation rate of the previous month as well as the increase in international crude oil prices. Thus, this was another factor that had a negative impact on the rate of increase of WPI. Agriculture prices that were increased due to flood disaster in Antalya, besides the seasonal effects, also played an important role in the upward trend of WPI in February.

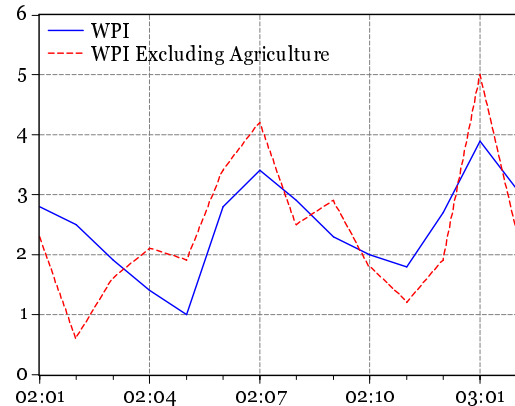
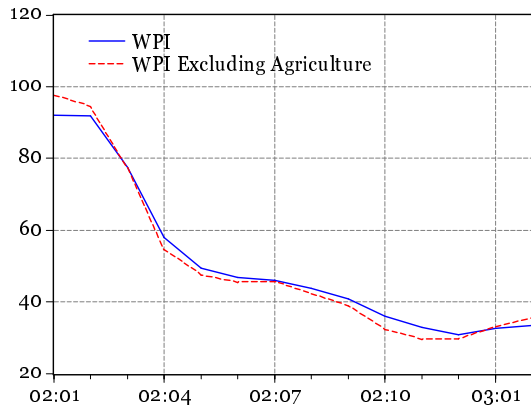
11. In February, the rate of increase in agricultural sector prices became 5.6 percent, remaining below 8.4 percent, the February average of the last eight years. The rate of increase in seasonally adjusted agricultural prices, which was 3.7 percent in January, decreased to 1.6 in February. The rate of increase of WPI, excluding the agricultural sector, declined compared to January and became 2.4 percent. In overall WPI, the seasonally adjusted rate of increase dropped by 0.8 points and realized at 3.1 percent.

12. In February, rising international crude oil prices had an effect on the public manufacturing sector prices that increased by 4,1 percent. Consequently, petroleum products manufacturing industry, which rose by 6.5 percent, made the major contribution to the increase in public manufacturing industry prices in February. When the petroleum products are excluded, the rate of increase in public manufacturing industry prices decreases to 1.2 percent. Considering the 6.6 percent of January, this drop shows a relative slowdown in the public price adjustments. Nevertheless, the rate of increase in public manufacturing prices maintained its upward trend on annual basis and reached 48.8 percent.

13. The rate of increase in private manufacturing prices slowed down significantly compared to January. As in the public manufacturing sector, petroleum-manufacturing sector made the major contribution to the increase in private sector manufacturing prices in February. Besides, the slowdown in prices of basic metal, metal products, machinery and equipment compared to January, which are sensitive to exchange rate developments, can be attributed to the appreciation of Turkish lira against US dollar by 2.0 percent in nominal terms. Due to these developments, annual rate of increase in private manufacturing sector prices rose by 1 percentage point in February compared to January and realized at 30.5 percent.

Figure 4: WPI and WPI Excluding Agriculture

Year-on-Year Change (%) **Monthly Change**
(Seasonally Adjusted(*), %)



Source: CBRT; SIS

(*) TRAMO/SEATS methodology is utilized for seasonal adjustment.

14. In February, energy prices rose by 0.7 percent. Despite an increase of 2.8 percent in water prices, the rise in energy prices was limited due to the increase in electricity prices by 0.2 percent. On annual basis, water prices increased by 31.6 percent, while electricity and natural gas prices rose by 13.7 percent.

15. Downward trend observed in WPI inflation since February 2002 had been interrupted in January 2003. The rate of increase in WPI on annual basis maintained its upward trend in February as well and reached 33.4 percent. Moreover, annual rate of increase in WPI excluding agriculture rose in February, as it was the case in January (Figure 4).

II. SIGNIFICANCE OF FISCAL DISCIPLINE WITH RESPECT TO GROWTH AND INFLATION

16. It is considered useful to underline once again, as reiterated many times by the Central Bank since the initiation of "Transition Program for Strengthening the Turkish Economy", that in countries with high public debt, expectations on the sustainability of debt stock are the main determinant of economic developments, especially of inflation and growth dynamics.

17. The ratio of public debt to GNP is a major indicator on which domestic and international markets are focused, and is included among the Maastricht criteria as well. The current level of this ratio provides vital clues as to the economic policies that have been adopted in a country for years. Besides, the future values of this ratio will be the main indicator that will reveal to what extent the current and future economic policies are "right" policies.

18. Putting the ratio of public debt to GNP on a downward trend in the course of time is the only way of reducing the unacceptable high level of real interest rates to reasonable levels in our economy. This is a must for the Turkish economy.

19. As is already known, a downtrend trend in the ratio of public debt to GNP can only be achieved by producing a primary budget surplus, pushing up the growth rate, lowering real interest rates, and safeguarding the value Turkish Lira. Economic policy-makers can exercise a direct control over only one of these factors; and it is the size of primary budget surplus. The other three variables will be determined by the strict budget policy and other economic policies consistent with such budget. Therefore, these are not controlling variables.

20. What is often misunderstood is that producing primary surplus, which is needed to put debt dynamics on track, not only reduces the ratio of domestic debt to GNP, but also has three additional favorable effects that are also very important.

21. The key factor is to convince economic agents on the sustainability of domestic debt. The level of primary surplus closely affects the opinions about the sustainability of domestic debt. The more optimistic expectations for the sustainability of domestic debt become widespread and improve; the lower will be the risk premium, and the real interest rates. The striking drop in real interest rates in the first half of the year, and after the elections is the most significant proof of this. This is the first effect. As was the case during the first half of 2002 and right after the elections, the decrease of the risk premium will prevent a depreciation of the Turkish lira in real terms. This is the second positive effect on the debt dynamics.

22. The third positive effect is the growth effect, which is not yet fully understood by many sections. Generally, it is claimed that the primary surplus imposes restraints on public expenditures and increases the taxes, which in turn allegedly decreases the

aggregate demand and makes a negative impact on growth. If the only effect of primary surplus had been this one, those who establish an inverse correlation between primary surplus and growth would have been right. However, the consumer and investor confidence would be bolstered by means of the above mentioned two indirect effects of an adequate primary surplus, in other words, with the substantially reduced real interest rates and the stable exchange rate, which in turn, would boost consumer and investor spending. Moreover, such a stable environment will make Turkey, as a country having the largest economy among all the EU candidates, more attractive for foreign investments. Like in all countries that have huge public debt stock, the primary budget surplus will make a favorable effect on growth.

23. This point is extremely important, and it is not a mere theoretical probability. In 1980s, a number of European countries suffering from very high ratios of public debt stock to GNP, implemented fiscal discipline policies for two or three years and increased their primary budget surplus substantially, and attained very high growth rates in the same period. Surprisingly enough, the growth rates attained have been higher than those attained in the periods when there was no fiscal discipline. This experience in the mid-1980s is referred to as the “growth effect of contractionary fiscal policies” in literature.

24. In the light of the above-mentioned explanations, it should now be evident that the actual importance of fiscal discipline for disinflation efforts comes not from its decreasing effect on aggregate demand by slashing public expenditures, but from its providing stability to the markets by building confidence in the economic units about sustainability of debt. This stability will certainly lessen the cost-push inflation. In 2002, the slump in inflation was based on such stability. In other words, it cannot be said that primary surplus would correspond to a certain inflation rate by focusing only on its reducing aggregate demand without analyzing its effects on debt sustainability. The level of inflation can be attributed not only to the level of primary budget surplus, but also to what extent market players are convinced that there would not be any problem with debt sustainability.

25. It is no doubt that how the primary surplus is produced is also an important issue. Other than the price adjustments resulting from exogenous shocks, making increments in the public prices above the targeted inflation cannot be justified. Such a policy may create a budget surplus initially, however it would then lead to rise in inflation and a nominal growth in spending items of the budget. Likewise, price adjustments below the targeted inflation rate would again jeopardize the fiscal discipline.

26. Achieving debt sustainability by sacrificing disinflation process would not be a viable option, not only because it would increase the risk premium under the given conditions but also because 75 percent of the domestic debt stock is comprised of floating rate debts.

27. It will be useful to reiterate what we have mentioned so far: It is essential to make

Turkish economy less vulnerable to changes in expectations of economic agents. This can be achieved by establishing a fiscal discipline. Therefore, reducing the inflation to an acceptable level will simultaneously help to achieve a more equitable income distribution, and a growth rate at the level of the potential growth rate.

III. OUTLOOK

28. According to the results of the CBRT Expectations Survey for the second half of February, the expected end-year CPI inflation is 5.8 percentage points above the targeted inflation. The average expectation for the next 12 months, which was 23.8 percent in the first half of February, went up to 24 percent in the second half. Thus, the downward trend observed in inflation expectations since August 2002 was interrupted in February (Figure 5). It is evident that the debates over primary surplus, the delays in reaching a consensus on the measures to be taken to attain fiscal discipline, and the uncertainties around the Iraq issue have made a strong impact on this development.

29. The future course of inflation depends mainly on two points: The first one is the economic fundamentals as usual. The second is the degree of impact of developments in Iraq on our country.

30. The extra measures introduced in the 2003 budget together with the current monetary discipline denote that the economic fundamentals will be strengthened even further. Taking into account of the success of the program in reducing inflation in 2001, it will be realistic to expect the downward trend to continue provided that the measures are implemented timely and decisively. Bringing both the nominal and the real interest rates down to the targeted levels in the program can only be possible under these conditions.

31. Furthermore, the way these measures are organized indicates that the inflationary pressure on the public side would not be so high in the rest of 2003. On the contrary, as part of them envisages public sector saving on personnel expenditures, and increase in real estate and motor vehicle taxes, the said measures are expected to make a restraining effect on the domestic demand.

32. It is possible to write various scenarios on the course of inflation depending on how the Iraqi problem will be settled, how long the military operation in Iraq will last, if there will be an operation, and what Turkey's role will be in such operation.

33. The point to be highlighted here is: If we consider the period starting from this very moment till the end of the Iraqi problem as the "extraordinary period", it is clear that the downward trend in inflation will continue also after the "extraordinary period" provided that the economic program is strictly implemented together with the reinforced economic fundamentals.

34. The main source of worry that creates uncertainty is whether a temporary deviation will happen from the downward trend in inflation during the "extraordinary period" due

to the possibilities mentioned in Article 32. The word “temporary” is to be underlined here. On condition that the program that succeeded in decreasing inflation is pursued with determination, the downward trend in inflation will continue to be the main trend and any price increases due to rise in costs will remain as temporary deviations from the main trend. However, the word “temporary” does not necessarily mean that the deviation will last for a very short time.

35. At this point, the main question to be asked is: “How much deviation from the main trend should be expected in this extraordinary period?”

36. We have just mentioned that it is possible to produce many different scenarios for this period. If some of these scenarios come true, no significant upward movement should be expected in inflation. Therefore, under these scenarios, a deviation, even a temporary one, is a low probability.

37. If the scenarios that would bring about temporary deviations from the main trend come true, then we may expect some cost-push pressures. The possibility of a further rise in oil prices is regarded as an important factor that might adversely affect manufacturing costs. Moreover, deterioration in the expectations due to exogenous shocks, and the resulting probable fluctuations in the markets are likely to disrupt the disinflation process. Assuming that domestic demand would not exert much pressure on inflation under the given conditions, it is possible to state that these effects will be compensated to some extent.

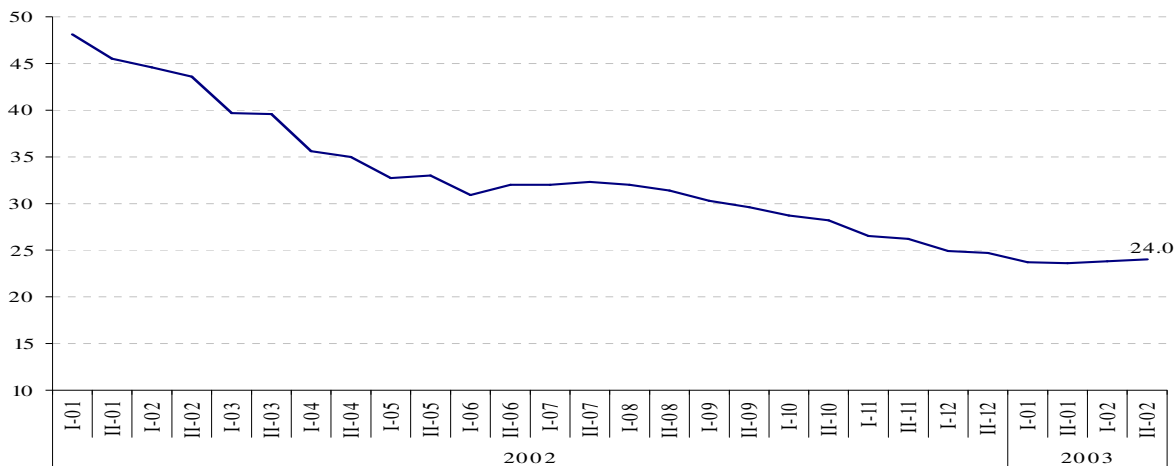
38. There is one more important point to be emphasized and taken into consideration in the shaping of future expectations: According to the inflation expectations obtained by using various methods under the case scenarios in which the economic program is strictly implemented, there is no problem in Iraq, or there is no significant deviation from the main trend in inflation, even temporary, the annual consumer price inflation is expected to follow a stable course in the first half of the year, and to enter into a downward trend afterwards, and to reach the year-end target. Therefore, the fact that there is no significant fall in inflation in the first half of the year, or the fact that there may be even a slight increase, as it was the case in February, should not mean that the downward trend in inflation has stopped or reversed.

39. The reason for this development is the base effect created by the fluctuations observed around the main downward trend in inflation throughout 2002. There were two distinct movements in the main trend: The seasonally adjusted monthly inflation rates remained relatively low throughout the first half of 2002 owing to the nominal appreciation of Turkish lira, and the modest increase of food prices in the first half of 2002. However, the monthly inflation rates relatively increased in the second half of 2002 resulting from the TL depreciation, and public price adjustments made in June due to perception of political uncertainty after May 2002.

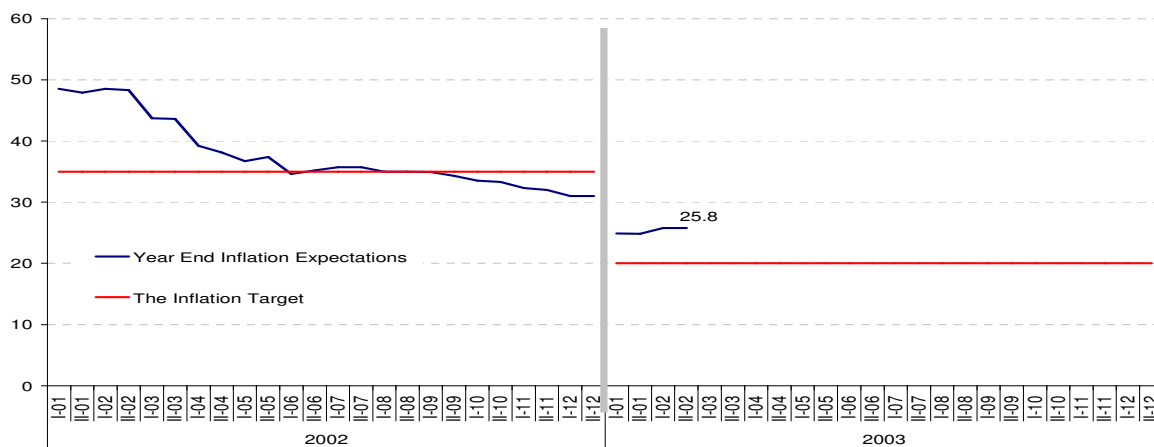
40. Consequently, the downward trend in inflation can only be sustained, if the envisaged measures are carried out, and the program is strictly implemented. In the medium term,

such trend will enable our economy to attain the inflation levels that the developed countries enjoy. Depending on which scenario comes true in the “extraordinary period,” it is expected that deviations from the main trend will either be negligible or temporary, on condition that the said measures are carried on.

Figure 5: Inflation Expectations According to CBRT Expectations Survey
Expected Inflation for the Next 12 Months



End-year Inflation and Inflation Target: 2002-2003



Source: CBRT Expectations Survey