

## MARCH INFLATION AND OUTLOOK

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

**1.** Downward trend in annual inflation rates continued in March 2004, and annual inflation figures dropped to 11.8 percent in CPI and 8 percent in WPI. Decline in annual inflation rates of CPI excluding food and WPI excluding agriculture continued as well, realizing as 13.1 percent and 5 percent, respectively.

**2.** In March, monthly price increases realized as 2.1 percent in WPI and 0.9 percent in CPI. Seasonally adjusted CPI inflation was 1.1 percent, while WPI became 1.5 percent.

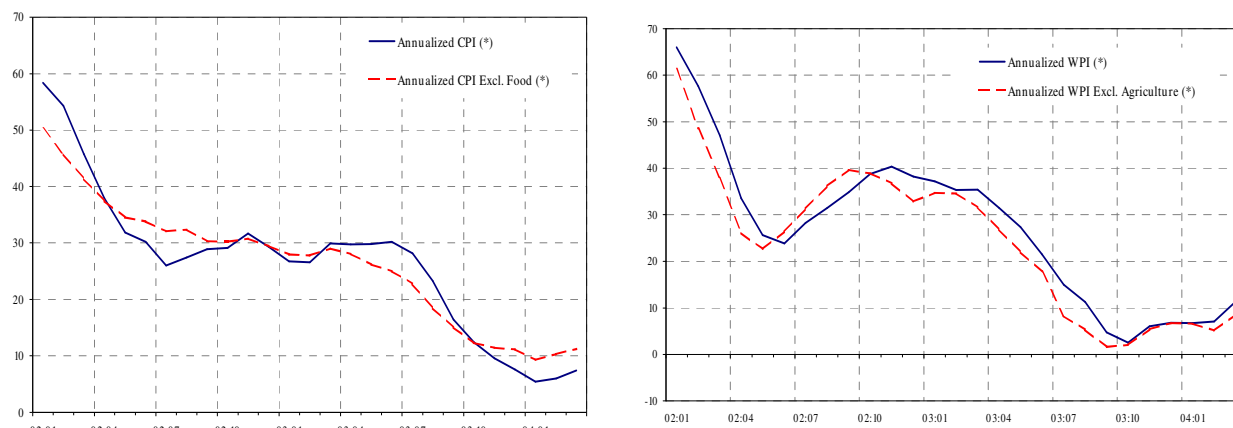
**Table 1: General CPI, WPI and Sub-items**

	Annual % Change		Monthly % Change			
	2003 March	2004 March	2004 January	2004 February	2003 March	2004 March
<b>CPI</b>	<b>29.4</b>	<b>11.8</b>	<b>0.7</b>	<b>0.6</b>	<b>3.1</b>	<b>0.9</b>
Goods	29.3	7.9	0.2	0.0	3.3	1.0
Services	29.6	19.7	1.8	1.5	2.7	0.7
Excl. Food	29.7	13.1	0.5	0.3	1.5	0.5
Food	28.5	8.0	1.4	1.5	8.2	2.2
<b>WPI</b>	<b>35.2</b>	<b>8.0</b>	<b>2.6</b>	<b>1.6</b>	<b>3.2</b>	<b>2.1</b>
Public	42.7	2.1	0.3	0.7	1.9	3.0
Private	32.4	10.3	3.5	2.0	3.7	1.8
Public Man.	47.6	4.4	0.7	1.1	1.8	4.1
Private Man.	30.9	6.7	0.6	0.1	1.6	0.7
Agriculture	33.9	16.8	9.3	5.4	7.8	3.6
Excl. Agriculture	35.6	5.0	0.5	0.3	1.8	1.6
Excl. Agr. and Energy	36.8	5.4	0.6	0.4	1.8	1.7

Source: CBRT, SIS.

**3.** The six-month average of seasonally adjusted inflation became 0.9 percent in WPI and 0.6 percent in CPI. Annualized figures correspond to 11.3 percent and 7.4 percent, respectively. During the same period, the average rate of increase in seasonally adjusted CPI excluding food realized as 0.89 percent. This figure corresponds to 11.2 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.** The downward trend in CPI inflation maintained its modest course in view of favorable cost conditions and positive expectations, and followed a path consistent with the end-year target of 12 percent in the first quarter of the year. However, the rate of increase in the prices of sub-groups, influenced by tax adjustments made in the supplementary budget, remained relatively above the general trend.

**5.** In March, the highest price increases were recorded in the food-alcoholic beverages-tobacco group and in the transportation group. The private consumption tax increases on tobacco and alcoholic beverages led to a 3.1 percent rise in the food-alcoholic beverages-tobacco group. On the other hand, the food prices excluding items mentioned above, maintained its downward trend of the first two months of 2004 with a 2.2 percent increase (zero percent in seasonally adjusted terms) in March. On the other hand, the price increase in the transportation group remained above the general increase in CPI and realized as 1.4 percent due to the 4 percent increase in personal vehicle repairs.

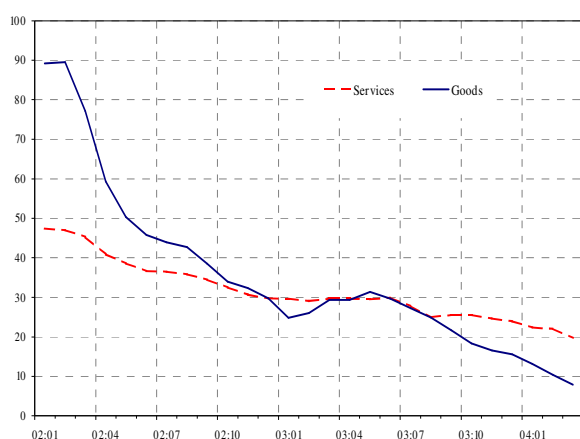
**6.** Rent increases in March were limited to 0.8 percent. The slowdown in rent increases may be considered as a positive development. House repair and maintenance –one of the sub-items of housing sector-, other expenditures for housing, and electric, gas and other fuel prices decreased by 1.7 percent, 0.3 percent and 0.1 percent, respectively. In an environment where CPI increases by 2.2 percent and CPI excluding food increases by 1.3 percent in January-March period, the 4.4 percent increase of rents shows the necessity of monitoring the rent increases more closely in the next period as well. On the other hand, the seasonally adjusted rate of increase in the services

group remained closer to its recent trend and realized as 1.4 percent. In this context, the downward rigidity in services group price increases seems to continue.

7. The positive developments in March include the decline in the prices of pharmaceuticals as a consequence of VAT adjustments and exchange rate developments, and the 2.1 percent decline in clothing prices. Historically, March is a period when the prices in clothing group increase at least slightly before entering a new season. The decline in March 2004 points out that the inflation trend is considerably low, and there is no cost-push pressure on prices.

**Figure 2: Prices of Goods and Services**

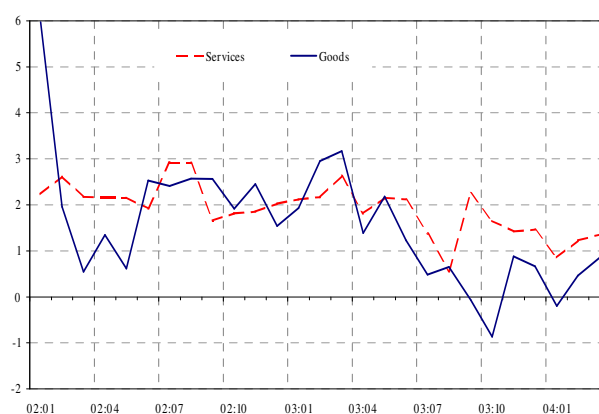
**Annual Percentage Change**



Source: CBRT, SIS.

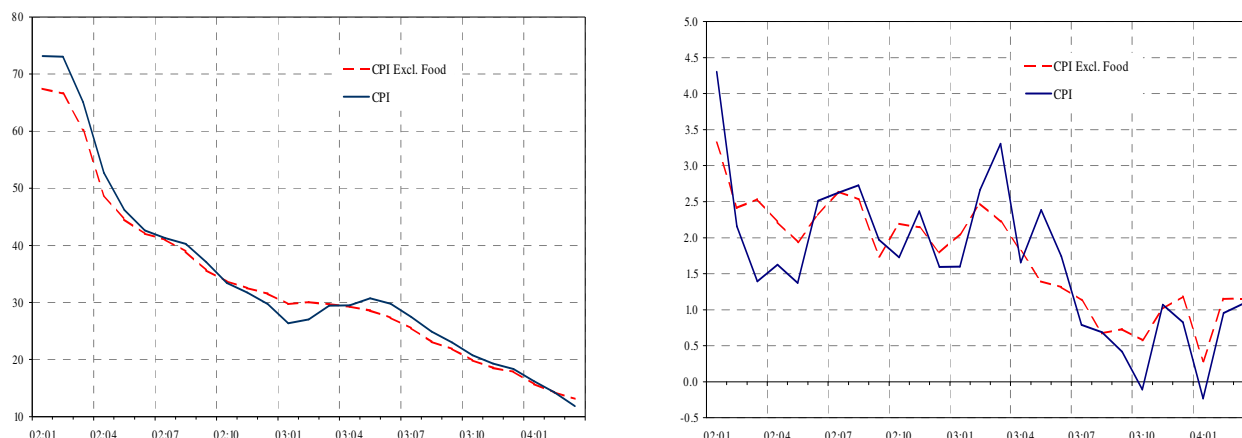
\*TRAMO/SEATS method has been used for deseasonalization.

**Monthly Percentage Change  
(Seasonally Adjusted)\***



8. Seasonally adjusted CPI increased by 1.1 percent, 0.2 point above that of February. However, it should be noted that one-off tax increases affected the price developments in March. Despite these increases, inflation maintained its downward trend.

**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 March 2004, WPI increased by 2.1 percent. The rate of increase in seasonally adjusted WPI rose by 0.4 point compared to February and became 1.5 percent. On the other hand, WPI inflation excluding agriculture reached the highest rate observed in this group since March 2003 and realized as 1.6 percent (Figure 4).

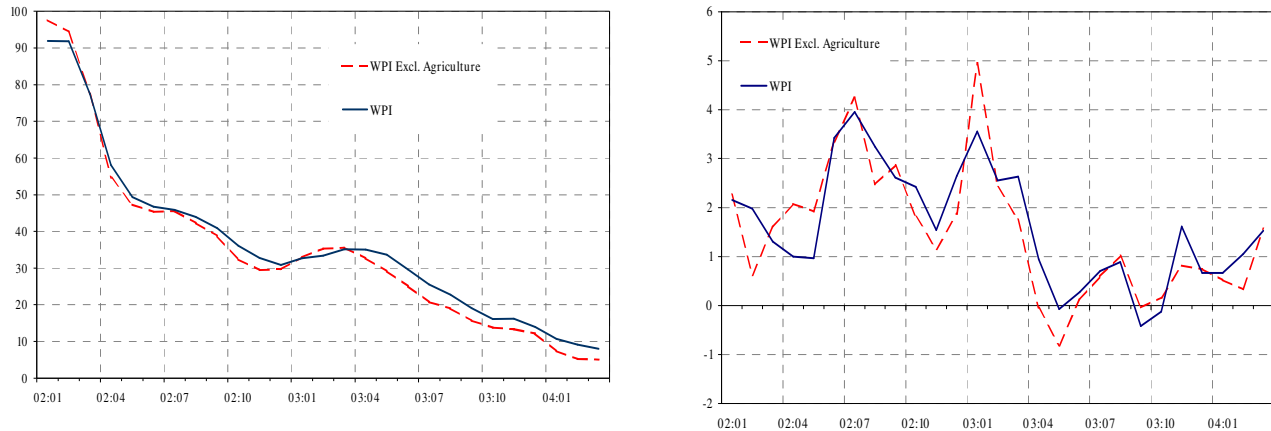
**10.** The greatest contribution to WPI increases in March was made by the manufacturing industry prices with a 1.8 percent rise. In addition to this, agriculture prices contribute 0.8 point to March WPI inflation with a 3.6 percent increase on a monthly basis. The seasonally adjusted rate of increase in agriculture prices rose by 0.3 point compared to February and realized as 1.5 percent.

**11.** The monthly rate of increase in WPI excluding agriculture resulted mainly from the public manufacturing industry prices. Despite the 11 percent decline in the average US Dollar rate during the last four months, public manufacturing industry prices increased by 4.1 percent in March. This was due to tax increases on tobacco products, brought about as a supplementary budget measure, and the rise in the international prices of the raw materials used as primary inputs in basic metal and oil products manufacturing sectors.

**12.** As of end-March, electric-water-gas prices decreased by 0.1 percent on a monthly basis and 0.5 percent on annual basis. It is especially remarkable that the water prices controlled by local governments displayed a 4.8 percent decline in January-March period. At this point, the course of natural gas and water prices gains importance for April and following months.

**13.** Despite remaining below the public manufacturing industry increase, rate of price increase in private manufacturing industry realized as 0.7 percent, 0.6 point above the February figure. The 3 percent increase in the prices of food and beverages manufacturing sector was the main determinant of this rise.

**Figure 4: WPI and WPI Excluding Agriculture**  
**Annual Percentage Change** **Monthly Percentage Change**  
**(Seasonally Adjusted)\***



Source: CBRT, SIS.

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

**14.** In line with the developments mentioned above, annual WPI inflation and WPI inflation excluding agriculture declined to 8 percent and 5 percent, respectively. High rates of increases in the first three months of 2003 owing to the developments in the Iraqi War have played a role in stimulating the drop in annual inflation figures of March 2004 as well.

## ***2. OUTLOOK***

**15.** While the favorable outlook in CPI inflation continued in March, a relative acceleration was observed in WPI inflation increases. Since the initiation of implicit inflation targeting regime, the end-year inflation target has been defined in terms of consumer prices. Besides, the CPI inflation has been given emphasis in “Outlook” section of our announcements and reports, whereas WPI inflation has been evaluated in the light of data on future CPI inflation. Given the aforementioned developments, it will be useful to interpret the developments in wholesale prices in March in terms of CPI inflation for the coming period.

**16.** The 0.5 percent drop in energy prices within WPI on an annual basis, continued to restrict cost-push inflation pressures. In March, WPI was adversely affected by agriculture prices and the public price increases due to budgetary measures. The effects of relatively high increase in agriculture prices on food prices in CPI were limited. Moreover, in the short run it is expected that high rate of increases in agricultural sector prices will be followed by negligible rate of increase or decline. Indirect effects of high rate of increase in prices in tobacco manufacturing industry, in WPI, will be negligible. However, the fact that the increase in WPI mainly stems from oil products and basic metal industry sectors, as well as the probable persistence of these increases indicate that inflation will likely be determined by cost-push pressures in general in the following months. Rises in international metal prices result from increase in demand of China, which is not considered to be transitory. Likewise, the upward trend in oil prices is not expected to reverse substantially for some time. Nevertheless, under the fundamental assumptions that relative stability in foreign exchange rates would continue and that domestic demand would be kept under control, these developments are not considered as a threat to 2004 inflation yet. Undoubtedly, these predictions are conditional on fiscal discipline.

**17.** In general, the belief that the end-year inflation target is achievable is getting stronger as of the first quarter of 2004. The cumulative CPI inflation and CPI inflation excluding food in the first quarter of the year became as 2.2 percent and 1.3 percent, respectively. These figures point out an inflation course consistent with the end-year target, which should be perceived as a favorable development. However, it should be kept in mind that the Central Bank focuses on likely course of future inflation, hence gives emphasis not only on the realized inflation figures, but also on the prospective course of inflation that can be judged from these realisations. In this context, the relative price dispersion between services group and goods group, and the global rise in prices of basic metal and oil are considered as risks for future inflation.

**18.** The drop in annual price increases in services from 22 percent of February to 19.7 percent in March can be regarded as a favorable development. However, the rate of increase in service prices in the last quarter, corresponding to 1.1 percent of the seasonally adjusted average price increases (14.6 percent in annual terms) is still inconsistent with the end-year target. Although

the slowdown in rent increases, one of the sub-items of services group, may be considered as a favorable development, close monitoring of developments in rent is warranted to ascertain whether such downward trend is permanent or not. Moreover, hospital services prices produced a less rosy picture, increasing by 13.0 percent during the January-March period. Adjusting health services prices in line with inflation target, as it is in other economic units, will contribute to the efforts of breaking the downward rigidity in inflation.

**19.** In 2004, it is predicted that the recovery in domestic demand will continue in a controlled manner and that economic growth would be based on investment and consumption as in 2003. Besides, low unit costs and favorable inflation expectations are expected to continue to support the downward trend in inflation. Moreover, recent increases in credits extended to Small and Medium-Sized Enterprises (SME) and in consumer credits will likely maintain their upward course for sometime. However, modest capacity utilization ratios in the automobile sector, to which consumer credits are mostly directed, are not yet in a position to push production capacity, and part of consumption stems from relatively low prices in these sectors. Therefore, it is not expected that a demand-push inflation pressure should build up in the short-term. On the other hand, it is considered that the credits extended to private sector will support investment, increasing the potential output, and ease inflationary pressures.

**20.** Nevertheless for the sake of financial stability, financial standings of banks should be strong, and their profitability should be maintained. At a time when inflation is in a downward trend and interest rate margins are shrinking, banks should try to reduce their costs and should focus on risk management in extending loans. While trying to recuperate their reduced interest rate margins by increasing their market shares and enlarging their customer base, banks should pay attention to interest rate and credit risks. Moreover, although consumer credit interest rates are declining rapidly, they are still at high levels considering the targeted inflation rates. At a time when no sharp increase is expected in real incomes, household tendency to finance consumption spending via consumer credits still bearing high real interest rates compared to the realized inflation, or higher compared inflation target, cannot be regarded as rational behavior. Despite the fact that the rise in consumer credits have not created a significant inflationary pressure until now, the Central Bank will continue to monitor the increases in consumer credits closely in the following period and will send necessary signals to markets on potential risks that may obstruct the ongoing downward trend of inflation or deteriorate the financial stability.

**21.** As it is emphasized repeatedly in our previous announcements and reports, it is of vital importance to correctly perceive the significance of the projected course of 12-month cumulative inflation figures consistent with the target in 2004. 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, which is also called as the base effect, the downward trend in annual inflation will continue evidently in the next two months, as in the last quarter. On the other hand, even though the downward trend in inflation continues in the rest of the year, annual inflation rates may stop decreasing or may increase due to the base effect. Yet, such a development will be consistent with the inflation target. At this point, it should be emphasized once more that while making its monetary policy decisions, the Central Bank will continue to focus itself on future course of inflation merely, not on the past inflation figures. Therefore, the economic units should refer to general trend of inflation and the consistency of price increases to be realized throughout 2004 with the inflation target, rather than the course of annual inflation rate, which is a backward-looking indicator.

**22.** The rigidity in services sector inflation should be minimized for the sake of convergence of the inflation in services to the goods sector, as well as the maintenance of downward trend in inflation in 2005. This development is closely related with the implementation of public pricing and incomes policy consistent with the targeted inflation, the correct management of expectations, the controlled recovery in domestic demand, and the establishment of a production process based on market rules and open to competition, in other words with structural reforms.

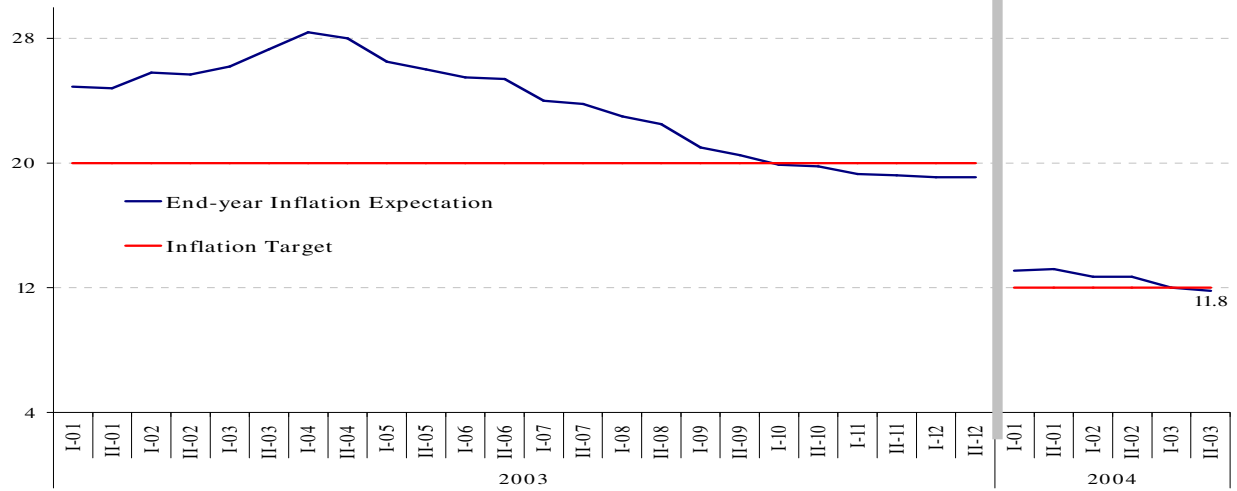
**23.** The current program has had favorable effects on macroeconomic stability and in steering expectations. As the inflation drops, there is an increasing consensus among every sector of the society that still much remains to be done for achieving permanent price stability. Reforms on tax, social security and public management are of vital importance for the sustainability of the structural public balance in medium and long terms. Moreover, each step taken for enhancing the economic role of private sector for the development of competitiveness and productivity, the measures for increasing the public productivity and the quality of governance, the improvement of investment environment and deepening the fiscal system, and each signal thereon will help Turkey to achieve a long-term economic stability.

**24.** In current period, the continuation of structural reforms is of vital importance. If the downward trend in inflation in 2005 is to be accompanied with high economic growth and rise in employment, general productivity level must be increased through the accomplishment of ongoing structural reforms as soon as possible. In general, realization of structural reforms, which means the transformation of an institutional structure that is the whole of rules, sanctions and organizations in order to remove restrictions in the economy, seems inevitable for the removal of obstacles to the productivity increase in production factors.

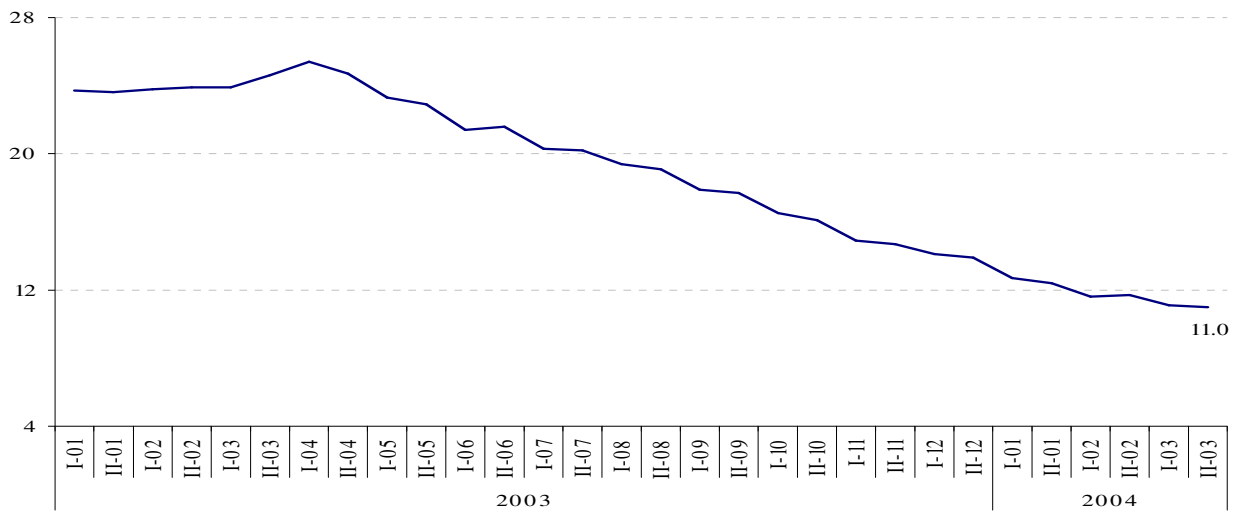


**Figure 5: Inflation Expectations According to CBRT Expectations Survey**

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



**Inflation Expectations for the Next 12 Months**



Source: CBRT Expectations Survey