

# June Inflation and Outlook

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

1. In June 2004, CPI decreased by 0.13 percent while WPI dropped by 1,05 percent. Annual CPI and WPI inflation became 8.9 percent and 10.5, respectively.
2. Seasonally adjusted monthly price increases were recorded as 1.7 percent and 1.0 percent in CPI and WPI respectively while seasonally adjusted monthly price increases in CPI excluding food and WPI excluding agriculture became 0.9 percent and 1.5 percent.

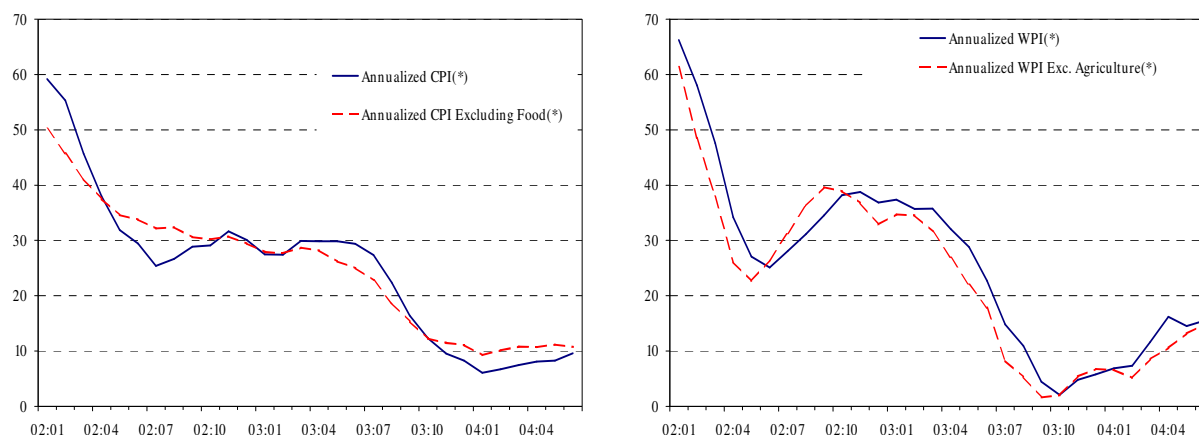
**Table 1: General CPI, WPI and Sub-items**

	Annual % Change		Monthly % Change			
	2003 June	2004 June	2004 April	2004 May	2003 June	2004 June
<b>CPI</b>	<b>29.8</b>	<b>8.9</b>	<b>0.6</b>	<b>0.4</b>	<b>-0.2</b>	<b>-0.1</b>
Goods	29.7	4.7	0.6	0.1	-1.1	-0.7
Services	29.9	17.3	0.6	0.9	1.7	0.9
Excl. Food	27.3	10.9	0.6	1.5	1.2	0.8
Food	38.3	2.6	0.6	-3.1	-4.4	-3.3
<b>WPI</b>	<b>29.6</b>	<b>10.5</b>	<b>2.6</b>	<b>0.0</b>	<b>-1.9</b>	<b>-1.1</b>
Public	25.1	11.5	0.5	2.3	0.0	2.0
Private	31.4	10.2	3.5	-0.9	-2.6	-2.2
Public Manufacture	28.6	13.3	0.4	2.6	0.2	1.5
Private Manufacture	24.7	10.2	1.5	1.8	0.2	1.2
Agriculture	45.4	10.0	6.9	-5.2	-7.6	-8.1
Excl. Agriculture	25.1	10.7	1.1	2.0	0.1	1.5
Excl. Agr. and Energy	25.8	11.5	1.2	2.1	0.1	1.6

Source: CBRT, SIS.

3. The six-month average of seasonally adjusted inflation was 1.2 percent in WPI and 0.8 in CPI. The mentioned average rates of increase correspond to 15.5 percent and 9.6 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 10.7 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. Inflation figures of June 2004, strengthens the view that the effects of recent cost-push pressures on consumer inflation will be limited. Increases in seasonally adjusted CPI excluding food was recorded as 0.9 percent. Increases in CPI excluding food, which mostly followed a horizontal course in 2004, were especially affected by the rigidity in services group prices but remained in line with the inflation target in the first six months of the year with a monthly average of 0.9 percent.

5. In June there were mainly three factors affecting CPI sub-items. These were: (i) as also previously stated, the rigidity in services group prices, (ii) increase in public prices especially oil prices, and (iii) prices of durable goods.

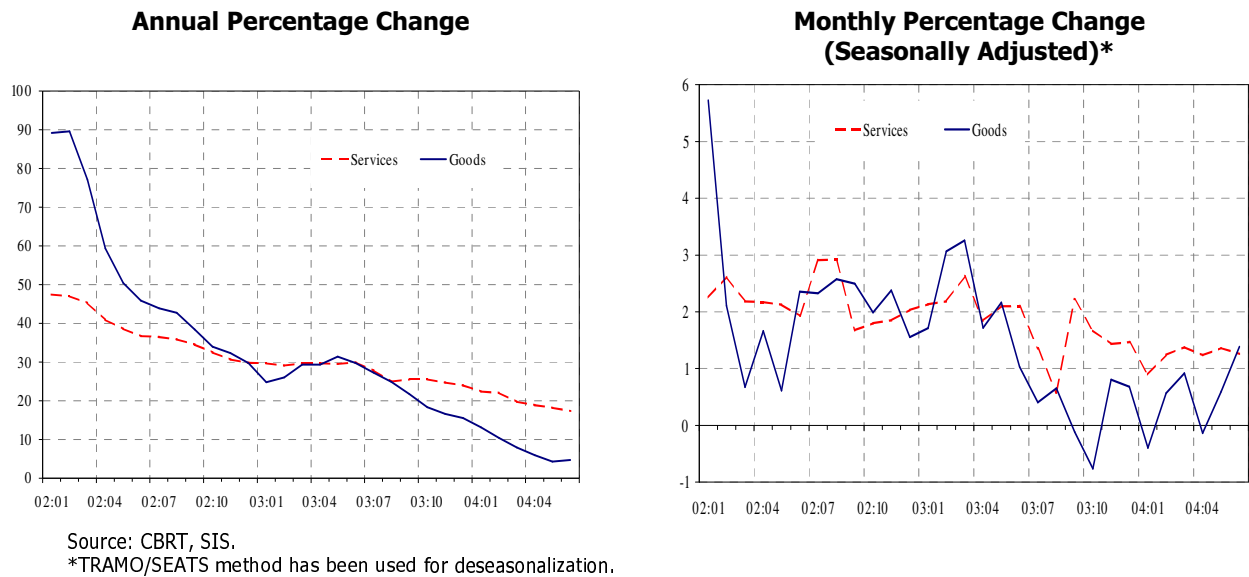
6. As of the first six months of 2004, the gap between the rate of increase in goods and services prices continues to mount. By the end of 2003 annual price increases in goods and services group were 15.5 percent and 24 percent respectively, and they became 4.7 percent and 17.3 percent in June 2004 (Figure 2). Also in June restaurant and hotel prices increased by 1.2 percent and rents increased by 1.3 percent. Especially the trend exhibited by the rent increases in the first half of the year approximately corresponds to 17 a percent in annual terms.

7. Meanwhile, the effects of exchange rates are observed most clearly in petroleum prices. In the period where TL appreciated, petroleum prices were stabilized, even rolled back by increasing tax incomes. However, along with the rise in exchange rates, the hike in petroleum prices became inevitable in order to avoid tax losses. The effects of the rise observed in petroleum prices in June will reflect on July inflation.

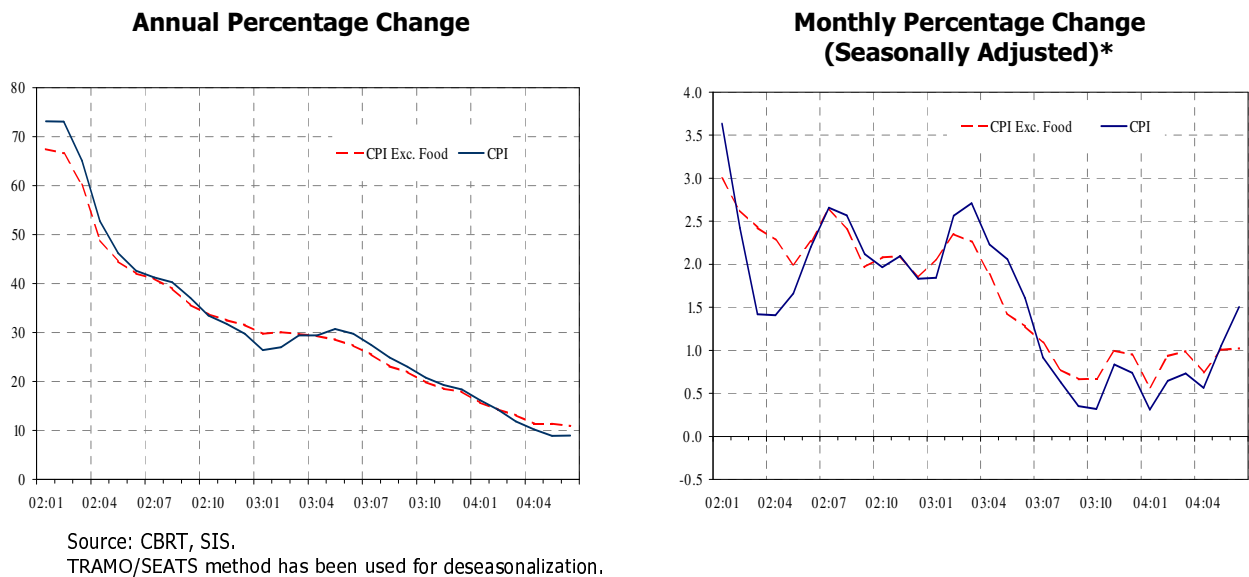
8. Another important development observed in June CPI figures is the decline in durable goods prices. The drop observed in the prices of durable goods sector, which is among the sectors that are

most sensitive to exchange rates, is remarkable in terms of pass-through effect. So, It can be concluded that companies have not reflected the cost increases on their prices since they made their productions and imports by looking into the future at a time when TL was dear, combined also with the increased competition in this sector.

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



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



## ***Developments in Wholesale Prices***

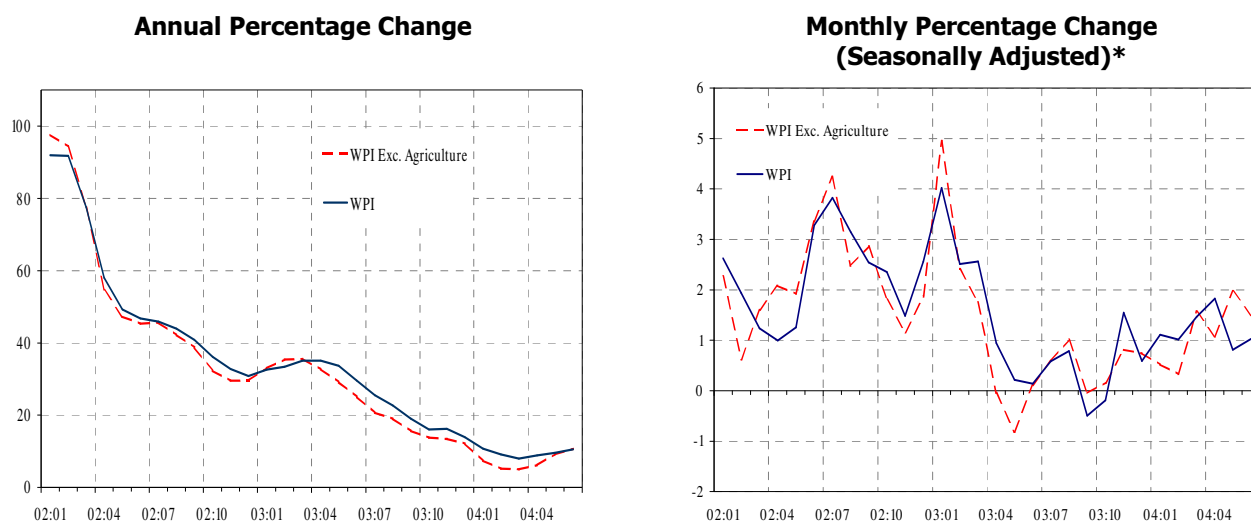
9. In addition to the WPI figures in May, those in June also confirm the idea that agricultural prices would compensate for high rates of increase observed in the first four months of the year with high drop-out rates in the summer. The inflation trend in WPI excluding agriculture increased in the second quarter of the year compared to the first quarter due to the rise in exchange rates and public price increases, however it has lost pace in June compared to May (Figure 4).

10. Agricultural prices dropped by 8.1 percent in June. The seasonally adjusted inflation rates indicate that agricultural prices increased cumulatively by 10.8 percent in the first four months of the year and declined by 3.3 percent in May and June. The limited effect of agricultural prices is expected to maintain its course during summer.

11. While the effects of exchange rates are clearly observed on public manufacturing industry prices, petroleum products manufacturing and chemicals production reached a peak. The price increase in food manufacturing realized relatively high due to the lagged effects of the rises in tea and sugar prices. Whereas the prices, which dropped by 3.2 percent in the main metal industry, point out to a halt in the rapid rise observed in this group in the first five months of the year.

12. In January-July period, accumulated WPI increase in public sector was 9.1 percent. As for manufacturing industry prices, public sector price increase was recorded as 11 percent during the same period. Recent price increases made in line with the budget target played a role in these increases as well.

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



Source: CBRT, SIS.

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

13. The rate of increase in prices of private manufacturing industry accelerated relatively in the second quarter of the year. Average rate of monthly increase in the first six months was 1 percent. However, analyzing in terms of three-month periods, the rate of increase, which was recorded to be 0.5 percent in the first quarter, rose to 1.5 percent in the second quarter of the year. Cost-push pressures were effective in this rise but price increases stipulated in the second quarter by the firms, which did not respond to the appreciation of Turkish lira by cutting down their prices in the first quarter, remained well below the level of increase in exchange rate.

14. Energy prices maintained their recent course and rose by 0.1 percent. Prices in this group decreased by 2.2 percent compared to June 2003. Price increase in natural gas, which is to be effective as of June 1, is expected to exert a pressure on prices of this group next month. However, the course of electricity prices bears more importance in terms of both the energy group and production costs.

## ***II. OUTLOOK***

15. As of the first half of 2004, prospects for the attainability of the year-end inflation target are strengthening. Above all, low level of inflation observed in the first half of the year took place along with the high rate of growth. Undoubtedly, the greatest contribution to this development comes from the current economic program that has been implemented for the last three years. It is of great importance to stick with such a rewarding program in an enduring manner by particularly focusing more on structural reforms.

16. An analysis of growth figures for the first quarter of the year in terms of demand components indicates that the greatest contribution to the GDP growth in the first three-month period of 2004 comes from private expenditures. The recovery in private spending resulted from high rates of consumption spending particularly on durable goods as well as from the rapid rise in investments on machinery-equipment. High level of demand for durable goods did not lead to a marked inflationary pressure as it occurred concurrently with the strengthening trend in Turkish lira. Meanwhile, the rise in production of investment goods will contribute to the fight against inflation through the upsurge in efficiency and potential production.

17. The increase in private consumption is forecasted to have continued during the second quarter of the year and accordingly the capacity utilization ratios are predicted to have realized at high levels. Nevertheless, as expressed by the first quarter growth figures, the recovery in the economy has not yet been observed to have spread to those sectors producing semi-durable and non-durable goods. The driving force of economic growth during this period has mostly been the fast production increase in the automotive and white goods sectors. While this development has a number of reasons, two basic issues have come to the forefront:

- (i) The relative price differentiation attributable to the appreciation of the Turkish lira observed in goods that are subject to foreign trade and that use a high ratio of foreign inputs.

- (ii) The fast decline in consumer credit interest rates in 2004, compared to the previous year.

18. It is predicted that developments such as the fluctuations observed in financial markets after the change in global liquidity trends in April and May, the increases in credit interest rates and the decline in consumer confidence will contribute to a controlled recovery in the durable consumption sector. And although growth rate is expected to slow down in the second half of the year compared to the first half, the GNP growth rates for 2004 will still end up above program targets. Having analyzed consumer credit developments during the last period in a thorough manner together with their sub-items, a tendency of slowdown was observed. Yet, it is closely monitored whether these developments stemmed from temporary factors and/or the tendency displayed a meaningful breaking point. However, in all cases, it is believed that demand conditions will not be supportive in terms of inflation in the second half of the year as much as they were in the last three years, and that continuing productivity increase is significant for the decline in inflation to carry on.

19. It is observed that together with the changing exchange rate regime, nominal exchange rate indexation behavior weakened and economic units adopted a more rational pricing policy. Academic studies demonstrate that periods of low and stable inflation may have significant effects on the pricing behavior of firms. Stronger expectations for the decline in inflation to be a lasting one will generate the belief that changes in prices and costs will be temporary, as a consequence of which the pass-through effect may weaken. In this sense, the fight against inflation and floating exchange rate policy are believed to bring about a structural change in the exchange rate-inflation relationship. Other factors contributing to the relative weakening of the pass-through effect are that fiscal policy perceives targeted inflation as an endogenous parameter, a more competitive environment, and the break in inflation expectations. As a matter of fact, May and June inflation data show that the pass-through effect of cost-push developments now materialize relatively slower compared to the past. However, the fact that the pass-through effect began to take place in a delayed fashion in recent years on account of the above cited reasons, call for more caution vis-à-vis the total final effect issue.

20. As repeatedly emphasized in our previous press releases and reports, monetary policy is focused on the harmony of future inflation with targeted inflation. In line with this, the low inflation figures in the first half of the year are evaluated within the scope of the information they contain with regards the 2004 and 2005 inflation. The information held with respect to the future by the inflation figures for the first half of the year and certain other risks are as follows:

21. Ongoing rigidity in the services sector continues to pose a risk for the 2005 inflation. For example, annual rent increases being around 21.4 percent while annual CPI is at 8.9 percent, show that despite the significant distance covered in the fight against inflation, it will take time to fully break the inertia in some sectors. Within this context, price rigidity in sectors such as education and rent requires to be carefully monitored in terms of the 2005 inflation.

22. It is projected that the effects of the rise in costs due to changes in the prices of raw materials and exchange rates as well as the increments in the prices of petroleum products will mostly become apparent in July. Therefore, taking into account last year's inflation figures in July, which were rather low, it is expected that annual inflation figures pertaining to July 2004 would probably display a rise. Although the indirect and lagged effects of the rise in petroleum products on inflation are believed to remain at a level not to jeopardize the end-year inflation target, it is still projected that these effects would be somehow more than "negligible".

23. It is now evident that agricultural prices and food prices would assist the downward trend in inflation in 2004. Undoubtedly, as it is not possible to foresee seasonal conditions, it is very important to act cautiously about agricultural prices and food prices. As these sectors provide very little information about the future course of inflation, they can lead to mistakes especially in periods when they are dominant in main indices. Therefore, it can be asserted that the current favorable course of the food prices provides very little information in terms of 2005 inflation as well.

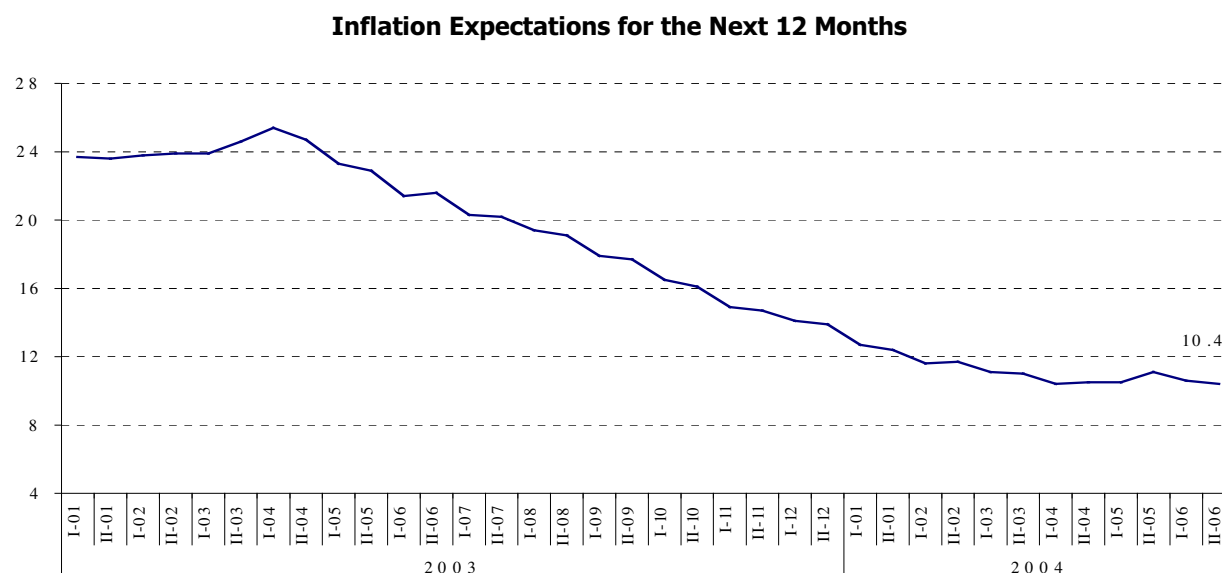
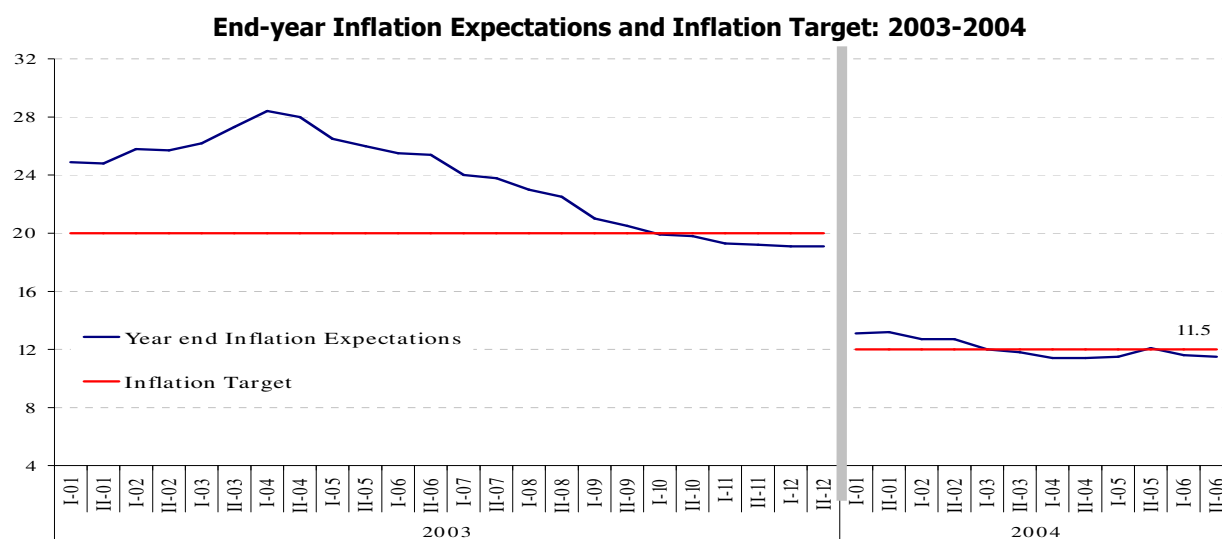
24. The manufacturing industry prices, which have been accelerating constantly for a while, are estimated to slow down in the second half of the year. The rapid rise observed in manufacturing industry prices in the first half would probably make a temporary pressure on CPI inflation in the second half. However, electricity prices would probably not increase for quite a while and the rise in main metal and petroleum raw materials would decelerate, which together would help cost pressures remain limited. As a result, it is believed that the recent developments in wholesale prices could effect the future CPI inflation through costs, however, it is firmly believed that such an effect would remain limited as is the case in exchange rate-inflation relation and would not reach a level that might jeopardize the end-year inflating target. However, with a long-term perspective, the mentioned developments are very closely monitored for 2005 inflation.

25. As a consequence, it is projected that although high capacity utilization ratios, the acceleration in public prices and relative recovery in consumption expenditures will start to be effective on inflation as of the next few months, the general trend of inflation will not exceed the targeted rates thanks to increased productivity and investments coupled with deceleration in the prices of raw materials and favorable course in inflation expectations. Yet, the cumulative inflation for the first six months of the year, which became only 3.1 percent, provides a room for maneuver in the face of prospective exogenous shocks.

26. The inflation figures obtained in the first half of the year confirms that the achievements so far are not of temporary nature. However, further deepening of the structural reforms is now more

important than ever for attaining macroeconomic stability. Arrangements intended for boosting productivity, completion of reforms in public sector, wiping up of bureaucratic hurdles before investments, tax and social security reforms, steps to be taken towards improving financial sector and public conviction that the commitments made thereto are credible are crucial. The serious steps taken towards social security and financial sector reforms are highly appreciated. Fortifying the mechanisms that ensures the sustainability of these steps is of course very important. Within this framework, it should be highlighted that following a program, which aims at ensuring sustainability of achievements and focuses on structural reforms by outlining structural criteria within a general as well as a medium-term plan is very important.

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



Source: CBRT Expectations Survey