September Inflation and Outlook

I. GENERAL EVALUATION

1. In September 2004, CPI increased by 0.94 percent and WPI by 1.85 percent. Annual CPI and WPI inflation became 9 percent and 12.5, respectively.

2. Seasonally adjusted monthly price increases were recorded as -0.2 percent and 1.4 percent in CPI and WPI respectively; and CPI excluding food and WPI excluding agriculture became 0.2 percent and 0.8 percent.

Table 1: General CPI, WPI and Sub-items

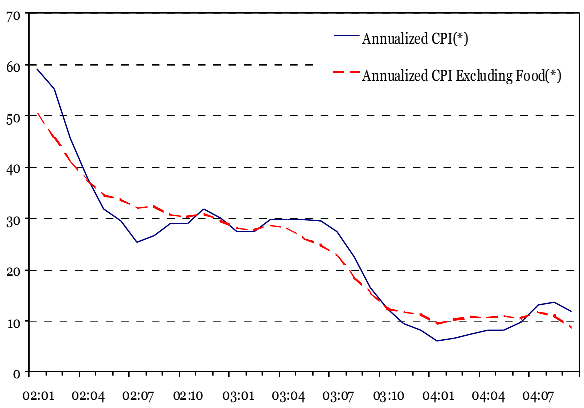
	Annual % Change		Monthly % Change			
	2003 Sept.	2004 Sept.	2004 July	2004 Aug.	2003 Sept.	2004 Sept.
CPI	**23,0**	**9,0**	**0,2**	**0,6**	**1,9**	**0,9**
Goods	21,7	5,6	-0,2	-0,1	1,3	0,4
Services	25,5	15,3	1,0	1,7	3,0	1,8
Excl. Food	21,9	9,7	0,4	0,7	2,0	1,2
Food	27,0	6,5	-0,6	0,1	1,6	0,1
WPI	**19,1**	**12,5**	**-1,5**	**0,8**	**0,1**	**1,8**
Public	14,9	15,4	1,8	2,3	-0,6	1,2
Private	20,8	11,3	-2,8	0,2	0,3	2,1
Public Manufacture	17,9	18,1	2,7	2,3	-0,8	1,1
Private Manufacture	15,8	11,2	0,3	1,5	0,2	0,6
Agriculture	32,0	11,8	-8,6	-2,5	0,4	5,5
Excl. Agriculture	15,7	12,7	0,8	1,8	0,0	0,8
Excl. Agr. and Energy	16,3	13,5	0,8	1,8	0,0	0,8

Source: CBRT, SIS

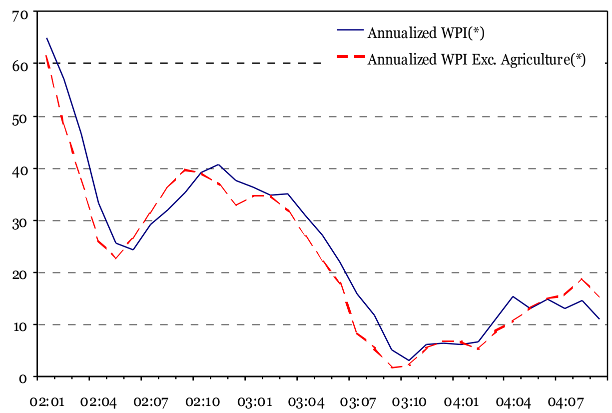
3. The last six-month average of seasonally adjusted inflation was 1.10 percent in WPI and 0.82 in CPI. The mentioned average rates of increase correspond to 14 percent and 10.3 percent in annual terms. In the same period again, the average rate of increase in seasonally adjusted CPI excluding food became 0.69 percent, which corresponds to 8.6 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



(*) 6 Months Moving Average (Annualized, Seasonally Adjusted)
TRAMO/SEATS method has been used for deseasonalization.
Source: CBRT, SIS.

Developments in Consumer Prices

4. In September, CPI inflation remained very limited, although goods and services group prices had to increase considerably for seasonal reasons. The increases in all prices of goods group (primarily in food and clothing prices) that were rather below the seasonal tendency affected this development. Seasonally adjusted food prices fell by 0.9 percent, clothing prices by 0.8 percent in September. Despite the increase in the average US dollar exchange rate of some 3.5 percent during the last two months, the decline in the prices of durable consumption goods continue: The durable group prices retreated by 1.9 percent in September, after the 2.5 percent decline in August.

5. Furthermore, the 10 percent increase in the education materials group pushed up the goods prices in September. Besides, with a 2.2 percent increase in September, as in August, furniture prices under the household goods group were one of the items recording the highest increase in the goods group. Cumulative price increase in this group reached 14.4 percent as of September. Within the framework of these developments, monthly goods price increase realized as 0.4 percent. When seasonally adjusted, this figure declines to –0.7 percent. The limited increase in goods prices despite seasonal effects, show that there is no strong demand pressure on prices.

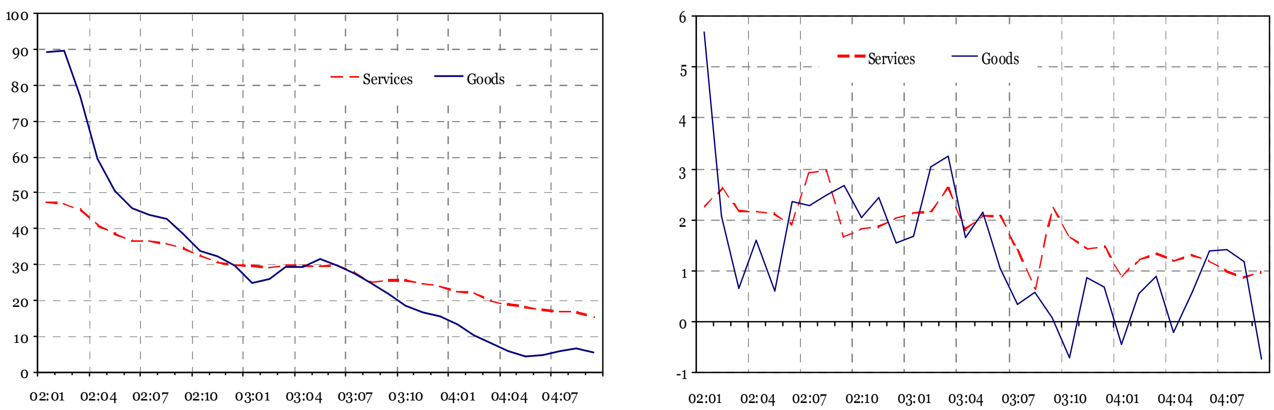
6. Meanwhile, with an increase of 1.8 percent, services group prices advanced much more than the goods group prices in September. Seasonally adjusted service prices increase realized at 1.0 percent, in line with the average level of the last three months. The item that recorded the highest increase in this group is the rents, which rose by 2.5 percent also owing to seasonality. Cumulative rent increase, having reached 13.9 percent as of September, realized 9.1 points higher than the 4.8 percent cumulative increase in CPI during the same period.

7. The highest increase in services group after the rents came from education services prices with a 2.1 percent of rise. The cumulative increase in education services prices from January through September 2004 became 13.5 percent, a very close figure to that of rents prices. However, in annual terms, the price increases in these two groups became differentiated in September: while annual increase in rents dropped from 20.8 percent in August down to 19.8 percent, that in education services prices came down to 13.6 percent from 21.6 percent. The rapid fall in the increase in education services prices owes to the limited rise in the tuition fees of nursery schools and kindergartens.

8. Within this framework, the difference between the rates of increase in the prices of goods and prices of services prevails. As of September, while the seasonally adjusted cumulative increase in the prices of goods is 4.7 percent, that in the prices of services reached 10.4 percent. In year-on-year terms, prices of goods came down to 5.6 percent while prices of services dropped down to 15.3 percent (Figure 2).

Figure 2: Prices of Goods and Services

Annual Percentage Change | **Monthly Percentage Change (Seasonally Adjusted)***

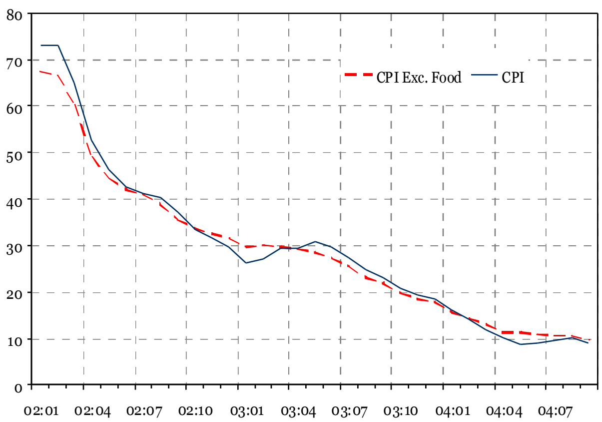


Source: CBRT, SIS.
*TRAMO/SEATS method has been used for deseasonalization.

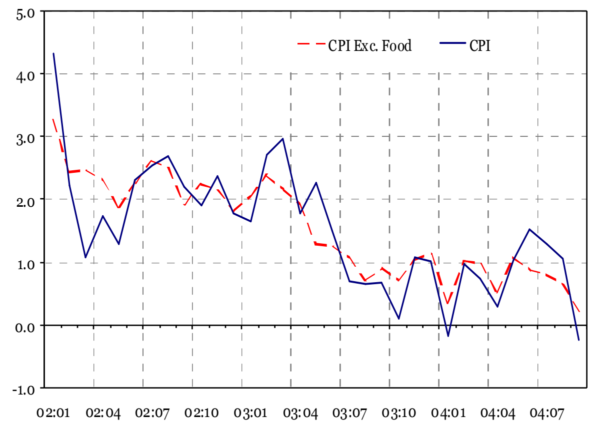
9. To conclude, in September, seasonally adjusted CPI and CPI excluding food prices decreased by 1.0 percent and 0.6 percent, respectively, compared to the average values recorded in the first eight months of the year. After a three-month halt, CPI inflation started to decrease again and became 9 percent in September. Meanwhile, CPI increase excluding food came down to 9.7 percent, in annual terms (Figure 3).

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

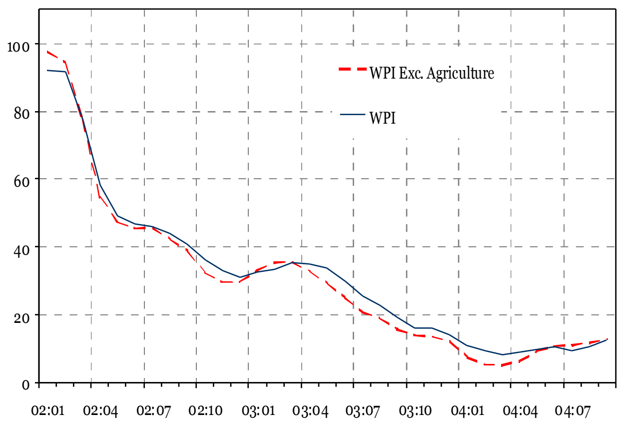
10. In September, seasonally adjusted WPI increased by 1.4 percent. In this period, the agriculture sector made the largest contribution to the rise in WPI. It is observed that the agricultural prices, which rose by 5.5 percent, are affected by fruit and vegetable prices that increased remarkably due to seasonal factors. Seasonally adjusted agricultural prices grew by 3.5 percent in September, compared to the previous month. However, since the beginning of 2004, the seasonally adjusted average increase has been 0.9 percent.

11. Analyzing in terms of the contribution of the agriculture sector to WPI throughout the year, it is however observed that the rapid rise in September was compensated with the declines during the summer months. Thus, on an annual basis, the rise in agriculture prices remained below the rise in WPI excluding agriculture. However, agriculture prices that will seasonally display a rapid rise in the rest of 2004 are likely to have an unfavorable effect on the WPI.

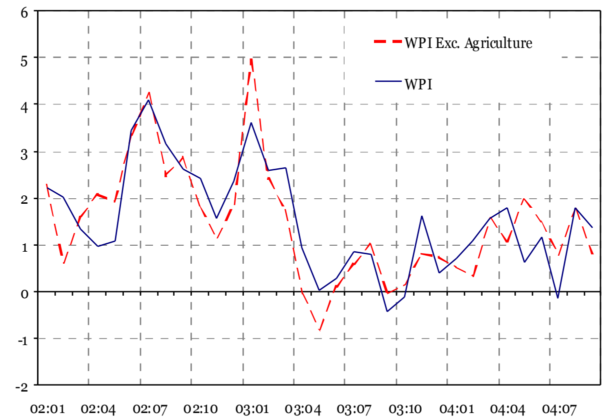
12. The biggest contribution to the 1.1 percent- price increase in public manufacturing industry came from chemicals production and petroleum products manufacturing sectors. Meanwhile, food and chemicals production stand as the determining factors in the 0.6 percent-price increase in private manufacturing sector. Energy prices maintained their current trend and rose by 0.3 percent. It is observed that the energy prices have displayed a downward trend on an annual basis with a 1.3 percent decline. In September, the annual WPI and WPI excluding agriculture rose to 12.5 percent and 12.7 percent, respectively.

Figure 4: WPI and WPI Excluding Agriculture

Annual Percentage Change



Monthly Percentage Change (Seasonally Adjusted)*



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

II. OUTLOOK

13. As foreseen in our inflation and outlook reports, the base effect has lost its weight in September and the downward trend in annual inflation has picked up its course again. Moreover, it has become clear that the inflation would have remained within the range of targets by the end of 2004 as well following 2002 and 2003. That the cumulative price increases in the first nine months of the year became only 4.8 percent highlights the fact that the possibility of exceeding the year-end target is very low even if any exogenous shocks emerge in the rest of the year.

14. In our recent analyses, we had mentioned that the rapid rises in prices of manufacturing industry posed a risk on consumer inflation, but it was highly likely that the effect of the said cost rises on consumer prices would most likely remain limited thanks to the rigid fiscal and monetary policies and the structural transformation in pricing behaviors. In this context, inflation figures for September support our claim that the boost in domestic demand does not exert a marked pressure on inflation.

15. The reason why no obvious inflationary pressure was observed despite the high growth rates in recent period should be carefully analyzed. The current economic program coupled with the rigid monetary and fiscal policies allows a controlled recovery in domestic demand and contributes to the favorable course of inflation expectations. Besides, the fact that the economic agents began to foresee the future more clearly while making their decisions and the ongoing boost in labor force productivity led to a rise in private sector investments as well, and the upward movement in potential production

level continued. In 2004, private consumer spending followed the output rise as well; however, ultimate domestic demand has not reached the level to keep up with the total output yet.

16. Growth figures of the second half of 2004 indicate that the recovery in domestic demand has had a spillover effect on sectors other than durable goods, especially, unlike the first quarter expenditures in terms of semi/non-durable goods rapidly increase. For example, compulsory consumption expenditures increased by 7.6 percent in the second quarter of 2004. However, the level of real compulsory consumption expenditures in the second quarter of 2004 is only 2 percent over that of the second quarter of 1998. In fact, as mentioned many times in previous reports, even though the calculations of output gap point out to the fact that the contributions of general supply-demand conditions on the declining process of inflation will not be as influential as it was in the past three years, as of the second quarter of 2004 the dominant view is that the level reached at output level will not cause an evident inflationary pressure. Although it is difficult to determine the current situation since the GNP figures have not been announced yet, there is no apparent pressure in the third quarter according to predictions and analyses made.

17. However, considering the prevalence of the increases in private consumption in terms of expenditure sub-items and rapid increase in expenditures regarding semi/non-durable consumption goods coupled with other services, indicators of domestic demand should be closely monitored. In line with this, the relative slowdown of rapid increase in the volume of credits and a similar tendency in money demand are significant developments. Moreover, it is observed that some selective measures taken towards the second half of the year, following the fluctuation in financial markets, slowed down the demand for durable goods and automobile. Therefore, as of the last quarter of 2004 the growth rate is expected to slacken. Nonetheless, it is foreseen that this slowdown will be moderate and high levels in production will continue parallel to stable foreign demand and consumer confidence.

18. On the other hand, the increase in employment is predicted to relatively accelerate next year, and so is the pressure on real wages. In this case, the persistence of high growth in line with the falling inflation will be linked to the continuance of productivity increases. Although higher investment expenditures in the recent period point to a high probability for the productivity increase and thus the stability in unit costs to continue next year as well, steps to be taken towards eliminating the obstacles to investments and production in the medium and long-term, enhancing productivity in the public sector and improving the competitive environment bear critical significance.

19. Although emphasized in our previous releases and reports, one basic issue related to inflation and monetary policy has not been clearly understood yet. The Central Bank, in its price stability-focused monetary policy strategy in effect for more than three years, has been targeting consumer prices, not wholesale prices. As a matter of fact, "inflation" is used synonymously with CPI increase in the reports published; CPI increases are taken into consideration in conducting inflation analysis and taking monetary policy decisions connected with this. Wholesale prices, on the other hand, are referred entirely on the basis of the forward-looking information they contain as regards CPI.

20. Within this context, what information does the WPI increase in September contain for the future inflation? It is observed that the 5.5 percentage-point rise in agricultural prices in September had a determinant impact on wholesale prices. A similar development is also expected next month due to irregular seasonalities. However, it should be highlighted that the private manufacturing sector prices, which is a more economically-meaningful sub-item that provides more hints pertaining to future inflation, has started to get stabilized following the slowdown both in raw material prices and in other cost increases. The rise in manufacturing industry prices, which started to accelerate due to the global rise in the prices of goods, decelerated both in public and private sectors in September. Excluding the unforeseen seasonal volatilities in agricultural prices and public price adjustments, WPI inflation is expected to follow a steady course in the upcoming period.

21. Undoubtedly, food prices played an important role in the favorable course of inflation in the first eight months of the year. Whereas food prices mostly depend on seasonal developments and natural conditions, therefore they provide very little information for the future inflation and can play no significant role in monetary policy decision-making process. The monetary authorities in the world do not have an effective instrument against price changes stemming from oil prices and indirect tax implementations. Moreover, central banks' sudden responses to such exogenous shocks may adversely affect the social welfare level in the short run. Therefore, most central banks officially aim at general consumer prices, however, sometimes they resort to another index that excludes energy, food or public prices and represent medium-term inflation more satisfactorily, and they use this index in making monetary policy decisions. Currently, the Central Bank and the State Institute of Statistics are jointly working on a project to develop a "core inflation" series to be used to this end.

22. For a long period of time, Central Bank has been drawing attention to the inflation in 2005 and focusing on the risks concerning this period. External developments stand as the most important factors to be followed closely in the upcoming period. Federal Reserve of the USA implied that it would not adopt an aggressive attitude towards the increase in interests. However, news over the full EU membership process worse than expected may cause a fluctuation in financial markets. Moreover, as it is emphasized repeatedly, in case where the three-year national program focuses on structural reforms and fiscal discipline is maintained, the mentioned fluctuations will be deemed as temporary deviations from the stability environment.

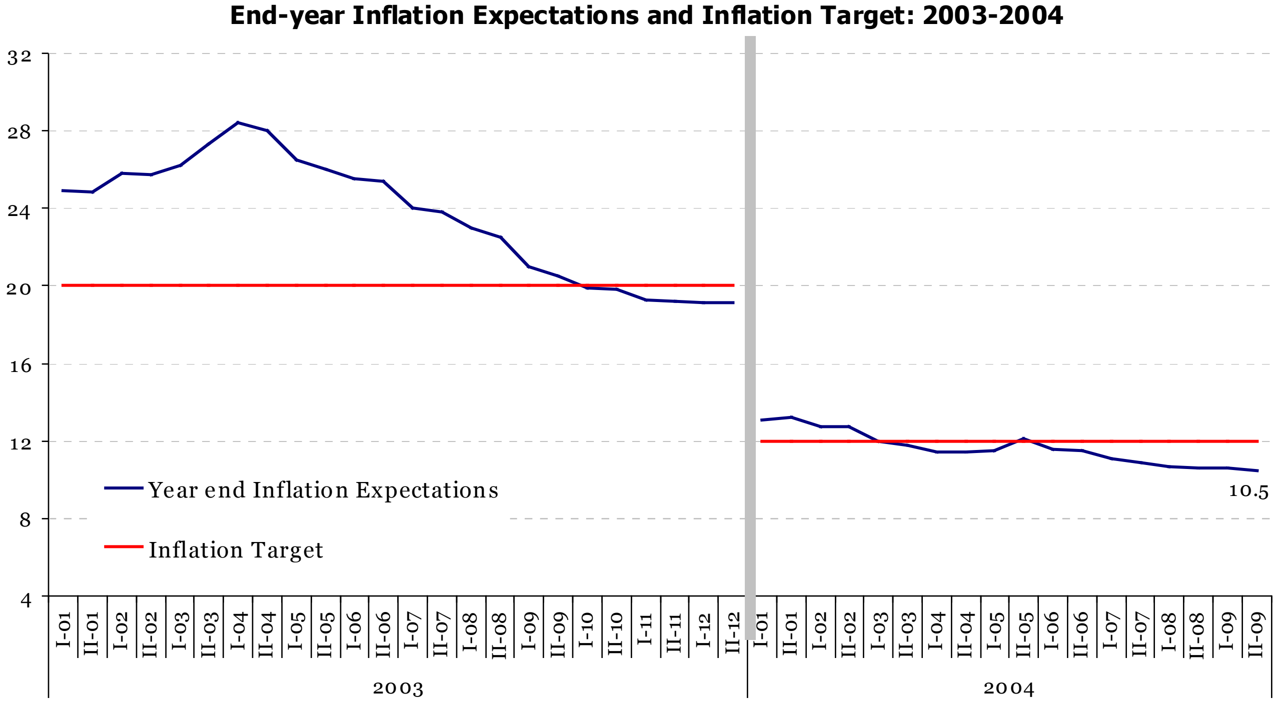
23. Another risk factor for 2005 inflation is that the price rigidity in services group has not been entirely broken yet. The difference between the price-increase rates of goods and services groups got bigger since August 2003. In September 2004, the annual inflation rate, which was about 25 percent in both groups in August 2003, rolled back to 5.6 percent and 15.3 percent in goods and services group, respectively. The difference between goods and services prices, which has been observed since 2003, can be explained by several factors: (i) the goods group has a relatively stronger pass-through from rates to prices compared to services group. (ii) Services prices display a backward-looking pricing behavior. (iii) Goods, which are subjected to foreign trade, display a high rate of productivity. However, in a period where general price increases are in single digits, the 20 percent-increase in

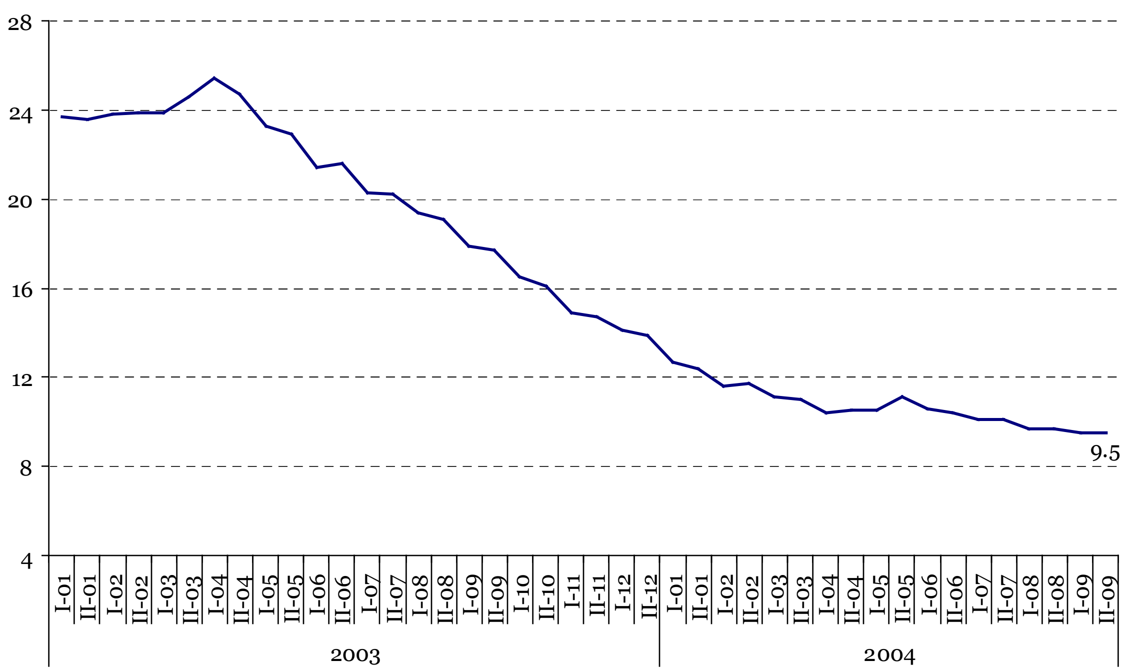
annual rent figures pose a considerable risk to price stability. Since a noticeable deviation of a sub-item, which has an important share in the targeted price index, will bear more significance than it does today in the upcoming term, where the goal is maintaining permanent price stability.

24. Another factor that might pose a risk for 2005 inflation is the possibility that the recent raises in oil and raw metal prices might not reverse in near future and might even continue with further rises. In the past periods when inflation was very high, effects of the changes in world prices on domestic inflation used to remain at ignorable levels. However, it is clear that the fluctuations in raw material import prices will increasingly gain more importance in the following period where single-digit inflation will prevail. The effects of recent rises in raw material import prices, which showed through to inflation directly or indirectly through input costs, started to be perceived in the second half of the year. However, there has been no signal of a disruption in inflation expectations up to this time. Nevertheless, indirect effects of the rises particularly in oil prices will continue to be monitored closely.

25. To conclude, it is believed that currently there are no serious risks that could jeopardize the end-year inflation target for 2004. Whereas, some risk factors are projected for 2005, such as: domestic demand and labor costs might not be contributing to the downward trend in inflation in 2005 as much as they did in 2004, high oil prices might pull up energy costs and impose pressure both on current account and inflation, and liquidity shortages in the international markets coupled with rise in interest rates might exert pressure on exchange rates. However, what is crucially important for the future inflation trend is to maintain budget discipline and the quality of budget discipline, to carry on with the structural reforms such as the tax and social security reforms that will smooth the way for budget discipline in the upcoming years, with no interruption. Provided these policies are effectively implemented, the main course of inflation would be downwards even if there were temporary fluctuations due to exogenous shocks. Under the assumption that the current economic policies would continue, the public revenues and budget policy would be carried out in compliance with the targeted inflation rate and the structural reforms within the framework of the three-year economic program would be intensified, it is projected that inflation would follow a course well below the program target throughout 2004 and downward trend in increase in food, energy and public prices, which are seasonally adjusted, would continue in 2005.

Figure 5: Inflation Expectations According to CBRT Expectations Survey





Source: CBRT Expectations Survey