



# **DISINFLATION AND BALANCE OF PAYMENTS IN THE TURKISH ECONOMY**

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# Presentation Outline

## **1) Inflation and Monetary Policy**

- **Recent Developments**
- **Monetary Policy Stance**
- **Demand Conditions**
- **Inflation Outlook**

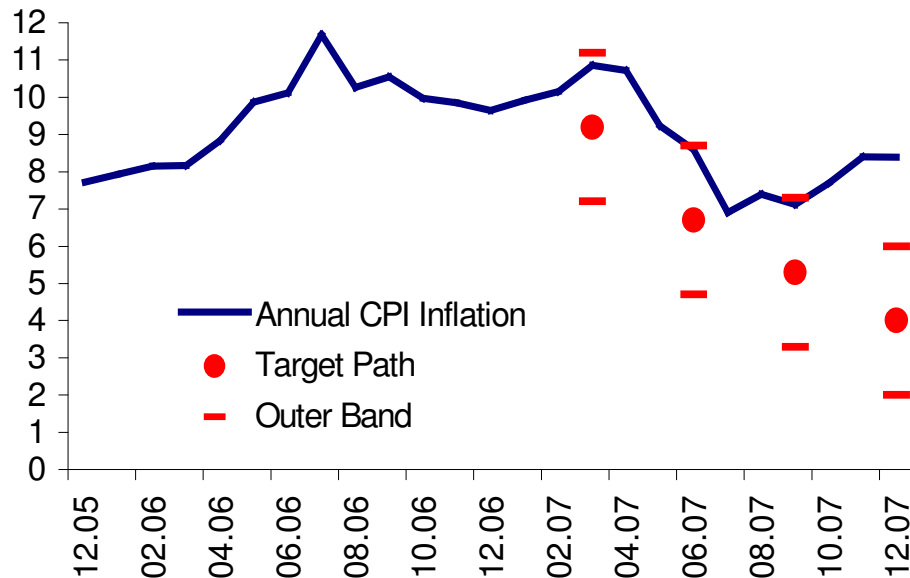
## **2) Balance of Payments**

- **Sources of Current Account Deficit**
- **Foreign Trade Developments**
- **Capital Flows**



# Inflation – Recent Developments

**Annual CPI Inflation and Target Path**  
(December 2005 – December 2007, yoy, percent)



Source: TURKSTAT, CBT

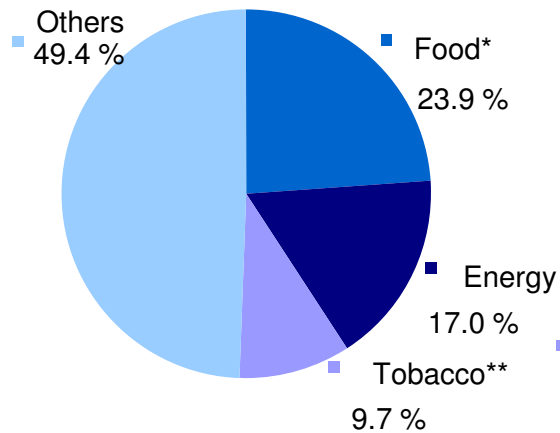
- ✓ Central Bank of Turkey (CBT) is implementing a formal inflation-targeting regime since the beginning of 2006.
- ✓ Central Bank has been decisively fighting against inflation for the last seven years.
  - Inflation targets were achieved and inflation was lowered by more than 60 percentage points between the years 2001 and 2005.
  - Inflation exceeded the targets in 2006 and 2007.
- ✓ Disinflation is a dynamic and ongoing process.



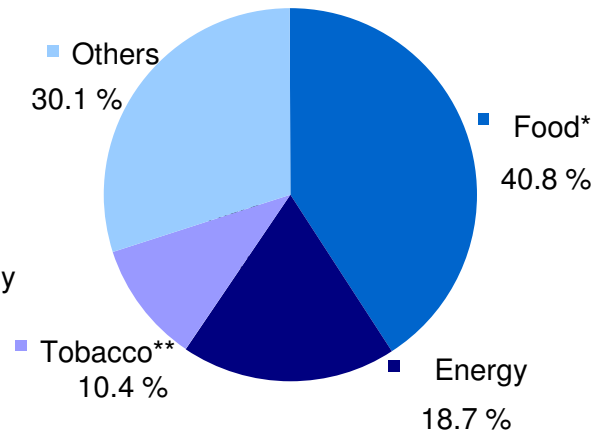
# Inflation – Main Causes

## Contribution to End-year CPI Inflation (percentage share)

2004-2006 Average



2007



\* Food: Food and non-alcoholic beverages

\*\* Tobacco: Tobacco products and alcoholic beverages

Source: TURKSTAT,CBT

✓ Food prices were the main factor impeding disinflation in 2007, with a marked contribution of about 3.4 percent on headline inflation.

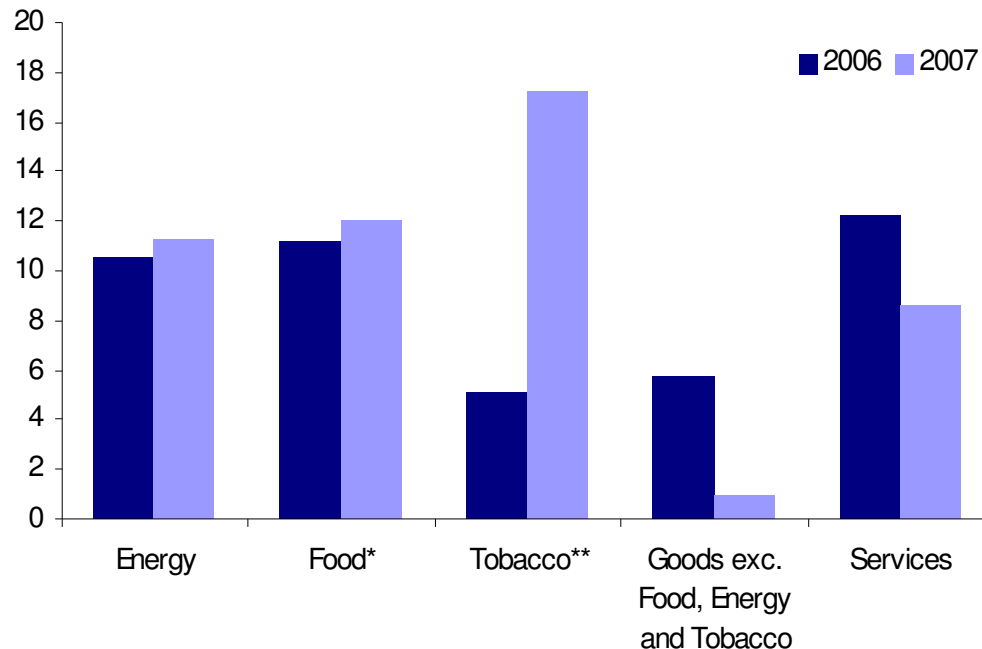
✓ The contribution of food prices to the headline inflation in 2007 was significantly higher than it had been during the past three years



# Inflation – Subcomponents

## Subcomponents of CPI

(Annual Percentage Change)



\* Food: Food and non-alcoholic beverages

\*\* Tobacco: Tobacco products and alcoholic beverages

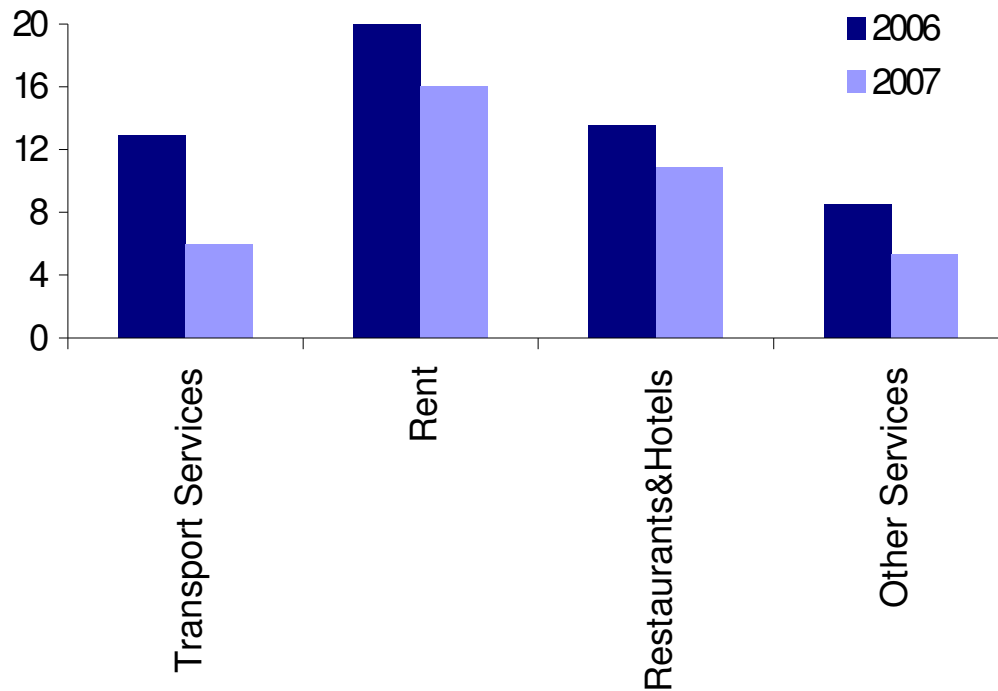
Source: TURKSTAT, CBT

- ✓ Annual inflation in certain subgroups of the CPI reveals the main factors behind the rise in inflation in 2007. Better-than-expected inflation figures in the services sector in the second and third quarters of the year gave a positive signal for inflation outlook.
- ✓ The fast pace of disinflation in services and core goods (goods excluding food, energy and tobacco) in 2007, confirms that supply side shocks were mainly responsible for the breach of the uncertainty band.



# Inflation – Services

**Subcomponents of Services Inflation**  
(Annual % Change)



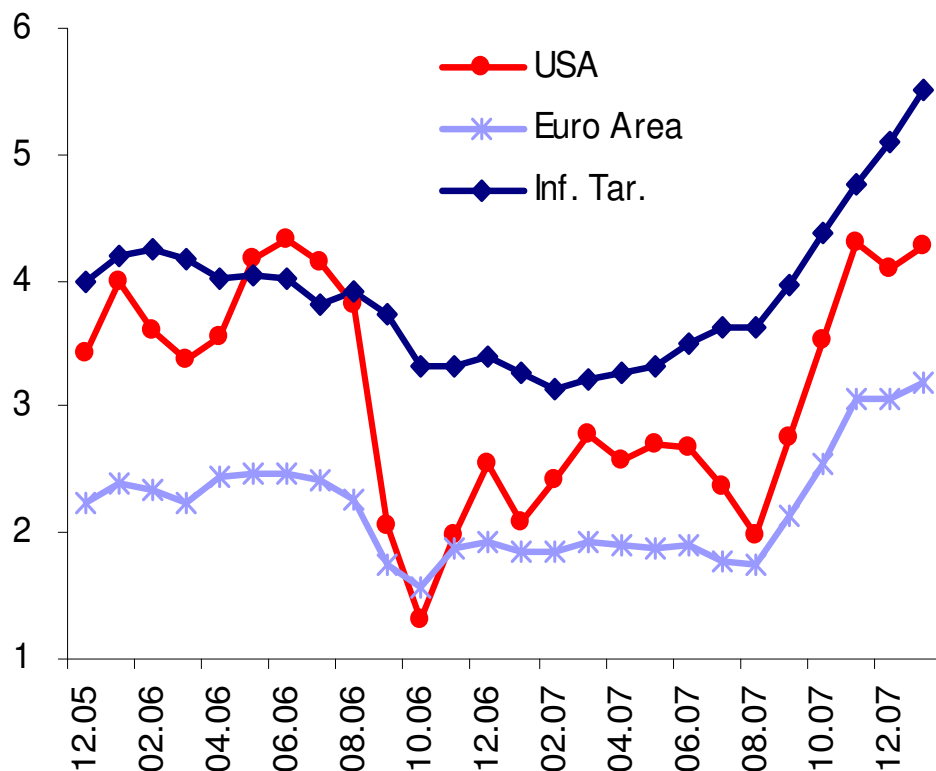
- ✓The effects of the monetary tightening were clearly visible on the prices of durable goods and services, consistent with the slowdown in the economic activity of related sectors. The weaker demand, coupled with a strong domestic currency, helped durables inflation to come down significantly.
- ✓Services inflation also eased remarkably, declining by 3.6 percentage points throughout 2007.

Source: TURKSTAT, CBT



# Inflation Worldwide

***Inflation in Other Regions\****



\*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.

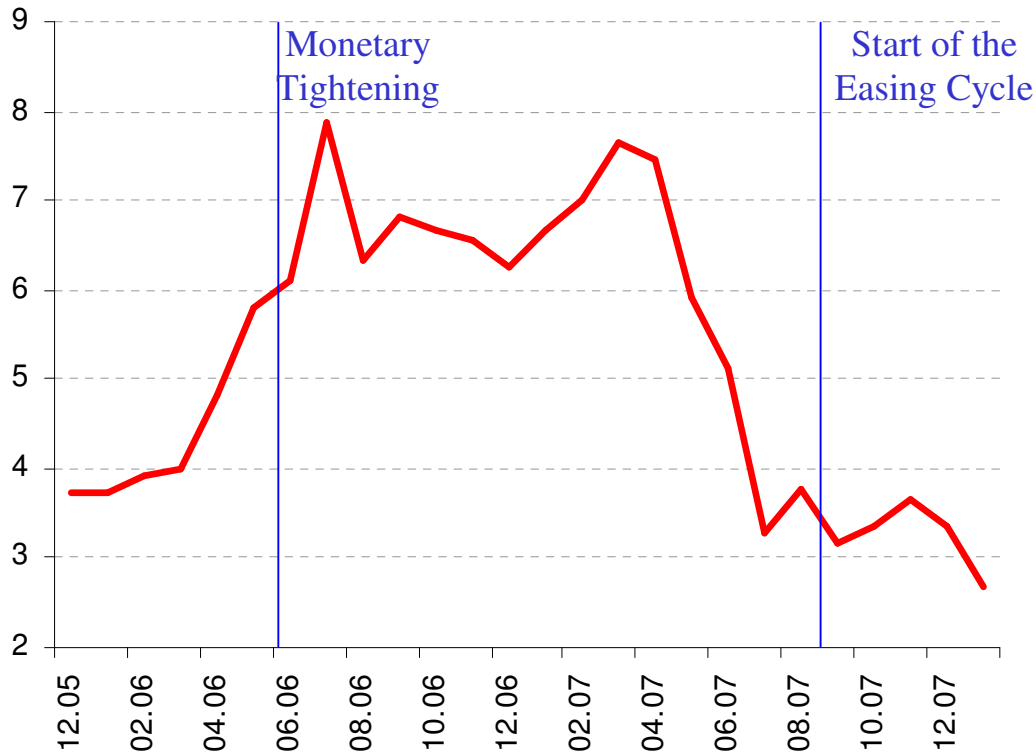
Source: Web sites of central banks

- ✓ Lately, inflation has been rising almost all over the world. In 2007, food group has added 3.4 percentage points to annual inflation.
- ✓ Elevated prices of crude oil, agricultural products and other commodities have continued to exert inflationary pressures.
- ✓ Although second round effects have been so far limited—thanks to well-established credibility of monetary authorities all over the world, sustained increases in commodity prices have started to take their toll on headline inflation, if not on core inflation.



# Inflation – Relative Success

***Difference Between Turkey and Other Emerg.  
IT'ers Inflation Rates***



✓ In 2007 inflation in Turkey followed a more favorable trend compared to other emerging economies with inflation targeting, despite the administrative price hikes in November, which added by about 1-percentage points to the Turkish CPI inflation.

\*Sample of emerging economies under inflation targeting covers Brazil, Czech Republic, Colombia, Philippines, South Africa, Israel, Hungary, Mexico, Peru, Poland, Romania, Chile, Slovakia and Thailand.

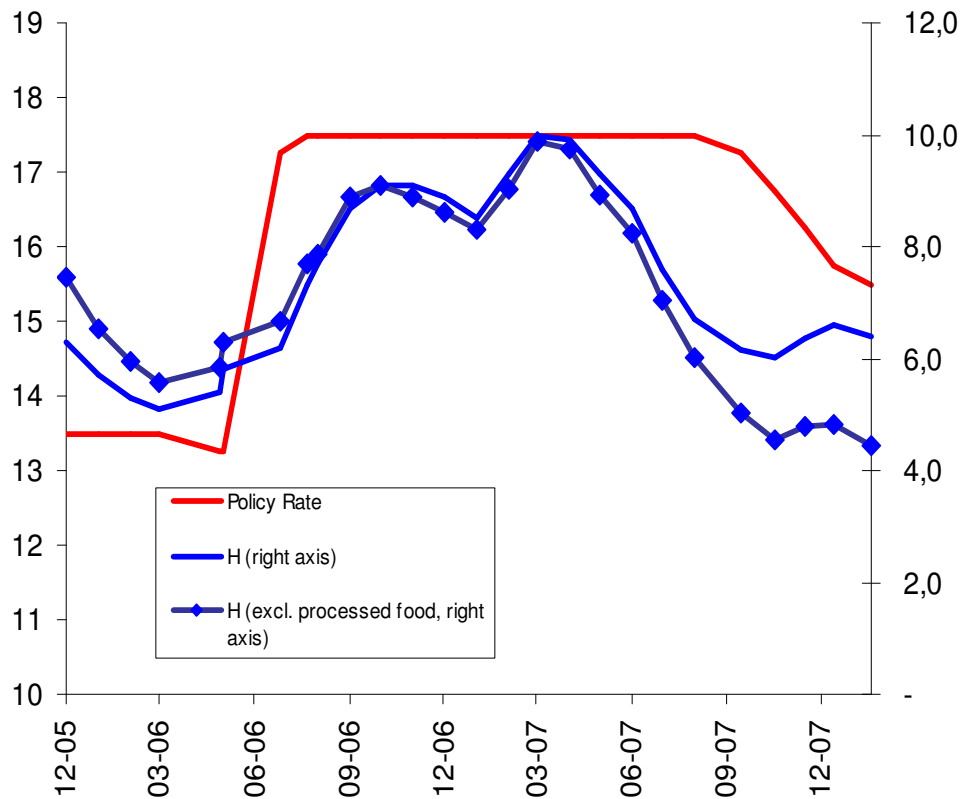
Source: Web sites of central banks





# Monetary Policy and Core Indicators

**Response of Inflation to the Monetary Tightening**



Source: CBT

- ✓ Annual percentage change in CPI excluding food, energy and tobacco items indicate an inflation trend of around 4.5 percent.
- ✓ Underlying inflation is not far away from the medium term target. Under the assumption that oil and food inflation will follow a more benign path in 2008 than in 2007, it is fair to expect some contribution to disinflation from the base effects.



# Monetary Policy Stance

## **Monetary Policy Committee (MPC) Decisions in 2007 and 2008**

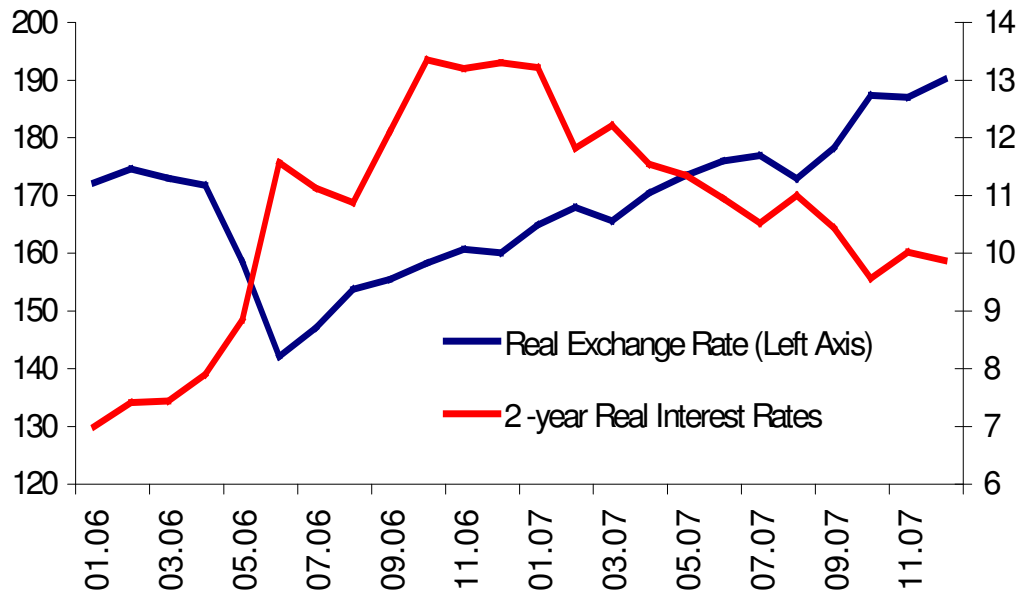
Dates for MPC Meeting	Decision on Interest Rate	Interest Rate
16 January 2007	No Change	17.50
15 February 2007	No Change	17.50
15 March 2007	No Change	17.50
18 April 2007	No Change	17.50
14 May 2007	No Change	17.50
14 June 2007	No Change	17.50
12 July 2007	No Change	17.50
14 August 2007	No Change	17.50
<b>13 September 2007</b>	<b>-.25</b>	<b>17.25</b>
<b>16 October 2007</b>	<b>-.50</b>	<b>16.75</b>
<b>14 November 2007</b>	<b>-.50</b>	<b>16.25</b>
<b>13 December 2007</b>	<b>-.50</b>	<b>15.75</b>
<b>17 January 2008</b>	<b>-.25</b>	<b>15.50</b>
<b>14 February 2008</b>	<b>-.25</b>	<b>15.25</b>

- ✓ The turbulence in mature financial markets in August increased the likelihood of a sooner-than- envisaged slowdown in global economic activity, and thus paved the way for initiating the policy rate cuts that was hinted earlier in the year.
- ✓ Accordingly, the MPC decided to start a measured rate cut cycle in September 2007.
- ✓ Policy rates were lowered by 225 basis points since then.



# Monetary Conditions

**Real Interest Rate and Real Exchange Rate\***



\*Real interest rates are computed by using the Expectations Survey and 2-year nominal rate estimated with Extended Nelson-Siegel method. Real exchange rate is CPI based (an increase means an appreciation).

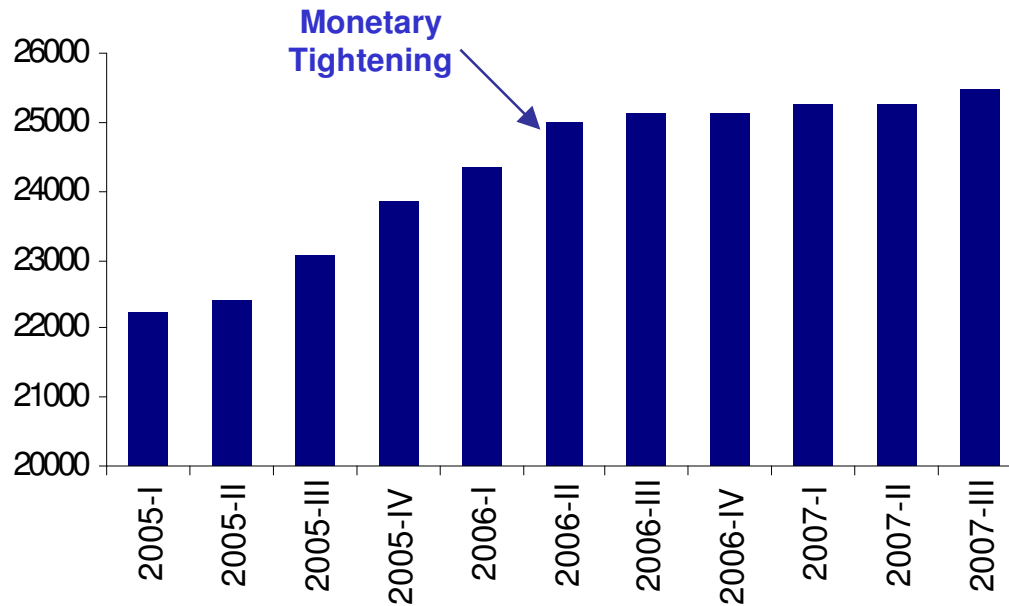
Source: CBT

- ✓ Although medium term interest rates followed a downward trend in the past quarter, 2-year real rates at this point fluctuate around 9 to 10 percent, implying a non-accommodative monetary stance.
- ✓ The currency remains strong, curbing inflationary pressures and easing the impact of rising commodity prices on domestic production costs



# Demand under Control

**Real Private Consumption**  
(Quarterly, seasonally adjusted)



- ✓ Strong monetary tightening was effective in moderating the private consumption demand
- ✓ Although government spending accelerated and external demand remained strong in the following quarters, monetary tightening was successful in curbing the aggregate demand, especially through the slowdown in durable goods, housing and other services.

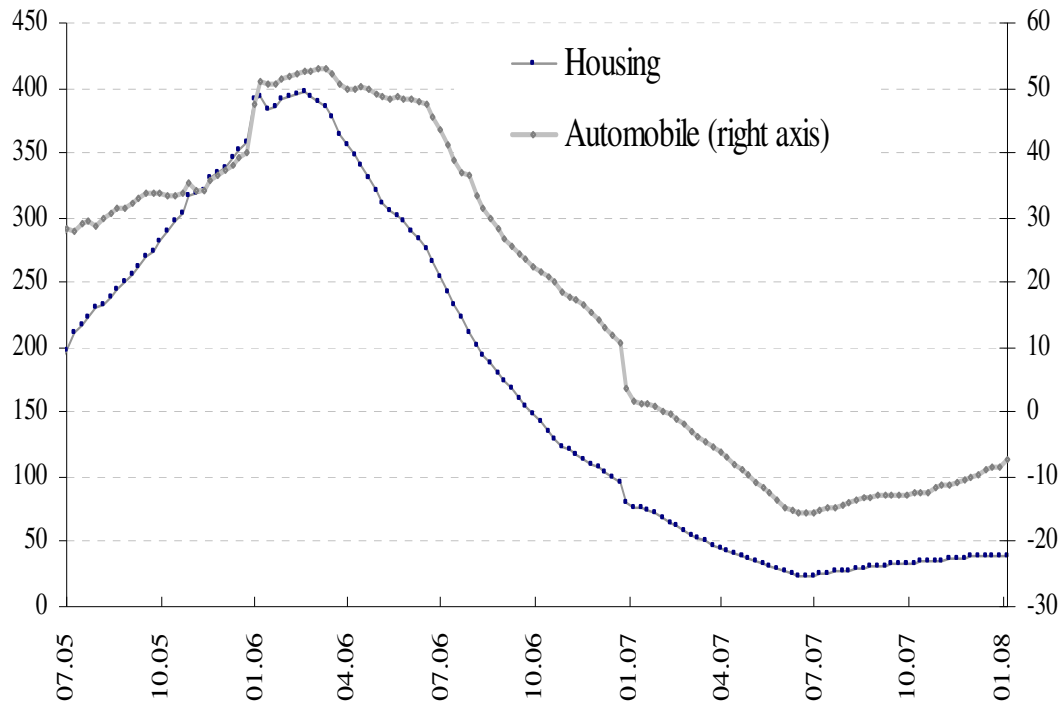
Source: TURKSTAT, CBT



# Moderate Credit Growth

## Selected Subitems of Consumer Loans

(Annual Percentage Change)



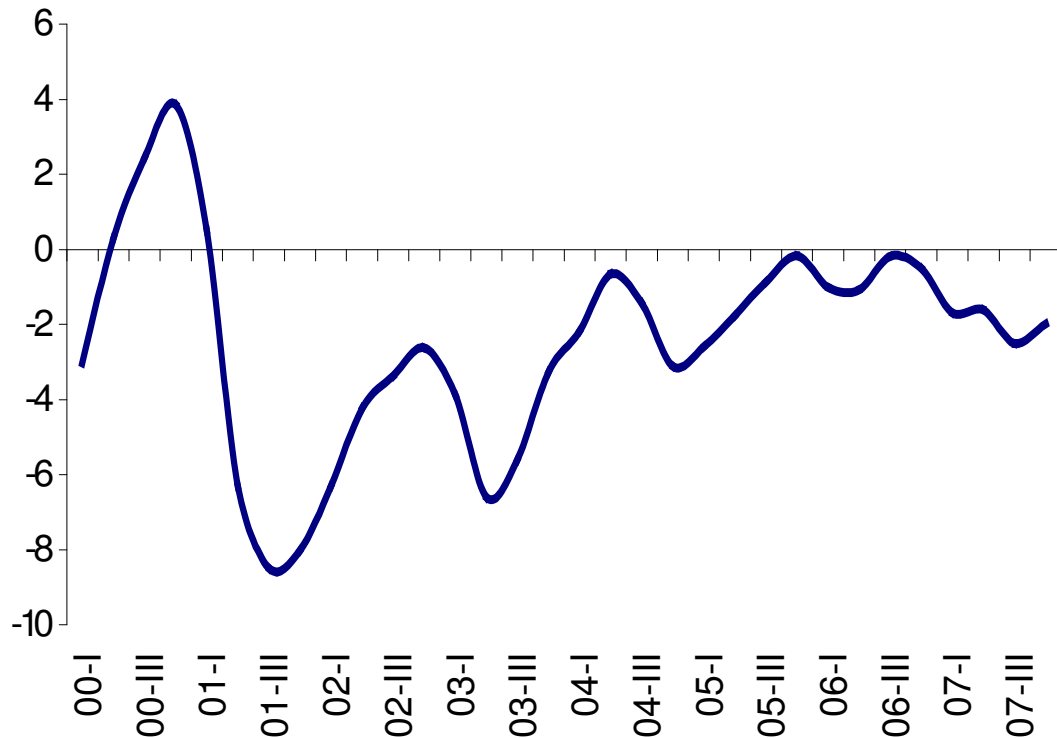
Source: CBT

- ✓ Credit data also suggest that monetary conditions are non-accommodative.
- ✓ Annual growth rates in the automobile and housing loans are much lower compared to the periods of vigorous domestic demand



# No Demand Pressures

*Output Gap*



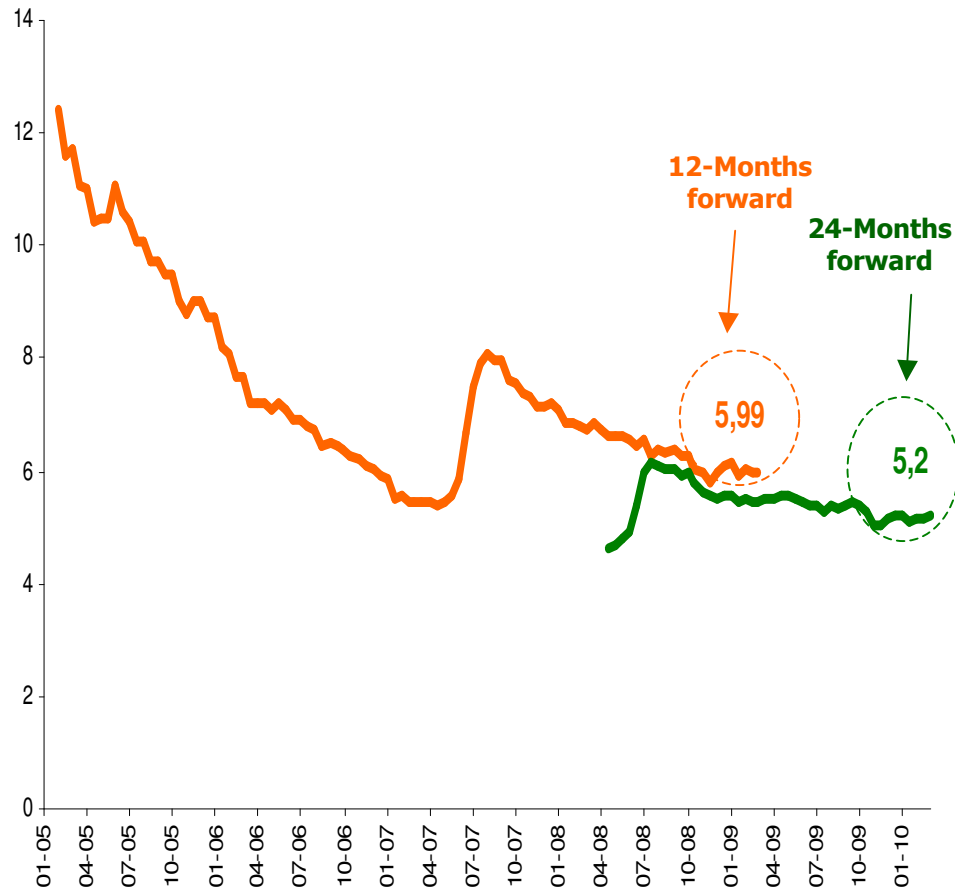
- ✓ Another factor likely to contribute to disinflation is a continuing output gap.
- ✓ Economic activity responded significantly to the strong monetary tightening in mid-2006.
- ✓ The sharp slowdown in the second half of 2006 created an ample slack in the economy. There are some signs of recovery in the second half of 2007.

Source: CBT



# Expectations Improving Slowly

## Medium Term Inflation Expectations



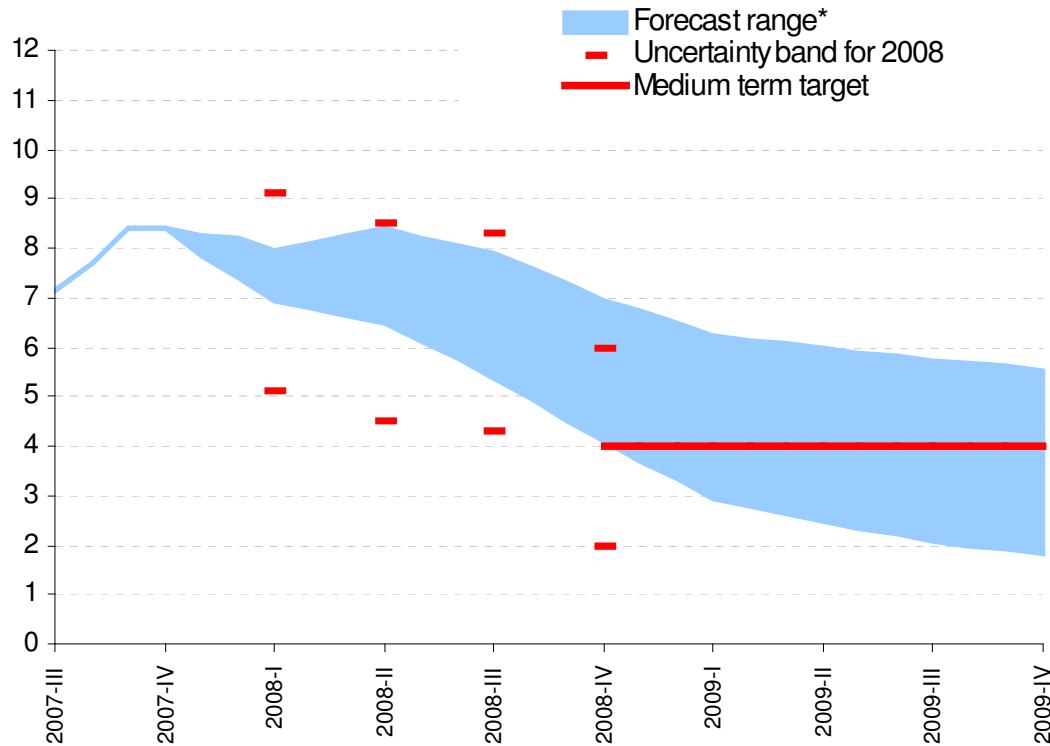
Source: CBT

- ✓ Both the 12-month and the 24-month ahead inflation expectations exhibited a declining pattern throughout 2007.
- ✓ However, the improvement in expectations, especially in the last quarter, was rather limited, owing to a backward looking behavior, and possibly, due to pre-announced hikes in administered energy prices.
- ✓ Nevertheless, it is worthwhile to mention that the administrative price hikes in November had little effect on medium term expectations.



# Inflation Outlook

## Inflation Projections\*



\*The shaded region indicates the 70 percent confidence interval for the forecast.

Source: CBT

- ✓ We forecast inflation, with 70 percent probability, between 4.1 percent and 6.9 percent (midpoint 5.5) at the end of 2008, and between 1.8 percent and 5.5 percent (midpoint 3.7) at the end of 2009.
- ✓ The forecasts are based on a scenario in which policy rates display a limited decline in 2008. Main message of the forecast is that continuation of the gradual easing cycle that started in September 2007 will remain conditional on favorable data and developments.





# Balance of Payments

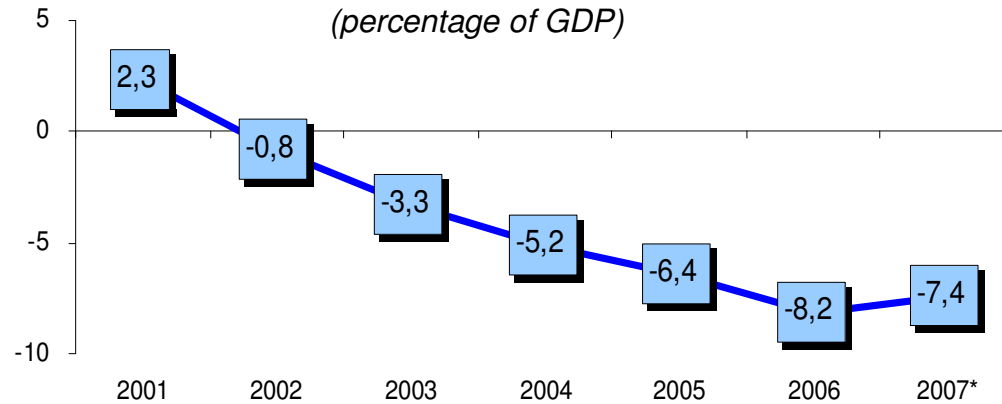
## **Why Current Account Deficit?**

- ✓ Domestic savings below investments
- ✓ 'Sustainability' and 'adjustment ability' are two main issues



# Savings and Investment

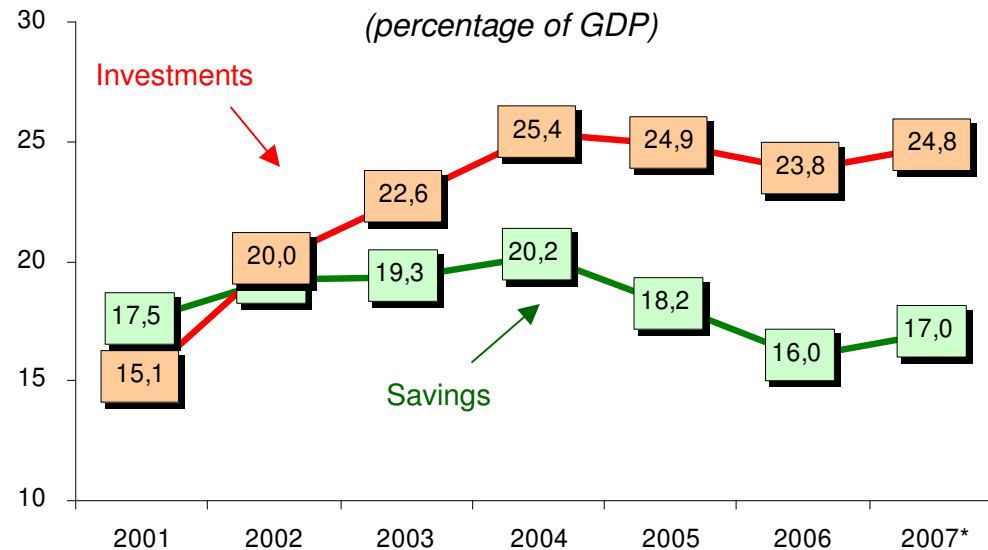
**Current Account Deficit**  
(percentage of GDP)



## Why Current Account Deficit?

Current account balance deteriorated by 10 percentage points between 2001 and 2007

**Domestic Savings and Domestic Investment**  
(percentage of GDP)



## Domestic savings are below investments

Between 2001 and 2007:

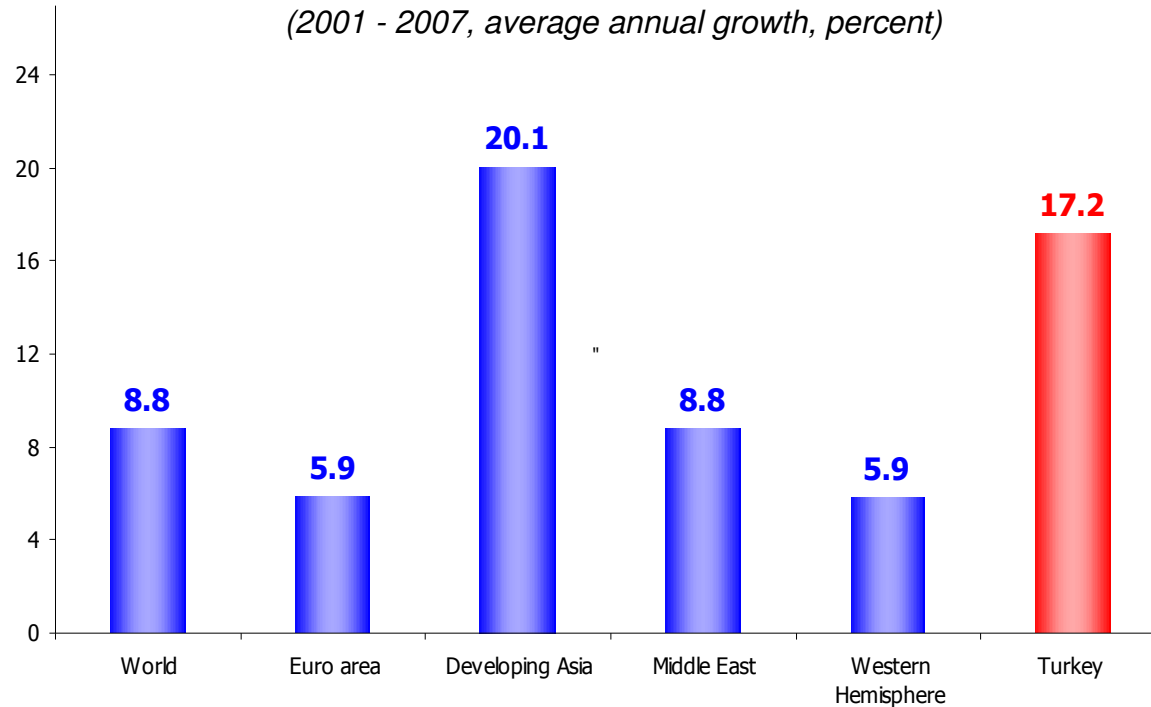
Savings decreased by 0.5 points and investment increased by 9.7 points



# Export Performance

## Export Growth Rate

(2001 - 2007, average annual growth, percent)



- ✓ Turkey is the one of the best export performers in the world.
- ✓ Between 2001 and 2007, average annual growth in exports was 17.2 percent.

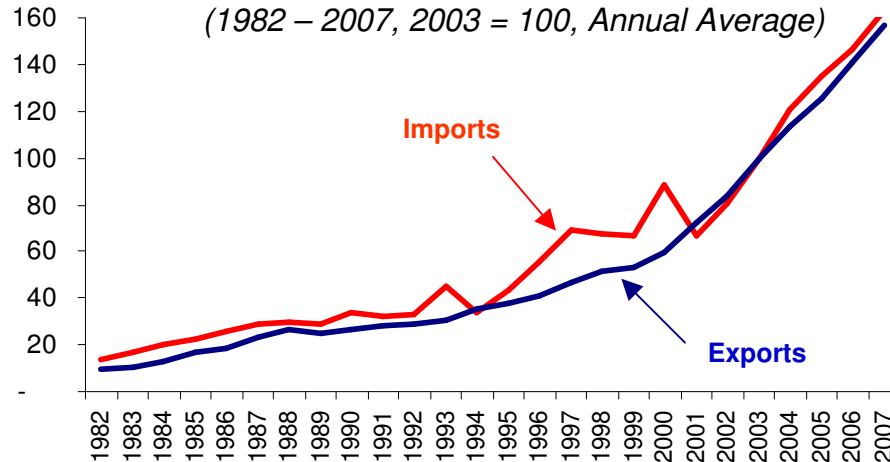
2007 figures are from IMF forecasts.

Source: TURKSTAT, IMF World Economic Outlook



# Trade balance

**Imports and Exports Quantity Indices**  
(1982 – 2007, 2003 = 100, Annual Average)



**The openness of the Turkish economy has accelerated since 2001.**



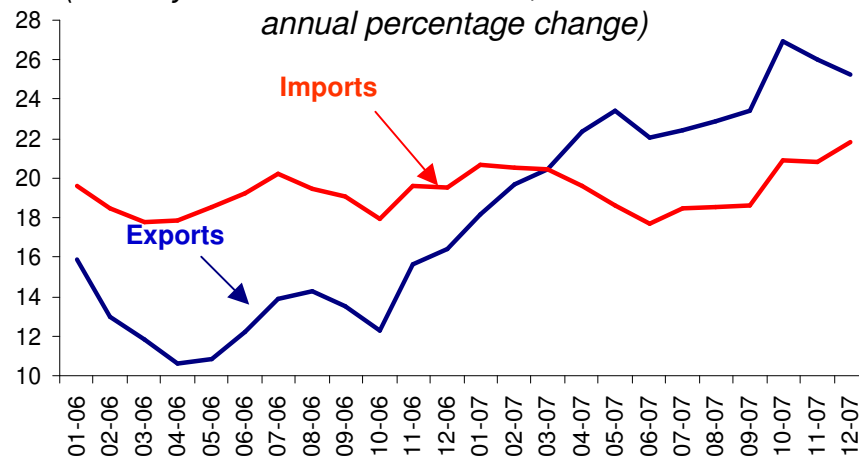
✓ According to the quantity indices adjusted for exchange rate and price movements, exports and imports have expanded almost in parallel in recent years, contrary to the 1995-2000 period.

✓ Exports growth rate was 25.3% in 2007, while that of imports stood at 21.8%.

✓ Annual growth rate of exports has outpaced that of imports since March 2007.

**Imports-Exports**

(January 2006 – December 2007, 12-month cumulative annual percentage change)

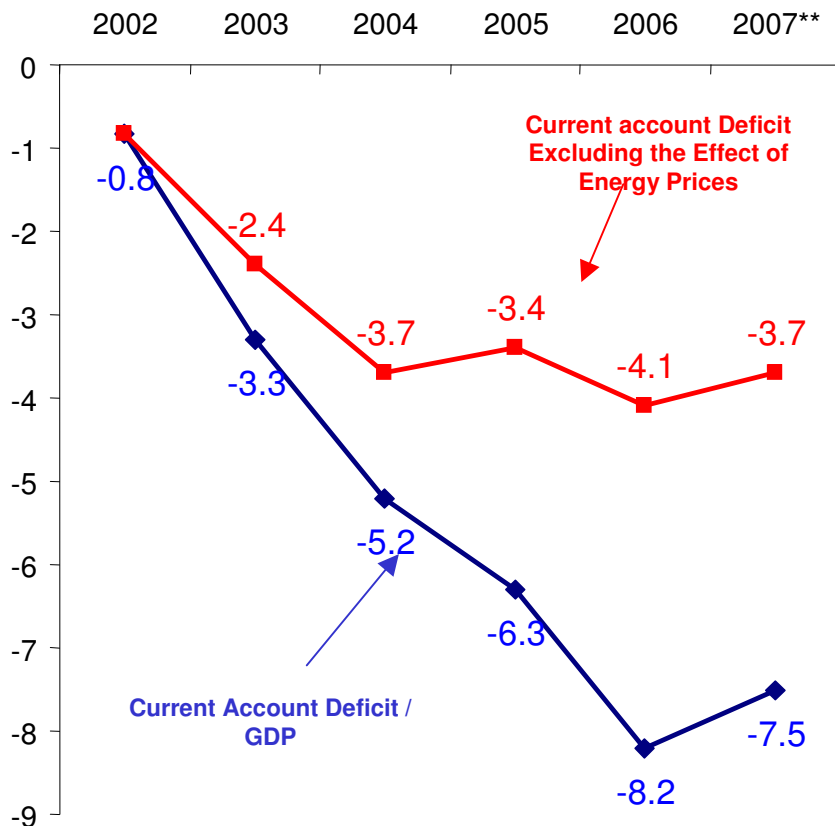


Source: TURKSTAT



# Effects of Energy Prices

**Current Account Balance and the Effect of Energy Prices on Current Account Deficit \***  
(2002 – 2007, ratio to GDP, percent)



\* The effect of energy price increases on the current account in the 2003-2007 period was calculated by keeping the prices of 2002 intact. Energy Sub-Items: Stone coal and lignite, crude oil and natural gas under the mining and quarrying sector, and coke coal, refined petroleum products and nuclear fuels under the manufacturing industry.

\*\* As of the third quarter of 2007

Source: TURKSTAT, CBT

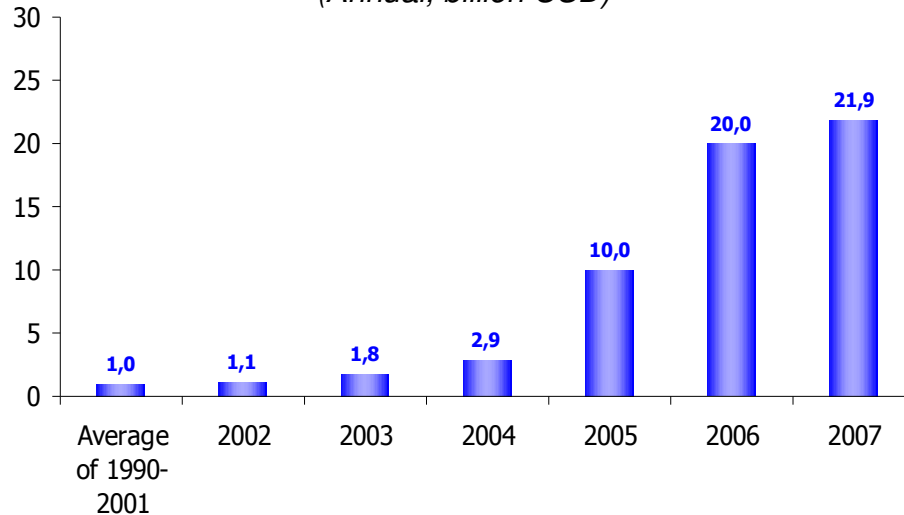
- ✓ The surge in energy prices was influential on the increase in CAD in recent years.
- ✓ High energy prices added 4.1 percentage points to the deficit in 2006.
- ✓ The deficit would have been 4.1 % of GDP in 2006, if the energy prices had remained at its 2002 level.
- ✓ High energy prices added 3.8 percentage points to the deficit as of 2007 Q3.



# Current Account Deficit and Its Financing

## Foreign Direct Investment

(Annual, billion USD)



Source: CBT

	FDI in 2006 (USD Billion)	Ratio to GDP (%)
China	69.5	2.6
Hong Kong	42.9	22.6
Russia	28.7	2.9
Singapore	24.2	18.3
Turkey	<b>20.1</b>	<b>5.0</b>
Mexico	19.0	2.3
Brasil	18.8	1.8
India	16.9	1.9
Romania	11.4	9.4
Chile	7.9	5.4

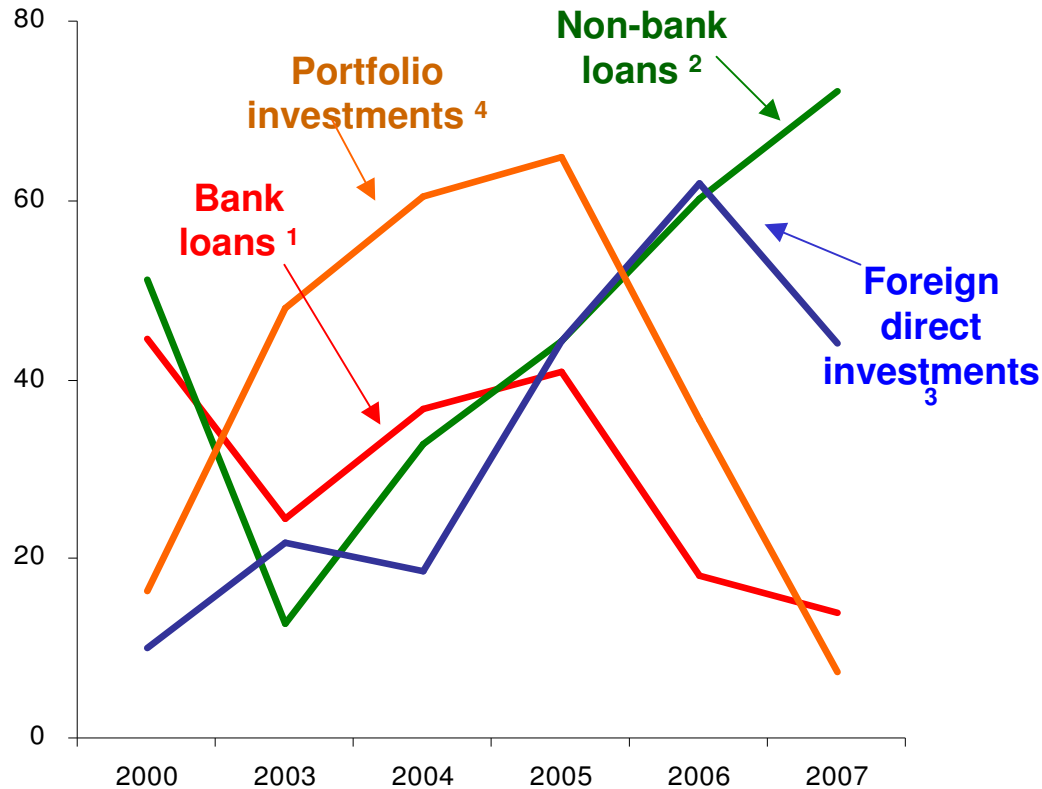
Source: UNCTAD, IMF WEO

- ✓ In 2007, foreign direct investment (FDI) net inflows was USD 21.9 billion.
- ✓ According to UNCTAD, Turkey ranked fifth among emerging countries in FDI in 2006.
- ✓ The strong performance in FDI inflows is expected to continue.



# Capital Flows

## Financing of the Current Account Deficit (2000 – 2007, 12-month cumulative, % of deficit)



✓ The ratio of the sum of foreign direct investments and long-term capital to GNP which was 12% in 2006 declined to 11,5% in 2007 while share of portfolio investments and short-term capital to GNP declined from 3,6% to 0,8% in the same period.

**1 Bank loans:** Net short-term and long-term loans borrowed by the banking sector from abroad.

**2 Non-bank sector loans:** Net short-term and long-term loans borrowed by the non-bank sector from abroad.

**3 Foreign direct investment:** Foreign direct investment inflows.

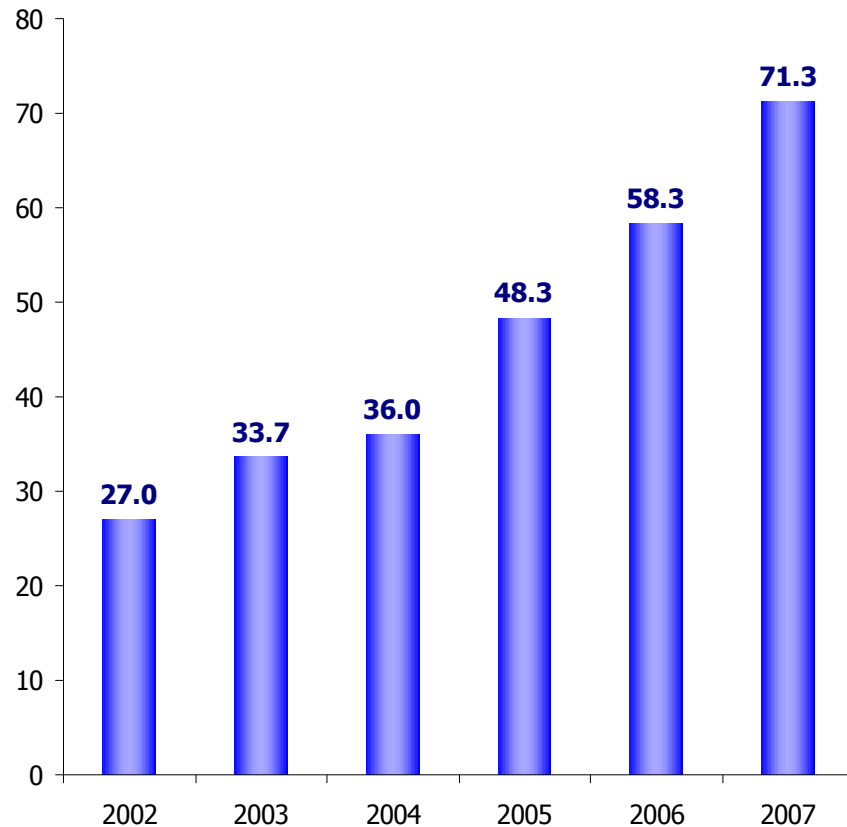
**4 Portfolio investments:** Government bonds, Treasury bills and stock purchases of non-residents.

Source: CBT



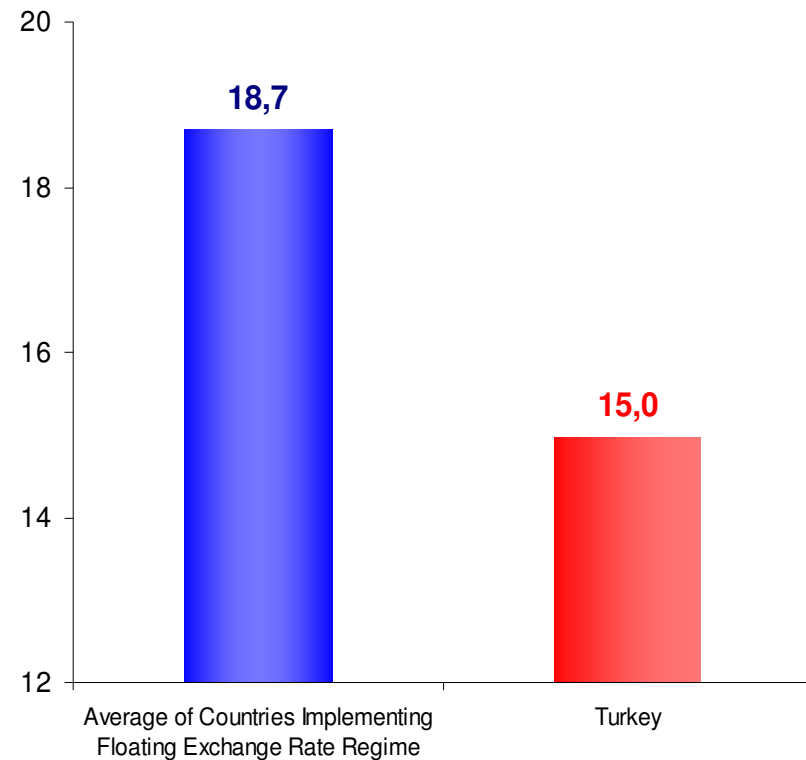
# Foreign Exchange Reserves

**Foreign Exchange Reserves**  
(Excluding gold, billion USD)



Source: CBT

**Ratio of FX Reserves to GDP in 2007 in Countries Implementing Floating Exchange Rate Regimes\***



\* Countries included in the calculation: Argentina, Brazil, Czech Republic, Indonesia, Philippines, South Africa, South Korea, Croatia, India, Kazakhstan, Colombia, Mexico, Paraguay, Peru, Poland, Romania, Russia, Chile, Thailand, Uruguay





# Balance of Payments

## Why Current Account Deficit?

- ✓ Domestic savings below investments
  - Deficit is driven and financed by the private sector.
  - Social security and energy sector reforms will improve savings.
  
- ✓ 'Sustainability' and 'adjustment capacity' are two main issues
  - Private sector is relatively better placed both to sustain and adjust if necessary.
  - Improvements in investment climate and labor market reforms will be helpful.



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