TÜRKİYE CUMHURİYET MERKEZ BANKASI

2013 JULY INFLATION REPORT

PRESS CONFERENCE

Erdem BAŞÇI

30 July 2013, Ankara

Distinguished Guests,

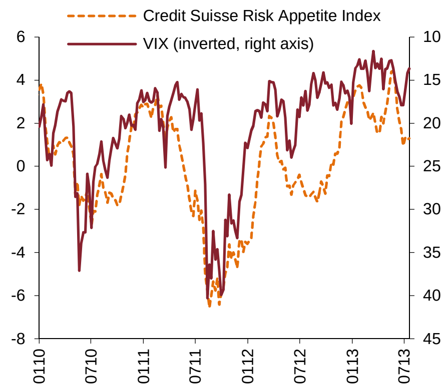
Welcome to the press conference held to convey the main messages of the Inflation Report. I will now present an overview of the report, which will be published on our website soon.

The report typically summarizes the economic outlook underlying monetary policy decisions, shares our evaluations on macroeconomic developments and presents our medium-term inflation forecasts, which were revised in view of the developments in the last quarter, along with our monetary policy stance. In addition to the main text, the report includes nine boxes entailing interesting and up-to-date analyses on various topics. For example, the report presents a box to contribute to a better understanding of the dynamics regarding the underlying trend of the current account balance in recent years. What is more, there are studies elaborating on the effects of the reserve options mechanism and our liquidity policy. There is also a box analyzing the effects of domestic cost factors on inflation. We also included studies on the hours worked and exports dynamics in the non-farm sector regarding the real sector in this report. Titles of the boxes are shown on the slide. All of these shed light on noteworthy issues in the Turkish economy. I strongly recommend that you read these boxes, which will soon be published on our website.

Now, I would like to convey the main messages of the report. Firstly, I will review the global economic outlook given its undeniable influence on our policies.

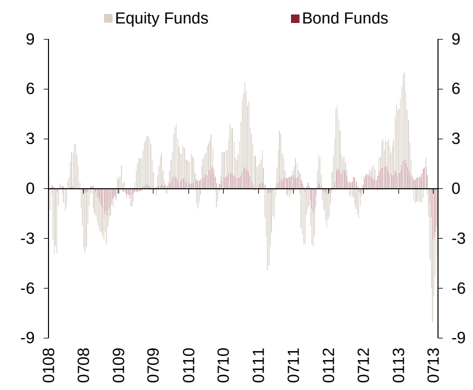
Developments regarding the global monetary policy influenced financial markets in the second quarter of the year. Persisting fragilities in the global economy in addition to increased uncertainty over the monetary policies of advanced economies led to higher volatility in the risk appetite (Chart 1). In particular, the Fed's signals for a pullback on bond purchases in the near future have resulted in capital outflows from emerging economies as of May (Chart 2).

Chart 1.
Global Risk Appetite



Source: Credit Suisse, Bloomberg.

Chart 2.
Portfolio Flows to Emerging Economies
(4-week MA, Billion USD)



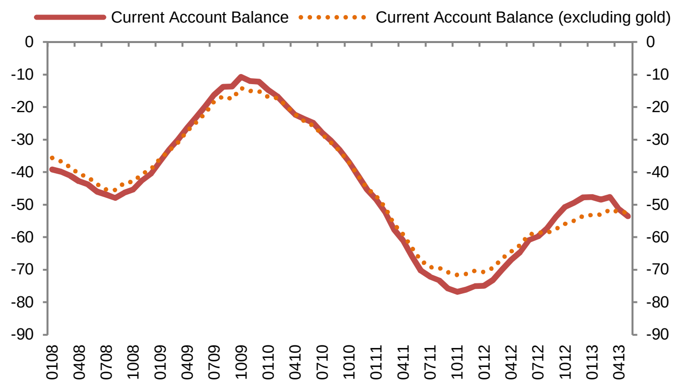
Source: EPFR, Bloomberg.

As global economic activity remains weak, we see that global growth forecasts are revised downwards. Despite the stable growth in the US economy, the weak course of the Euro area economies and the slowdown in emerging economies still persist. The recent surge in the volatility of capital flows has exacerbated the downside risks on emerging economies through the credit and expectations channel. In such an economic environment, maintaining a flexible monetary policy framework with multiple instruments remains crucial in order to preserve price stability while observing financial stability.

1. Monetary Policy and Monetary Conditions

Since end-2010, the CBRT has been implementing a monetary policy framework designed to take macro financial risks into account. Accordingly, we place special emphasis on containing the distortionary effects of capital flow volatility on price stability and financial stability. In fact, the new policy framework contributed greatly to the considerable decline in the portion of the current account balance stemming from cyclical effects. As seen on the slide, the current account balance excluding gold displayed a notable improvement in 2012. The stabilization trend has recently lost pace; still, a deterioration is out of the question. We may see a slight rise in the current account deficit in the short term because of the base effect stemming from gold, but I would like to state that no deterioration is envisioned in the underlying trend. Even a stable recovery is expected in the current account balance, excluding gold, in the second half (Chart 3).

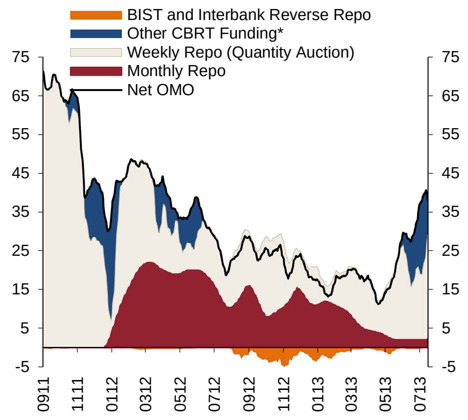
Chart 3.
Current Account Balance*
(12- Month Cumulative, Billion TL)



Source: TurkStat, CBRT.

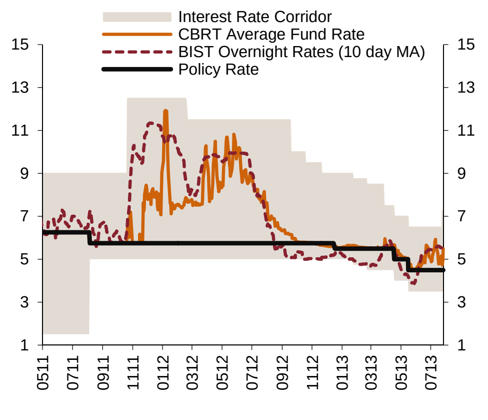
Now, I would like to continue with recent developments in the monetary policy. As you will recall, owing to the improved inflation outlook and strengthened capital inflows as of the third quarter of 2012, the CBRT opted for a gradual monetary easing. Despite occasional fluctuations stemming from the global risk appetite, liquidity policy in this period has been largely accommodative (Charts 4 and 5). We reduced short-term interest rates and the CBRT average funding rate until May 2013. Moreover, in order to alleviate the adverse effects of capital inflows on macroeconomic stability, reserve options coefficients were gradually raised.

Chart 4.
CBRT Funding
(2-Week Average, Billion TL)



Source: BIST, CBRT.

Chart 5.
Policy Rate and Liquidity Policies
(Percent)



Source: BIST, CBRT.

Developments as of late May called for a change in the monetary policy stance. Elevated uncertainties regarding global monetary policies caused rapid capital outflows from all emerging economies, including Turkey. This resulted in an excessive depreciation of the Turkish lira and fluctuations in financial markets, which led the CBRT to tighten the liquidity policy by changing the composition of the liquidity injected into the market (Chart 4).

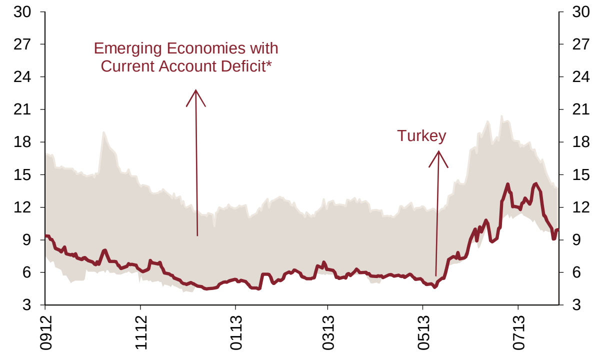
Multiple elements to fuel inflation appeared simultaneously in the last couple of months, leading inflation to record a higher-than-expected increase in the short-term. In the July meeting, the MPC decided to raise the upper band of the interest rate corridor by 75 basis points to contain the distortionary effects on the pricing behavior and to support financial stability. I will elaborate on these effects shortly.

Moreover, we introduced some arrangements to strengthen the effects of the interest rate corridor and the liquidity policy on the days of additional monetary tightening. I would like to emphasize that the monetary policy will remain cautious until the inflation outlook aligns with the medium-term targets and we may implement additional monetary tightening when deemed necessary.

Meanwhile, the Turkish lira liquidity policy was provided with more flexibility in the face of the persisting uncertainties regarding the global economy and the volatility in capital flows. Accordingly, I would like to remind you that developments regarding price stability and financial stability will be closely monitored and necessary adjustments will be made regarding the composition of the Turkish lira liquidity.

These decisions on the interest rate corridor have been helpful in alleviating the exchange rate volatility. As you know, the rise in the risk premiums of emerging economies and fluctuations in the foreign exchange markets caused our exchange rate volatility to record a relative increase. However, we signaled a widening in the interest rate corridor at the MPC Meeting. Then, we raised the upper limit, which led the exchange rate volatility to ease. As you see on the slide, the implied volatility of the Turkish lira remains low compared to those currencies of emerging economies running current account deficits (Chart 6).

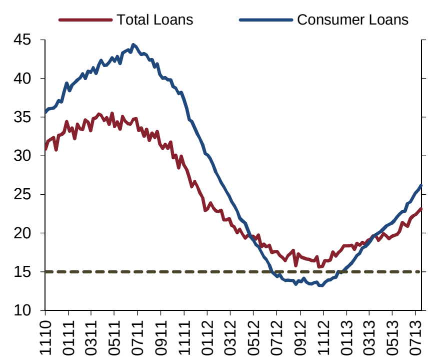
Chart 6.
Implied Volatility of Exchange Rates* (1-Month Ahead)



* Emerging economies with current account deficit include Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, Romania and Colombia.
Source: Bloomberg.

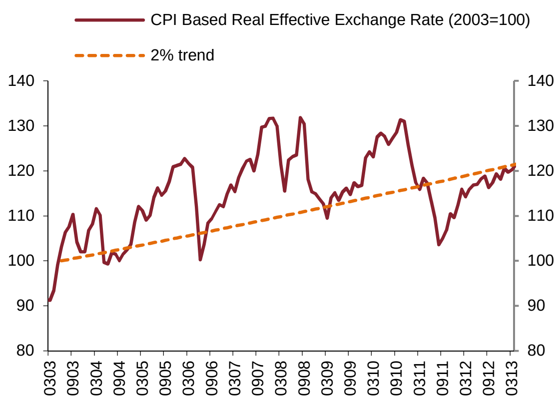
I think it will be helpful to evaluate the recent MPC decision in terms of financial stability. Monetary tightening in times of intense capital flows increases the excessive appreciation pressure on the local currency and adversely affects financial stability. This kind of a drawback is currently out of the question, since the Turkish lira is far away from excessive appreciation. Moreover, the credit growth rate still hovers above the reference value, which indicates that monetary tightening will also underpin financial stability through this channel. As a result, I would like to reiterate that in such an environment, raising the upper limit of the corridor was necessary for price stability and supportive for financial stability.

Chart 7.
Annual Growth Rate of Loans
(Annualized, Percent)



Source: BRSA, CBRT.

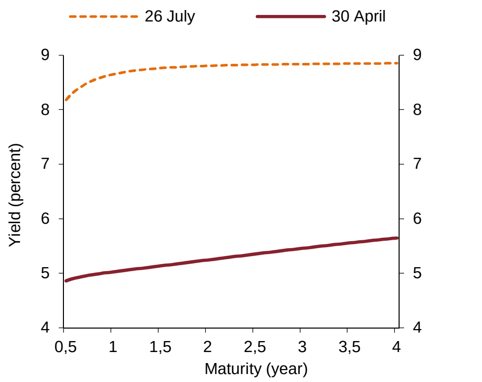
Chart 8.
CPI Based Real Effective Exchange Rate
(2003=100)



Source: Bloomberg.

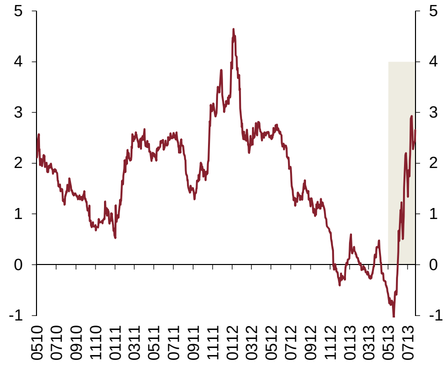
The effect of the recent developments on financial conditions has been slightly contractionary as expected. In line with the declining risk appetite, the tightening liquidity policy and the rising global interest rates, nominal market interest rates increased notably across all maturities, while real interest rates also followed a similar trend (Charts 9 and 10).

Chart 9.
Yield Curve*
(Percent)



*Calculated from the compounded returns on bonds quoted in BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

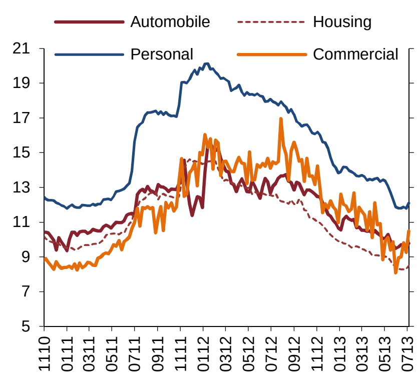
Chart 10.
2-Year Real Interest Rates for Turkey*
(Percent)



* Calculated as the 2-year discounted bond returns derived from the yield curve, minus the 24-month ahead inflation expectations from the CBRT's Survey of Expectations.
Source: BIST, CBRT.

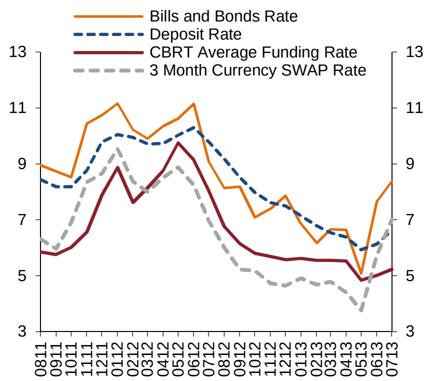
Recently, loan rates have also moved upwards. While commercial loan rates, which respond more quickly to liquidity conditions, posted an evident increase, consumer loan rates recorded a more limited rise (Chart 11). Meanwhile, deposit rates, currency swap rates, the CBRT's average funding rate as well as bill and bond rates issued by banks, which all represent the Turkish lira funding costs of banks, increased as well (Chart 12).

Chart 11.
TL Loan Rates
(Percent)



Source: CBRT.

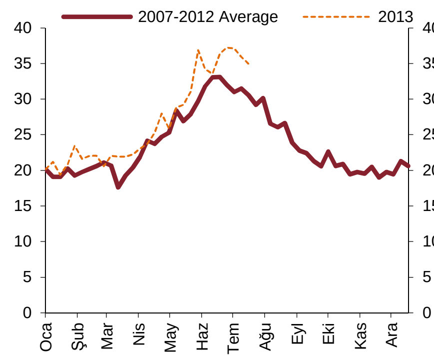
Chart 12.
Funding Costs of Banks
(Percent)



Source: CBRT, PDP.

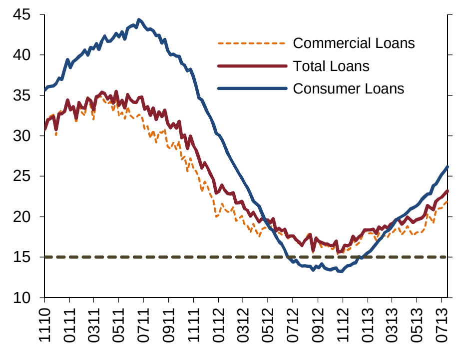
On the other hand, despite the recent slowdown in capital flows, credit growth remains robust. The course of credits as of July points to a faster growth compared to the average of the past years (Chart 13). Against this backdrop, annual credit growth rates also hover above the reference value (Chart 14). Due to mounting uncertainties in financial markets, we expect a slowdown in the growth rates of credit supply and credit demand in the forthcoming period. Nevertheless, we expect the annual credit growth rate to exceed the reference level at end-2013.

Chart 13.
Growth Rate of Total Credits
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)



Source: CBRT.

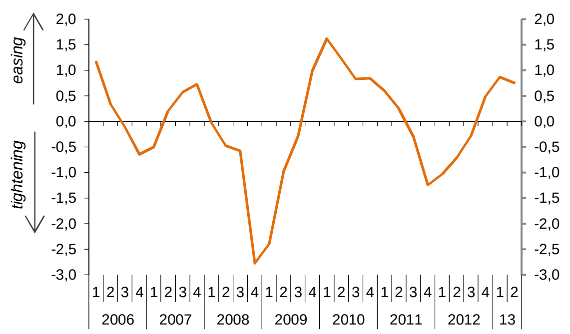
Chart 14.
Annual Growth Rate of Loans
(Percent)



Source: CBRT.

In the second quarter of the year, financial conditions continued to be accommodative notwithstanding a limited quarter-on-quarter tightening (Chart 15). Meanwhile, amid the slowdown in capital flows as of May, we envisage that financial conditions tightened further in July. In view of the cautious stance of the monetary policy, our forecasts are based on an outlook where the accommodative effect of financial conditions on domestic demand and credits tapers off in the second half of the year.

Chart 15.
Financial Conditions Index



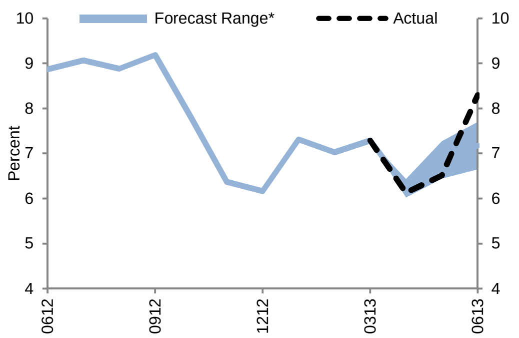
*For further details on financial conditions index, see CBT Research Notes in Economics No.12/31 and Inflation Report 2012-IV, Box 5.2.
Source: CBRT.

2. Macroeconomic Developments and Assumptions

Now, I will talk about the macroeconomic outlook and our assumptions on which our forecasts are based. First, I will summarize the recent inflation developments, and then continue with the domestic and foreign demand outlook.

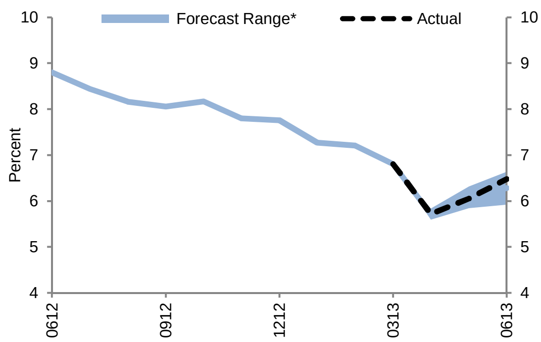
Inflation overshot expectations in the second quarter of 2013 and stood at 8.3 percent at the end of the quarter (Chart 16). This higher-than-estimated course of inflation was mainly attributed to developments in unprocessed food prices, which we stated would pose upside risks on inflation in the April Inflation Report. In fact, inflation excluding unprocessed food and tobacco was largely in line with our forecasts (Chart 17).

Chart 16.
April 2013 Inflation Forecasts and Realizations
(Percent)



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

Chart 17.
Inflation Forecast and Realizations Excluding Unprocessed Food, Tobacco and Alcoholic Beverages
(Percent)

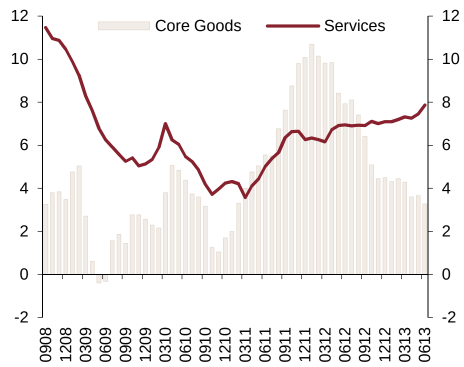


* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

The higher-than-projected rise in inflation in the previous quarter was partly motivated by the services inflation, which overshot expectations. This unexpected rise in services inflation added around 0.1 percentage points to the year-end inflation forecast.

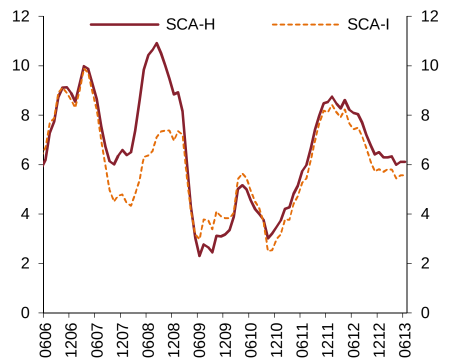
On the other hand, as the effects of exchange rate developments on core goods prices had not yet materialized by June, prices of core goods continued with a downward trend, owing also to the base effect (Chart 18). Thus, core inflation indicators followed a flat course in the second quarter (Chart 19). Meanwhile, we estimate that depending on the effects of the volatility exchange rate on inflation, headline inflation will slightly increase in the upcoming period. As I have just mentioned, in order to ensure this rise to be temporary and contain its distortionary effects on general pricing behaviors, we opted for a tighter policy stance by widening the interest rate corridor. I would like to point out that we will preserve this cautious stance until the inflation outlook aligns with the target.

Chart 18.
Core Goods and Services Prices
(Annual Percent Change)



Source: TurkStat.

Chart 19.
Core Inflation Indicators SCA-H and SCA-I
(Annual Percent Change)

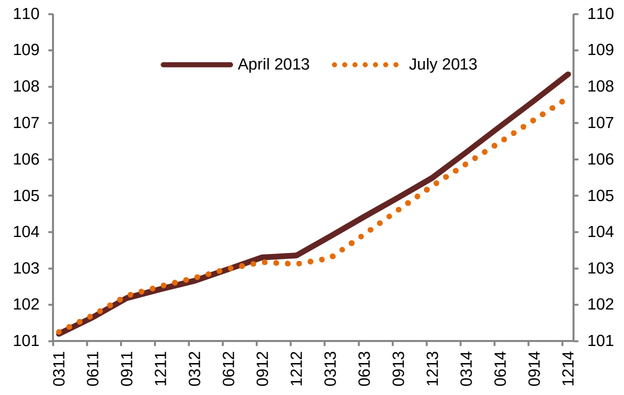


Source: TurkStat.

Now, I would like to talk about developments in economic activity and the short-term outlook, on which the inflation forecasts are based. National accounts data pertaining to the first quarter of 2013 pointed to a domestic-demand-driven recovery in economic activity as envisaged in the April Inflation Report. The second quarter data indicated that demand for consumption maintains a moderate growth. However, the recent volatility in financial markets created by the changes in global liquidity conditions may cause the domestic demand to follow a weaker course in the second half of the year than assumed in the previous reporting period. In fact, firms' expectations for domestic orders have recently displayed a slight decline.

External demand remained weak in the second quarter of 2013. Euro Area economic activity remained on a downward track, while global growth forecasts were pulled down in this period. Accordingly, the export-weighted global growth index was slightly revised downwards (Chart 20).

Chart 20.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)



* For methodology, see Inflation Report 2010-II, Box 2.1 “Foreign Demand Index for Turkey”.
Source: Bloomberg, Consensus Forecasts, CBRT.

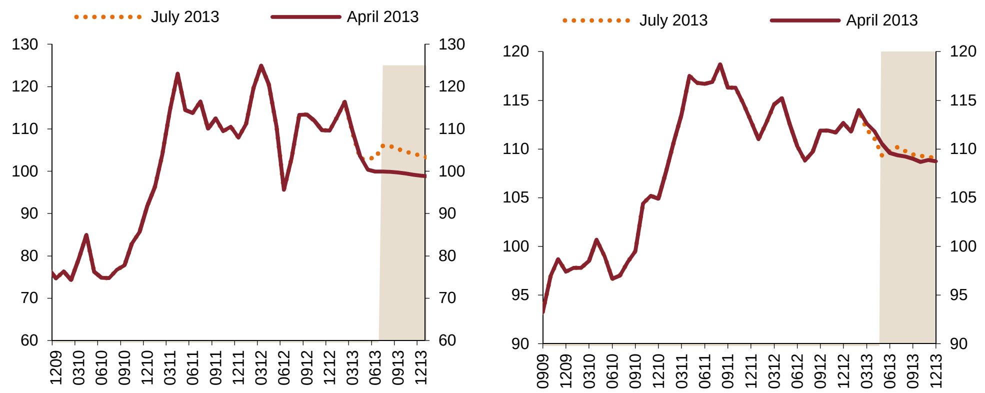
To sum up, a co-analysis of domestic and foreign demand reveals that forecasts are based on an outlook in which the contribution of aggregate demand conditions to the fall in inflation has slightly increased compared to the previous reporting period. As the effects of the economic activity on inflation generally appear with a lag, this revision did not affect end-2013 inflation forecasts, whereas it pulled the end-2014 inflation forecasts down by 0.1 percentage points.

As you all know, food, energy and import prices also play a great role in inflation forecasts. Therefore, before moving on to forecasts, I will briefly talk about our assumptions regarding these variables.

Import prices remained flat in the last quarter largely consistent with the assumptions of the April Inflation Report (Chart 21). On the other hand, TL-denominated import prices rose notably due to the recent developments in exchange rates. In addition, in line with the average futures prices in the first three weeks of July, average oil price assumption for 2013, which was set as USD 103 in April, was revised upwards to USD 107 (Chart 21). These developments added 0.8 percentage points to end-2013 forecast and 0.2 points to the end-2014 inflation forecast.

Chart 21.
Oil and Import Price Assumptions

Oil Prices (USD/bbl)* | Import Prices (USD, 2010=100)*



* Shaded region indicates the forecast period.
Source: Bloomberg, CBRT.

* Shaded region indicates the forecast period.
Source: TurkStat, CBRT.

We preserved our assumption for the annual rate of increase in food prices as 7 percent. In other words, it was assumed that the recent unfavorable course of unprocessed food prices would be temporary, and prices would gradually be normalized by August.

Before moving on to forecasts, I will talk about our assumptions regarding public finance. Medium-term projections are based on the assumption that no additional tax adjustments will be introduced to tobacco and energy products the rest of the year. Meanwhile, we assumed other tax adjustments and administered prices would be consistent with the inflation targets and automatic pricing mechanisms.

Regarding the fiscal policy stance, MTP projections are taken as given. Accordingly, we assumed that fiscal discipline would be preserved and the ratio of primary expenditures to GDP would not display a notable change compared to the first half of the year. Thus, there has been no change in end-2013 inflation forecast stemming from the fiscal policy.

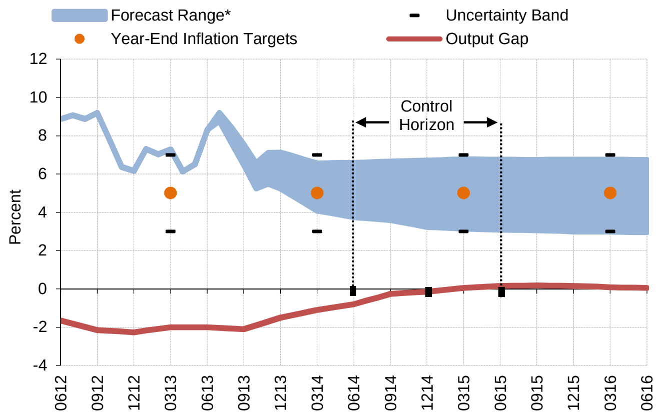
3. Inflation and the Monetary Policy Outlook

Now, I would like to present our inflation and output gap forecasts based on the outlook I have described so far.

Our medium-term forecasts perceive an outlook where the cautious and flexible stance of the monetary policy is preserved on account of the recently-elevated uncertainties regarding global monetary policies and weakening capital flows. In other words, we assume that the liquidity policy will be tight, the interest rate corridor will be actively used when necessary, and the annual growth rate of credit will fall to 15 percent by mid-2014.

Accordingly, we expect inflation to be, with 70 percent probability, between 5.2 percent and 7.2 percent (with a mid-point of 6.2 percent) at end-2013 and between 3.3 percent and 6.7 percent (with a mid-point of 5.0 percent) at end-2014 (Chart 22).

Chart 22.
Inflation and Output Gap Forecasts



* Shaded region indicates the 70 percent confidence interval for the forecast.

Source: CBRT.

In sum, given the assumptions underlying the inflation forecasts and external conditions, end-2013 inflation forecast was revised upwards by 0.9 percentage points mainly due to developments in the exchange rate and oil prices. Given the sluggish outlook of the global economy and the mild course of domestic demand, we believe these developments will have a limited effect on end-2014 inflation.

As seen on the slide, inflation is estimated to fluctuate in the short term due to base effect on energy prices. Accordingly, annual inflation is expected to climb to around 9 percent in July before trending downwards from August onwards. Although inflation is likely to overshoot the 5 percent target at the year-end, it is expected to approach the target by early 2014 as the effects of the hike in tobacco prices on annual inflation taper off in January 2013 (Chart 22). We expect core inflation indicators (SCA-H and SCA-I) to display a limited rise in the third quarter due to the lagged effects of the recent exchange rate developments, and then remain largely flat until the end of the year.

In addition to these forecasts, alternative scenarios on the inflation outlook and the global economy are discussed in the Risks section of the Inflation Report. Basically, we mention that global liquidity conditions will play a considerable role on the future stance of the monetary policy. You can examine the Report for details.

While concluding my remarks, I would like to thank all my colleagues who contributed to the Report, primarily those at the Research and Monetary Policy Department as well as the members of the Monetary Policy Committee, and thank every one of you for your participation.