TÜRKİYE CUMHURİYET MERKEZ BANKASI

2013 OCTOBER INFLATION REPORT

PRESS CONFERENCE

Erdem BAŞÇI

31 October 2013, İstanbul

Distinguished Guests,

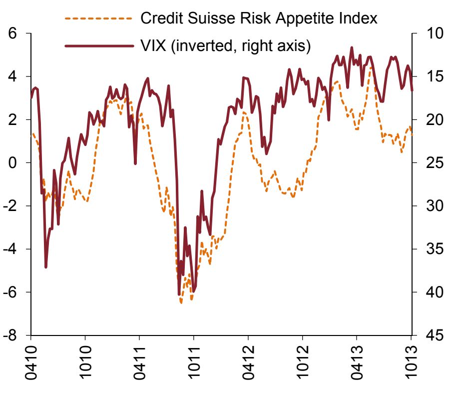
Welcome to the press conference held to convey the main messages of the Inflation Report. I will now present an overview of the report, which will be published on our website soon.

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 ten boxes entailing interesting and up-to-date analyses on various topics. 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.

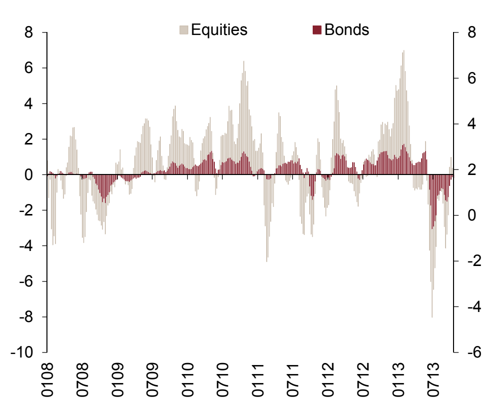
Global monetary policy developments continued to influence financial markets in the third quarter of the year. Ongoing concerns over global growth led to expectations that the US Federal Reserve might soon start trimming its bond purchases, while the pullback on bond purchases was postponed later on, causing the global risk appetite to remain volatile (Chart 1.1). Emerging economies witnessed capital outflows since the Fed’s first signal for tapering off bond purchases in May (Chart 2). In this period, all financial assets have been re-priced on a global scale.

Chart 1
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

Chart 2.
Portfolio Flows to Emerging Economies
(12-Week Moving Average, Billion USD)



Source: EPFR.

As global economic activity remains weak, we expect uncertainties over global monetary policies to linger for some time. While the US economic recovery is yet to stabilize, financial volatilities and the recent budget battle have posed risks to the recovery by tightening financial conditions. Despite some positive signs from the Euro Area economies, both the high unemployment rate and problems in the credit transmission mechanism have caused the economic outlook to remain weak. The fact that global monetary policies depend on high frequency data releases as well as the course of economic recovery, and that those data and recovery indicators are volatile, cause the uncertainties about global monetary policies to persist.

1. Monetary Policy and Monetary Conditions

Elevated uncertainties regarding global monetary policies since May led the CBRT to adopt a cautious monetary policy that took into account both inflation indicators and macro financial risks fueled by global uncertainties. Accordingly, we continued to implement additional monetary tightening to contain the negative effects of rising inflation on the pricing behavior. In August, to enhance the effectiveness of the additional monetary tightening, the Bank widened the interest rate corridor by raising the overnight lending rate from 7.25 percent to 7.75 percent. In addition, the effective liquidity management helped short-term rates to be realized close to the upper band of the corridor. Hence, a front-loaded monetary tightening was implemented in the same period, which compensated for the distortion in inflation expectations. As of August, we decided to enhance the predictability of the Turkish lira liquidity policy in order to limit the impacts of global monetary policy uncertainties on the domestic economy. To this end, we adopted a strategy of reducing interest rate uncertainty by creating a framework where the relationship between global interest rates and domestic interest rates has largely weakened and market rates have become more sensitive to domestic macroeconomic developments as they should be.

In the third quarter, we continued to provide the market with foreign exchange liquidity via foreign exchange selling auctions, which fed into the growing Turkish lira liquidity deficit in the market (Chart 3). We cut the share of one-week repo in total funding in this quarter, which led to an increase in the share of funds from overnight and monthly lending facilities. Correspondingly, the CBRT's average funding rate and the BIST interbank overnight repo rate increased (Chart 4).

Moreover, in line with its strategy of enhancing the predictability of liquidity management, we have been sharing more information about the frequency and timing of the additional tightening since August. Recently, due to our cautious monetary stance, the Interbank Repo Market rates have been mostly hovering between 6.75 and 7.75 percent. We are able to control the interest rates in the money market via various policy instruments through an efficient liquidity management and affect the money market rates in the favored direction and to the required extent. Accordingly, I would like to underline that in addition to the average funding cost, Interbank Repo Market rates shown in the chart should be closely monitored for a better assessment of the monetary policy stance.

Chart 3
CBRT Funding# (2-Week Average, Billion TL)

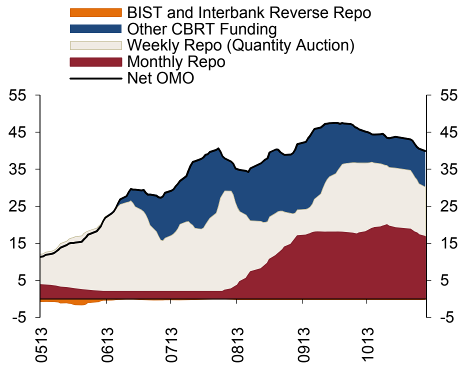
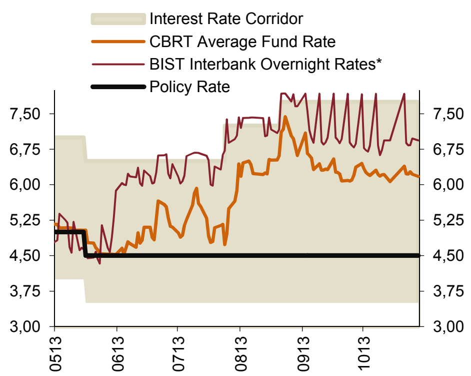


Chart 4.
Policy Rate and Liquidity Policies (Percent)



Other CBRT funding includes primary dealer repo transactions, repo transactions at the BIST Repo and the Reverse Repo Market and lending depo facility at the Interbank Money Market.

* 18 basis points were added to BIST Interbank Overnight Repo Rate. For BIST Interbank Repo Market overnight rates see: http://borsaistanbul.com/veriler/verileralt/tahvil-ve-bono-piyasasi-verileri/piyasa-verileri

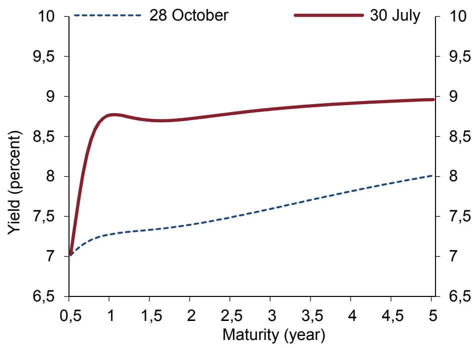
Source: BIST, CBRT.

We will gradually raise this predictability of the monetary policy in the period ahead and ensure that interest rates in the Interbank Money Market to hover around 6.75 percent except the days on which the EPS is implemented. To enhance predictability in the funding strategy, we will limit the stock amount of the weekly funding we provide through the quantity auction method at 4.5 percent, not to exceed TL 10 billion until the year-end. Moreover, issues regarding the implementation procedures besides the funding amount to be made under this method as of 2014 will be elaborated on in the Monetary and Exchange Rate Policy for 2014 to be published in December 2014.

Under this outlook with a gradual increase in predictability, I would like to remind you that our monetary policy will remain cautious until the inflation outlook becomes consistent with the medium-term projections.

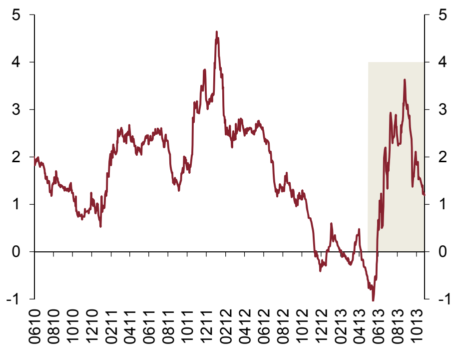
In the third quarter, interest rates were down from the previous reporting period across all maturities, with a larger decrease in the shorter end, while the yield curve trended upwards (Chart 5). This is due to the slightly improved global risk sentiment and Turkey's falling country risk premium as well as the CBRT's monetary policy strategy to reduce interest rate uncertainty which had a greater impact on short-term rates. Meanwhile, 2-year real rates declined on falling nominal rates and rising inflation expectations (Chart 6).

Chart 5.
Yield Curve*
(Percent)



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

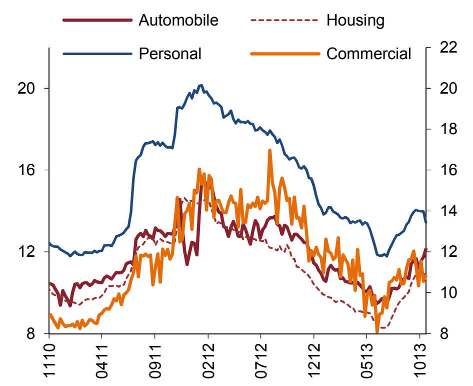
Chart 6.
2-Year Real Interest Rates for Turkey*
(Percent)



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

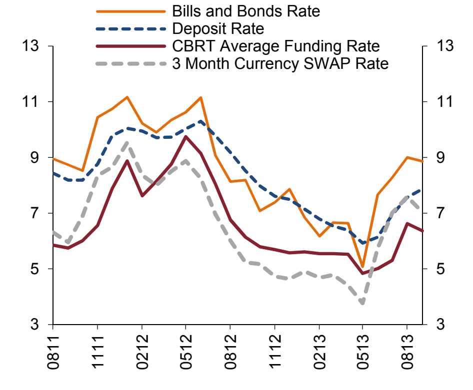
Loan rates that trended down in the first half of 2013 started to go up by the third quarter (Chart 7). This quarter-long uptrend reflects global financial developments and the CBRT's July and August tightening of overnight lending rates via the interest rate corridor. Moreover, deposit rates, currency 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 in the same period (Chart 8).

Chart 7.
TL Loan Rates
(Percent)



Source: CBRT.

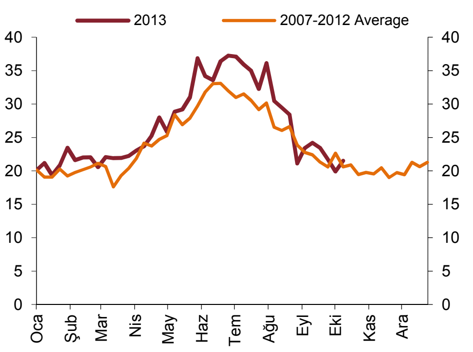
Chart 8.
Funding Costs of Banks
(Percent)



Source: PDP, CBRT.

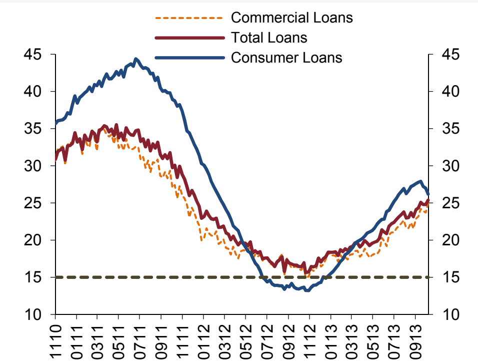
After a more robust first half compared to the average of past years, loan growth has come down to levels similar to the average of those years as of August (Chart 9). Rising loan rates due to recent financial fluctuations and our cautious monetary stance have contributed to this slowdown. Yet, the annual rate of loan growth still recorded a striking 25 percent in the third quarter (Chart 10). We envisage the cautious monetary stance, recent macroprudential measures and weak capital inflows to bring the loan growth rates gradually to more plausible levels in the forthcoming period.

Chart 9.
Growth Rate of Loans
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)



Source: CBRT.

Chart 10.
Annual Growth Rate of Loans
(Percent)

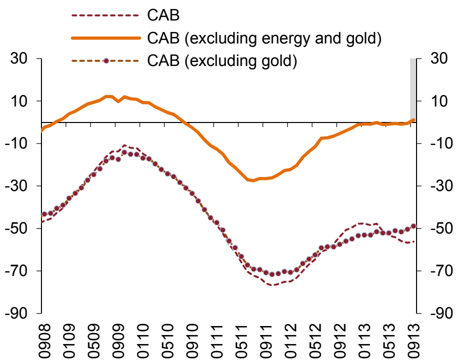


Source: CBRT.

The current policy framework has a favorable impact on the current account balance. After hitting an all-time high at the end of 2011, the current account deficit saw a major correction in 2012. Although there has been some deterioration in the 12-month cumulative current account deficit since early 2013, this is largely due to the gold market dynamics, which is a temporary factor. In terms of the current account balance excluding gold, the correction that started in 2012 has continued into 2013, albeit more slowly (Chart 11).

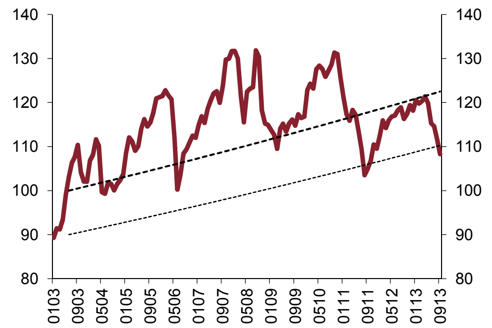
We expect real exchange rate and credit developments to support the economic rebalancing over the upcoming period. The real effective exchange rate depreciated after the recent nominal exchange rate developments and largely retreated from the levels that can be called excessively overvalued (Chart 12). We expect the current account balance to correct further in the forthcoming period amid expectations for a more acceptable rate of loan growth, a moderate final domestic demand growth and developments in the real exchange rate. This will cushion the Turkish economy against the potentially high levels of global uncertainty in the upcoming period by strengthening its financial stability and supporting the re-balancing process.

Chart 11.
Current Account Balance (CAB)*
(12-Month Cumulative, Billion USD)



* Third quarter data includes July-August realization and September forecast.
Source: CBRT, TURKSTAT.

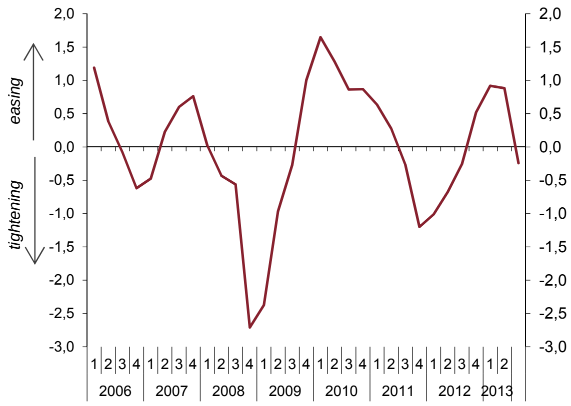
Chart 12.
Real Effective Exchange Rate
(CPI based, 2003=100)



The dotted lines show the 2 percent annual trend starting from June 2003=100 and June 2003=90.
Source: CBRT.

In sum, uncertainty continued to reign over financial markets in the third quarter of 2013 and financial conditions tightened (Chart 13). The tightening of the index is mostly due to weak capital inflows, rising loan rates and higher market rates.

Chart 13.
Financial Conditions Index *



*For further details on financial conditions index, see CBT Research Notes in Economics No.12/31.
Source: CBRT.

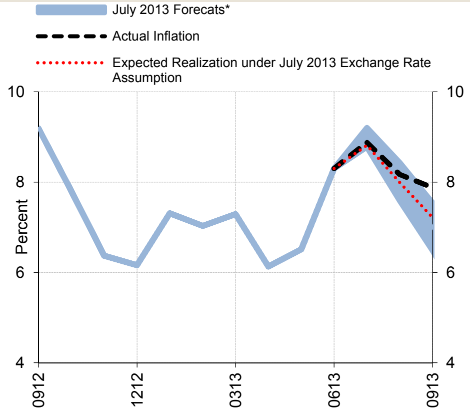
2. Macroeconomic Developments and Assumptions

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.

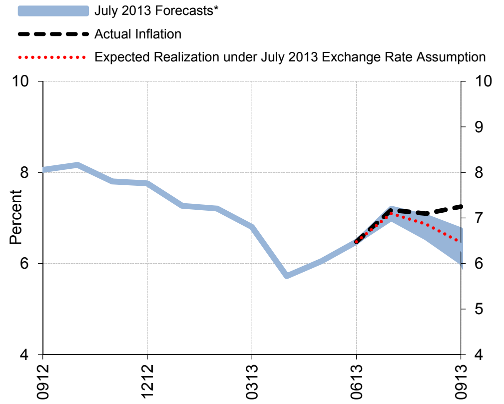
Annual consumer inflation fell by 7.9 percent in the third quarter of 2013, slightly overshooting the July Inflation Report forecasts (Chart 14). This overshooting was mainly attributed to a weaker Turkish lira and higher unprocessed food prices. As a result, the main inflation indicators increased as well (Chart 15).

Chart 14.
July 2013 Inflation Forecasts and Realizations
(Percent)

Chart 15.
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.

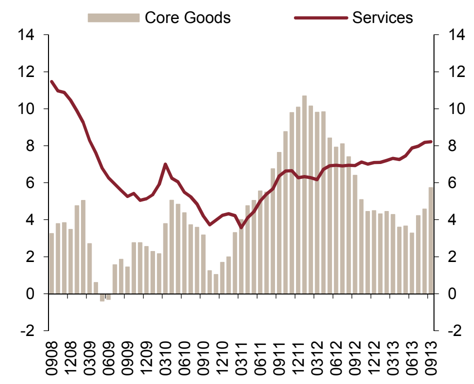


* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

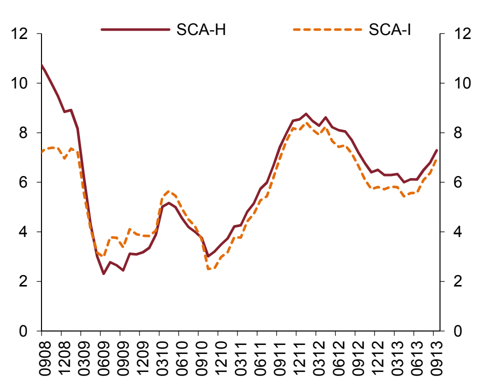
The higher-than-projected inflation in the previous quarter was largely induced by the additional depreciation in the Turkish lira (Charts 14 and 15). I think it shall be useful to inform you about how the exchange rate assumptions are made in the Inflation Report. Traditionally, the Inflation Report takes the exchange rate realizations during the reporting month as given for the current quarter, and adopts a framework where exchange rates respond endogenously to the monetary stance and other economic developments afterwards. Accordingly, the exchange rate estimations are based on the July average in the July Inflation Report. The Turkish lira depreciated following the July Inflation Report, and this depreciation caused inflation to be higher than projected in the third quarter. This additional depreciation put an upward pressure of about 0.4 points on the end-2013 inflation forecast.

Exchange rate developments affect core inflation via prices of core goods (Chart 16). Services inflation went up in the third quarter as well, but remained relatively more stable. Accordingly, core inflation indicators displayed an upward trend (Chart 17).

Chart 16.	**Chart 17.**
Core Goods and Services Prices (Annual Percent Change)	Core Inflation Indicators SCA-H and SCA-I (Annual Percent Change)



Source: TurkStat.



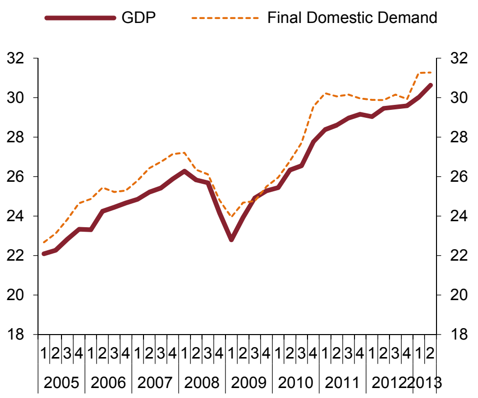
Source: TurkStat.

Now, I would like to talk about developments in economic activity and the short-term outlook, on which the inflation forecasts are based. Economic activity was more favorable in the second quarter of 2013 compared to the outlook set in the July Inflation Report. The stronger-than-expected economic activity was mostly driven by changes in inventories. Private consumption demand saw a dramatic recovery, while final domestic demand remained almost flat due to slowing public demand (Chart 18). On the other hand, imports grew strongly, while exports increased only modestly due to weak global demand.

Indicators for the third quarter of 2013 suggest that economic activity will grow more moderately than in the second quarter. In the July-August period, production of consumer goods was down from the previous quarter, while imports of consumer goods continued to rise. On the investment side, indicators show a weaker outlook compared to consumption demand. While exports were flat, imports saw a remarkable decline. Therefore, we expect the negative contribution of net exports to growth to decrease in the third quarter. Meanwhile, the export-weighted global growth index remains virtually unchanged from the previous reporting period (Chart 19).

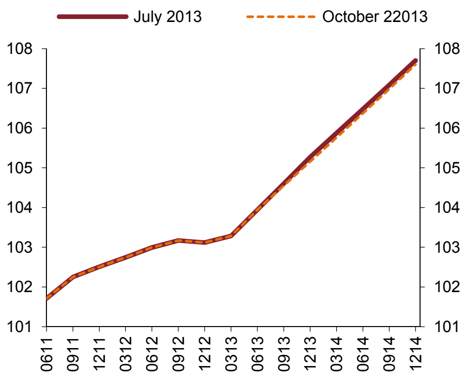
Final domestic demand is likely to continue to recover modestly in the second half of the year. Thus, we revised output gap forecasts slightly upwards for 2013. However, downside risks to recovery increased following the latest financial developments. Accordingly, we revised output gap forecasts downwards for 2014. We expect domestic demand developments to support the downtrend in inflation and the improvement in current account deficit in the months to come.

Chart 1.2.5.
GDP and Final Domestic Demand
(Seasonally adjusted, Billion TL, 1998 prices)



Source: TurkStat, CBRT.

Chart 1.2.6.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)



* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".

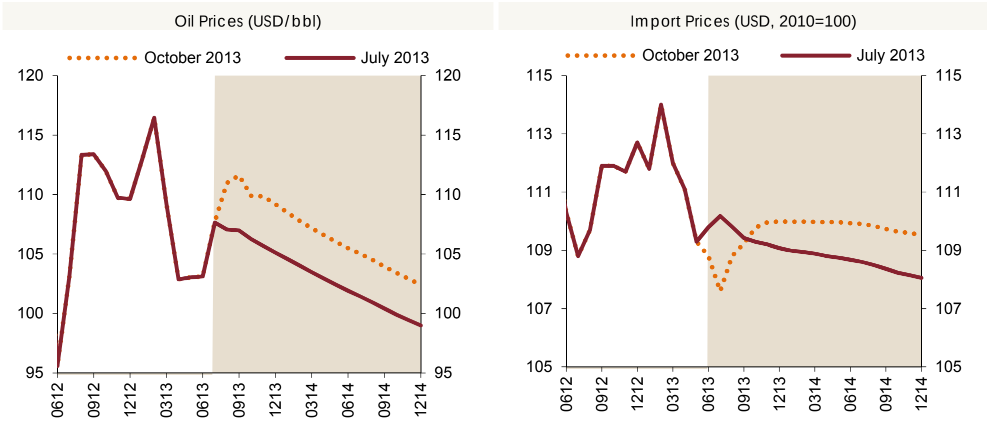
Source: Bloomberg, Consensus Forecasts, CBRT.

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 end-2013 inflation has slightly increased compared to the previous reporting period. This revision drove the end-2013 inflation forecast up by 0.1 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 below the assumptions of the July Inflation Report in the third quarter. On the other hand, oil prices materialized slightly above the assumptions (Chart 20). In line with the average futures prices in the first three weeks of October, the average assumption for 2013, which was set as USD 107 in July, was revised upwards to USD 109. This revision added 0.1 percentage points to the end-2013 inflation forecast.

Chart 20.
Oil and Import Price Assumptions



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

* Shaded area 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.

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. Thus, there has been no change in the end-2013 inflation forecast stemming from the fiscal policy.

Regarding the fiscal policy stance, recently-revised MTP projections are taken as given. Accordingly, we assumed that fiscal discipline would be preserved and the ratio of primary expenditures to GDP would gradually decline starting next year.

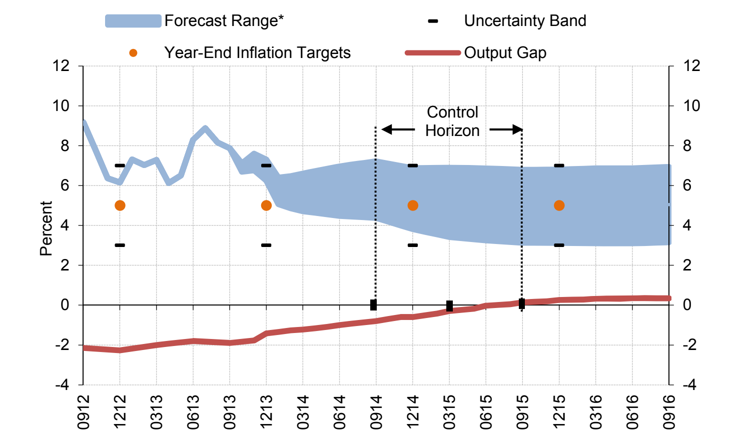
3. Inflation and the Monetary Policy Outlook

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

Medium-term forecasts perceive an outlook where a gradual increase in the predictability of the monetary policy is continued. In addition, we envisage that the cautious stance of the monetary policy is preserved and the liquidity policy remains tight~~;~~ and the annual growth rate of credit will fall to 15 percent reference value by mid-2014 owing also to recent macroprudential measures.

Accordingly, inflation is expected to be, with 70 percent probability, between 6.3 percent and 7.3 percent (with a mid-point of 6.8 percent) at end-2013 and between 3.8 percent and 6.8 percent (with a mid-point of 5.3 percent) at end-2014 (Chart 21).

Chart 21.
Inflation and Output Gap Forecasts



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

As a result, we revised inflation forecasts for 2013 and 2014 upwards by 0.6 and 0.3 percentage points, respectively, in the inter-reporting period. 0.4

percentage points of the revision in 2013 was led by exchange rate developments, while 0.1 percentage points stemmed from the rise in average oil price assumption. Moreover, the output gap forecast, which was revised upwards owing to the better-than-expected growth outlook for 2013 compared to the figures presented in the July Inflation Report, added 0.1 percentage points to the year-end inflation forecast. Developments in the exchange rate and oil prices were also influential on the revision in the inflation forecast for 2014. When evaluated together with output gap forecasts, we expect these cost-side factors to push the inflation rate in 2014 up by 0.3 percentage points.

Although inflation is estimated to fluctuate in the short term due to the base effect on energy prices, we expect it to remain on a downward track. As the effects of the hike in tobacco prices in January 2013 on annual inflation taper off, we expect inflation to plunge in early 2014, and come down to levels consistent with the target by the last quarter of 2014.

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. 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.