2013 APRIL INFLATION REPORT

PRESS CONFERENCE

Erdem BAŞÇI

30 April 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 soon be published on our website.

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 eleven 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 relationship between credit and economic environment. Moreover, there is a box offering a comprehensive analysis of the effect of employment initiatives of 2008 on various demographic groups. We also included informative studies on the influence of the revisions in the Manufacturing Industry Index and the capital accumulation on the Capacity Utilization Rates. Titles of the boxes are shown on the slide. I strongly recommend that you read these boxes, which will be 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 economic activity continued to be weak in the first quarter of the year. Meanwhile, risk appetite and capital flows displayed a volatile outlook amid persisting uncertainties regarding the global economy (Chart 1). Problems related to the Euro Area and uncertainties regarding the economic policies of advanced economies stood out as the leading factors underlying the increase in the volatility of the risk appetite in this period. While the recent additional monetary easing by the BoJ stimulated the appetite for investment in risky assets, developments in Southern Cyprus and Italy proved that fragilities in the global economy remained significant.

Sustained quantitative easing in advanced economies causes global rates to remain at historic lows, and fuels capital flows towards emerging economies. On the other hand, lingering fragilities in the global economy lead to an unstable risk appetite. This outlook for global liquidity and risk appetite brings about large and volatile portfolio flows towards emerging economies (Chart 2). This underlines the importance of maintaining a flexible policy framework with multiple instruments.

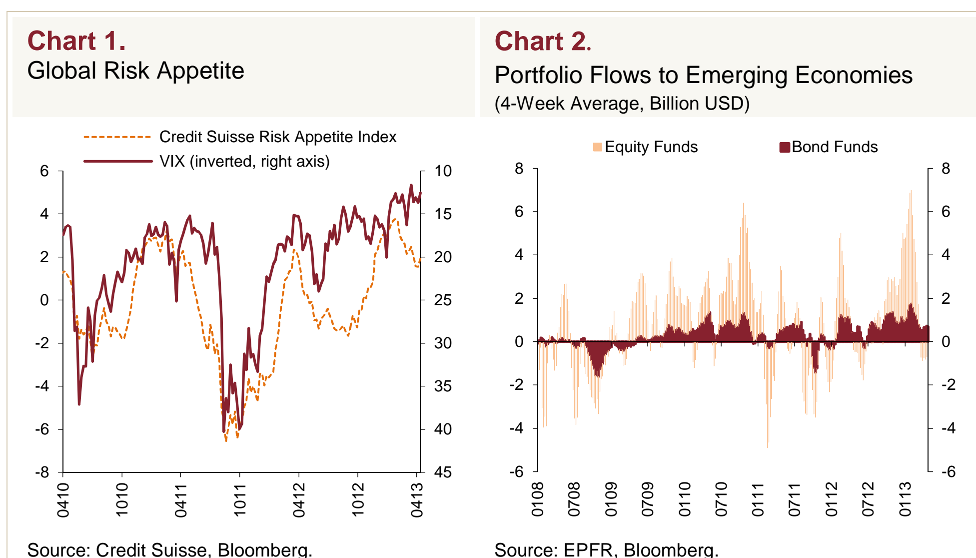


Chart 1. Global Risk Appetite

Source: Credit Suisse, Bloomberg.

Chart 2. Portfolio Flows to Emerging Economies (4-Week Average, Billion USD)

Source: EPFR, Bloomberg.

1. Monetary Policy and Monetary Conditions

The CBRT has designed and implemented a new policy framework that takes into account macro financial risks from the end of 2010. Policies implemented in this period aimed at managing macro financial risks without prejudice to price stability in the medium term. I would like to remind you that to this end, additional policy instruments were developed. Under our new strategy, monetary policy put special emphasis on containing the potential excessive volatility in domestic credit and exchange rates caused by capital flows. In this respect, it is useful to underline that while credit growth and its volatility have been brought down; the exchange rate has been aligned closer with economic fundamentals.

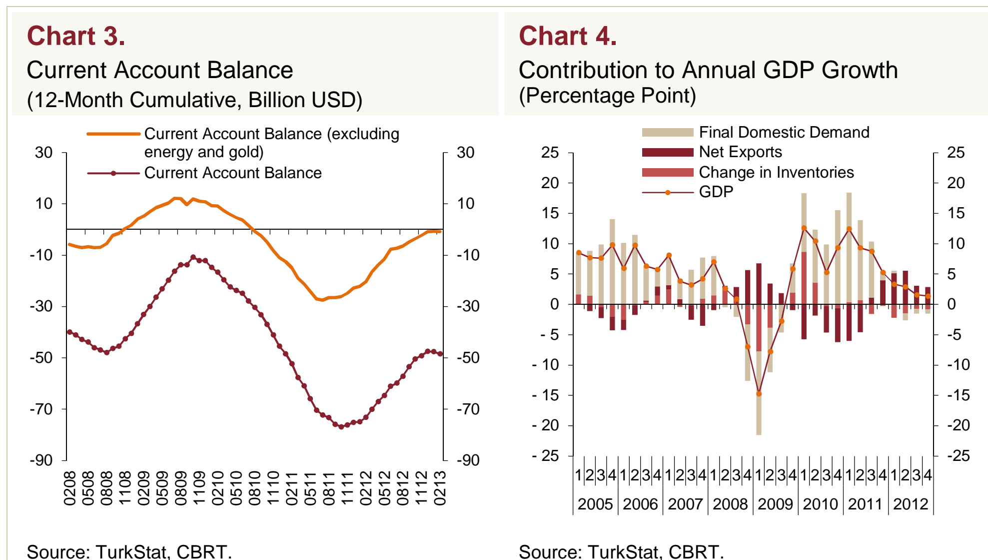


Chart 3.
Current Account Balance
(12-Month Cumulative, Billion USD)

Source: TurkStat, CBRT.

Chart 4.
Contribution to Annual GDP Growth
(Percentage Point)

Source: TurkStat, CBRT.

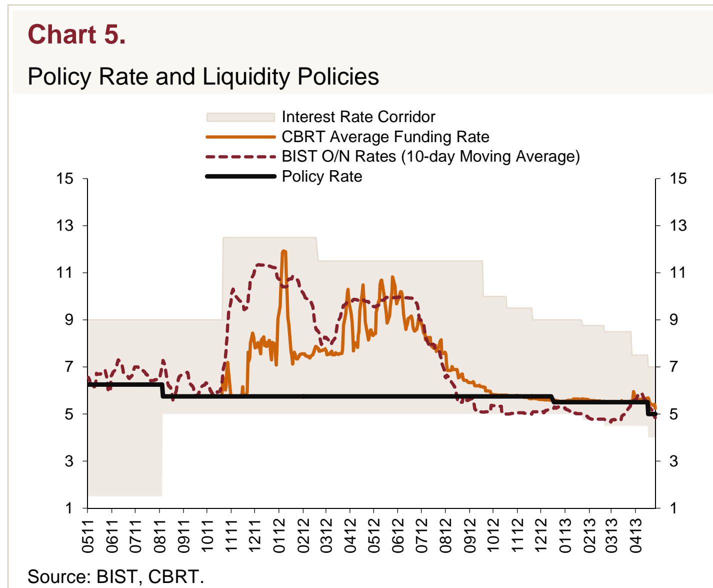
Due to these policies, 2012 was marked as a year of re-balancing. As seen on the slide, the composition of growth displayed a healthier outlook, while the current account continued to improve (Chart 3). The contribution of net exports to growth increased markedly (Chart 4).

In the second half of 2012, credits decelerated further, domestic demand remained subdued and inflation followed a downward trend. Accordingly, we adopted a more accommodative monetary policy stance by gradually increasing the liquidity injected into the market. On the other hand, as of late 2012, accelerated capital inflows, revived credit growth and the appreciation pressure on the Turkish lira led us to re-focus on macro financial risks. As you may recall, we stated that in such an environment, the proper policy would be to keep interest rates low while preserving macro prudential measures. Accordingly, we reduced short-term interest rates in the first quarter of the year, while continuing with a moderate tightening through required reserves (Chart 5).

The winding down of risks regarding the Euro Area, owing to the support of the ECB as well as the more effective use of the ROM, alleviated the need for a wide interest rate corridor as of end-2012. Therefore, we gradually narrowed the interest rate corridor by lowering the overnight lending rate (Chart 5).

Chart 5.

Policy Rate and Liquidity Policies



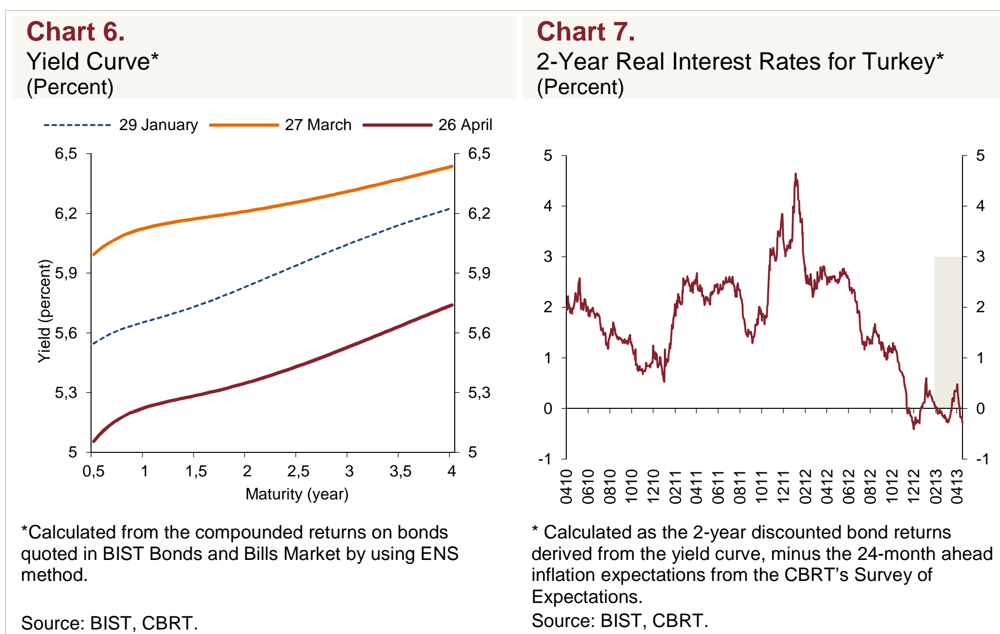
Source: BIST, CBRT.

In order to slow down the credit growth rate, which remained well above the reference value of 15 percent, we normalized the liquidity stance in late February. This has recently resulted in overnight market rates to hover around the policy rate (Chart 5). Moreover, we continued with a moderate tightening through required reserves so as to contain the excessively expansionary effects of capital inflows on credit growth. Strong capital inflows in this period necessitated further increases in ROC's, ensuring a more effective use of ROM.

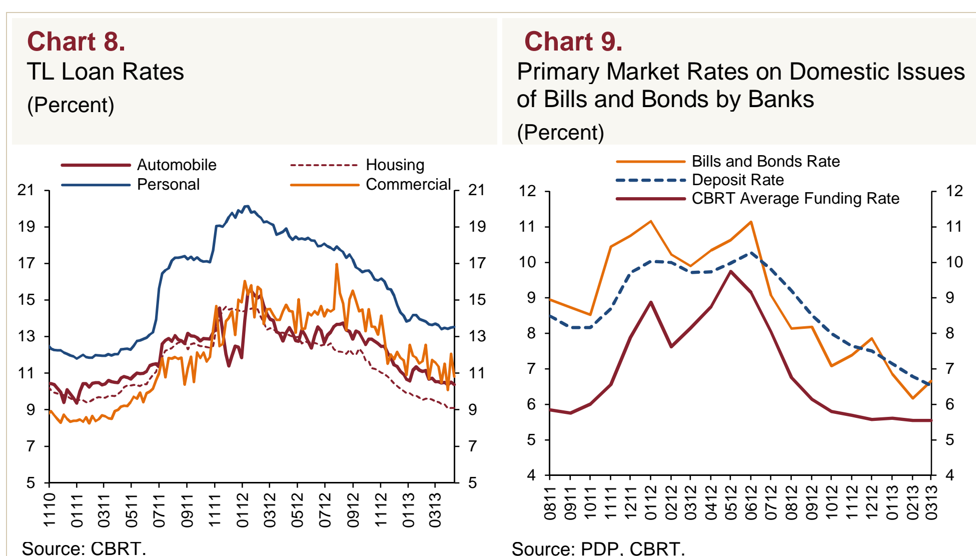
In the first quarter of the year, due to the ongoing uncertainties regarding the global economy as well as the volatility in capital flows, we maintained our stance that monetary policy should be kept flexible in both directions. In this context, I would like to remind you that the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, when needed.

Parallel to the volatility in the risk appetite, market rates also followed a volatile course in the first quarter of the year. Following the publication of the January Inflation Report, uncertainties in the Euro Area shifted the yield curve upwards. More recently, capital inflows re-accelerated due to the quantitative easing package announced by the BoJ. Furthermore, the CBRT's policy rate cut in April as well as the favorable risk perceptions regarding Turkey also supported the downward movement of interest rates. Because of these developments, the yield curve shifted downwards for each maturity compared to the previous

reporting period, as also displayed on the slide (Chart 6). Real interest rates also displayed a similar movement and continued to hover around historically-low levels (Chart 7).



As a result of easing external financing conditions and our monetary policy decisions, credit rates have remained on a downward track in recent months. Consumer loan rates declined further in line with the fall in long-term market rates, while the fall in commercial loan rates became more notable upon the reduction of the upper bound of the interest rate corridor (Chart 8). Moreover, deposit rates and the bill and bond rates issued by banks also trended downwards in the first quarter of the year, following the fall in the CBRT's average funding rate (Chart 9).



Against this background, credits have re-accelerated as of late 2012. Total credit growth and the past years' average have recently converged (Chart 10). Thus, annual credit growth rates have been hovering above the reference value (Chart 11).

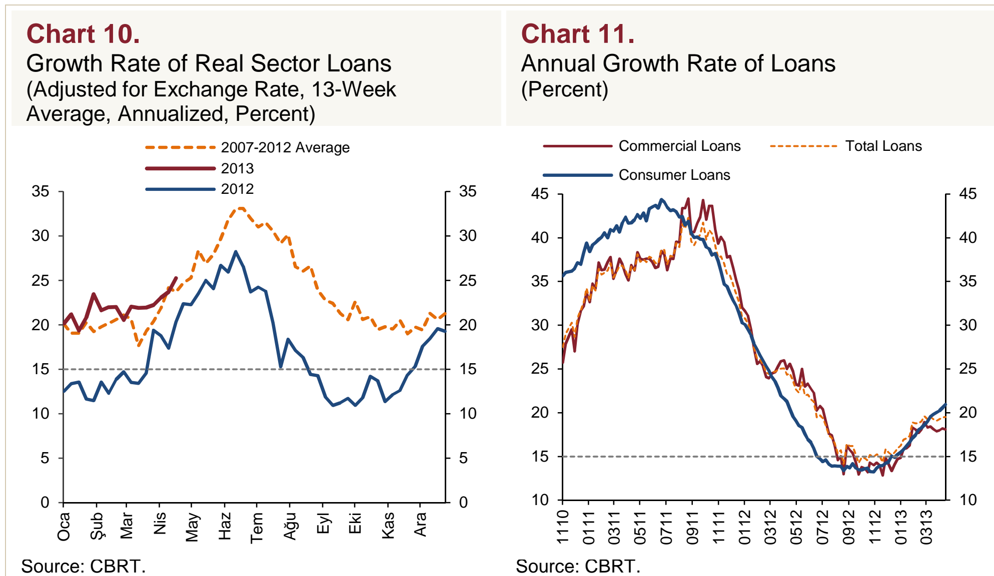


Chart 10.
Growth Rate of Real Sector Loans
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)
Source: CBRT.

Chart 11.
Annual Growth Rate of Loans
(Percent)
Source: CBRT.

In sum, strong capital flows and falling interest rates led the FCI to improve in the first quarter of the year (Chart 12).

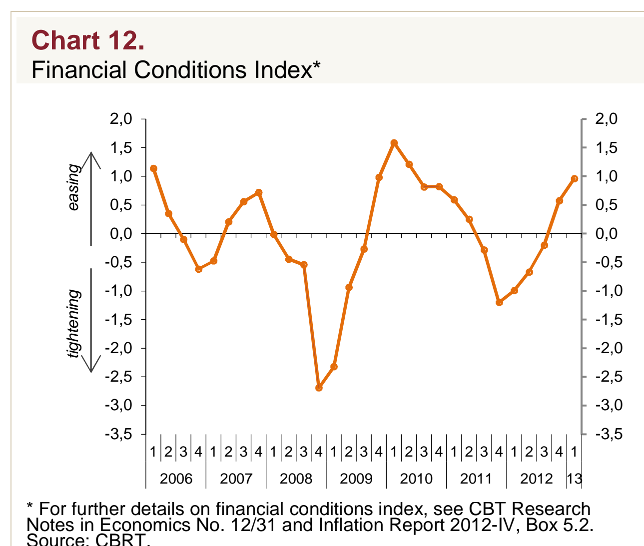


Chart 12.
Financial Conditions Index*

* 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 compare the realizations in the first quarter of 2013 to the short-term forecasts we shared in the previous report and

summarize the recent inflation developments. Then, I will continue with the domestic and foreign demand outlook.

Inflation overshot the forecasts in the first quarter of 2013, and climbed to 7.3 percent (Chart 13). The higher-than-envisaged increase in inflation was mainly driven by unprocessed food prices, which we mentioned in the January Inflation Report as an upside risk. Meanwhile, core inflation indicators also remained slightly above expectations.

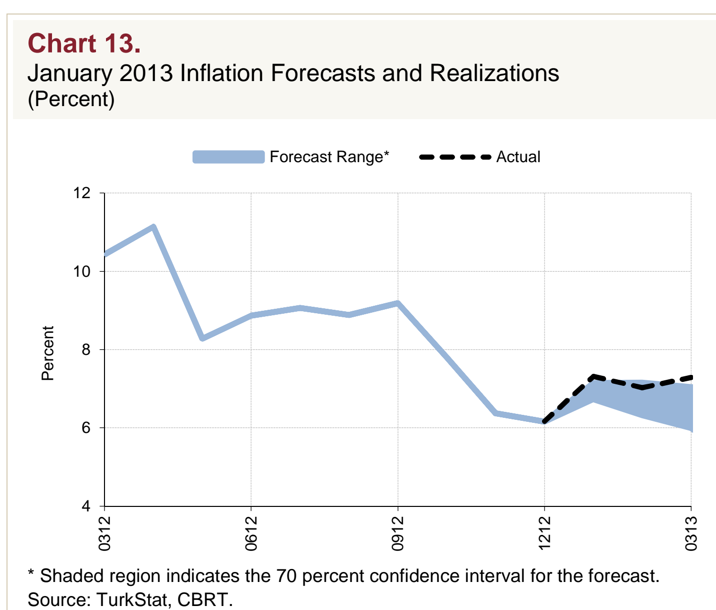
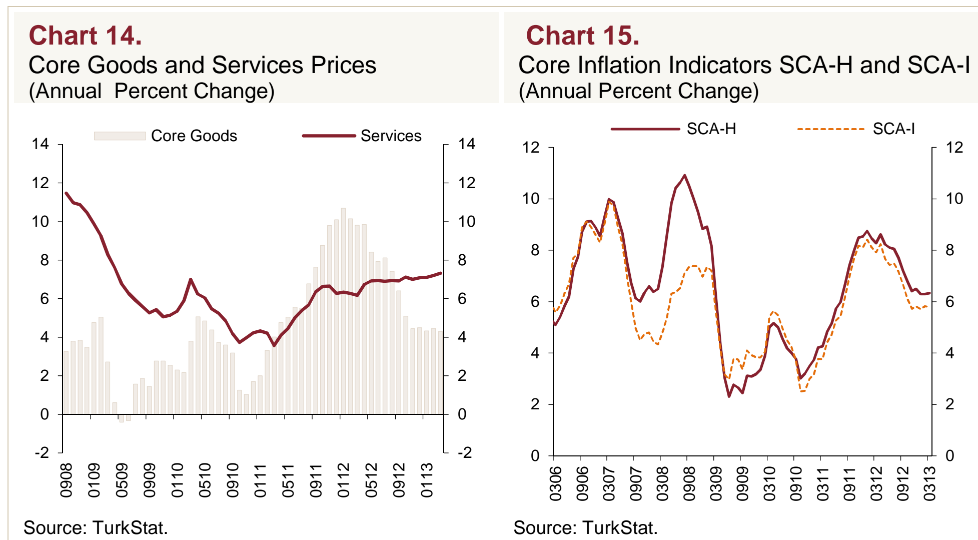


Chart 13.
January 2013 Inflation Forecasts and Realizations
(Percent)

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

The contribution of exchange rate developments to disinflation declined in this period. This, coupled with a partial recovery in domestic demand, slowed down the decline in the inflation rate of core goods prices. On the other hand, the underlying trend of services prices slightly picked-up (Chart 14). Accordingly, core inflation indicators remained flat in the first quarter (Chart 15). As core inflation indicators stood above expectations, we revised the initial point of inflation forecasts slightly upwards. This revision added around 0.2 percentage points to the year-end inflation forecast.



Now, I would like to talk about developments in economic activity and the short-term outlook, on which the inflation forecasts are based. National income data regarding the last quarter of 2012 point to a decline in domestic demand due to private investment demand. Demand conditions in this period followed a slightly weaker course compared to the projections of the January Inflation Report. Meanwhile, the first quarter data indicated a mild pick-up in the consumption demand and a notable rebound in investment. Recently, sustained support of financial conditions, improvement in confidence indices and the upward trend in credits signal that the recovery will continue in the second quarter. Thus, our forecasts were based on an outlook entailing a slightly weaker aggregate demand in the last quarter of 2012 compared to the previous reporting period, while keeping projections for 2013 broadly unchanged.

External demand remained subdued, while domestic demand signaled a recovery. Despite the slowdown in the Euro Area economic activity, global growth as well as export-weighted global growth index remained almost unchanged (Chart 16).

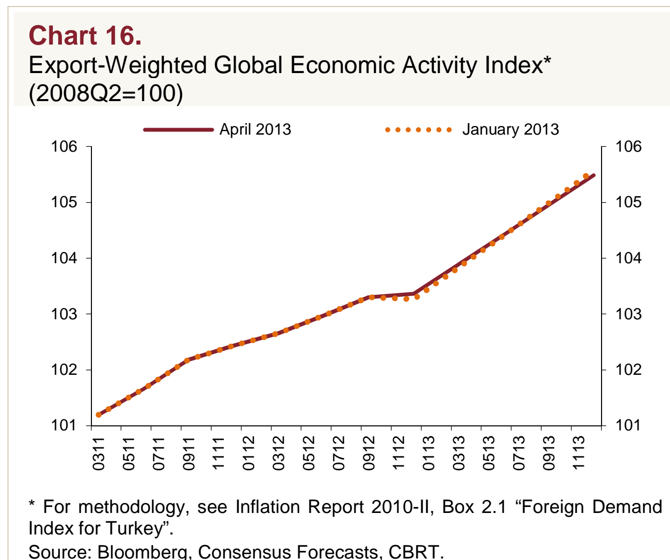


Chart 16.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)

* 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 the effect of aggregate demand conditions on inflation forecasts has remained almost the same compared to the previous reporting period.

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 projections of the January Inflation Report (Chart 17). In particular, commodity prices have recently displayed a higher-than-envisaged decline. Therefore, our assumption for the average oil price in 2013, which was USD 108 in the January Inflation Report, was revised downwards in line with the average of the futures prices in the first three weeks of April (Chart 17). The effect of this revision on the inflation forecast for end-2013 was around 0.2 percentage points on the downside. On the other hand, we kept our projection for the annual rate of increase of food prices unchanged at 7 percent as in the previous reporting period.

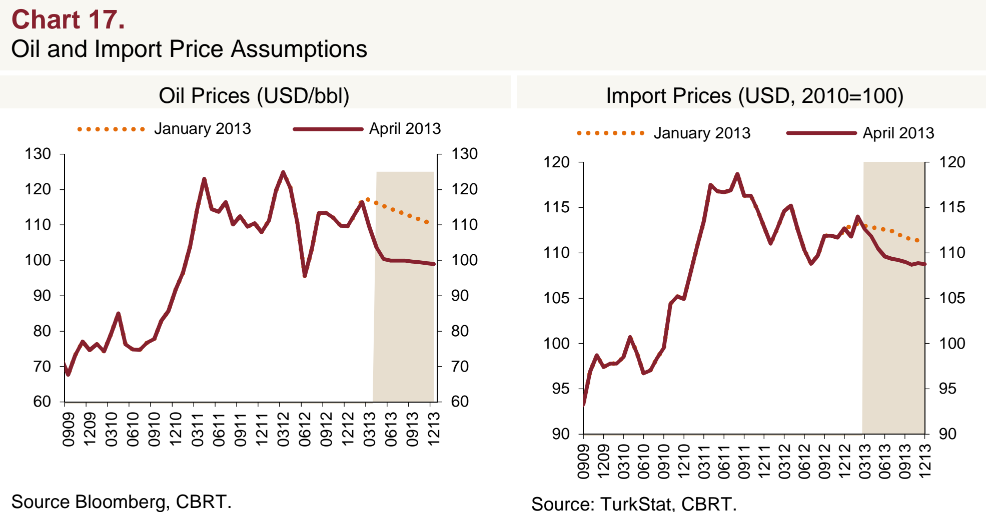


Chart 17.
Oil and Import Price Assumptions

Source Bloomberg, CBRT.

Source: TurkStat, CBRT.

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 for the rest of the year. Meanwhile, we assumed other tax adjustments and administered prices to be consistent with the inflation targets and automatic pricing mechanisms.

Regarding the fiscal policy stance, MTP projections are taken as given. Accordingly, we assume that fiscal discipline will be preserved and the structural budget balance will 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

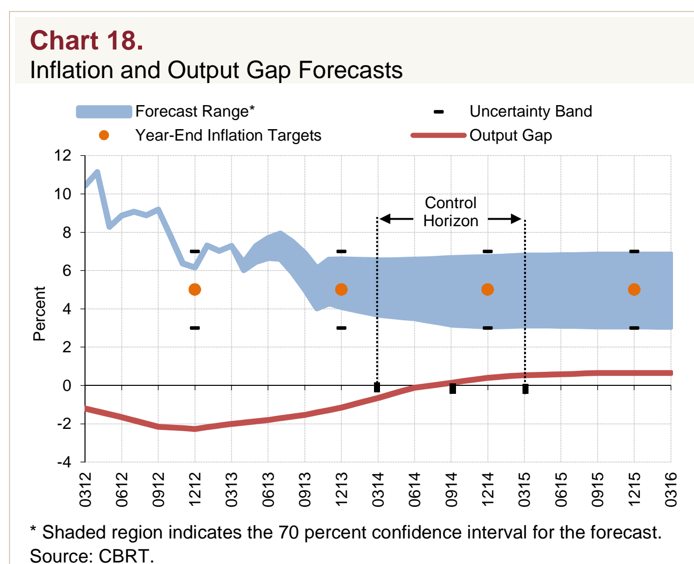
Now, I would like to present our inflation and output gap forecasts based on the outlook I have described so far.

Our medium-term forecasts envisage an outlook in which the risks that may stem from the recent surge in capital flows are contained. In other words, we assume that the interest rates will remain low, macroprudential policies will be sustained and the annual loan growth rate will hover around 15 percent.

Accordingly, we expect inflation to be between 4.1 percent and 6.5 percent (with a mid-point of 5.3 percent) at end-2013 and between 3.1 percent and 6.7

percent (with a mid-point of 4.9 percent) at end-2014. Inflation is envisioned to stabilize around 5 percent in the medium term (Chart 18).

Chart 18.
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, we can assert that the upward revision in the starting point of the inflation forecast was compensated by the downward revision in commodity prices. Thus, we preserve our end-2013 inflation forecast as 5.3 percent.

We expect inflation to fluctuate in the short term due to the base effect in energy prices. Accordingly, annual inflation may plunge in April, and may exhibit slight increases in the May-July period. We expect the downward trend in inflation to resume after July, bringing inflation down to 5.3 percent at the year-end (Chart 19). Meanwhile, core inflation indicators are projected to remain on a mild track.

The slide displays the revisions in the inflation forecasts. Although the year-end forecast was kept unchanged, we revised inflation path upwards in the short term mainly due to the recently-soaring unprocessed food prices (Chart 19).

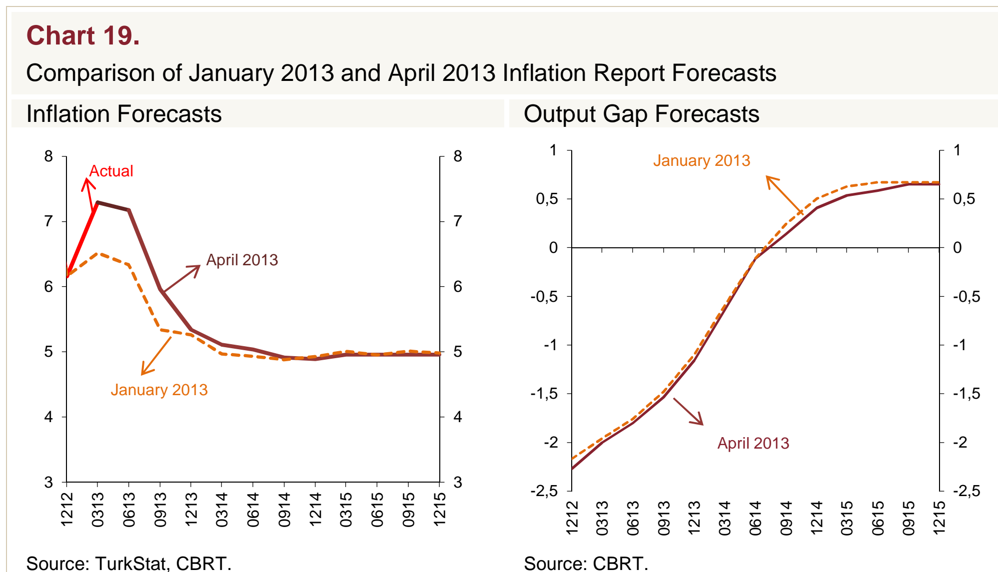


Chart 19.
Comparison of January 2013 and April 2013 Inflation Report Forecasts

The same slide presents the revision in output gap forecasts. Due to weaker-than-expected economic activity in the last quarter of 2012, we slightly revised the initial point of the output gap forecasts downwards compared to the previous Report. Nevertheless, in line with the expected recovery in domestic demand, we assumed that the output gap would stay close to the path envisaged in January over the course of the year.

I would like to emphasize once again that inflation forecasts and the policy stance are formulated in consideration of macro financial risks. Forecasts are based on an approach which not only aims at bringing inflation close to the target of 5 percent, but also warrants stable economic growth.

In the upcoming period, bringing inflation close to the target without a deterioration in external balance requires that credit should be growing at a reasonable rate (Chart 20), while domestic currency should not be appreciating excessively (Chart 21). Therefore, we consider that accommodating the global low interest rate environment while continuing with a stance to increase reserves is the optimal policy mix.

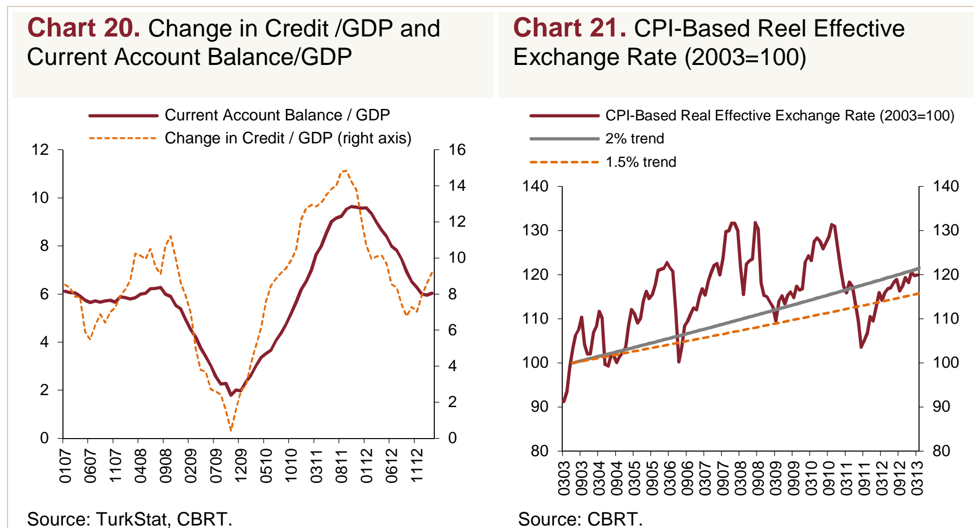


Chart 20. Change in Credit /GDP and Current Account Balance/GDP

Source: TurkStat, CBRT.

Chart 21. CPI-Based Reel Effective Exchange Rate (2003=100)

Source: CBRT.

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.