Central Bank of the Republic of Turkey

PRESS CONFERENCE FOR THE PRESENTATION OF THE INFLATION REPORT

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26 January 2009, Ankara

Distinguished Guests and Members of the Press,

Welcome to the press conference for the presentation of the January 2009 Inflation Report, one of the most important communication tools of the inflation-targeting regime.

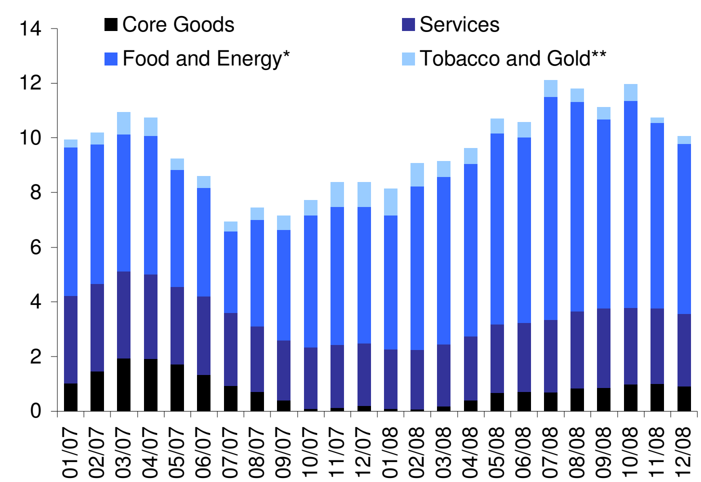
In this conference, I would like to give you a short summary of our evaluations and the Central Bank's inflation forecasts in the Inflation Report and the Open Letter which will be posted on the CBRT website today.

1. Inflation Developments

Distinguished Members of the Press,

I would like to start with a general assessment of inflation developments in 2008. CPI inflation stood at 10.06 percent at end-2008. Inflation in 2008 was largely determined by global economic developments. Sharp increases in energy and other commodity prices in the first three quarters were replaced by a dramatic shift in inflation dynamics in the last quarter due to the deepening of global financial crisis and the apparent slowdown in the world economic activity. Accordingly, there has been a marked fall in domestic energy and processed food inflation in the last quarter. Yet, cumulative past increases in the commodity prices have kept annual inflation at relatively high levels. Around 6.2 percentage points of the 10.1 percent annual CPI inflation in 2008 was due to the direct impact of the increases in food and energy prices (Figure 1).

Figure 1: Contribution to Annual CPI Inflation

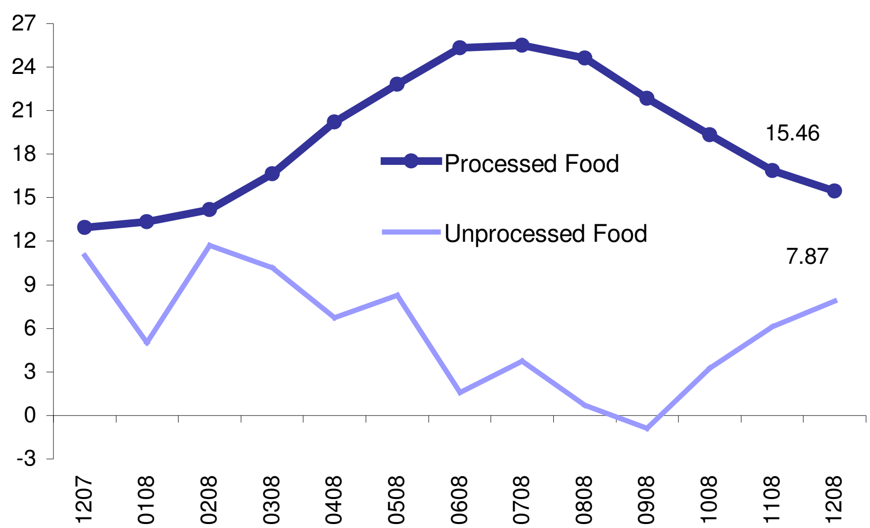


* Food and Energy: Food, non-alcoholic beverages and energy.
** Tobacco and Gold: Alcoholic beverages, tobacco products and gold.
Source: TURKSTAT, CBRT.

Distinguished Guests,

For a more comprehensive evaluation of the factors determining inflation in 2008, I would like to elaborate on the developments in energy and food prices. Processed food prices, displaying hikes in the first half of the year, followed a more favorable course than our expectations in the last quarter of 2008 owing to sharply declining commodity prices. On the other hand, the high volatility in the unprocessed food inflation persisted throughout the year, displaying a marked rise in the last quarter. Overall, although food inflation eased in 2008 compared to 2007, it was still higher than the headline inflation. (Figure 2)

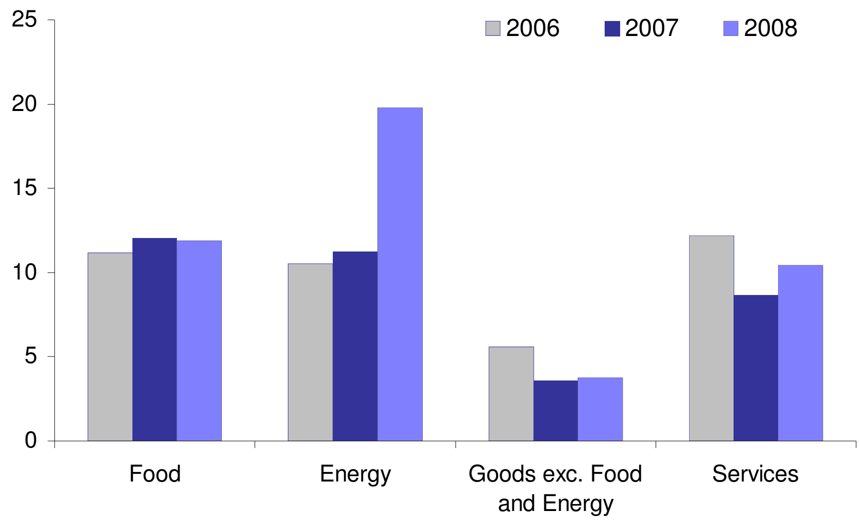
Figure 2: Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Likewise, despite sharp slowdown of the last quarter, energy price inflation stood at around 20 percent by the end of the year (Figure 3). Therefore, given the recent decline in oil prices, we think there is still ample room for energy inflation to fall further. Accordingly, we expect the contribution of energy prices to headline inflation to come down considerably throughout 2009.

Figure 3: Energy Prices
(Annual Percentage Change)

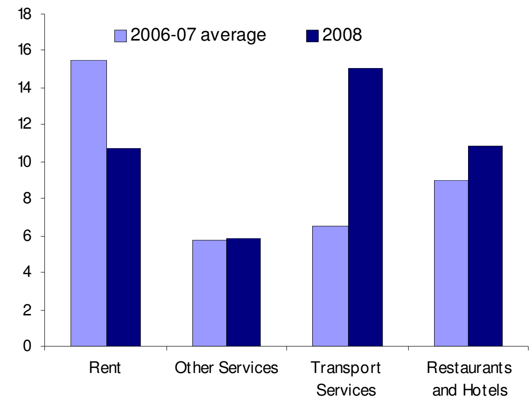


Source: TURKSTAT, CBRT.

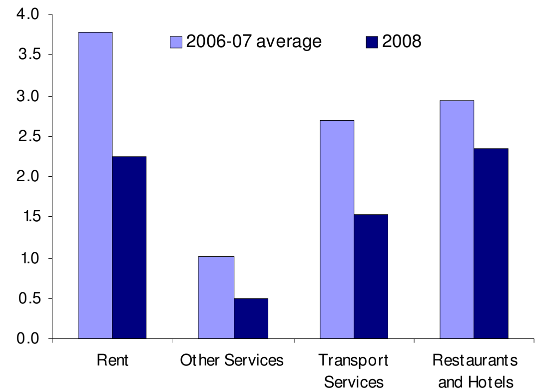
During the first three quarters of the year, inflation in services stayed at high levels due to lagged impacts of food and energy prices, especially in catering and transport services. The upward trend in services inflation reversed in the last quarter with the sharp slowdown in economic activity and falling commodity prices (Figure 4). Rent inflation, on the other hand, displayed a steady decline throughout the year. We expect the deceleration in services inflation to continue in 2009, as the accumulated impacts of the supply shocks fade away and the domestic demand remains weak.

Figure 4: Subcomponents of Services Index (Cumulative Percentage Change)

First Three Quarters



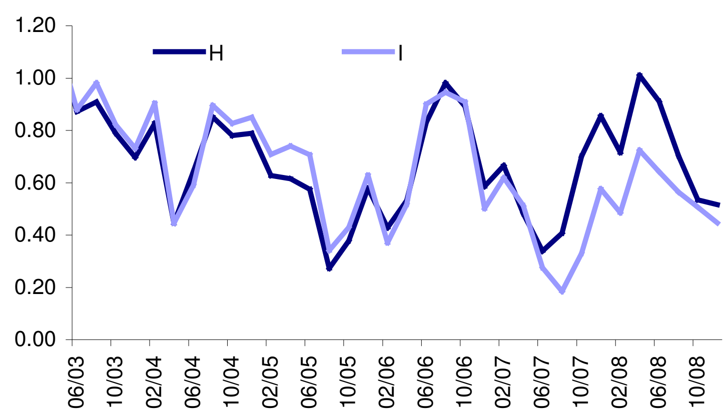
Last Quarter



Source: TURKSTAT, CBRT.

Annual rate of increase in CPI excluding food, energy, tobacco and gold (I-Index) declined from 7.3 percent to 7 percent in the last quarter. Seasonally adjusted monthly core inflation figures suggest that underlying inflation has a downward trend (Figure 5). I would like to underline the downward trend of core inflation despite the movements in the exchange rate in the last quarter of the year.

Figure 5: Main Inflation Indicators: H* and I**
(Seasonally Adjusted, Annual Percentage Change, 2 Months Average)

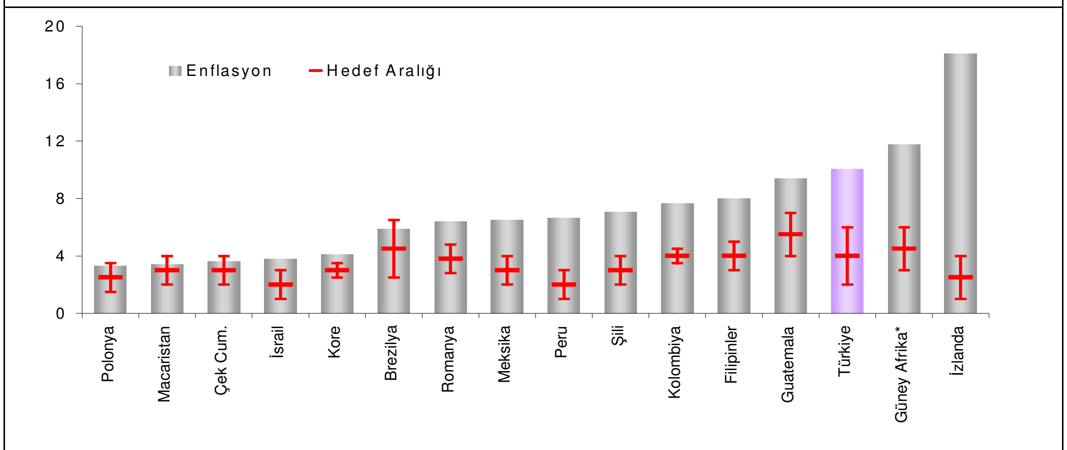


* CPI excluding unprocessed food, energy, alcoholic beverages, tobacco products and gold.
** H. excluding processed food products Source: TURKSTAT, CBRT.

Distinguished Members of the Press,

As I have just mentioned, the rise in inflation in 2008 was not specific to Turkey. Inflation data of other emerging economies confirm that inflation has been driven mostly by global factors last year. Elevated commodity prices in the first three quarters of 2008 exerted inflationary pressures all over the world, pushing inflation rates above the targets. Notwithstanding the downturn in the last quarter, most of the inflation targeting emerging economies breached their inflation targets at the end of 2008 (Figure 6).

Figure 6: Inflation and Target Bands in Emerging Economies (as of December 2008)



* as of November 2008.
Source: Web sites of central banks, IFS, TURKSTAT, CBRT.

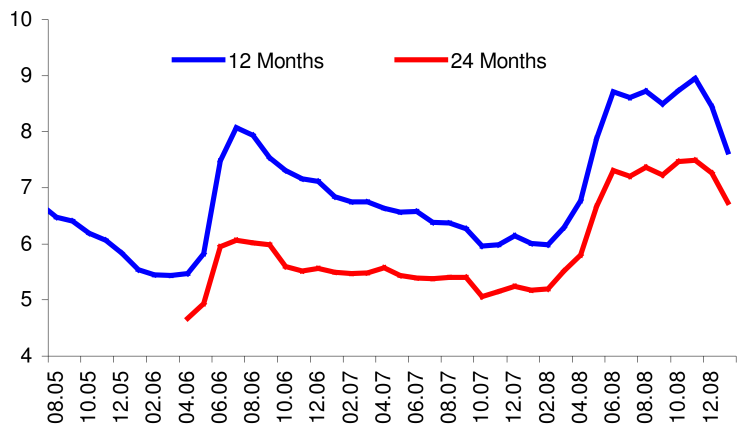
2. Reaction of Monetary Policy

Distinguished Guests,

After making brief remarks on the inflation developments in 2008, in this part of my speech, I would like to touch on the policies carried out by the Central Bank in 2008.

Inflation dynamics in the first half of 2008 were dominated by the surge in commodity prices, leading to a rise in inflation expectations. In order to contain the deterioration in inflation expectations and to prevent the materialization of the second round effects of these shocks, the Monetary Policy Committee (MPC) implemented a monetary tightening during May-July period, increasing the policy rates by a cumulative of 150 basis points. In order to control expectations in this period, inflation targets were revised as well. Monetary tightening accompanied with a revision of inflation targets was effective in controlling expectations (Figure 7).

Figure 7: Inflation Expectations*

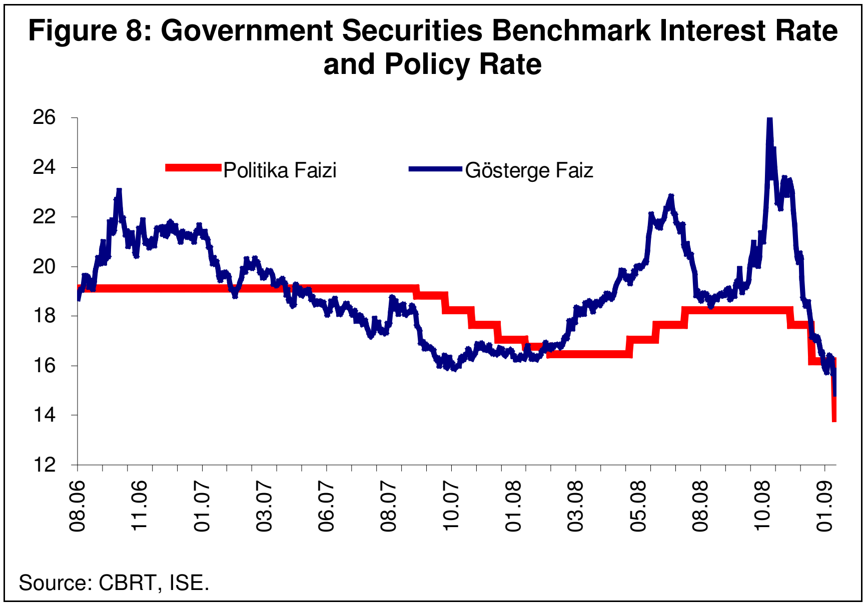


* 24 months expectations is available from May 2006 onwards.
Source: CBRT.

With the deepening global economic problems, both domestic and external demand slowed down considerably in the last quarter of 2008. Moreover, the inflationary pressure of commodity prices disappeared gradually. Despite the weakening in aggregate demand, uncertainties regarding the global financial and commodity markets and concerns about their reflections on the inflation outlook required us to remain cautious during the peak of the turmoil, like other emerging economies. Accordingly, the MPC decided to keep policy rates constant in September and October meetings. Developments since then suggested that the significant slowdown in the aggregate demand and falling commodity prices would lead to a sharp fall in inflation, and that inflationary impact of the exchange rate movements would be lower than implied by historical estimates. Therefore, the CBT cut interest rates by 50 basis points in November and a further 125 basis points in December (Table 1).

Table 1: Monetary Policy Committee Decisions in 2008 and 2009		
MPC Meeting Dates	**Decision on Interest Rates (Percentage Points)**	**Interest Rate**
January 17th, 2008	-0.25	15.50
February 14 th,2008	-0.5	15.25
March 19 th,2008	No Change	15.25
April 17 th ,2008	No Change	15.25
May 16 th,2008	+0.50	15.75
June 17 th,2008	+0.50	16.25
July 18 th,2008	+0.50	16.75
August 14 th,2008	No Change	16.75
September 18 th,2008	No Change	16.75
October 22 th,2008	No Change	16.75
November 19 th,2008	-0.50	16.25
December 18 th,2008	-1.25	15.00
January 15 th,2009	-2.00	13.00
Source: CBRT.		

As the incoming information on inflation and economic activity vindicated the policy rate cuts, result inflation expectations reacted favorably. This led to a noteworthy recovery in the medium-term inflation expectations especially in January 2009 (Figure 7). As a consequence, monetary policy decisions and the associated communication had concrete effects in shaping the yield curve. Benchmark bond rates came down significantly, partly driven by the easing tensions in global financial markets (Figure 8).



Recent forecasts suggest that the ongoing problems in international credit markets and the global economy may last longer than what had been previously envisaged in the period following the rate cuts in November and December. Downward revisions in growth forecasts and the sharp fall in oil and other commodity prices have increased the probability of undershooting our medium term targets. Accordingly, the MPC decided to cut policy rates by a further 200 basis points in January 2009, moving forward a sizeable part of the interest rate cuts envisaged for the incoming months (Table 1).

3. Inflation Outlook and Monetary Policy

Distinguished Guests,

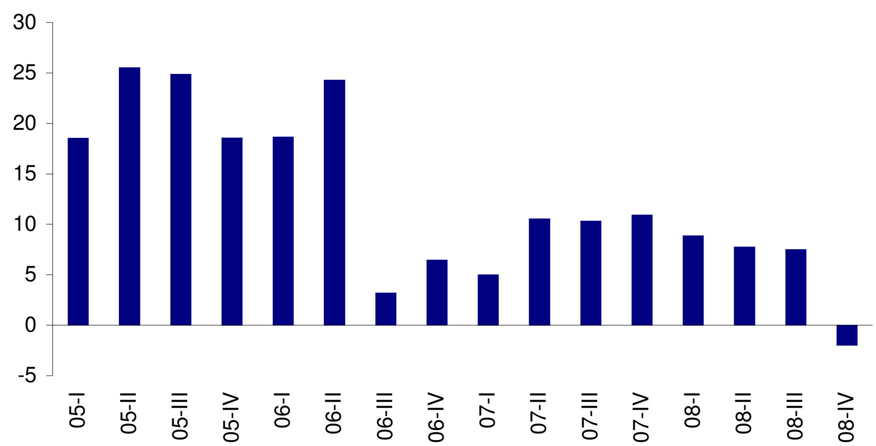
Having summarized the developments in inflation and monetary policy in 2008, in this part of my speech, I would like to share with you our projections about the inflation and the monetary policy in the upcoming period and the seasonally adjusted inflation forecasts of the Central Bank.

As I mentioned before, factors affecting inflation outlook displayed a sharp downturn in the last quarter with easing commodity prices and the slowdown in economic activity. Both import prices and aggregate demand turned out to be weaker than envisaged in our baseline assumptions. As a consequence, end-year inflation declined to 10.06 percent—significantly below our forecast of

11.1 percent. Therefore our starting point for the medium term inflation forecasts has shifted down.

Credit conditions tightened considerably and bank loan rates displayed a sharp rise after the intensification of the global financial crisis. The pace of consumer credit growth suggests that financial conditions were restrictive in the last quarter of 2008, as consumer loans fell in nominal terms for the first time in the recent past (Figure 9).

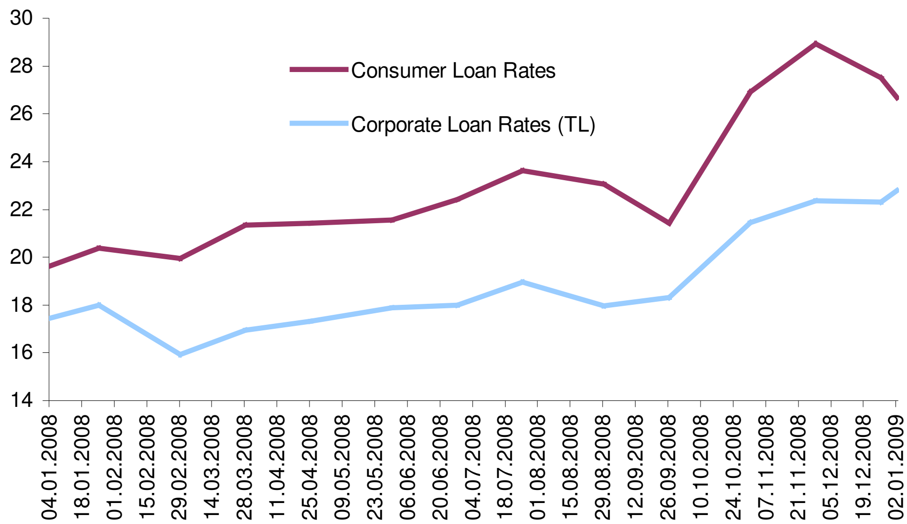
Figure 9: Nominal Growth Rates of Consumer Loans (3 Months Percentage Change)



Source: TURKSTAT, CBRT.

Recent easing in monetary policy has helped relieve the tension in domestic credit markets, as there has been a significant fall in consumer loan rates following the policy rate cuts. Yet, business loan rates remained high (Figure 10). In view of the adverse effects of the slowdown in economic activity on firms' profitability and thus on lending appetite, tight financial conditions might persist despite interest cuts.

Figure 10: Interest Rates on Bank Loans*

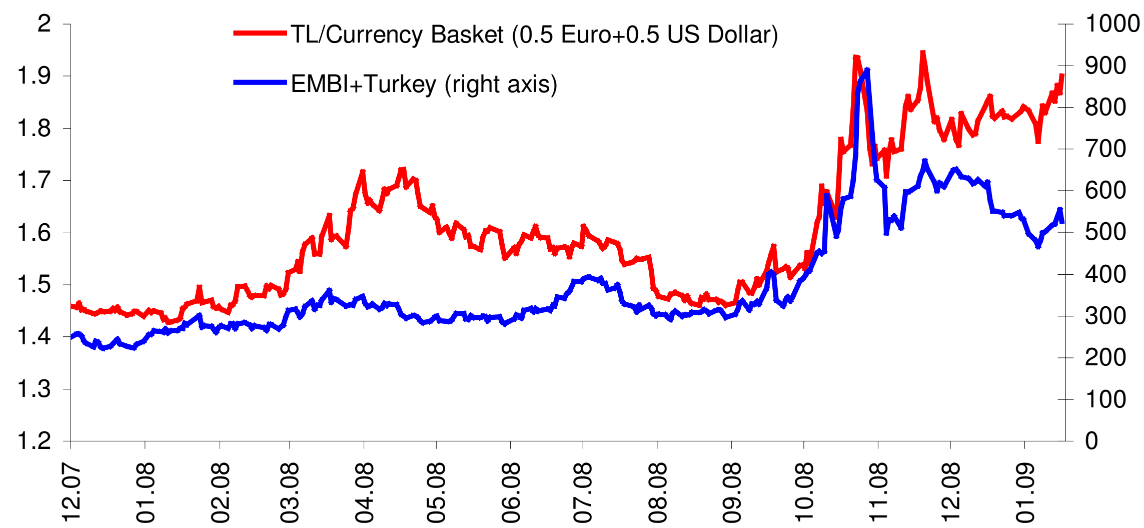


* Weighted average, flow.
Source: CBRT, İSE.

Distinguished Members of the Press,

In September and October, high level of uncertainty stemming from the intensification of global financial market turmoil has led to a wave of financial deleveraging, leading to a sharp rise in sovereign credit risk premia and a significant depreciation of currencies in emerging markets, including Turkey (Figure 11). Today, the pressure on emerging market currencies has not yet entirely disappeared.

Figure 11: Nominal Currency Basket and Risk Premium

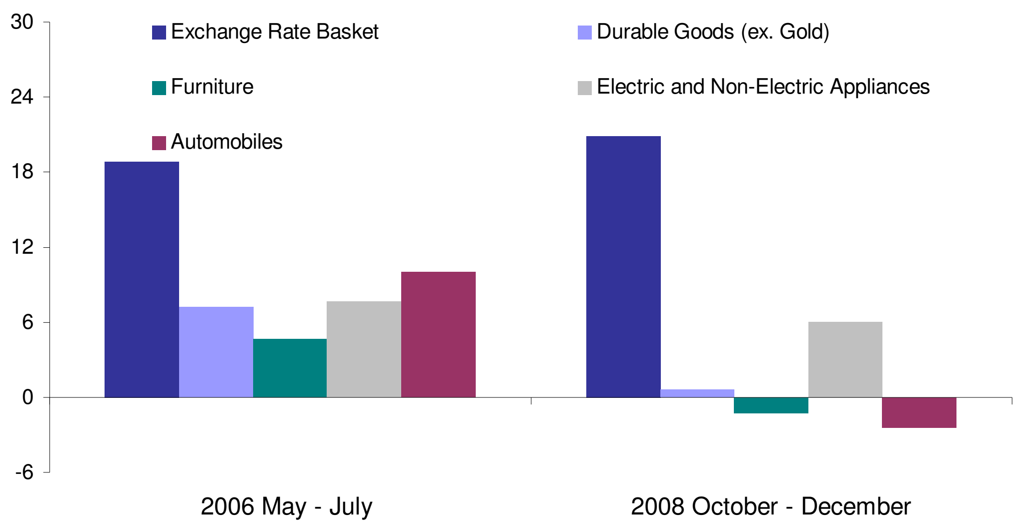


Source: CBRT, ISE.

When we published our October Inflation Report, the extent of the pass-through from exchange rates to domestic inflation was a major source of uncertainty for the inflation outlook. In that period, we indicated that the significant slowdown in domestic demand growth should limit the second round effects of the exchange rate pass-through, and that the pass-through from exchange rates to domestic inflation should be relatively limited compared to previous periods. Still, given the sizeable depreciation, we forecasted that the first round effects of the depreciation would add around 1.2 percentage points to 2008 end-year inflation and a further 1.5 percentage points to 2009 inflation.

The exchange rate pass-through in the last quarter of 2008 turned out to be even lower than our October estimates. The figure depicted on the slide compares two different periods of significant currency depreciation, namely October-December 2008 and May-July 2006, in terms of pass-through in durable goods—historically the most sensitive item in the CPI to the exchange rate developments (Figure 12). Prices of most of the durables goods in the CPI basket displayed no significant change (with the exception of electrical appliances, prices of which are largely indexed to exchange rates) in the October-December 2008 period, whereas all durable goods had showed sharp increases in the May-July 2006 period. This confirms that the short-term exchange rate pass-through effect remained quite limited. Considering that no significant recovery is expected in the aggregate demand in 2009, it is probable that the exchange rate pass-through effect will remain limited for a while. Nevertheless, it is too soon to make a definite conclusion about the medium-term effect.

Figure 12: Exchange Rate Pass-Through Effect: Durable Goods Prices (3-Month Cumulative Percentage Change)



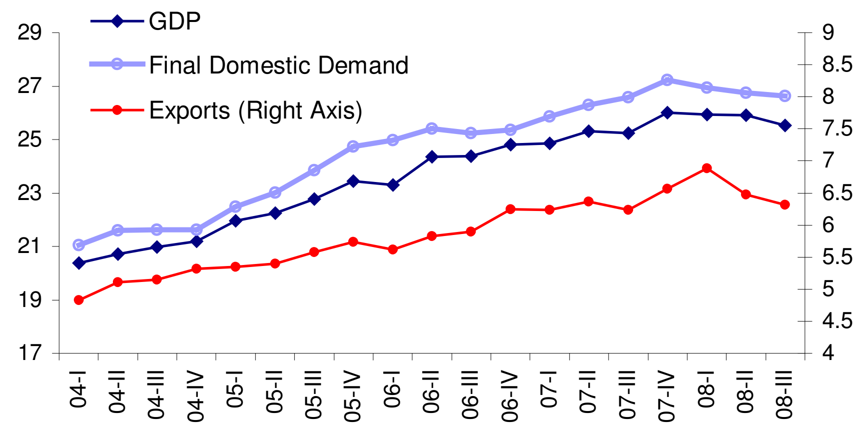
Source: CBRT, TURKSTAT.

Distinguished Guests,

In the October Inflation Report, we predicted that the sharp slowdown in aggregate demand and the depreciation in the Turkish Lira would lead to a higher contribution from net exports to aggregate demand. We also predicted, though, that this effect would be largely offset by the slowdown in external demand due to sharp economic downturn in our major trading partners. We consider that our export performance has become more sensitive to global business cycles in the past years as the share of durables and capital goods has increased in time. Although export developments in the fourth quarter were in line with our expectations, the extent of the slowdown in our major trading partners and thus the contraction in exports were deeper than in our baseline scenario. (Figure 13)

World economies have become increasingly interdependent since the onset of the global crisis in September 2007. Given the present conjuncture, we think that domestic inflation and monetary policy outlook is likely to remain sensitive to global economic developments, at least in the short-to-medium term. Therefore, in this period, assumptions on the global economic outlook are far more crucial than usual. Our medium-term forecasts were produced based on the "Consensus Forecasts", which is a compilation of the projections of various international institutions. Accordingly, our baseline forecast is based on the assumption that there will be a gradual recovery in the global economy starting from the first quarter of 2010. This assumption is in line with the forecasts of other institutions. The analyses and forecasts presented in the Inflation Report are based on this framework.

Figure 13: GDP, Final Domestic Demand, Exports (Seasonally Adjusted, at 1998 prices, Billion TL)

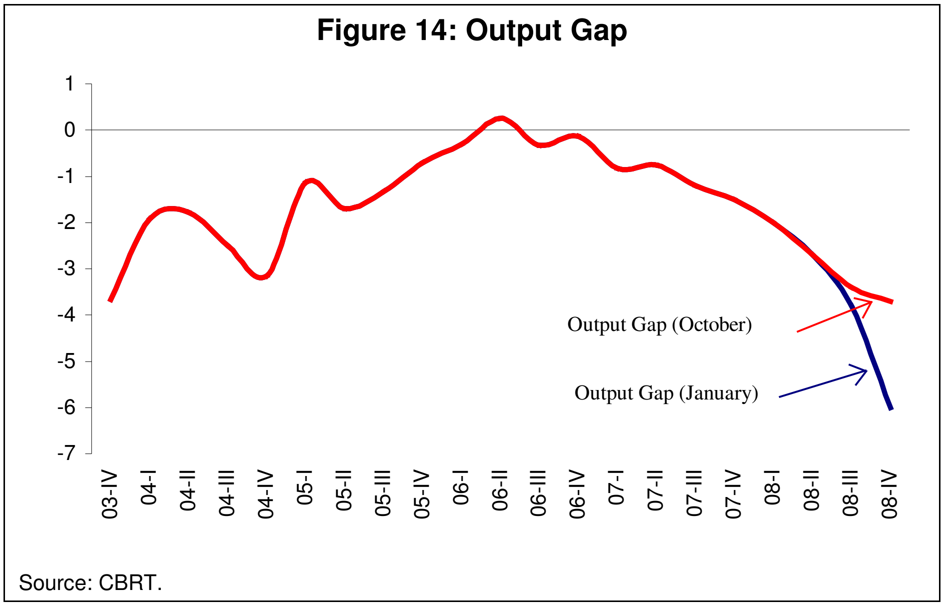


Source: TURKSTAT, CBRT.

Distinguished Members of the Press,

Similar to external demand, the domestic economic activity has recently been on a significant downward trend. Seasonally adjusted Gross Domestic Product figures indicate that the domestic demand contracted in the third quarter whereas, the last quarter readings point to an increasingly marked deceleration in the economic activity.

Accordingly, the figure on the slide displays the revision in our output gap estimates for the third and fourth quarters of 2008 with respect to the estimates appeared in the October Inflation Report (Figure 14). As depicted in the figure, there has been a marked downward revision for the fourth quarter, which is the major factor for the recent change in inflation and monetary policy outlook.



Looking ahead, intensified problems in global economy and the tight credit conditions are likely to restrain domestic demand for an extended period. We envisage some recovery in consumption expenditures in the second half of 2009, as the policy rate cuts will start feeding through the economy in about two quarters. However, we expect the recovery to be gradual, as it will take time to fully restore consumer confidence in the aftermath of the most serious global crisis in decades. Overall, we are likely to face a protracted period of weak economic activity in the forthcoming period. Hence, our revised forecasts incorporate a significantly larger contribution from aggregate demand conditions to disinflation, compared to the previous quarters.

After this brief summary of aggregate demand conditions, now I would like to talk about our assumptions related to energy and food prices, that is, factors that are mostly beyond the domain of monetary policy.

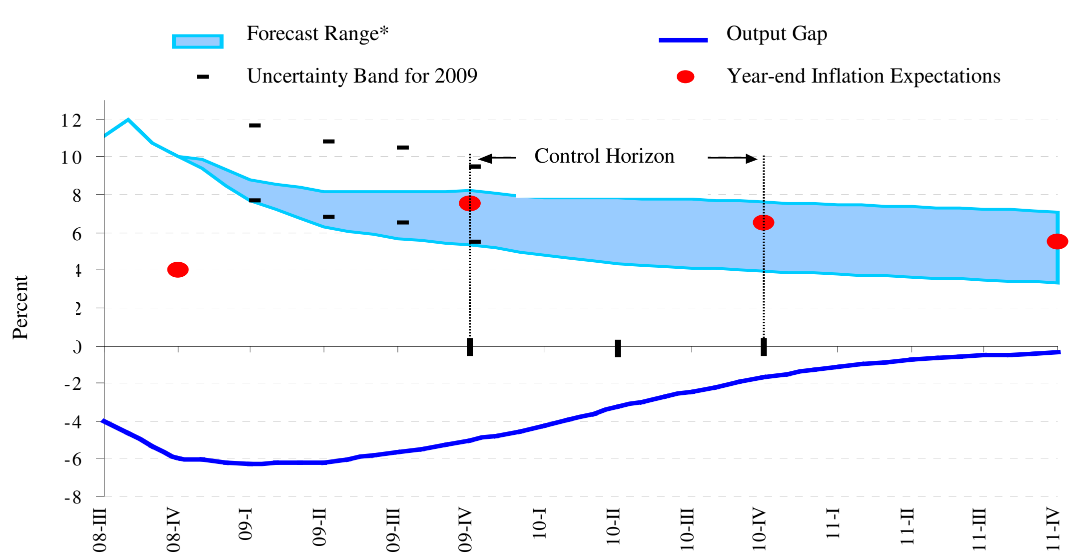
The sharp fall in oil prices is another major factor leading to a downward revision in our end-2009 inflation forecasts. Our baseline scenario in the October Inflation Report envisaged a constant path for oil prices around USD 80 per barrel over the forecast horizon. However, oil prices continued to fall in the meantime, averaging around 56 USD in the last quarter of 2008. Therefore, in this report, taking the average of oil price futures in the first three weeks of January as a benchmark, we have revised our baseline scenario for oil prices down to USD 55 per barrel for the next two years.

The course of food inflation was close to the path outlined in the baseline scenario of the October Inflation Report. Although processed food prices followed a sharper downward trend than expected, unprocessed food inflation continued to display a high volatility, materializing at a level higher than predicted for end-2008. Accordingly, we retained our assumptions for food inflation at 7.5 percent for 2009 and 6 percent for the following years.

Distinguished Guests,

Against this background, our medium term forecasts suggest that, assuming a decelerating pace of reductions in policy rates during the early 2009; with 70 percent probability, inflation will be between 5.4 and 8.2 percent (mid-point 6.8) at the end of 2009, and between 4 percent and 7.6 percent (mid-point 5.8) at the end of 2010. (Figure 15) We expect inflation to come down to 5.2 percent by the end of 2011.

Figure 15: Inflation Forecasts*



Source: CBRT.
* The shaded region indicates the 70 percent confidence interval for the forecast.

To sum up, there has been a downward revision in our medium term inflation forecasts, especially for the end-2009, owing mainly to the impacts of the favorable energy prices and the weakening aggregate demand. The main message of the forecast is that the probability of undershooting the end-2009 inflation target has increased, notwithstanding the significant policy easing in the past couple of months.

I would like to reiterate that any new data or information regarding the inflation outlook might lead to a change in our policy stance. Therefore, let me highlight once more that the assumptions on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBT.

4. Risks and Alternative Scenarios

Distinguished Members of the Press,

I would like to dedicate the last part of my speech to the upside and downside risks to inflation and monetary policy in the upcoming period, as well as the alternative projections we mentioned in our Inflation Report within this framework.

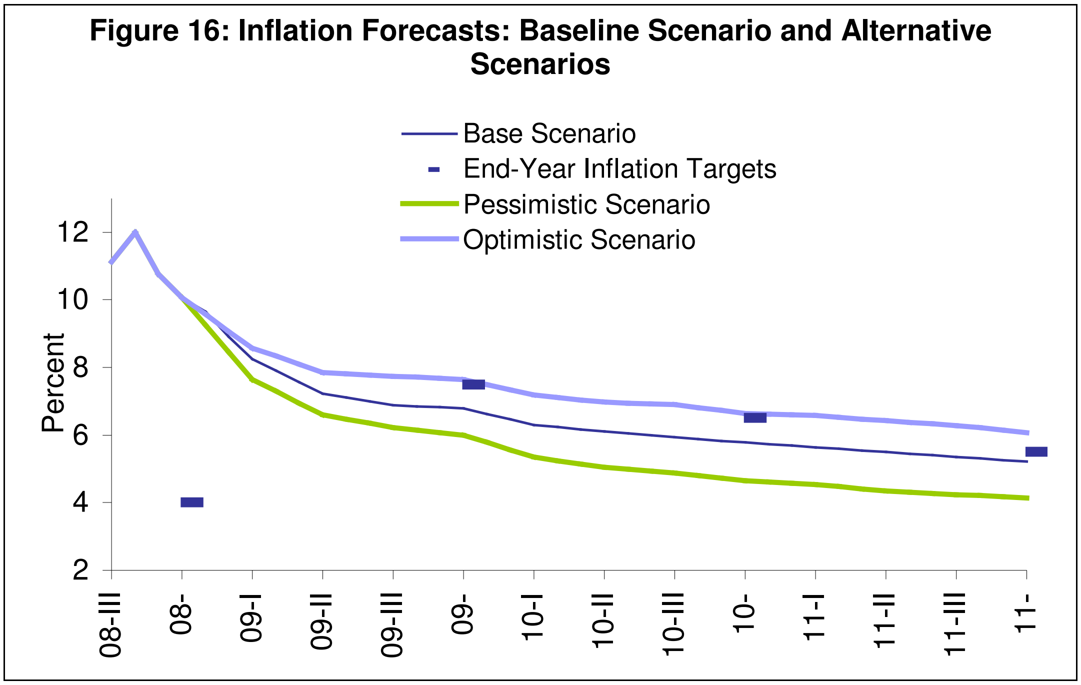
Strains on global money and capital markets have shown signs of easing since the publication of our October Inflation Report. However, the overall confidence loss, wealth destruction and the tightening of credit conditions especially for the business sector, have led to a marked downturn in the global economic activity. In line with the latest Consensus Forecasts, our baseline scenario envisages a recovery in global economic activity starting from the first quarter of 2010. Yet, there is still a considerable amount of uncertainty surrounding the global economy. We think developments in the global economy will be the main determinant of the outlook for domestic inflation and monetary policy in the medium term. Hence, in order to enhance the predictability and transparency of monetary policy, we decided to present two alternative scenarios in the January Inflation Report, soon to be published on our website, each one based on different timing and speed of the global economic recovery. The two alternative scenarios are embedded in our forecasts through four main channels: External trade, portfolio flows, commodity prices, and credit channels.

Our first alternative scenario is based on the assumption that, owing to the measures taken, the recovery in the world economy will be earlier and faster than envisaged in the baseline scenario, accompanied by a rebound in the second half of 2009. Accordingly, we assume that the commodity prices will start to increase in the second half of the year and that oil prices will see USD 75 by the end of 2009, remaining flat over the forecast horizon. Moreover, this scenario points to a further relaxation in credit conditions from the second half of 2009 on, resurge in capital inflows and a sooner-than-expected pick-up in external demand in line with the early recovery in the global economic activity. This scenario also suggests that food inflation will follow a higher course relative to the baseline scenario as a result of the quick turnaround in global demand, hence reach 9.5 percent by the end of 2009 and become 8.5 percent afterwards.

According to the framework I have elaborated so far, under the assumption of a measured policy rate hikes towards end-2009, our forecasts suggest that with 70 percent probability, inflation will be between 6.2 and 9.0 percent (mid-point 7.6) at the end of 2009, and between 4.8 percent and 8.4 percent (mid-point 6.6) at the end of 2010 and become 6.1 percent in 2011 (Figure 16). Under this scenario, in the event of an earlier and faster-than-expected recovery in global economic activity, meeting medium term inflation targets of 7.5, 6.5 and 5.5 percent in the 2009-2011 period, respectively, could require measured policy rate hikes towards the end of 2009.

Our second alternative scenario is based on the assumption of a further deepening in global crisis in the first half of 2009 and a recovery in global economic activity starting only in the second half of 2010. Accordingly, we assume that oil prices will drop to USD 35 by the end of 2009 and remain flat throughout the forecast horizon. This scenario is also based on the assumption of tighter credit conditions, capital outflows and a long-lasting weak external demand due to a late recovery in global economy. In this framework, we assume that food inflation will be lower than envisaged in the baseline scenario to become 5.5 percent at end-2009 and 3.5 percent afterwards.

Under the assumption of a measured interest rate cuts throughout 2009, our forecasts suggest that with 70 percent probability, inflation will be between 4.6 percent and 7.4 percent (mid-point 6) at the end of 2009, and between 2.8 percent and 6.4 percent (mid-point 4.6) at the end of 2010 and become 4.1 percent in 2011 (Figure 16). Our forecasts suggest that in the event of a longer-than-expected recession in global economy, medium term inflation targets could be undershot even with a measured policy rate cuts throughout 2009.



It is worth to mention that a critical assumption underlying the inflation and monetary policy outlook outlined above is that government fiscal stance will remain neutral in cyclically adjusted terms. In other words, we assume that except for the slowdown unavoidably born by the economic contraction, no major change is expected in the budget balance from the previous year, and within this framework contribution of public expenditures to growth will remain at reasonable levels. Besides, I would like to note that we assume no changes in indirect taxes or administered price adjustments, except those required by the existing automatic pricing mechanisms. Any significant deviation from these assumptions may lead to a revision of the outlook for inflation and monetary policy.

Distinguished Guests,

In sum, factors affecting the inflation outlook have undergone significant changes in the last quarter of 2008. With the financial crisis turning into a worldwide recession, there has been a sharp downturn in both domestic and external demand. Moreover, commodity prices sharply declined in response to the worsening global economic outlook. Growth forecasts for the global economy have been constantly revised downwards in the last couple of months, and the risks are still seen on the downside. These developments have increased the probability of undershooting our inflation target at the end of year 2009, setting the ground for policy rate cuts. Accordingly, we have cut the policy rates by a total of 375 basis points in the past three months. Moreover, we have taken several measures in order to facilitate the smooth functioning of our financial markets since October. In this framework, the Central Bank, above all, resumed its intermediary activities in the foreign exchange deposit markets in Foreign Exchange and Banknotes Markets on 9 October 2008. Following this, transaction limits for the banks in the Foreign Exchange and Banknotes Markets were increased significantly to reach USD 10.8 billion. Besides, the maturity of the FX deposit borrowed by the banks from the Foreign Exchange Deposit Markets was extended and the lending rate in the said market was reduced. In addition to these measures, the FX required reserves ratio dropped, providing the banking system with an additional foreign currency liquidity amounting to USD 2.5 billion.

The Central Bank will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the objective of price stability.

In the event of deepening financial turmoil in global markets, additional measures might be taken. Accordingly, the transaction limits in the Foreign Exchange Deposit Markets might be increased, the maturity of the FX deposits to banks might be extended and lending rates might be reduced. The FX required reserves ratio might be moderately reduced once again. Under the basic principles of the floating exchange rate regime, during times of decreasing depth experienced in the foreign exchange market, the CBT might resume foreign exchange selling auctions and directly intervene in the market in the event of unhealthy fluctuations stemming from speculative behavior.

Distinguished Guests and Members of the Press,

Uncertainties regarding the extents of impact of the problems in the global financial markets on real economic activity remain at high levels. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis, especially under current conditions. Preserving the fiscal discipline and strengthening the structural reform agenda would help to mitigate the adverse effects of the ongoing shocks on the domestic economy. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of utmost importance. Concluding my speech, I would like to highlight that in particular, advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity gains, are monitored closely by the CBT with regard to their implications for macroeconomic and price stability. Thank you for your attention.