Durmuş Yilmaz: Press conference for the presentation of the inflation report

Speech by Mr Durmuş Yilmaz, Governor of the Central Bank of the Republic of Turkey, at the press conference for the presentation of the second issue of the Inflation Report, Central Bank of the Republic of Turkey, Ankara, 30 April 2008.

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Distinguished Guests and Members of the Press,

Welcome to the press conference for the presentation of the second issue of the 2008 Inflation Report, one of the most important communication tools of the full fledged inflation targeting regime that we have been implementing.

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 which will be posted on our website later today.

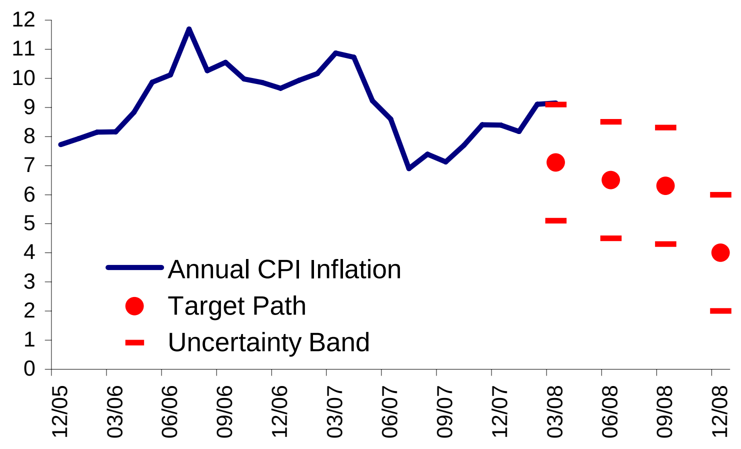
1. Inflation developments

Dear Members of the Press,

I would like to start with a general assessment of inflation developments.

The monetary tightening exercised since mid-2006 has been successful in achieving a significant reduction in underlying inflation. The fall in headline inflation, however, has been more limited, owing mainly to factors largely beyond the control of monetary policy, such as developments in food, energy, and administered prices. Consumer prices rose by 3.1 percent in the first quarter of 2008 and annual inflation reached 9.15 percent (Figure 1). Thus, as of March, annual inflation exceeded the upper limit of the uncertainty band, which was 9.1.

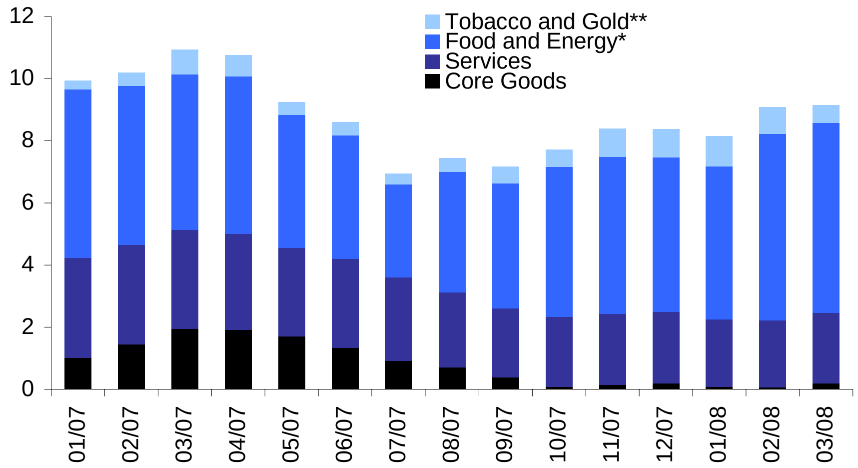
Figure 1: Annual CPI Inflation and Target Path



Source: TURKSTAT, CBT.

Prolonged increases in food, energy and commodity prices have recently led to upward pressure on headline inflation and in turn to upward revisions in inflation forecasts in many countries across the world. Turkey is not an exception in this regard, as the deviations of inflation from our forecasts can be mostly attributed to these factors. For instance, our forecasts in the October 2006 Inflation Report suggested that inflation would converge to the 4 percent target at the end of the first quarter of 2008. The forecast was based on a scenario in which food inflation moderated to levels comparable with medium term targets and oil prices remained stable at 60 USD per barrel. However, oil prices continued to rise and averaged around 100 USD per barrel in the first quarter of 2008. Moreover, annual food price inflation has continued to remain at elevated levels, reaching 13.4 percent in March. As a consequence, 6.13 percentage points of the 9.15 percent annual CPI inflation in March came from food and energy items (Figure 2).

Figure 2: 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, CBT. .

Both domestic and international developments have played a part on the course of food prices. A prolonged shortage of rainfall in Turkey resulted in low crop yields in 2007, which turned into an adverse supply shock. Strong global demand for food and continued elevation in agricultural commodity prices further added to domestic food inflation through the external trade channel. Recently, adverse impacts of these factors have been quite visible especially in processed food prices. Accordingly, annual food inflation maintained its high levels with a marked contribution of about 2.3 points to the 3.1 percent year-to-date headline inflation. Therefore, food prices became the main factor impeding the disinflation process (Figure 3, Table 1).

Adverse developments in energy prices have been another major factor in slowing the disinflation process. Rising oil prices continued to lead to significant hikes in the prices of fuel-oil products. Elevated oil prices have also affected the prices of energy items in housing utilities, including electricity tariff rates, which were adjusted upwards by a significant margin. Consequently, the contribution of energy items to year-to-date CPI inflation reached about 0.9 percentage points.

Figure 3: Subcomponents of CPI (First Quarter Percentage Change)

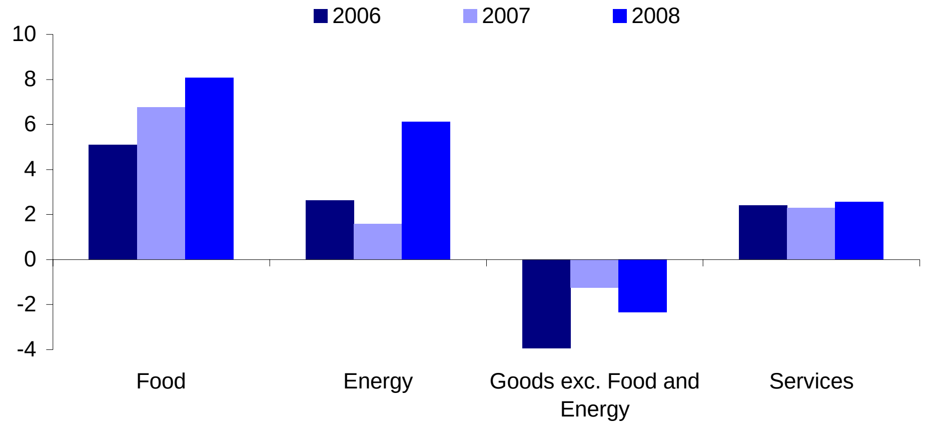


Table 1: Contribution to First Quarter CPI Inflation (Percentage Points)

	CPI	Food*	Energy	Goods exc. Food and Energy	Services
2008	3,09	2,31	0,86	-0,74	0,65
2007	2,36	1,93	0,22	-0,39	0,60
2006	1,25	1,41	0,38	-1,20	0,66

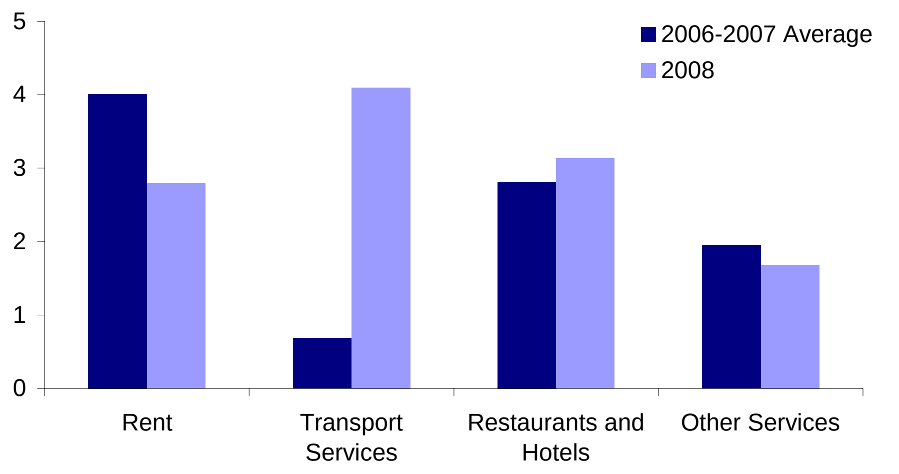
* Food: Food and non-alcoholic beverages.

Source: TURKSTAT, CBT.

Distinguished Guests;

The decline in services inflation came to a halt in the first quarter of 2008. Elevated food and energy prices have been exerting upward pressures on the prices of catering and transport services. Rents and other services, on the other hand, have continued to decelerate (Figure 4).

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



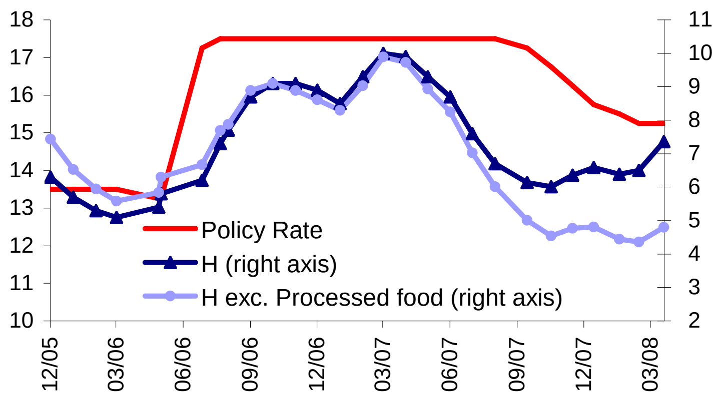
Source: TURKSTAT, CBT.

Distinguished Guests,

Global uncertainties and their reflections on the domestic financial markets have led to exchange rate movements, which in turn affected March inflation especially through the prices of fuel and high-tech consumer durables. The first round effects of exchange rate pass-through are expected to continue in the short term.

Inflation in CPI excluding food, energy and tobacco items remained flat over the previous quarter and remained at 4.8 percent, confirming that the rise in inflation can be mostly attributed to factors beyond the control of monetary policy (Figure 5). The recent rise in core inflation indicators has reinforced the risks related to second-round impacts of previous shocks.

Figure 5: Main Inflation Indicators and Policy Rates



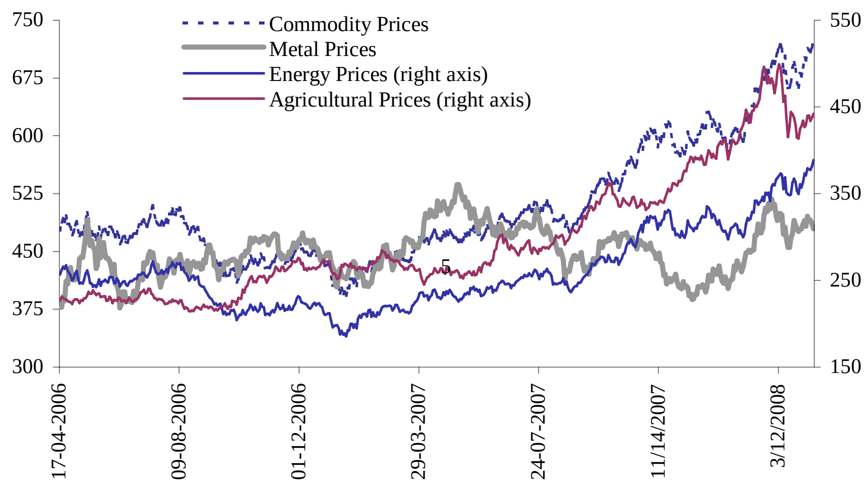
H: CPI excluding unprocessed food, energy, alcoholic beverages, tobacco and gold.

Source: TURKSTAT, CBT.

Dear Members of the Press,

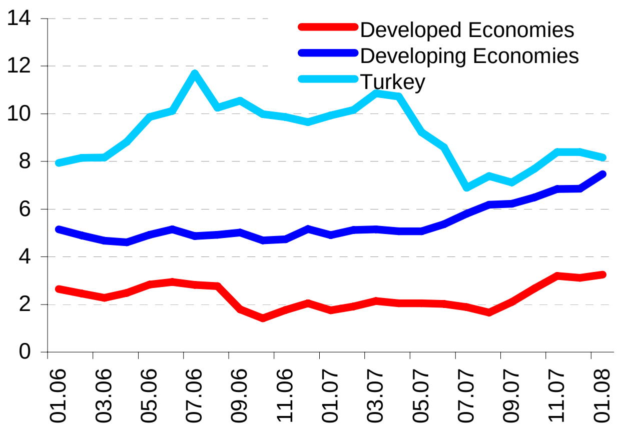
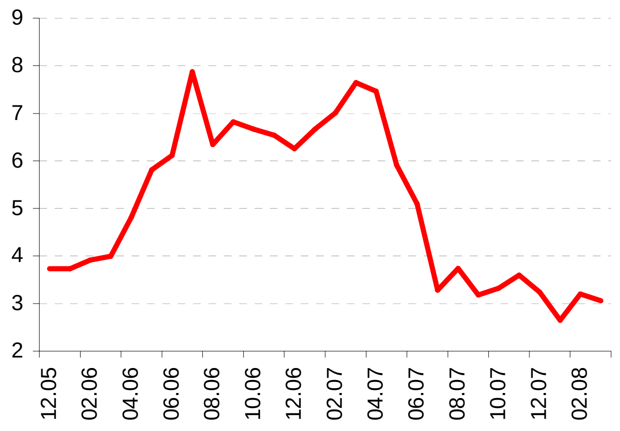
Elevated prices of crude oil, food/agricultural products and other commodities continue to exert inflationary pressure (Figure 6). As a result, inflation has recently been rising worldwide (Figure 7). Inflation in developed economies edged up in the last quarter of 2007, while emerging economies with inflation targeting have faced an upward trend since June 2007. By the end of the first quarter annual inflation in Turkey was 9.2 percent, which is below its end-2006 level of 9.7 percent. During the same period, the average inflation in emerging market economies with inflation targeting rose from 3.4 percent to 6.1 percent.

Figure 6: S&P Goldman Sachs Commodity Price Indices



Source: Goldman Sachs.

Figure 7: Inflation in Other Countries

a. Inflation Rates	**b.** Diff. Between Turkey and Other Emerg. IT'ers*
	

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

Source: Web sites of central banks, IFS, TURKSTAT, CBT

2. Monetary policy response

The CBRT has been clear about its approach in responding to inflation resulting from factors beyond its control: Monetary policy will tolerate the first round effects, but will promptly respond to any deterioration in overall pricing behavior. I want to emphasize that the policy pursued since September 2007 should be interpreted in this context.

In September 2007, the Monetary Policy Committee (MPC) decided to initiate the rate cuts, which had already been signaled earlier in the year. Accordingly, policy rates were lowered by 225 basis points between September 2007 and February 2008 (Table 2).

Table 2: Monetary Policy Committee (MPC) Decisions in 2007 and 2008

Dates for MPC Meetings	Decision on Interest Rates	Interest Rate
January 16th, 2007	No Change	17.50
February 15th, 2007	No Change	17.50
March 15th, 2007	No Change	17.50
April 18th, 2007	No Change	17.50
May 14th, 2007	No Change	17.50
June 14th, 2007	No Change	17.50
July 12th, 2007	No Change	17.50
August 14th, 2007	No Change	17.50
September 13th, 2007	-0.25	17.25
October 16th, 2007	-0.50	16.75
November 14th, 2007	-0.50	16.25
December 13th, 2007	-0.50	15.75
January 17th, 2008	-0.25	15.50
February 14th, 2008	-0.25	15.25
March 19th, 2008	No Change	15.25
April 17th, 2008	No Change	15.25

Source: CBT.

In the January 2008 Inflation Report, we indicated that uncertainties in the global economy, hikes in electricity prices, and risks to price setting behavior had compelled the CBRT to be more responsive to incoming information. The letter also expressed that further monetary accommodation would depend on the factors affecting the medium term inflation outlook. Food and energy prices and global uncertainties have continued to rise since then, feeding into inflation expectations and core prices and thus increasing the risks regarding price setting behavior and the degree of inflation persistence. Consequently, the MPC decided to suspend the rate cuts in the March meeting and announced in the April meeting a clear tightening bias to be exercised when deemed necessary.

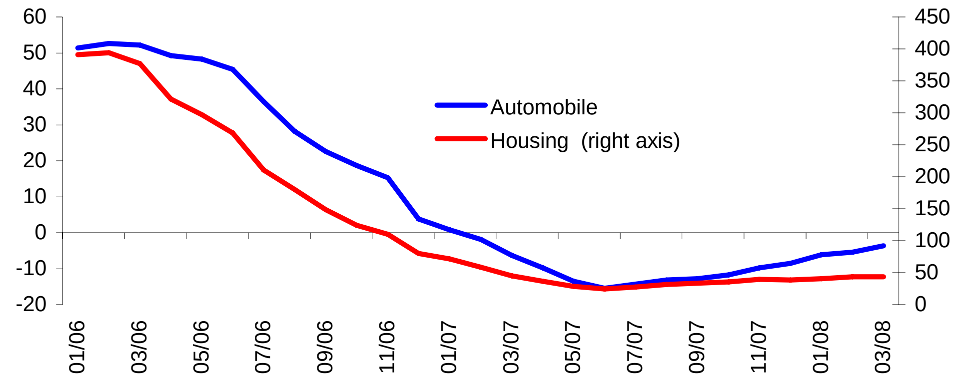
3. Inflation outlook

Distinguished Guests and Members of the Press,

Now that I have summarized inflation and monetary policy developments, I would like to share with you our evaluations of the inflation and monetary policy outlook.

Current supply and demand conditions support the downward trend in inflation. Data on consumer credits suggest that monetary conditions continue to be non-accommodative. Annual growth rates in automobile and housing loans are at lower levels compared to the periods of vigorous domestic demand (Figure 8). Although consumer credits displayed signs of recovery in 2007, the cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.

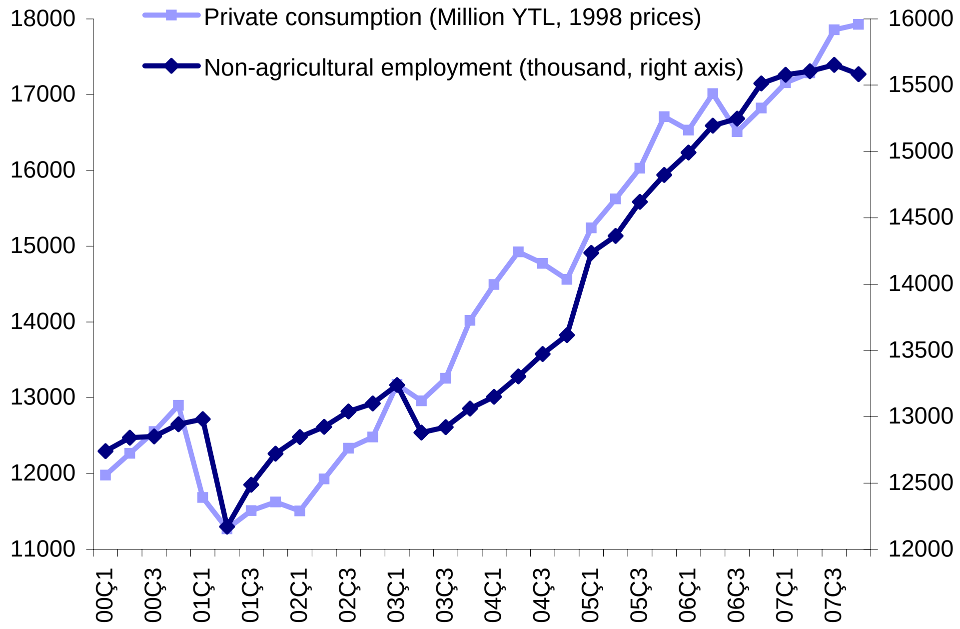
Figure 8: Consumer Loans (Annual Percentage Change)



Source: CBT.

The sharp slowdown in the second half of 2006 created some slack in the economy. The recent methodological change in national accounts led to a limited upward revision in our output gap measure and hence did not change the inflation outlook. Looking ahead, we expect a continued moderation in economic activity and non-farm employment on the back of rising precautionary saving due to global and domestic uncertainties (Figure 9).

Figure 9: Private Consumption Expenditure and Non-Agricultural Employment*

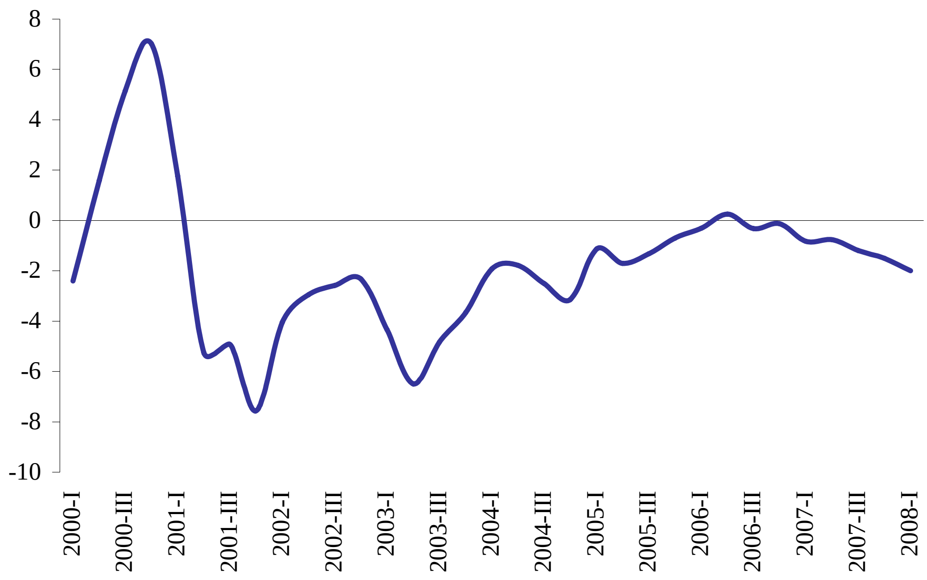


*Seasonally adjusted

Source: TURKSTAT, CBT.

Accordingly, demand and capacity conditions are expected to continue to support disinflation (Figure 10). Therefore, assuming that supply shocks gradually fade out over time, headline inflation is expected to decelerate.

Figure 10: Output Gap

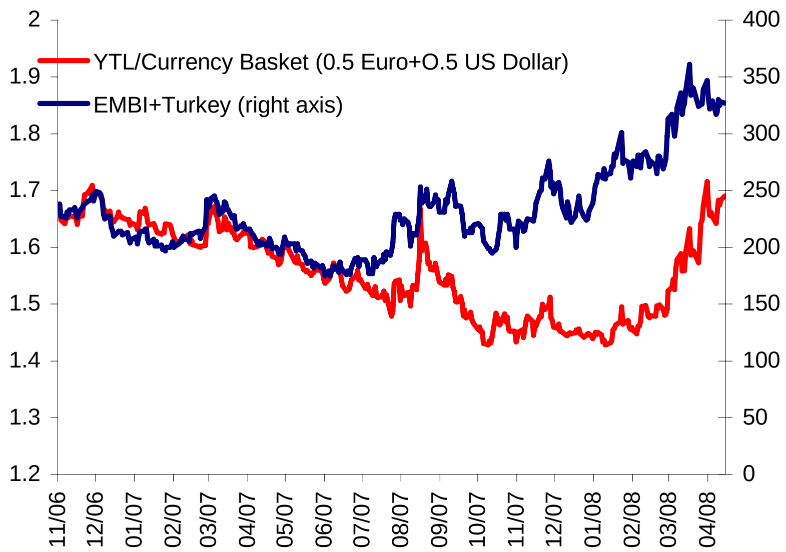


Source: CBT.

Distinguished Members of the Press,

The domestic currency has depreciated by more than 15 percent in nominal terms since the beginning of the year. Notwithstanding the expected deceleration in the core inflation indicators in the medium term, the first round impacts of the exchange rate pass-through may be significant in the short term (Figure 11).

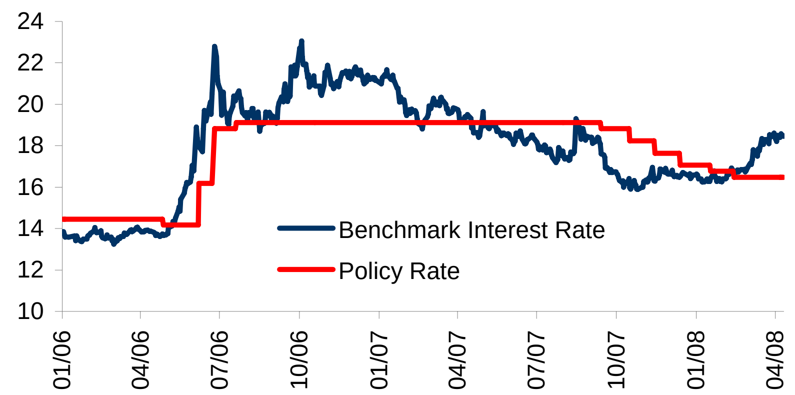
Figure 11: Risk Premium and Nominal Exchange Rates



Source: CBT, Bloomberg.

Longer term interest rates have increased lately due to the rising risk premium (Figure 12). Although higher interest rates contain domestic demand and thus support disinflation, the impact of the higher risk premium on pricing behavior should be closely monitored.

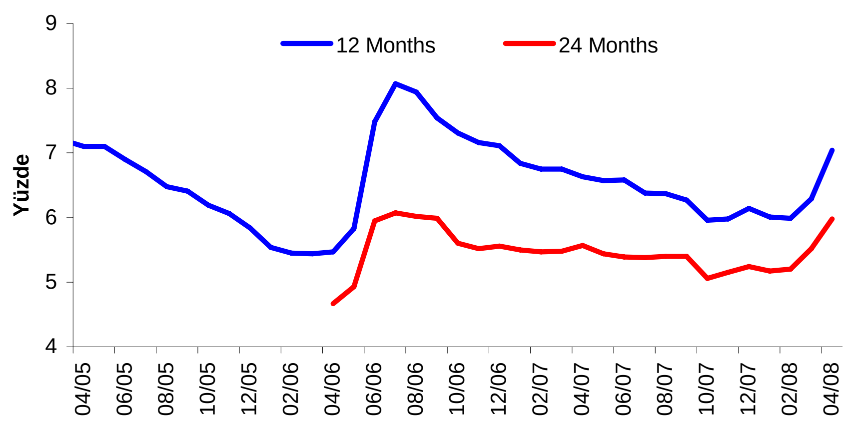
Figure 12: Benchmark Interest Rate and Policy Rate



Source: CBT, ISE.

The CBT survey of expectations suggests that economic agents expect inflation to pursue a downward trend. One year forward expectations are at 7 percent, whereas 2-year ahead inflation expectations stand at around 6 percent. However, the recent upward movement in expectations has increased the risks to price setting behavior (Figure 13).

Figure 13: Inflation Expectations*



*24 months expectations is available from May 2006 onwards.

Source: CBT

Distinguished Guests,

In the January Inflation Report, we envisaged a correction in food inflation justified by more favorable weather conditions. However, the long-awaited correction in food prices has not yet materialized. Processed food inflation has accelerated even further on the back of rising global demand and elevated agricultural commodity prices.

At this point, global perceptions regarding the persistency of the increases in agricultural commodity prices in the medium term have become stronger. In this conjuncture, the analysis of the forecasts for world food prices and their impacts on domestic food prices bears great importance. In this respect, we included the summary of a particular study in the Inflation Report. The said study analyzes in detail the price developments observed in food products, determines their relative impacts by excluding the determinants of domestic food prices and accordingly makes assessments for the future. As stated in the study, the reinforcement of global perceptions regarding the persistency of the increases in agricultural commodity prices in the medium term indicates that upward risks on domestic food prices and especially on processed food prices will continue in the foreseeable future.

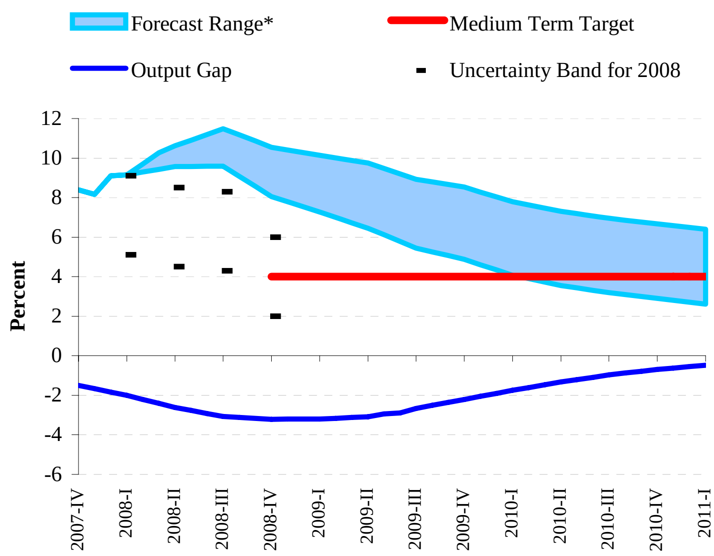
In this framework, we revised our forecasts for medium term inflation to incorporate more conservative assumptions on food prices and we have raised our assumptions for food inflation to 13 percent for the year 2008 and 8 percent for the year 2009. These changes have led to upward revisions in our inflation forecasts, by about 1.2 points for 2008 and 1.1 points for 2009.

The assumption on oil prices in the January Inflation Report stood at USD 85 per barrel. However, oil prices averaged about USD 100 in the first quarter of 2008. Considering the most recent developments, we have revised our assumption for oil prices to USD 105 per barrel. Moreover, we assume that electricity tariffs will be adjusted as required by the automatic pricing mechanism. These changes imply upward revisions in our forecasts by 0.9 points for end-2008, and 0.4 points for end-2009.

Although weak domestic demand should limit the second round effects of the exchange rate pass-through, the first round impact of the recent depreciation is estimated to be close to 2-percentage points at the end of 2008, which implies further upward revision in our forecasts.

Within the framework that I have drawn up so far, we now forecast inflation to be around 9.3 percent at the end of 2008. Our medium term forecasts suggest, with 70 percent probability that, under the assumption of a measured and gradual tightening towards mid-2008 and constant policy rates thereafter for the rest of 2008, inflation will be between 4.9 and 8.5 percent (mid point 6.7) at the end of 2009 (Figure 14). Assuming a gradual moderation in food inflation, headline inflation is expected to decelerate to 4.9 percent at the end of 2010 and to 4 percent by mid-2011. We expect non-food inflation to be lower than these figures.

Figure 14: Inflation and Output Gap Forecasts



Source: CBT

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

Distinguished Guests and Members of the Press,

Supply shocks have turned out to be more persistent than expected, increasing the risks to the second round effects and necessitating a significant upward revision in our inflation forecasts. Accordingly, monetary policy has already assumed a more cautious stance in order to eliminate the materialization of potential second round effects. Ensuring a steady decline in inflation will likely require tight monetary policy to be maintained for an extended period. Even then, the earliest time for reaching the 4 percent medium term targets is likely to extend beyond two years. However, this does not mean that the Central Bank will implement a looser monetary policy in the forthcoming period. On the contrary, the forecasts that I just presented are based on a tighter monetary policy stance compared to the previous period.

I would once again like to emphasize that any new data or information on the inflation outlook may lead to a change in the policy stance of the Central Bank. Therefore, the indicated path for the policy rates should not be perceived as a commitment on behalf of the CBT.

Distinguished Guests,

Revised projections suggest that the contribution of energy, food and services will be close to 5 percent at the end of 2009. In other words, assuming no further hikes in administered prices (except those implied by automatic pricing mechanisms), meeting the 4 percent target at the end of 2009 would be possible only if the prices of goods excluding food, energy and tobacco deflate by 3 percent. However, factors such as rising import prices, potential second round impacts of supply shocks, and the structural inertia in inflation could continue to impose downward stickiness in goods prices. Therefore, converging to the medium term target of 4 percent may extend beyond two years, even when tight monetary policy is maintained for an extended period.

Under these circumstances, getting inflation back to the 4 percent by the end of 2009 would require offsetting the first round effects, and thus create undesired fluctuations in economic activity and relative prices. That is why we envisage a framework in which inflation remains higher than 4 percent at the end of 2009.

The forecasts presented above deserve particular attention, given that inflation is likely to stay above the target in the next two years. The forecasts should serve as anchors for the intermediate term, representing the inflation path that is likely to be followed on the way to 4 percent medium term target.

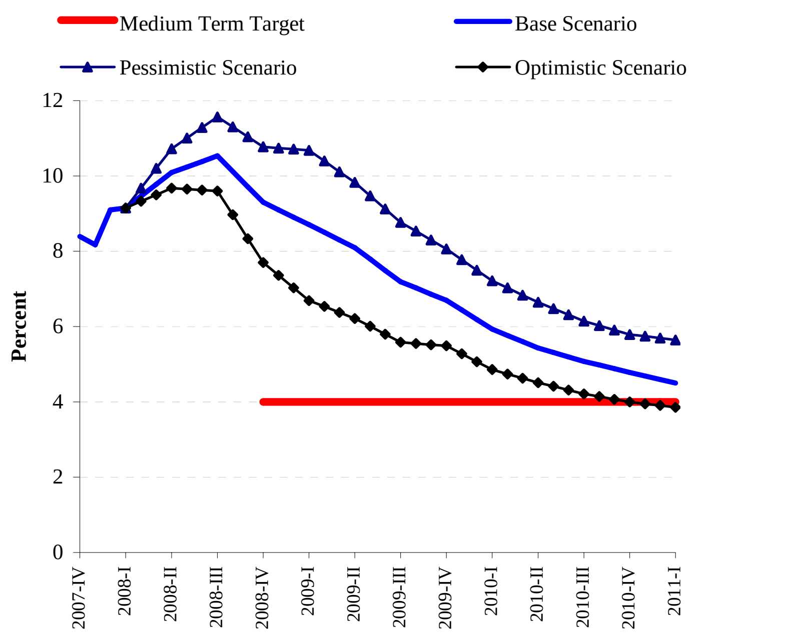
4. Risks and monetary policy

Distinguished Guests,

In the last part of my speech, I would like to mention the upside and downside risks regarding inflation and monetary policy in the upcoming period.

Our revised forecasts are based on rather conservative assumptions, especially for food and energy prices, implying that downside risks are as significant as upside risks. In the April Inflation Report, we provide projections under alternative scenarios for food and energy prices. The pessimistic scenario assumes food inflation to materialize at 17, 11 and 10 percent in the next three years, and oil prices to soar to 150 USD per barrel at the end of 2009. Under this scenario, assuming that policy rates increase gradually throughout the year 2008 and then stay constant for a while, it would four years for inflation to go back to 4 percent (Figure 15). The other scenario, which is the optimistic one, assumes that food inflation materializes at 9, 5 and 4 percent in the next three years, and oil prices eases to 85 USD per barrel at the end of 2009. Under this scenario, assuming a limited rate hike in short term and gradual cuts starting from the last quarter, inflation would reach 4 percent at the end of 2010. Therefore, the materialization of upside risks would require further tightening of the monetary policy stance, while downward surprises in food and energy prices would be perceived as an opportunity to bring inflation back to the target in a shorter period.

Figure 15: Inflation Forecasts, Base Scenario and Alternative Scenarios



A protracted period of rising food and energy prices have led to significant breaches in inflation targets since the adoption of the inflation-targeting regime and consequently increased the stickiness in inflation expectations, as economic agents have become more backward looking. Under normal conditions, supply shocks are expected to alter relative prices rather than the underlying inflation trend. Nevertheless, the fact that several long-lasting shocks appeared concurrently has increased the risks to price setting behavior. As a matter of fact, recent studies by the Central Bank reveal that economic agents have been increasingly grounding their expectations on past inflation figures. In this respect, recent developments in the pricing behavior and the underlying inflation trends are of particular concern. It may be necessary to pursue a tighter monetary policy should the price setting behavior deteriorate.

Distinguished Guests,

Another major risk to the inflation outlook is a sharper than expected slowdown in global economic activity, which, in turn, could lead to further volatility in financial markets. The eventual impact of financial turmoil on global economic activity triggered by mortgage loans in the US economy is yet to be seen. These uncertainties have been dampening the risk appetite and thus slowing capital flows to emerging economies. The CBT will not react to temporary fluctuations in financial markets. Yet, we will not hesitate to tighten monetary policy in case of a significant worsening in the overall pricing behavior.

Under current liquidity conditions, I believe it is useful to note that the Central Bank has the resilience to implement a strong monetary tightening within a short time. The recent cuts in the amount of foreign exchange auctions, reduced FX borrowing of the Treasury and the increase in demand for money has led to a decline in the withdrawal of excess liquidity in the overnight market. The said tendency is expected to persist in the upcoming period, which will thus lead to relatively tighter monetary conditions. This framework not only allows the Central Bank to perform more resilient and efficient liquidity management but also to adopt tighter monetary policy without the need for a Monetary Policy Committee Meeting.

Finally, it may be useful to note that our medium-term projections assume that government expenditures will evolve in line with the official projections and that there will be no further increases in indirect taxes or any administered price adjustments. Any deviation from this assumption may alter the outlook for inflation and monetary policy.

Distinguished Guests and Members of the Press,

Inflation targets have been breached by a significant margin in the past two years as a result of exceptionally persistent supply shocks, and there is a considerable chance that the shocks are likely to stay for a while. Besides, the ongoing uncertainty resulting from the global economy has been increasing the risks related to the second round effects of these supply shocks. Our revised projections incorporating the latest developments suggest that in 2008 and 2009 inflation is likely to materialize at higher levels than 4 percent. In light of these evaluations, economic agents need reference values in order to establish inflation expectations in the short term. These projections, presented by the Central Bank, are prepared to meet this need. Our projections should be evaluated as the intermediate indicators to be taken as a reference on the way to the 4 percent target. Therefore, we envisage a framework in which inflation forecasts serve as an anchor in the short term, while 4 percent targets continue to be the medium term anchor. The accurate comprehension of this framework by the public, thus mapping out their economic plans accordingly will enhance the efficiency of expectations management.

Distinguished Guests,

Once more I would like to underline that extending the horizon within which inflation converges to the target of 4 percent does not mean that monetary policy will be looser in the forthcoming period. On the contrary, the presented inflation forecasts are based on a tighter monetary policy stance compared to the previous period. Monetary policy will be more responsive to bad news than good news in the period ahead. This approach reflects our firm commitment to attaining price stability.

I would like to stress that prudent monetary policy is a necessary but not a sufficient condition in itself for attaining price stability. The support from fiscal policy and structural reforms are also critical in this respect. Sound fiscal policy has been one of the main factors in driving inflation down to single digits. The role of fiscal policy will continue to be critical on the road to price stability. Preserving the resilience of the economy, especially under current conditions, requires the continuation of fiscal discipline and structural reforms. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain to be of the utmost importance. Finally, I would like to conclude my speech by specially emphasizing that advances in structural reforms, which would improve the quality of fiscal discipline and raise productivity, are monitored closely by the CBRT with regard to their implications on macroeconomic and price stability.

Thank you.