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 inflation report, Central Bank of the Republic of Turkey, Ankara, 31 January 2008.

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Distinguished Guests and Press Members,

Welcome to the press conference for the presentation of the Inflation Report that is one of the most important communication tools of the formal inflation targeting regime that we implement.

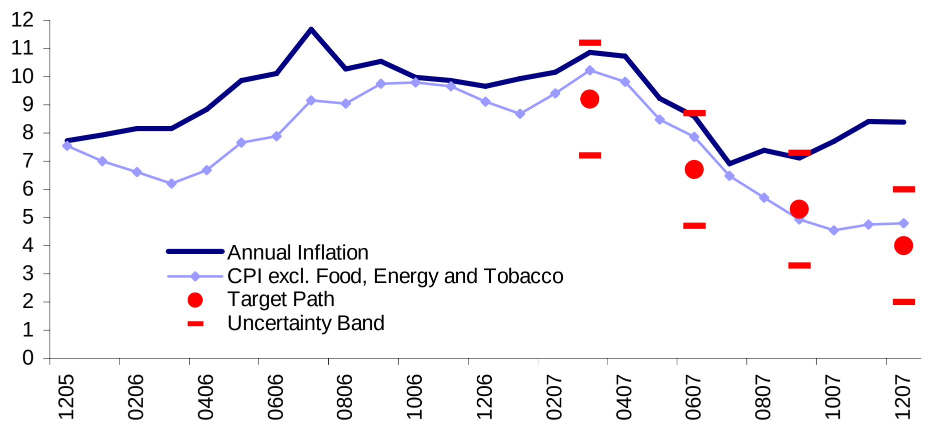
In this conference, I would like to give you a short summary of our evaluations and the Central Bank's inflation forecasts which appear in the Inflation Report that will be posted on our website shortly today.

1. An assessment of the year 2007

I would like to start by a general assessment of inflation developments in the year 2007.

The monetary tightening exercised since mid-2006, has been successful in leading to a significant reduction in the underlying inflation. Especially the 3.6 percentage points fall in the services inflation, which confirmed the marked disinflation trend during 2007, was remarkable. The fall in headline inflation, however, was more limited, owing mainly to factors beyond the control of monetary policy, such as developments in energy, food, and administered prices. Accordingly, inflation realized as 8.39 percent at the end of 2007, breaching the upper bound of the uncertainty band of 6 percent. On the other hand, annual CPI inflation excluding food, energy and tobacco products was at 4.8 percent (Figure1).

Figure 1: Annual CPI Inflation and the Target Path

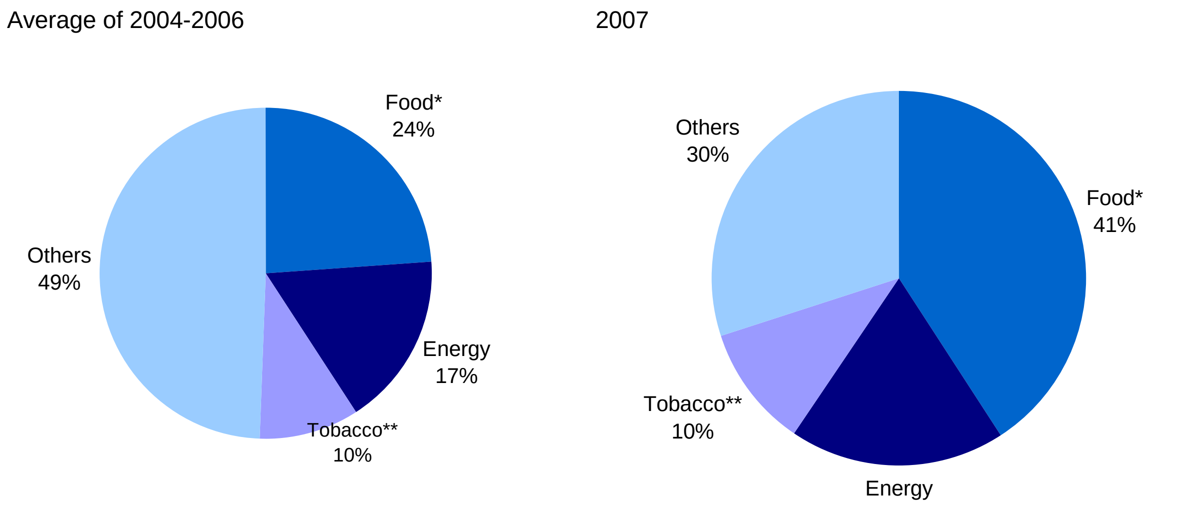


Source: TURKSTAT, CBRT.

The course of food prices has been main factor slowing down the disinflation process. A prolonged shortage of rainfall in Turkey since Autumn 2006 has resulted in low crop yields in 2007, which in turn translated to an adverse supply shock. Global developments, such as increasing bio-fuel production, strong global demand for food and consequent rises in agricultural commodity prices, further added to the domestic food inflation through the external trade channel. These factors had an impact not only on unprocessed food such as fresh fruit and vegetables, but also on processed food such as grain and dairy products. Accordingly, annual food inflation maintained its high levels, with an end-year figure of 12 percent. Hence, food prices became the main factor impeding the disinflation process in 2007, with a marked contribution of about 3.4 percent on headline inflation. The contribution of food prices to the headline inflation in 2007 was significantly higher than it had been in the past three years (Figure 2).

Figure 2: Contribution to End-Year CPI Inflation

(Percentage Share)



* Food: Food and Non-Alcoholic Beverages

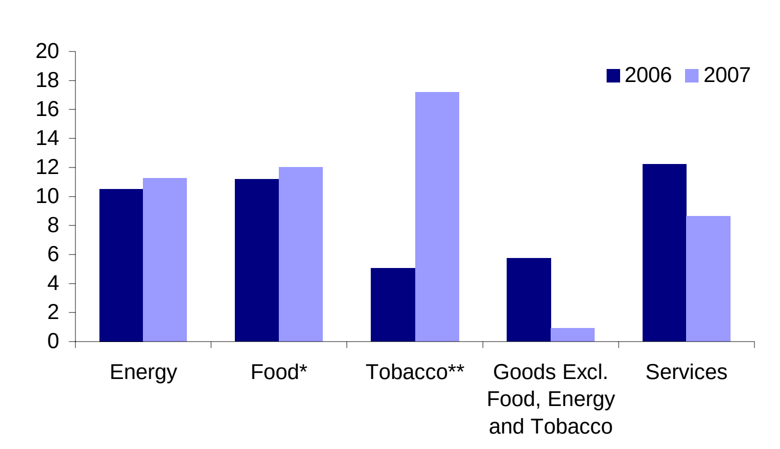
** Tobacco: Tobacco products and Alcoholic Beverages

Source: TURKSTAT, CBRT.

Another major factor slowing down the disinflation process in 2007 was the adverse developments in energy and administered prices. The crude oil price in December 2007 was nearly 50 percent above the levels registered at the end of 2006. This development, together with the changes in special consumption tax on fuel products, led to a significant rise in prices of fuel-oil products in 2007. Meanwhile, another energy item, housing water prices, which is administered by municipalities, edged up in the last quarter of 2007, partly owing to the drought conditions. Overall, 1.6 points of the headline inflation resulted from the energy price hikes, where the contribution of administered component outweighs that of the oil price (Table 1). While food, energy and tobacco products displayed significant increases in 2007, the fast pace of disinflation in services and core goods excluding food, energy and tobacco in 2007, confirms that supply side shocks were mainly responsible for the breach of the uncertainty band (Figure 3).

Figure 3: Subcomponents of CPI

(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Table 1: Contribution to Annual CPI Inflation (Percentage Points)

	Energy	Food*	Tobacco**	Goods Excl. Food, Energy Tobacco	Services
2007	1.57	3.42	0.87	0.24	2.28
2006	1.51	3.09	0.28	1.43	3.33

* Food: Food and non-alcoholic beverages

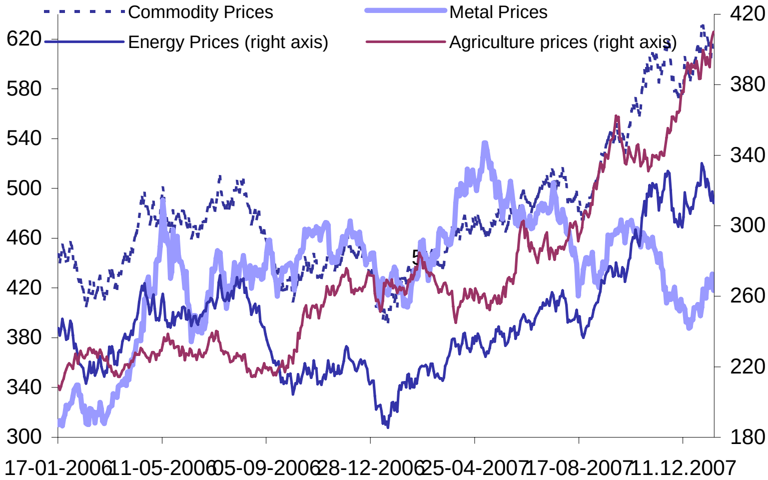
** Tobacco: Tobacco products and Alcoholic beverages.

Source: TURKSTAT, CBRT.

Distinguished Guests,

Elevated prices of crude oil, agricultural products and other commodities exert inflationary pressures all over the world. Recently, both the developed and emerging economies have been facing a rise in inflation. Inflation in Turkey followed a more favorable trend in 2007 compared to other emerging economies under inflation targeting, notwithstanding the administrative price hikes in November, which added by about 1-percentage point to the Turkish CPI inflation. During the past year, inflation in Turkey declined to 8.4 percent from 9.7 percent, while the average of inflation in emerging market economies under inflation targeting rose from 3.4 percent to 5.1 percent (Figures 4&5). Among the mentioned economies, only 4 countries experienced a decline in inflation in 2007, including Turkey, which recorded the highest rate of decline. In other words, Turkey was the country with the largest rate of decline in inflation, in comparison with other economies in this group.

Figure 4: Commodity Prices

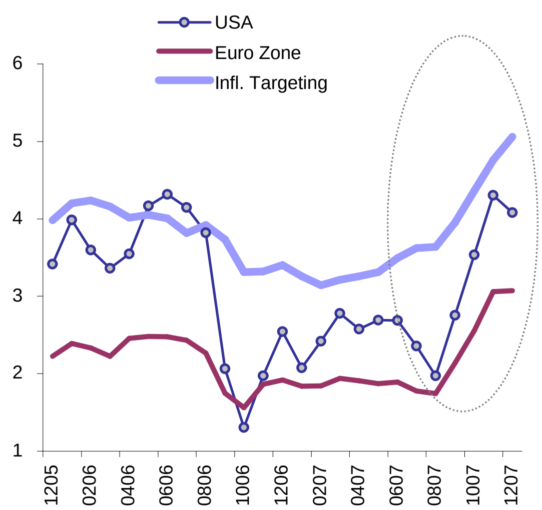


Source: Goldman Sachs.

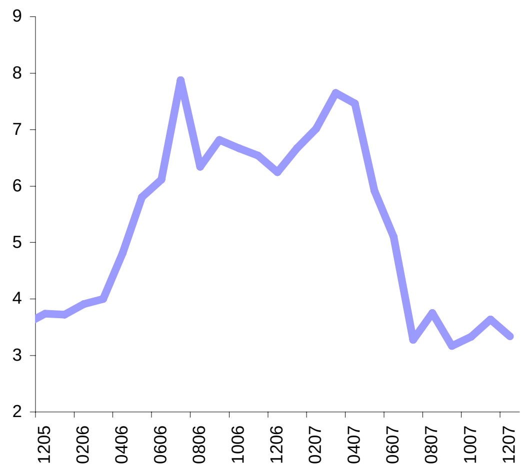
Figure 5: International Developments in Inflation:

Inflation in the USA, Euro Zone, and Emerging Economies Implementing Inflation Targeting

a. Inflation Rates*



b. Inflation Gap Between Turkey and Other Emerging Economies under Inflation Targeting *



*The 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 related countries' central banks.

2. Monetary policy reaction and outcomes

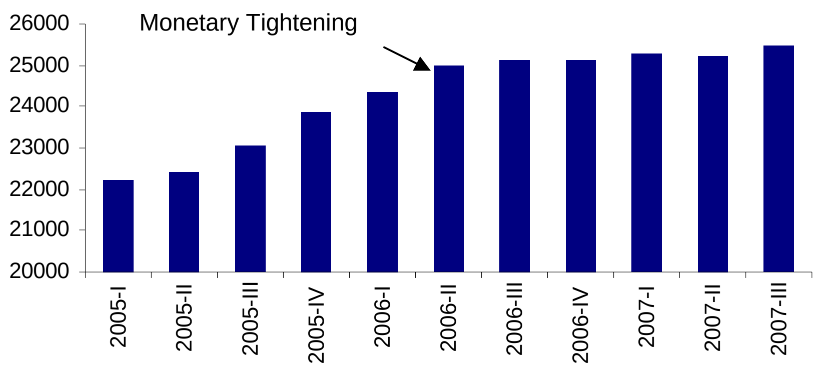
Distinguished Press Members,

The monetary tightening exercised since June 2006 has had a manifest impact on private sector demand for the last one and a half year (Figures 6&7). In the first three quarters of

2007, the Gross National Product (GNP) increased by merely 4 percent, remaining at a level lower than previous years. Sorting out the underlying dynamics of growth developments is critical in shaping monetary policy decisions. It should be emphasized that while the limited GDP growth compared to previous years can be attributed essentially to the impact of monetary tightening; the marked contraction in the agricultural sector also had a significant influence, especially on the reduced growth rate in the third quarter. In other words, the slowdown in growth resulted partially from the supply shock. As I have emphasized at the beginning of my speech, the contraction in the agricultural sector did not only affect the growth unfavorably, but it also pushed inflation up for a temporary period in 2007.

Figure 6: Private Final Consumption

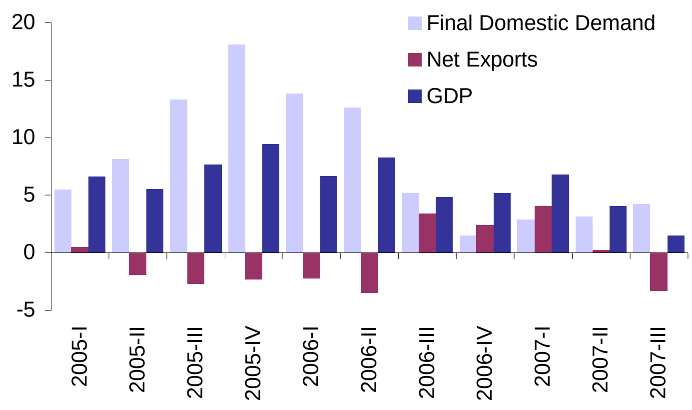
(Real, quarterly, seasonally adjusted)



Source: TURKSTAT, CBRT.

Figure 7: Contributions to Annual GDP Growth

(Percentage Points)

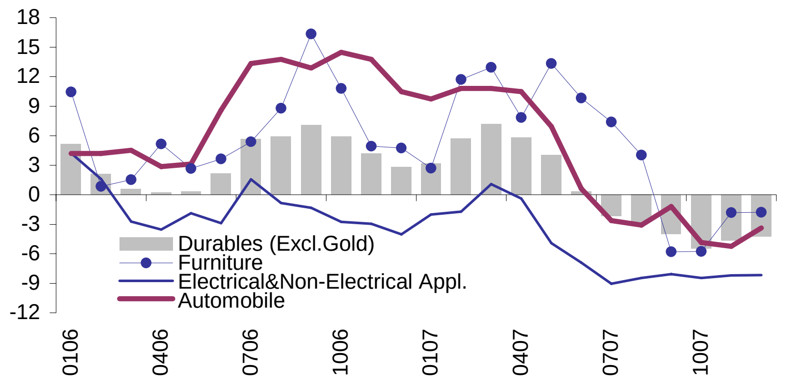


Source: TURKSTAT, CBRT.

Despite the unfavorable developments in food prices, almost a year after monetary tightening, core inflation indicators displayed a significant deceleration starting from the second quarter of 2007. The effects of tightening were clearly visible on the prices of durable goods and services consistent with the slowdown in the economic activity in the related sectors. The weaker demand, coupled with a strong domestic currency, helped durables inflation to come down significantly (Figure 8). In this respect, services inflation also eased remarkably, declining by 3.6 percentage points throughout 2007. The improvement in services inflation spread across all sub-items. Especially, the fall in rent inflation, the stickiest component of services inflation, was significant (Figure 9).

Figure 8: Durable Goods Prices

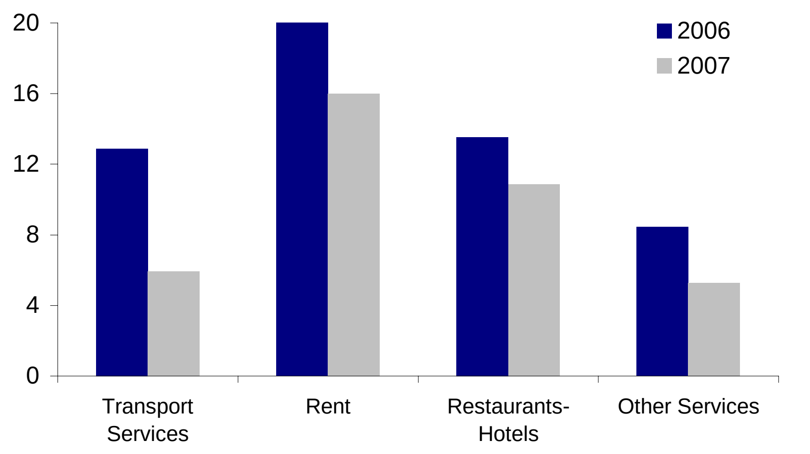
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Figure 9: Services Group Sub-Items

(Annual Percentage Change)



Source: TURKSTAT, CB.

The significant deceleration in the core inflation indicators set the ground for a relatively less restrictive monetary policy. Hence, we decided to start the measured easing cycle in September 2007 with a 25 basis-points cut, while continuing with 50 basis-points in the consecutive three meetings. At this point, I have to underscore that monetary policy remained restrictive even after these rate cuts. Nevertheless, we underlined the need to remain cautious against the risks related to potential second round effects of food and energy prices as manifested in the sticky inflation expectations; and reduced the pace of rate cuts in January 2008. Consequently, policy rates were lowered by 200 basis points in the period between September 2007 and January 2008 (Table 2).

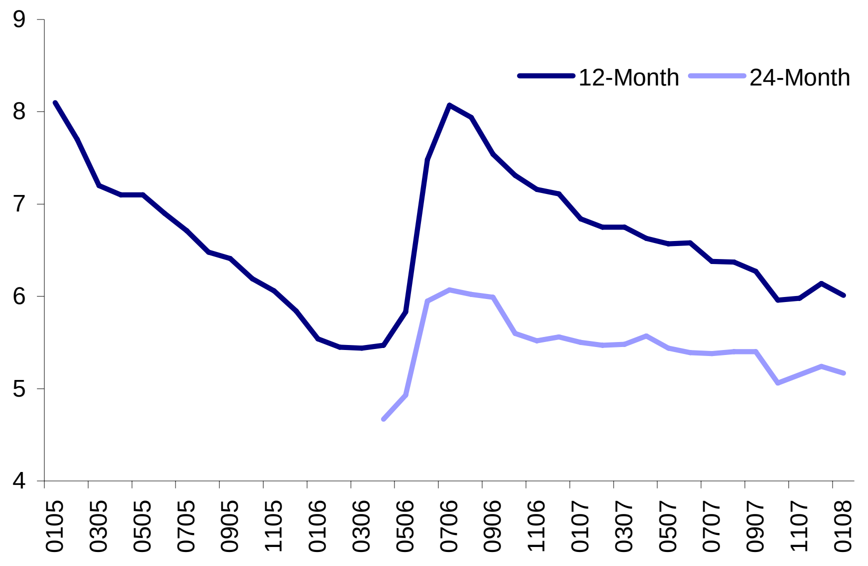
Table 2: Monetary Policy Decisions in 2007 and 2008

MPC Meeting Dates	Interest Rate Decisions	Interest Rates
16 January 2007	No Change	17.50
15 February 2007	No Change	17.50
15 March 2007	No Change	17.50
18 April 2007	No Change	17.50
14 May 2007	No Change	17.50
14 June 2007	No Change	17.50
12 July 2007	No Change	17.50
14 August 2007	No Change	17.50
13 September 2007	-0.25	17.25
16 October 2007	-0.50	16.75
14 November 2007	-0.50	16.25
13 December 2007	-0.50	15.75
17 January 2008	-0.25	15.50

Source: CBRT.

Both the 12-month and 24-month ahead inflation expectations exhibited a declining pattern throughout 2007 (Figure 10). However, the improvement in expectations, especially in the last quarter, was rather limited, owing to backward looking behavior, and possibly due to pre-announced hikes in administered energy prices. Nevertheless, it is worthwhile to mention that the administrative price hikes in November had little effect on medium-term inflation expectations, despite the upward revision in the year-end inflation expectations. This observation shows that inflation target, to a significant extent, continue to serve as an anchor and that economic agents expect the disinflation process to continue in the medium term. Nevertheless, the fact that currently medium-term inflation expectations are significantly above our medium term target of 4 percent necessitates a cautious policy stance[1].

Figure 10: Medium-Term Inflation Expectations*



Expectations regarding the period after 24 months have been published since May 2006.

Source: CBRT.

[1] As of January, one-year and two-year ahead inflation expectations are 6.01 percent and 5.17 percent, respectively.

3. Inflation and monetary policy outlook

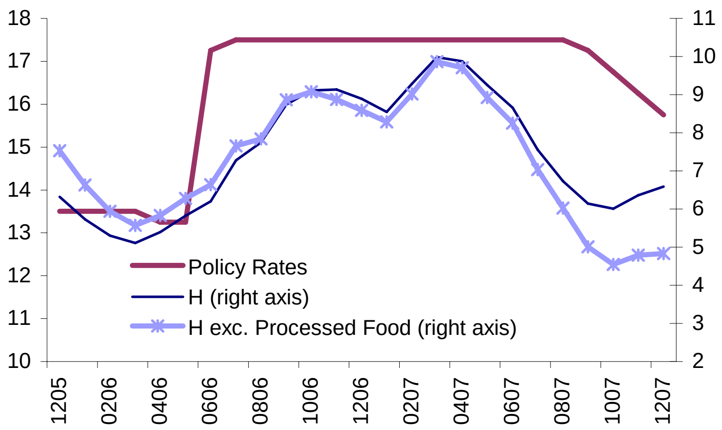
Distinguished Guests and Press Members,

After summarizing inflation and monetary policy developments in 2007, in this part of my speech, I would like to share our evaluations on inflation and the monetary policy outlook.

First of all, I would like to summarize several factors that might enable the disinflation process to continue in the upcoming period:

Annual percentage change in CPI excluding food, energy and tobacco imply an inflation trend of 4.8 percent (Figure 11)[2]. In other words, underlying inflation in the past year was not far away from the medium-term targets. Therefore, under the assumption that oil and food inflation will follow a more benign path in 2008 than 2007, we expect some contribution to disinflation from the base effects.

Figure 11: Response of Inflation to Monetary Tightening



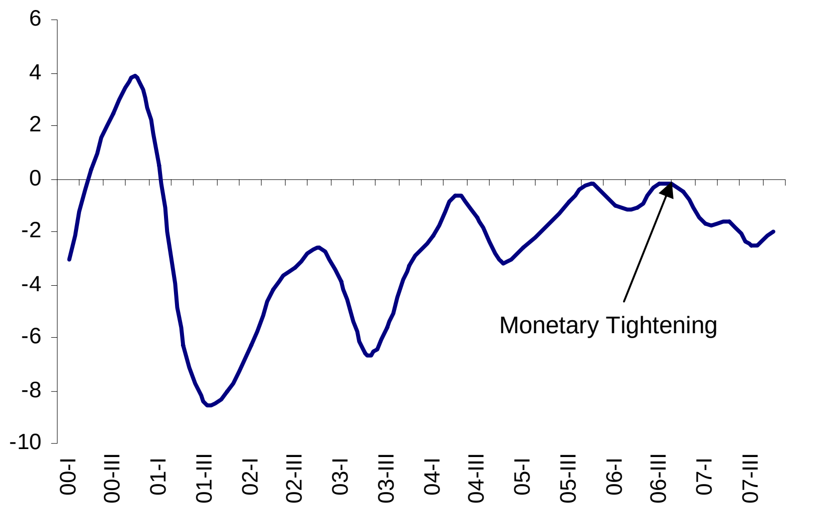
H: Unprocessed food, energy, alcohol beverages-tobacco, and gold excluded CPI.

Source: TURKSTAT, CBRT.

We believe that existing supply and demand conditions continue to support disinflation. The sharp slowdown in the second half of 2006 created an ample slack in the economy (Graph 12). Although domestic demand showed some signs of recovery in the second half of the year 2007, the pace of economic activity does not appear to be fast enough to eliminate the output gap. Moreover, the uncertainty created by the ongoing difficulties in the mature credit markets is expected to hold back the domestic consumer and investment spending in the forthcoming period. Accordingly, our medium term projections are constructed under the assumption that demand and capacity conditions contribute to the disinflation process throughout 2008.

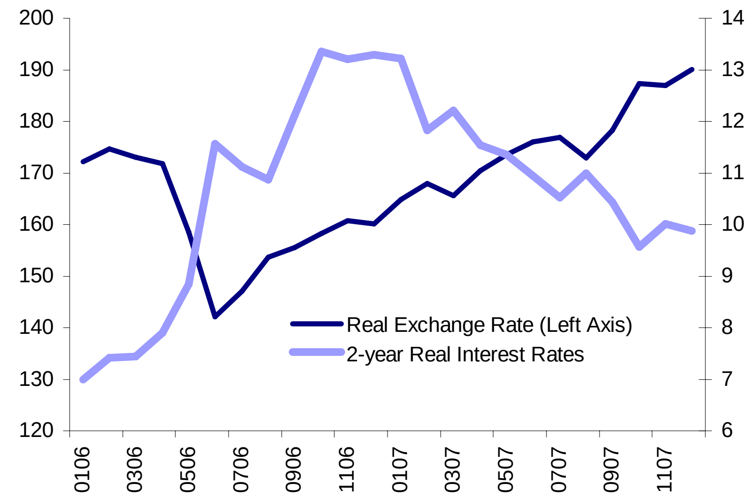
[2] Official core inflation measures, published under the name “Special CPI Aggregates“ (SCA),do not exclude processed food prices. We believe that excluding this item, in line with the international practice, could give a better proxy for recent inflation trends.

Figure 12: Output Gap



Monetary conditions continue to support the disinflation process. Despite the recent rate cuts, monetary policy can still be considered to be in the restrictive territory. Underlying rate of monetary expansion remains modest, consistent with a relatively restrictive monetary stance. Although medium term interest rates followed a downward trend in the past quarter, 2-year-real rates at this point fluctuate between 9 and 10 percent, implying a non-accommodative monetary stance. Moreover, the currency remains strong, curbing inflationary pressures and easing the impact of rising commodity prices on domestic production costs. (Figure 13).

Figure 13: Real Interest Rate and Real Exchange Rate*



*Real interest rates are computed by using the Expectations Survey and 2-year nominal rate estimated with Extended Nelson-Siegel method. Real exchange rate is CPI based (an increase means an appreciation).

Source: CBRT.

Credit data also confirm that monetary conditions are still non-accommodative. Annual growth rates in the automobile and housing loans are at much lower levels compared to the periods of vigorous domestic demand (Figure 14). Following the significant slowdown in the second half of 2006, consumer credits showed signs of recovery after the first quarter of 2007 (Table 3). However, we expect the cautious monetary policy stance and the tightening in global credit conditions are likely to restrain credit expansion in the forthcoming period.

Figure 14: Selected Sub-items of Consumer Loans

(Annual Percentage Change)

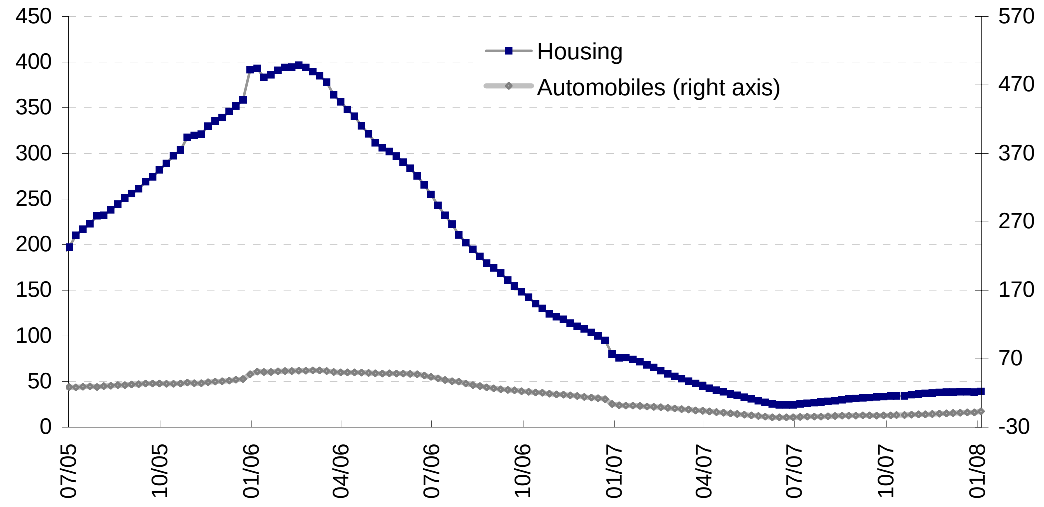


Table 3: Consumer Loans and Claims From Credit Cards

(Quarterly Real Percentage Change)

	2006-II	2006-III	2006-IV	2007-I	2007-II	2007-III	2007-IV
Consumer Loans	20,0	1,5	3,6	2,6	9,0	10,0	6,6
Housing	22,8	0,9	2,2	2,7	7,5	10,2	5,4
Automobile	5,1	-6,4	-5,0	-8,9	-3,4	-2,0	-1,4
Other	24,3	6,0	8,9	6,6	14,5	12,8	9,9
Credit Cards	6,8	2,1	2,1	-1,6	7,7	2,4	3,2

Source: CBRT.

External demand conditions are also expected to contribute to disinflation in 2008. Recent data on global economic activity suggest that world economic growth is likely to moderate in the forthcoming period, increasing the downside risks on external demand. Accordingly, our medium term outlook is constructed under a baseline scenario of gradual slowdown in external demand.

Esteemed Press Members,

Overall, we expect aggregate demand conditions to support the downward trend in the underlying inflation, i.e., inflation excluding items beyond the control of monetary policy such as energy, food and tobacco prices. Hence, barring new supply shocks, headline inflation should continue to move towards the target. The speed of the convergence to the target, however, will depend mainly on the course of food and energy prices.

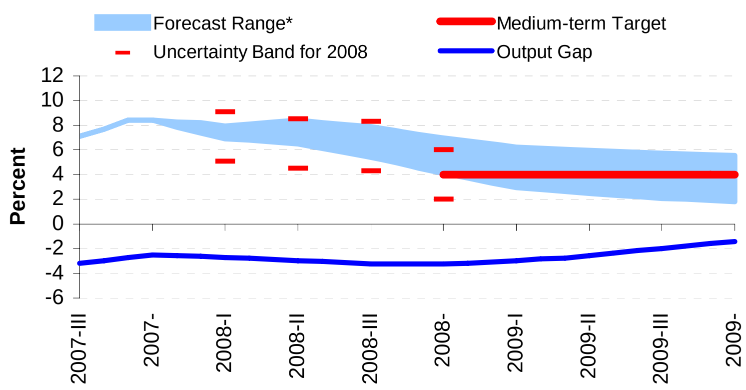
Distinguished Guests,

Our forecast in the 2007 October Inflation Report incorporated two main assumptions: The assumption for oil price was set as 70 USD per barrel. Observing the high base created by the unusually elevated food prices in 2006, we assumed food inflation to correct towards the values consistent with medium term inflation in 2007. However, food and energy inflation turned out to be more persistent than we had envisaged, as the prices of oil and agricultural commodities continued to rise throughout 2007. These developments not only led to an undershooting of our inflation projections for end-year 2007, but also necessitated an upward revision in our medium term forecasts.

In this framework, we revised our assumption for oil prices from USD 70 to USD 85 per barrel in 2008. Higher oil price assumption added about 0.5 percentage points to the end-2008 inflation forecasts. Moreover, the first round impacts of the recent hikes in end-user electricity and natural gas prices on end-2008 inflation are expected to be around 0.6 percentage points, which is higher than what we assumed in the previous Inflation Report. Meanwhile, considering the lagged impacts of last year's drought and elevated prices of agricultural commodities in global markets, we now envisage that the price increases in processed food will persist for a while and the inflation in this item will stay at relatively high levels throughout 2008, albeit a slight decline.

Upside revisions on the assumptions for food and energy inflation imply that it may take longer to bring headline inflation to 4 percent than envisaged in our previous Inflation Report. Therefore, in the absence of a significant correction in food inflation, headline inflation will most probably exceed the target level of 4 percent at the end of 2008.

Figure 15: Forecasts for Inflation and Output Gap



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

Within the framework that I have drawn up so far, we forecast inflation, with 70 percent probability, to be between 4.1 percent and 6.9 percent (midpoint 5.5) at the end of 2008, and between 1.8 percent and 5.5 percent (midpoint 3.7) at the end of 2009 (Figure 15). The forecasts are based on the scenario in which policy rates display a limited decline in 2008. Main message of the forecast is that continuation of the gradual easing cycle that started in 2007 September will remain conditional on favorable data and developments. In that sense, the current policy stance envisages a more moderate decline in policy interest rates than indicated in the previous Inflation Report.

I would like to emphasize once more that any new data or information on the inflation outlook may lead to a revision in the future policy stance of the Central Bank. Therefore, the policy path that was indicated above should not be perceived as a commitment on behalf of the CBRT.

4. Risks and monetary policy

Distinguished Guests,

I would like to dedicate the last part of my speech to the upside and downside risks to the inflation and monetary policy outlook in the upcoming period.

The main upside risk factor for the current medium term inflation outlook pertains to the potential second round effects of the accumulated supply shocks, which may also create a higher than expected inflation inertia, as currently manifested in the medium term inflation expectations. So far, the second round impact of food prices has been limited and confined to selected sub-components of the overall index such as restaurants and catering services. The potential second round impact of elevated food and energy prices, however, on overall economy should not be overlooked. Therefore, the CBRT will keep a close eye on the price setting behavior along with various core inflation measures. In the upcoming period, the Central Bank will tolerate the first-round impacts on inflation resulting from food, energy and one-off adjustments in administered prices, yet remain responsive to the second round effects such as possible deterioration in general pricing behavior.

The Central Bank closely monitors the developments in global markets. The potential impact of ongoing difficulties in the US credit markets, on the financial markets and the real economy, continue to create uncertainty about the course of the global economy. Our baseline scenario assumes a soft landing in developed economies, with no major portfolio shock on the Turkish financial markets. However, the probability of a sharper than expected slowdown should not be ruled out. While the possibility of a sharper-than envisaged slowdown in global economic activity, through its potential impact on the exchange rates, may constitute an upside risk for the short term inflation outlook, it also poses downside risks for inflation in the medium term through a possible weakening in external demand and domestic credit.

It should be underlined that fiscal discipline of the past several years, by reducing the long-term risk premium, has been the key force allowing the achievement of robust output growth during a remarkable disinflation period. In that sense, I believe it is useful to emphasize once more that maintaining the prudent fiscal policy during an episode of worsening risk appetite is even more critical for preserving the resilience of the economy.

Our medium term projections are based on the assumption that government expenditure targets will be met in 2008. Moreover, we assume that any extra need to readjust the primary budget balance will be implemented primarily through expenditure cuts rather than hikes in indirect taxes. Therefore the medium-term outlook that I mentioned above does not envisage major shocks arising from administered price adjustments, except the hikes in electricity and natural gas in January 2008. It should be kept in mind that any deviation from this assumption may alter the inflation and monetary outlook.

The recent increase in end-user energy prices may continue to exert some temporary upward pressure on headline inflation in the coming months. However, these adjustments will also support lower inflation in the medium term as they contribute to a prudent fiscal stance and facilitate an expansion of the domestic energy production. Hence the central bank’s policy will not to react to these price adjustments, except to contain second-round effects.

Developments in food prices are still considered as an important risk to the short-term inflation outlook, as food items constitute more than one fourth of the CPI basket. The course of food inflation is highly dependent on domestic weather conditions as well as global developments. In the medium term, there is a significant chance of a downward correction in *unprocessed* food inflation, especially given the base effect created by the last two years’ elevated food prices. On the other hand, it is also possible that global developments and increasing demand for certain food items may continue to push up the food prices. Therefore, food prices continue to pose risks to the inflation outlook on both sides.

So far, Turkish economy has been resilient to reappraisal of risks in global financial markets. The support of fiscal policy and structural reforms are critical in shielding the economy against possible further deterioration in global sentiment. In this respect, the European Union accession process and the implementation of structural reforms envisaged in the economic program remain crucial. Finally, I would like to conclude my speech by mentioning that advances in structural reforms enhancing the quality of fiscal discipline and raising productivity are monitored closely with regard to their implications on macroeconomic and price stability.

Thank you.