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 presenting the third issue of the Inflation Report, Central Bank of the Republic of Turkey, Ankara, 28 July 2008.

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Distinguished Guests and Members of the Press,

Welcome to the press conference for the presentation of the third 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

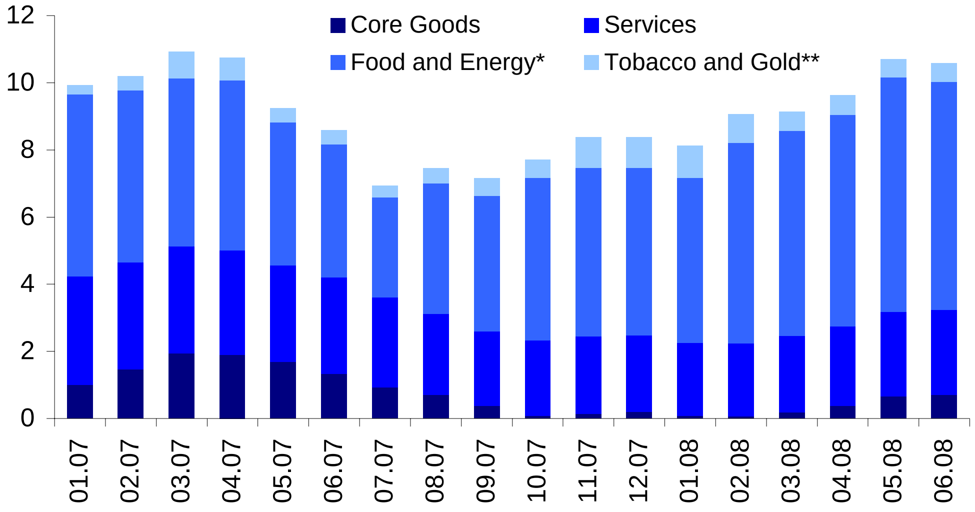
Esteemed Members of the Press,

I would like to start with a general assessment of inflation developments in the previous period and share with you the factors impeding the disinflation process in the first half of the year.

Distinguished Guests,

In April, both the Open Letter and the Inflation Report issued by the Central Bank of Turkey presented a detailed explanation for the factors impeding the disinflation process. The source of inflation has not changed in the past quarter. In the second quarter of 2008, prolonged increases in food, energy and other commodity prices continued to exert significant upward pressures on headline inflation. As a consequence 6.8 percentage points of the 10.61 percent annual CPI inflation in July resulted from the direct impact of the rise in food and energy prices (Figure 1).

Figure 1: Contribution to Annual CPI Inflation



* Food and Energy: Food, non-alcoholic beverages and energy.

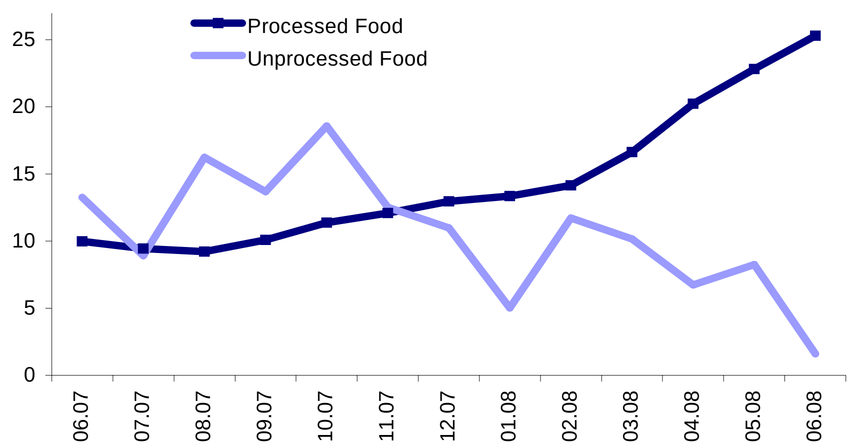
** Tobacco and Gold: Alcoholic beverages, tobacco products and gold.

Source: TURKSTAT, CBT.

Food price developments were determinant in inflation in the second quarter of the year. Although domestic weather conditions turned more favorable in the first half of 2008, lagged effects of last year's poor harvest and continued elevation in agricultural commodity prices continued to keep processed food inflation at high levels. As a consequence, processed food inflation displayed a cumulative increase of 14.2 percent in the first half of the year (Figure 2). At this point, I would like to remind you that the July Inflation Report, soon to be published on our website, will provide a detailed explanation on the factors driving domestic food prices.

Figure 2: Processed and Unprocessed Food Prices

(Annual Percentage Change)

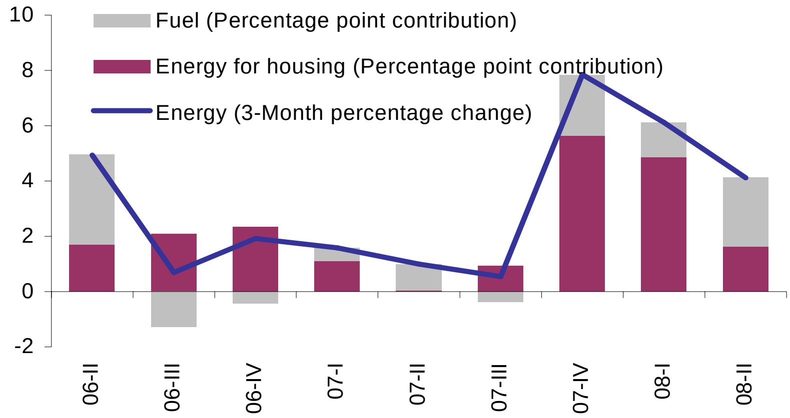


Source: TURKSTAT, CBT.

Developments in energy prices have been the other major factor driving inflation in the second quarter (Figure 3). Soaring oil prices continued to lead to significant hikes in the prices of domestic fuel products, also putting pressure on housing utilities such as electricity and natural gas.

Figure 3: Energy Prices

(Quarterly Percentage Change, Percentage Point Contribution)

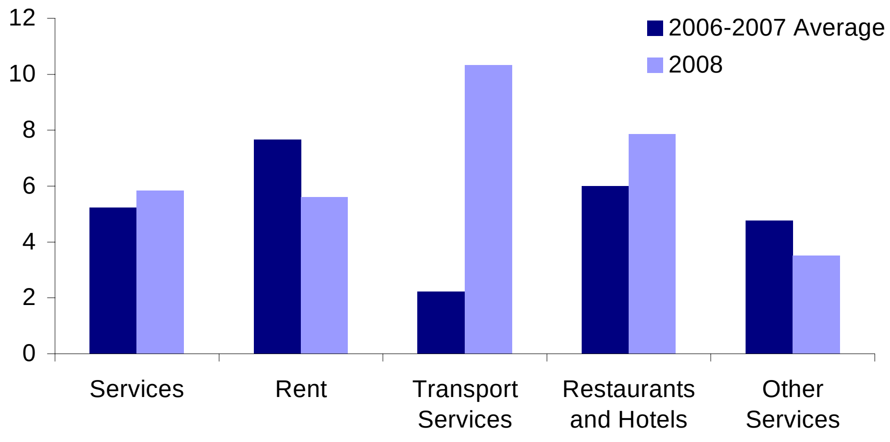


Source: TURKSTAT, CBT.

Services inflation displayed a limited rise in the first half of 2008. Food and energy prices continued to exert upward pressures on the prices of catering and transport services. Rents and other services, on the other hand, continued to decelerate (Figure 4).

Figure 4: Subcomponents of Services Index

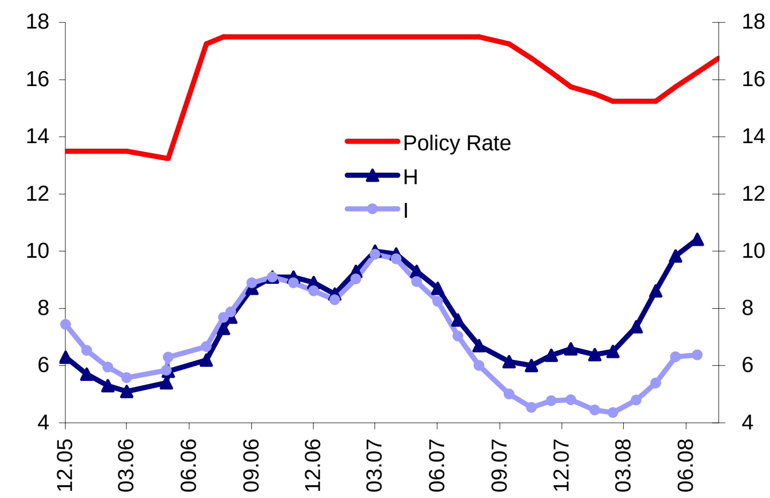
(First Half Cumulative Percentage Change)



Source: TURKSTAT, CBT.

In the second quarter of 2008, core inflation indicators also showed an upward trend. The rise in core inflation in the second quarter should be viewed as a temporary movement arising from the exchange rate pass-through, rather than deterioration in the general price setting behavior. Ongoing difficulties in global credit markets coupled with domestic uncertainties have led to a depreciation of Turkish Lira vis-à-vis major currencies in the first four months of the year. As a consequence, first round effects of exchange rate pass-through have been significant on the headline inflation as well as on core inflation figures during the March-May period. Yet, the recent rebound in Turkish lira and weakening domestic demand has limited the overall pass-through and consequently core inflation showed signs of easing in June. Currently, annual rate of increase in CPI excluding food, energy, tobacco and gold items stands at 6.4 percent, confirming that the inflation can be mostly attributed to factors beyond the control of the Central Bank of Turkey (Figure 5).

Figure 5: Main Inflation Indicators and Policy Rates



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

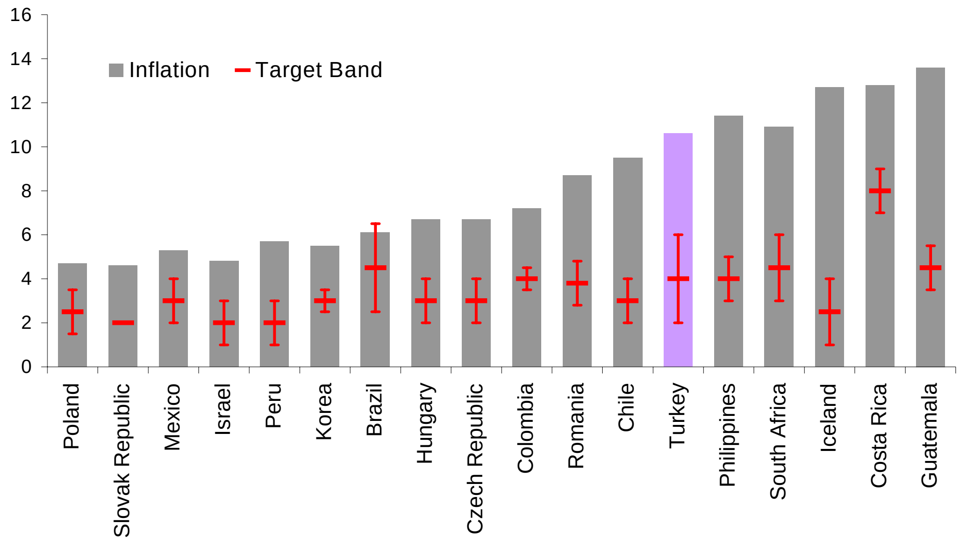
I: H excluding processed food.

Source: TURKSTAT, CBT

The rise in inflation rates stands out to be an ongoing global trend. Elevated commodity prices have continued to exert inflationary pressures all over the world. As depicted in the slide, almost all emerging economies under inflation targeting have faced significant breaches in their inflation targets (Figure 6).

Figure 6: Inflation and Target Bands in Emerging Economies

(as of May 2008)



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

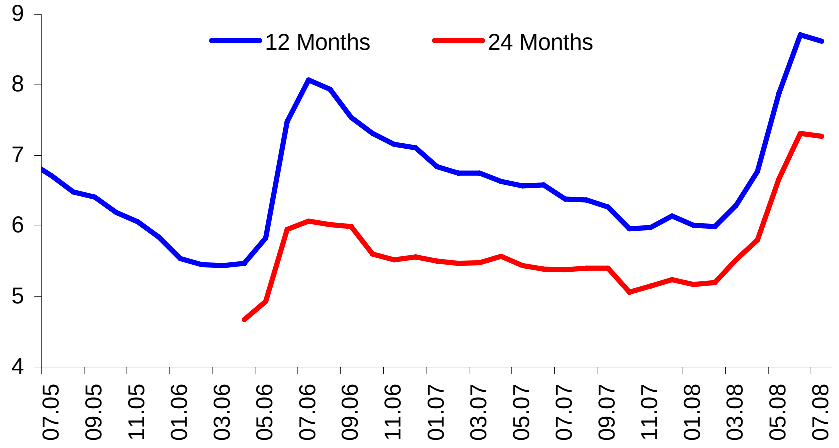
2. Reaction of monetary policy

Distinguished Guests and Members of the Press,

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

In the April Inflation Report and the open letter dated April 2008, we indicated that uncertainties in the global economy, hikes in energy prices, and the risks to price setting behavior compelled the monetary policy to be more responsive to the incoming information. In this framework, they revealed a clear tightening bias against increased risk related to the second round effects of the supply side shocks. Food and energy prices continued to rise in the second quarter of 2008 and financial markets remained under stress. In the meantime domestic uncertainties have intensified, having further adverse impact on the medium term inflation expectations. Accordingly, there has been a significant upward surge in the medium term inflation expectations in the second quarter of 2008 (Figure 7).

Figure 7: Inflation Expectations*



*24 months expectations is available from May 2006 onwards.

Source: CBT.

In order to contain the deterioration in inflation expectations and to prevent the materialization of the second round effects of supply-side shocks, the Monetary Policy Committee tightened monetary policy in the past three months, increasing the policy rates by a cumulative of 150 basis points (Table 1). In current conjuncture, where the consumption demand keeps slowing down, I would particularly like to emphasize that the monetary tightening policy was adopted in order to halt the deterioration in inflation expectations and the upsurge in the risk premium. As a consequence, the deterioration in inflation expectations ceased and market rates declined in July (Figure 7). In other words, the monetary tightening policy conducted by the CBT contributed to the decline in medium and long-term interest rates by diminishing the inflation risk premium.

At this point, I would like to underline an operational aspect of monetary policy relating to policy rates. In the first half of 2008, excess liquidity sterilized in the overnight market shrank due to the cut in the volume of daily FX-buying auction as well as the Treasury's less FX borrowing and the rise in money demand. These developments led to occasional liquidity shortages. By May 2008, liquidity shortage has started to emerge more often for longer periods. During this period, the Central Bank provided the required liquidity into the system via one-week repo auctions, targeting overnight interest rates to materialize at levels close to Central Bank borrowing rate. Still, there has been some undesired volatility in the overnight rates due to unforeseen movements in the liquidity, mainly arising from the banks' demand for reserves. Considering these developments, the Monetary Policy Committee has decided to reduce the margin between the borrowing and the lending rates by 50 basis points in July.

Current projections do not point to a permanent shortage in the liquidity in the upcoming term. In case of temporary shortage, the Central Bank will provide the required liquidity through one-week repo auctions, targeting the overnight interest rate in the money market to stay close to the Central Bank borrowing rate. Hence, the key policy rate will continue to be Central Bank's overnight borrowing rate.

Table 1: 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
May 16th, 2008	+0.50	15.75
June 17th, 2008	+0.50	16.25
July 18th, 2008	+0.50	16.75
Source: CBT.		

3. Inflation outlook and monetary policy

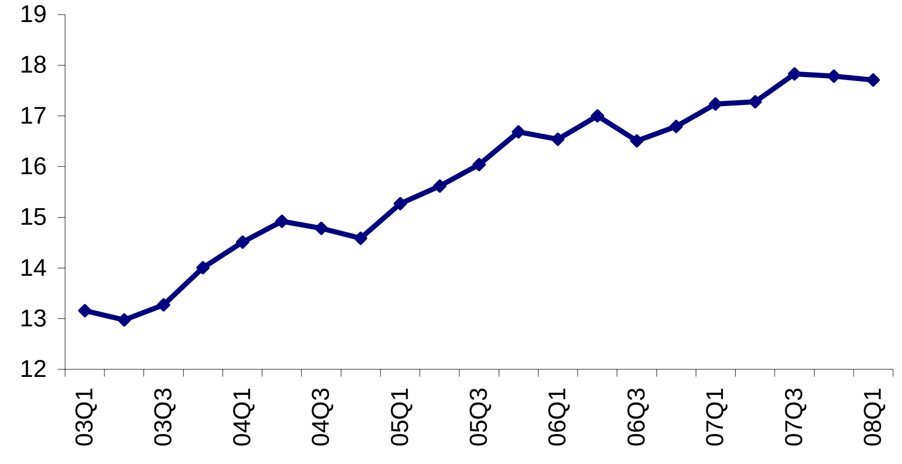
Distinguished Guests,

After summarizing the developments in the previous period, 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.

Recent readings on supply and demand conditions are in line with the outlook presented in our April Inflation Report and the open letter of April 2008. Although first quarter private consumption growth at 7.3 percent appears quite strong in annual terms, the seasonally adjusted figures point to an ongoing moderation in economic activity (Figure 8). Recent readings on domestic sales, production and confidence indicators suggest a similar outlook. At this point, I would like to remind you that the indicators regarding the course of domestic demand are presented in detail in the July Inflation Report.

Figure 8: Private Consumption

(Seasonally Adjusted, Billions, YTL)

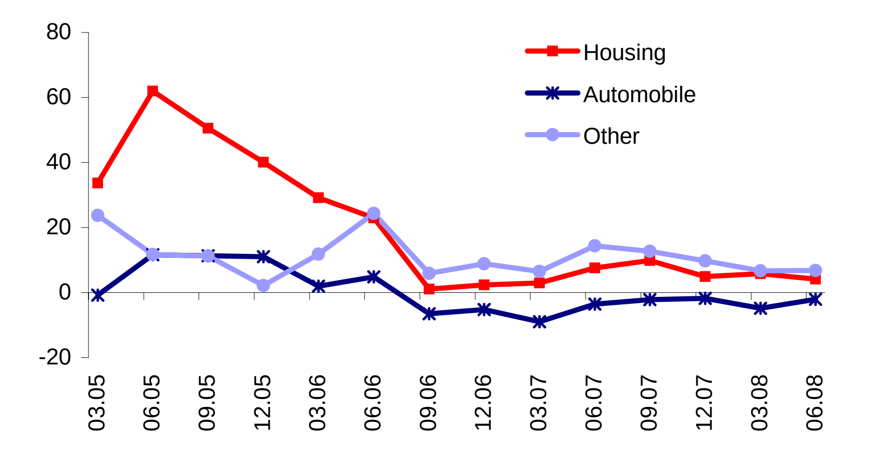


Source: TURKSTAT, CBT.

Data on consumer credits suggest that monetary conditions continue to be restrictive. Consumer loans have been growing at a moderate pace compared to the periods of vigorous domestic demand (Figure 9). The decline in risk appetite and the tightening in global credit conditions are likely to restrain credit expansion in the period ahead.

Figure 9: Consumer Loan Growth Rate

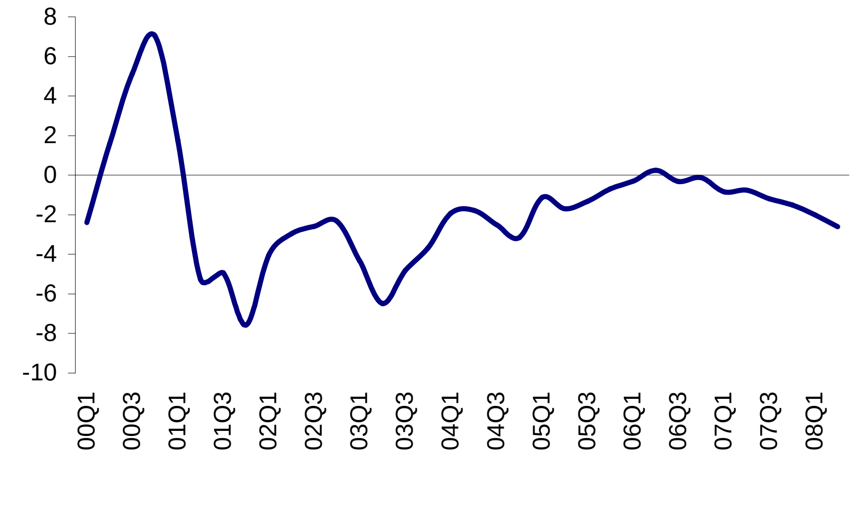
(Q-on-Q, in real terms)



Source: TURKSTAT, CBT.

Overall, domestic demand conditions continue to support disinflation (Figure 10). Therefore, the underlying inflation is expected to decelerate in the medium term.

Figure 10: Output Gap

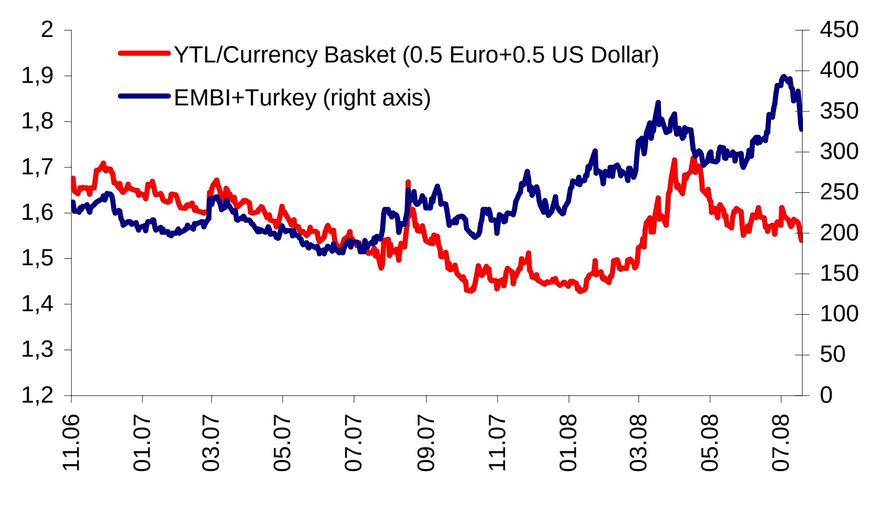


Source: CBT.

Dear Guests,

After the significant weakening of the Turkish lira in the first four months of 2008 (Figure 11), exchange rates have reversed direction in the past two months, easing to some extent potential pressures on tradable inflation resulting from the exchange rate pass-through. In the April Inflation Report and the Open Letter, the first round impact of the recent depreciation was estimated to be close to 2-percentage points for the end-2008 headline inflation. The recent rebound in currency has led to a downward revision in the estimated pass-through. We now anticipate a cumulative exchange pass-through of around 1.2 percent points for 2008, most of which has already been materialized between March-May period.

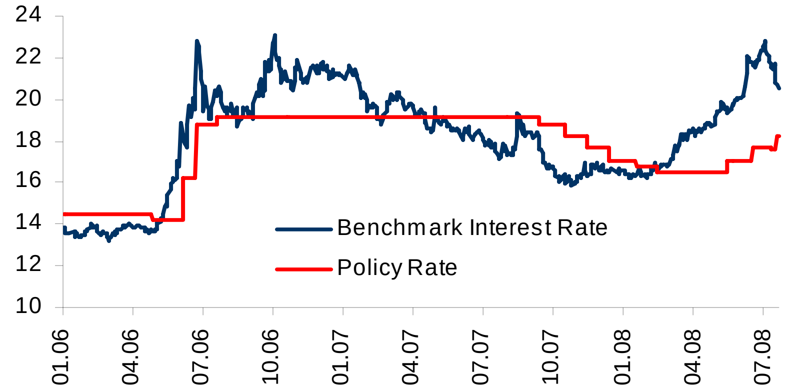
Figure 11: Risk Premium and Nominal Exchange Rates



Source: CBT.

Longer-term interest rates have also increased in 2008 due to rising risk premium and inflation expectations (Figure 12). Although higher market interest rates contain the domestic demand and support disinflation, the impact of the heightened risk premium on the overall pricing behavior should be closely monitored.

Figure 12: Benchmark Interest Rate and Policy Rate

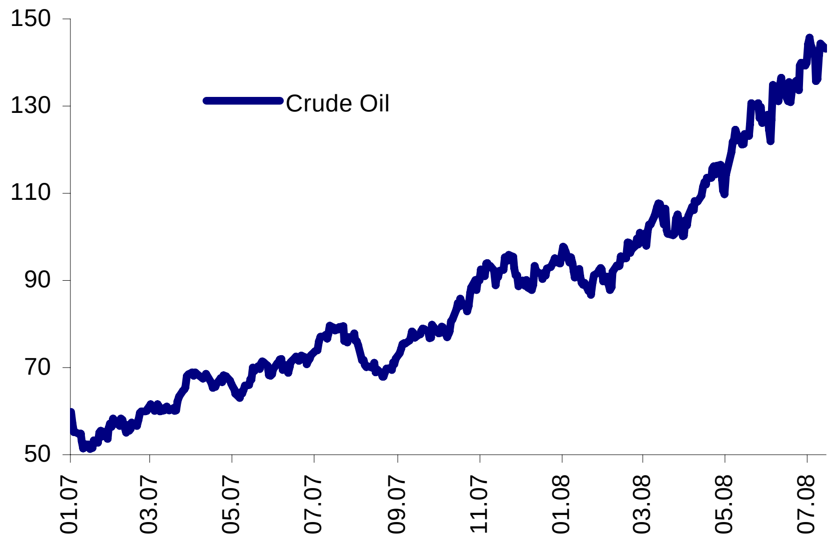


Source: CBT, ISE.

Baseline assumptions in the April Inflation Report envisaged a constant path for oil prices around 105 USD per barrel over the forecast horizon. However, oil prices continued to rise on the back of increasing international commodity prices, necessitating an upward revision (Figure 13). Taking the average future prices in the first three weeks of July as a benchmark, our baseline scenario for oil prices has been revised to USD 140 per barrel. As for the future adjustments in electricity tariffs – to be made within the scope of automatic pricing –, they are forecasted to be in compliance with the assumption for the oil price. This revision has increased the end-2008 inflation forecast by 1.8 percentage points, and also added to the end-2009 forecasts 0.6 percentage points.

Figure 13: Crude Oil (Brent)

(USD/Barrel)



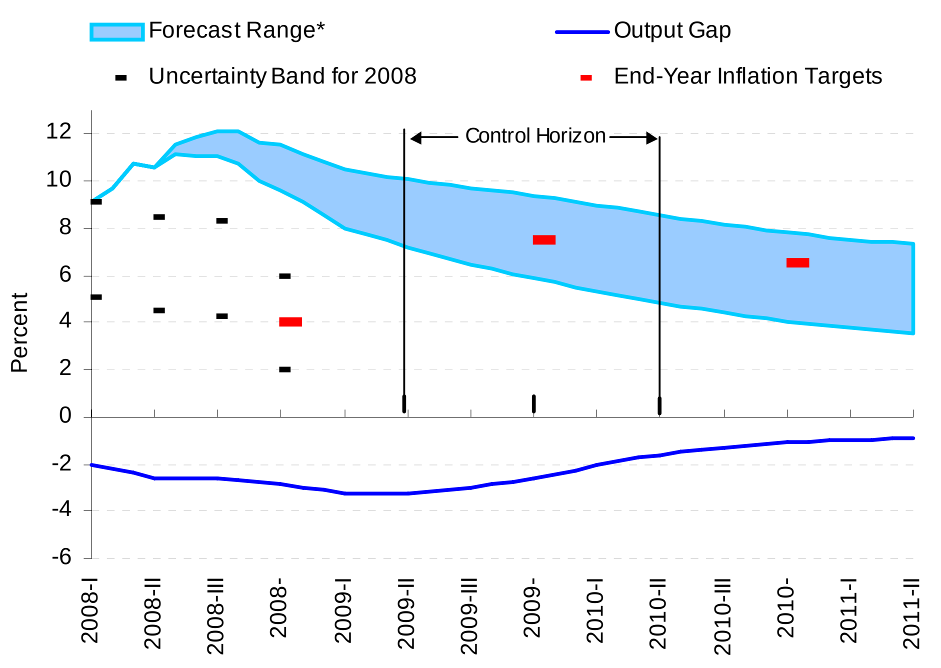
Source: Bloomberg.

Members of the Press and Dear Guests,

Our revised forecasts envisage slightly higher food inflation in 2008 and 2009 compared to the April Inflation Report. Although unprocessed food prices followed a relatively favorable course, processed food inflation is likely to stay at high levels for while, given the elevated course of agricultural commodity prices. Against this backdrop, we have raised the assumptions for food inflation from 13 percent to 14 percent for the year 2008, and from 8 percent to 9 percent for the year 2009. These changes have led to an upward revision in our inflation forecasts by about 30 basis points, for both 2008 and 2009. The projections envisage gradually moderating food inflation throughout the forecast horizon. In this context, assumption for 2010 food inflation is 7 percent.

According to the framework drawn so far, we now forecast inflation to be around 10.6 percent at the end of 2008. Under the assumption of a limited tightening towards the end of 2008, our medium term forecasts suggest that, with 70 percent probability, inflation will be between 5.9 and 9.3 percent (mid-point 7.6) at the end of 2009, and between 4 percent and 7.8 percent (mid-point 5.9) at the end of 2010 (Figure 14). Our inflation forecast for mid-2011 is 5.4 percent. We expect non-food inflation to be lower than these figures.

Figure 14: Inflation Forecasts*



Source: CBT

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

To sum up, although economic activity in the past quarter have evolved in line with our expectations, the significant increases in oil and processed food prices have led to an upward revision in our forecasts. The main message of the forecast is that preventing the materialization of potential second round effects and ensuring a steady decline in inflation towards the medium term targets, requires the monetary policy to maintain a cautious stance for a while.

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

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 inflation and monetary policy in the upcoming period.

Uncertainties about food and energy prices still continue. Our baseline scenario is based on quite conservative assumptions for food and energy prices, implying that downside risks on these factors are as apparent as upside risks. In order to enhance the predictability of the monetary policy, in a period when uncertainties pertaining to oil and agricultural commodity prices continue, we deem it to be useful to share with the public the inflation and monetary policy outlook, which is based on alternative scenarios for food and energy prices.

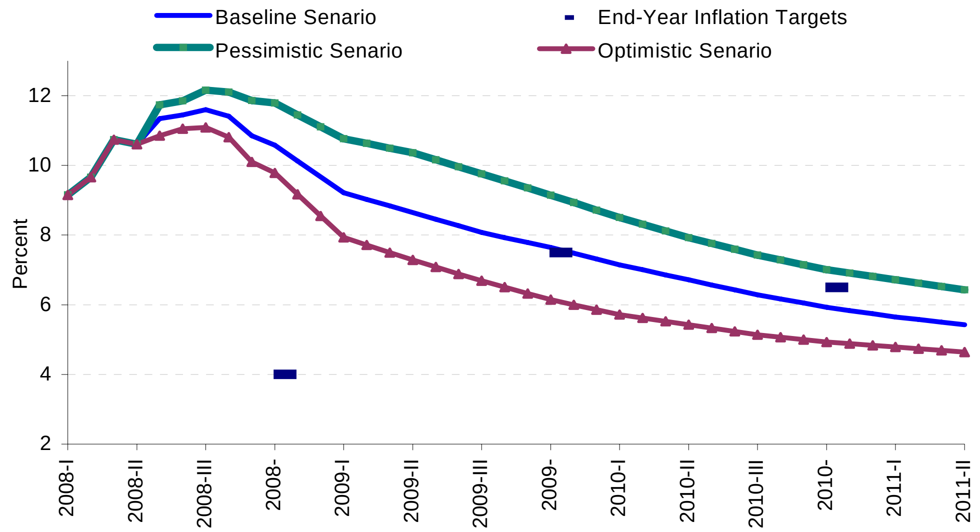
In our pessimistic scenario, we assume that food price inflation materializes at 16, 12 and 10 percent in 2008, 2009 and 2010 respectively; whereas oil prices rise to USD 180 at the end of 2008, staying constant thereafter. Additionally, adjustments in electricity tariffs are forecasted to be made in compliance with this assumption. Assuming a gradual monetary tightening during the rest of the year, our forecasts under this scenario suggest that inflation will be 9.1 percent at the end of 2009 and around 7 percent at the end of 2010 (Figure 15).

In our optimistic scenario, we assume that food price inflation materializes at 12, 6, and 4 percent respectively, in the 2008-2010 period, whereas oil prices ease to USD 100 at the end of 2008, staying constant thereafter. Additionally, adjustments in electricity tariffs are forecasted to be made in compliance with this assumption. Assuming that policy rate stays constant for a while and gradually ease thereafter, our forecasts under this scenario suggest that inflation will be 6.1 percent at the end of 2009 and around 4.9 percent at the end of 2010.

In sum, monetary policy will be conducted so as to minimize upside deviations from the targets should the upside risks materialize. Downward surprises in food and energy prices, on the other hand, will be perceived as an opportunity to bring inflation back to target in a shorter period than envisaged in our baseline scenario.

Figure 15: Inflation Forecasts,

Baseline and Alternative Scenarios



Source: CBT.

Distinguished Guests,

Despite the expected decline in inflation in the medium term, uncertainties exist regarding the degree of inflation persistence. Long-lasting supply shocks have been keeping headline inflation at elevated levels and thus increasing the risk of rising backward-looking schemes in the wage and price setting behavior. Although current demand conditions contain the second round effects of the supply shocks, the exact pace of disinflation would still depend on the extent new inflation targets serve as a strong reference for economic agents. Having this in mind, the CBT will continue to focus on enhancing the credibility of the new inflation targets. In this context, developments in the general pricing behavior and the underlying inflation trends will be monitored closely.

International financial markets remain fragile and the credit conditions continue to tighten up. The eventual impact of the financial turmoil on the global economic activity is yet to be seen. Moreover, rising commodity prices continue to exert pressure on global inflation. These uncertainties have been dampening the risk appetite and thus slowing down the capital flows to emerging markets, leaving these economies susceptible to shifts in the market sentiment. Domestic uncertainties have exacerbated these effects, as manifested by the significant rise in the sovereign credit risk of Turkey in the first half of the year, compared to the average risk premium of emerging economies. The CBT will not display a sharp reaction to temporary fluctuations in the financial markets, unless there is a threat to the medium-term disinflation trend and/or a significant worsening in the general pricing behavior.

Finally, I would like to state that our medium-term projections do not foresee any significant effect to be brought about by the increases in indirect taxes or administered price adjustments, except those required by the automatic pricing mechanisms. In other words, should a requirement arises for a tightening in the public budget, we assume that this requirement will be met by measures for cutting down on expenditures rather than increasing the indirect taxes. Any deviation from this framework may lead to a revision of the outlook for inflation and monetary policy.

Distinguished Members of the Press,

A protracted period of rising food and energy prices has been hampering our disinflation efforts since the adoption of the inflation targeting regime. Ongoing uncertainties resulting from global as well as domestic factors that led to a significant deterioration in inflation expectations necessitated a more cautious monetary policy stance. In this respect, in order to prevent the said uncertainties to be reflected on the general pricing behavior, we have conducted a monetary tightening over the past three months. Monetary tightening was effective in containing inflation expectations, as the deterioration in inflation expectations came to a halt in July.

Current stance of the monetary policy supports disinflation. We expect inflation to remain at elevated levels in the short term before gradually moderating towards the targets. Our revised inflation forecasts suggest that the inflation targets of 7.5 percent, 6.5 percent, and 5.5 percent set for the next three years are attainable, even under quite conservative assumptions on food and energy prices. I would like to underline that adverse impacts of the supply side shocks on the economy will be more limited should all the economic agents take these targets as a benchmark in forming their expectations.

Prudent monetary policy is a necessary but not sufficient condition for attaining price stability. The support from fiscal policy and structural reforms are as critical as the monetary policy 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 utmost importance. I would like to conclude my remarks by stating that advances in structural reforms, which would improve the quality of fiscal discipline and enhance productivity, are monitored closely by the CBT with regard to their implications on macroeconomic and price stability. Thank you.