Durmuş Yılmaz: Recent economic and financial developments in Turkey

Speech by Mr Durmuş Yılmaz, Governor of the Central Bank of the Republic of Turkey, at the press conference for the presentation of the Inflation Report, Ankara, 25 January 2011.

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Distinguished Guests and Members of the Press,

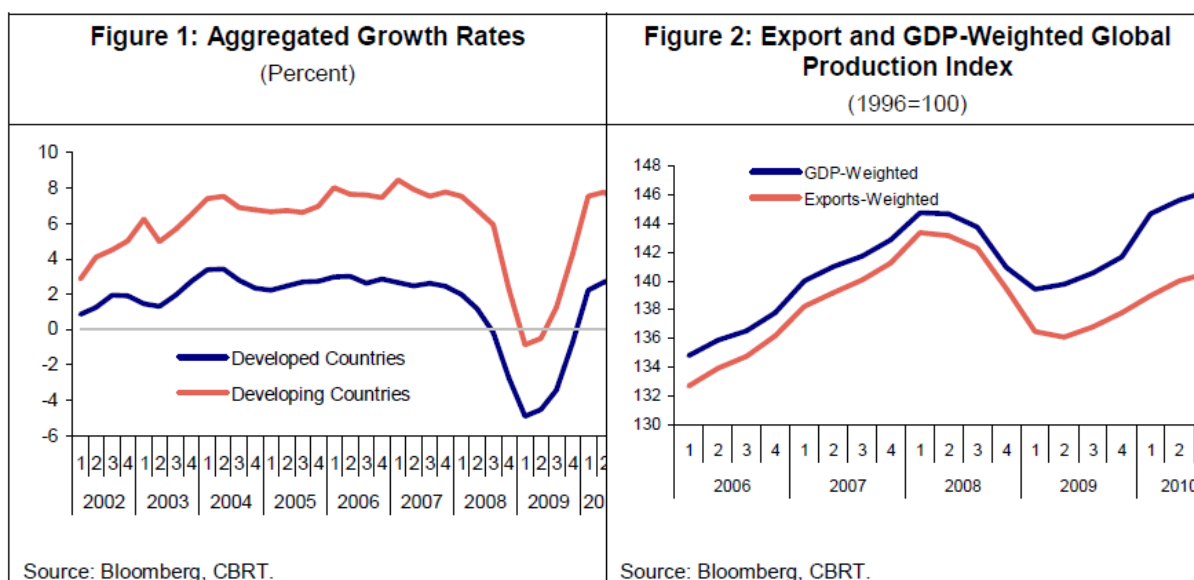
Welcome to the press conference held to convey the main messages of the January 2011 Inflation Report.

The report typically summarizes the economic framework addressed in monetary policy decisions, elaborates global and domestic macroeconomic developments and presents the medium-term inflation forecasts, which have been revised in view of previous quarter developments, along with the monetary policy stance.

The report contains eight boxes written in the light of completed and continuing research projects conducted under the aegis of the Central Bank. These boxes include detailed analyses on issues affecting our policies. Considering the extraordinary significance of developments in the global economy for our policies, one of the boxes where the developments in the euro area and the USA are analyzed explains the sensitivities of the peripheral economies of the euro area against the debt crisis. On the other hand, in the second box the reasons for the increase in long-term nominal bond yields in the USA following the second round of quantitative easing is discussed. Besides, two more boxes were prepared aiming to elucidate domestic inflation dynamics. While the first of these examines the reasons for volatility in unprocessed food prices, the second box offers an assessment of Core inflation indicators. Moreover, the report also incorporates a study that examines recent developments in foreign exchange and derivatives markets by relating them to monetary policy decisions. Two boxes also clarify the new policy approach we are currently implementing. The former discusses the place of the reserve requirements in the monetary policy and its channels to influence economy, while the latter discusses the relationship between price stability and financial stability within the context of the inflation-targeting regime. Lastly, the sources of our revisions of inflation forecasts during 2010 are explained in a study that we designed within the context of our liability of accountability.

Before moving on to the Central Bank's assessments of inflation outlook and economic activity, which I will cover in detail shortly, I would like to summarize the current global conditions that continue to be determinant of the domestic economic outlook.

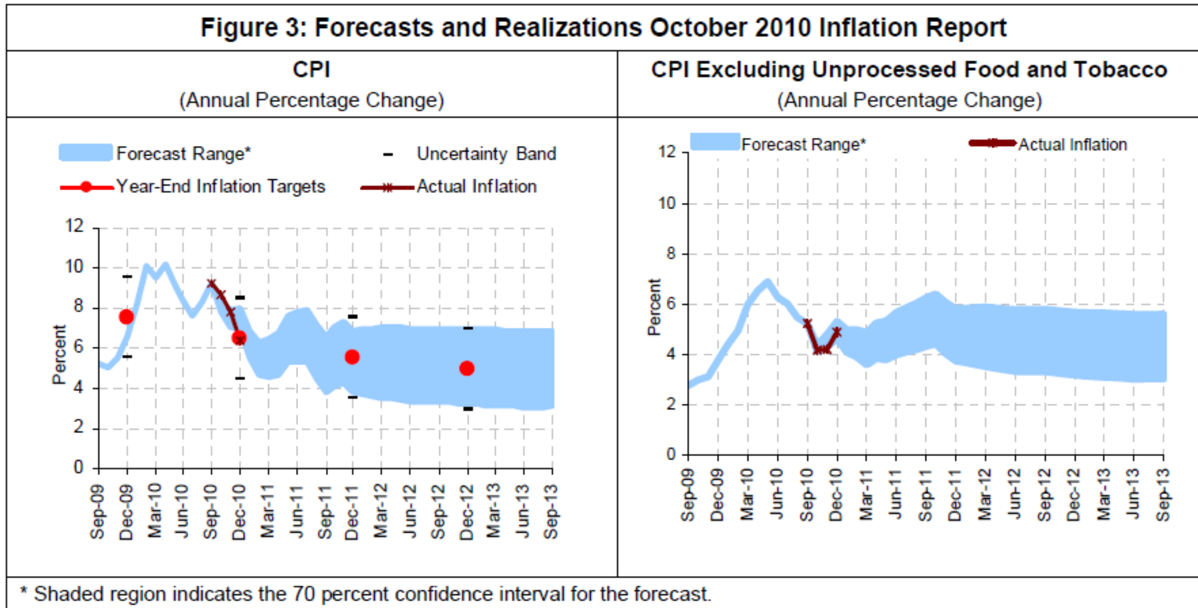
The world economy continued to recover gradually in the final quarter of 2010, while downside risks remained a major concern for advanced economies. Financial institutions, firms and households in advanced economies are still undergoing the process of balance-sheet repair, limiting the contribution of private consumption and investment to the economic recovery. On the other hand, the relatively less affected emerging economies are recovering steadily amid robust domestic demand (Figure 1).



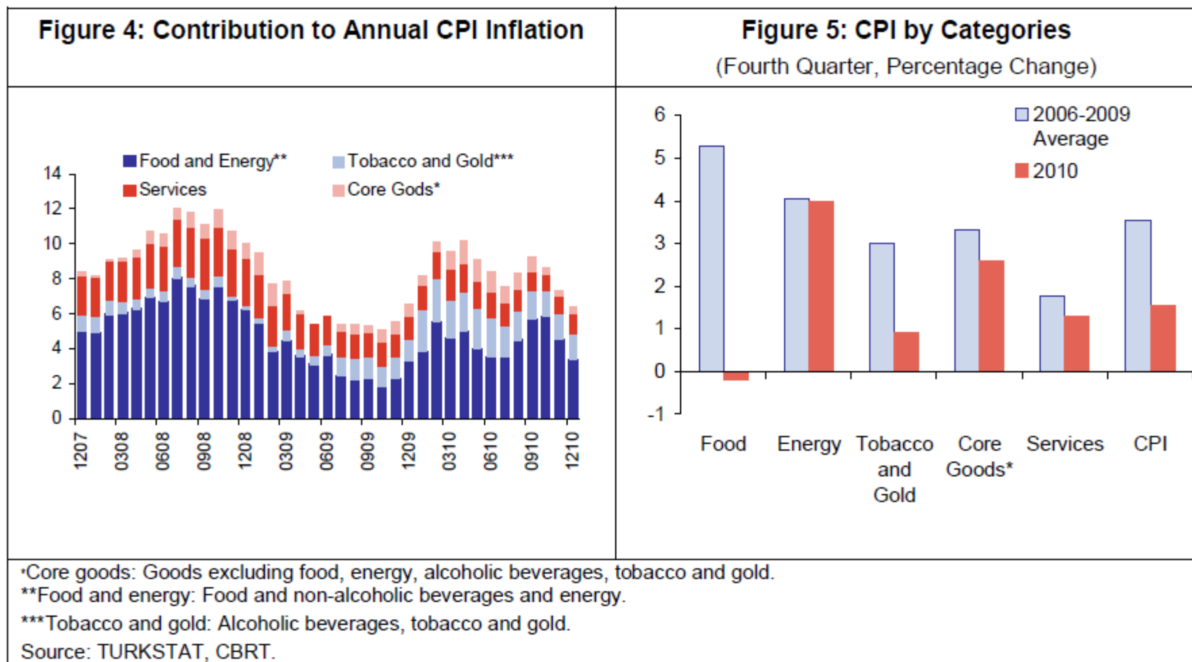
This growth discrepancy between advanced and emerging economies and its implications for the Turkish economy became the key determinants for the Central Bank of Turkey's (CBRT) monetary policy strategy in the fourth quarter. Exceptionally loose monetary policies adopted by advanced economies to eliminate the downside risks on economic activity not only boosted global liquidity but also stimulated the search for yield, which encouraged more capital flows into emerging economies. Moreover, the weak recovery in developed economies – Turkey's main export destinations, dampened foreign demand growth (Figure 2). Low interest rates across the globe, soaring imports driven by strong credit growth amid increased short-term capital inflows, and weaker foreign demand caused the current account deficit to widen rapidly in 2010. All of these developments prompted the CBRT to adopt a strategy, which partly targets financial stability besides the main objective of price stability, parallel to the conditions referred to as the "new normal". In this context, as stated previously, the CBRT has actively begun to use tools such as required reserves and liquidity management, in addition to the one-week repo auction rate, the main policy instrument.

1. Inflation developments

Having summarized the global economic conditions and the implications of this outlook on the monetary policy, I would now like to inform you about the inflation developments of the last quarter. As you will recall, we underlined in the October 2010 Inflation Report that the increases in unprocessed food and tobacco prices – which are beyond the immediate control of the CBRT – added about 5 percentage points to annual inflation, and suggested that these items would leave sizable room for disinflation. Indeed, inflation dropped by 2.83 percentage points, yielding a rate of 6.4 percent, meeting the year-end inflation target. As predicted in the previous report, the decline in inflation was due to the sharp drop in unprocessed food prices. Accordingly, the annual rate of increase in food prices was 7.02 percent at the end of 2010, undershooting the October estimate of 10.5 percent. The slowdown that occurred was sharper than we expected. These developments in unprocessed food prices explain the almost one percentage point deviation in short-term inflation forecasts. In fact, as also illustrated on the slide, inflation excluding unprocessed food and tobacco remained in line with the outlook presented in the October Inflation Report (Figure 3).



Food prices became the main determinant of the course of consumer prices in the last quarter of 2010 as well. Food prices that posted record highs in the third quarter due to the hikes in unprocessed food prices, declined in the last quarter as opposed to the previous years (Figure 4). Moreover, the favorable developments in inflation in this quarter did not remain limited to food prices; quarterly inflation across all goods and services items stayed below the average of previous years (Figure 5). Meanwhile, energy prices, which followed a horizontal course in the second and third quarters of the year, increased in the last quarter parallel to the developments in international oil prices and exchange rates.



The core inflation indicators decelerated in the fourth quarter of 2010 compared to the third quarter (Figure 6). Although hikes were seen in these indicators, which edged up again in

November and December, the main trend of inflation remained in line with medium-term targets (Figure 7).

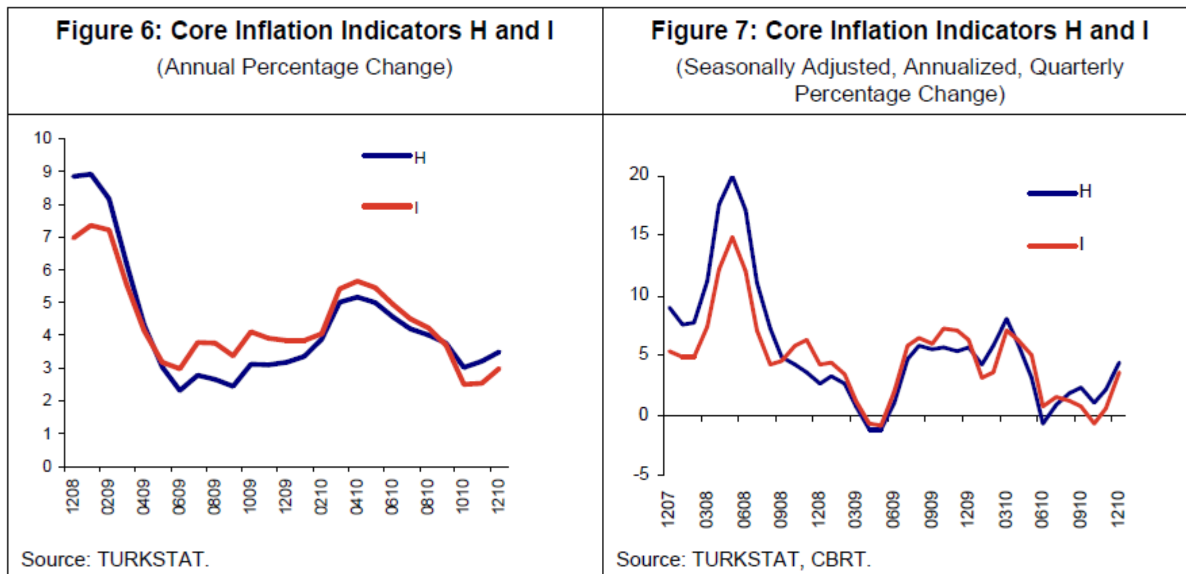


Figure 6: Core Inflation Indicators H and I
(Annual Percentage Change)

Figure 7: Core Inflation Indicators H and I
(Seasonally Adjusted, Annualized, Quarterly Percentage Change)

Against this background, medium-term inflation expectations declined significantly (Figure 8). While near-term inflation expectations declined in a higher ratio compared to the previous quarter, the longer the maturities, the less was the decline in expectations. 12 and 24-month ahead inflation expectations remained above the figures implied by the targets for 2011 and 2012 year-ends, however, the difference went down slightly in the last quarter (Figure 9).

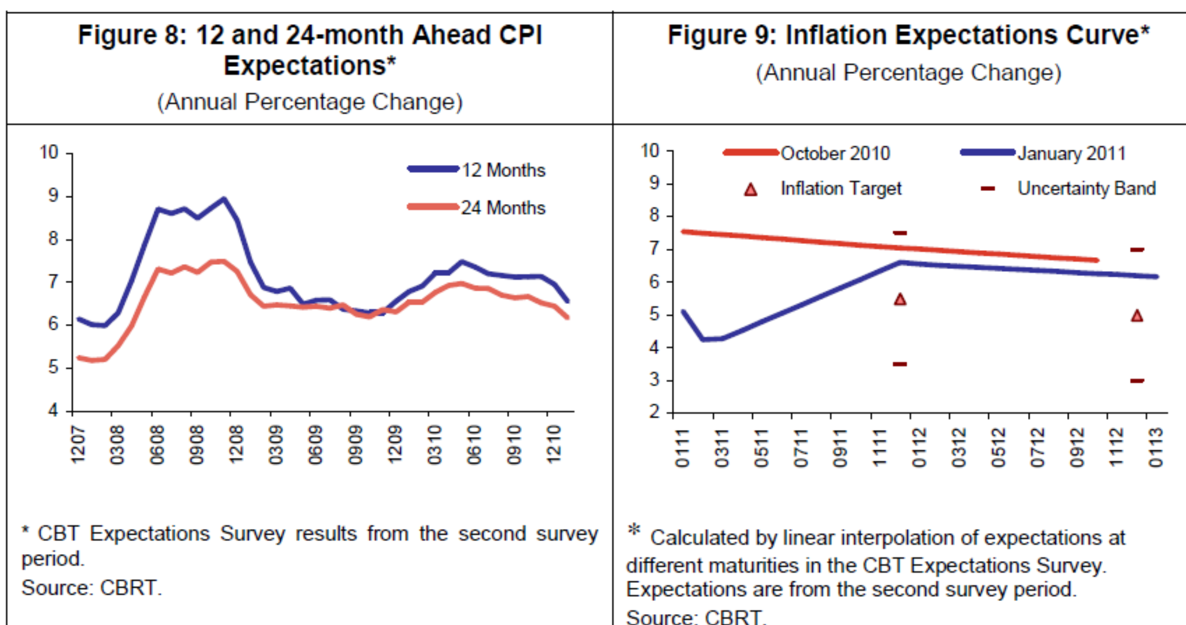


Figure 8: 12 and 24-month Ahead CPI Expectations*
(Annual Percentage Change)

* CBT Expectations Survey results from the second survey period.
Source: CBRT.

Figure 9: Inflation Expectations Curve*
(Annual Percentage Change)

* Calculated by linear interpolation of expectations at different maturities in the CBT Expectations Survey. Expectations are from the second survey period.
Source: CBRT.

2. Monetary policy response

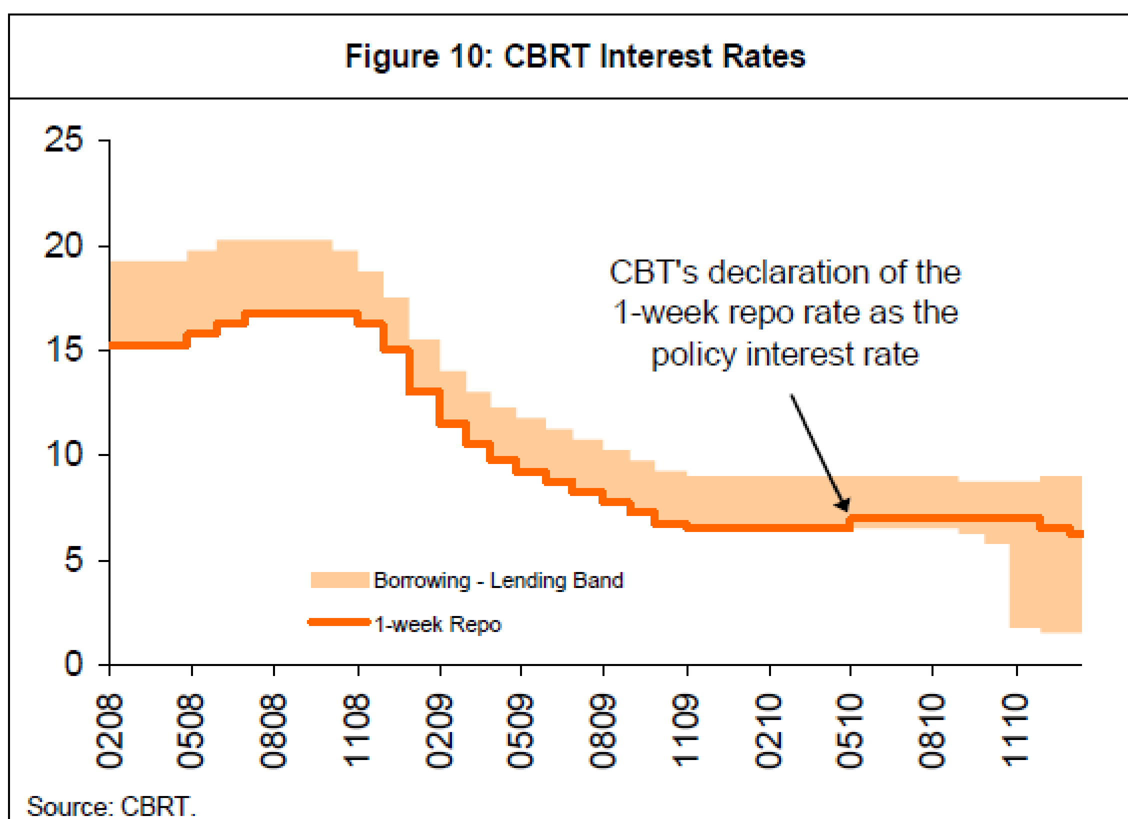
After commenting briefly on inflation developments, I would now like to cover the policies pursued by the Central Bank during the last quarter.

The second round of quantitative easing initiated in the last quarter of 2010 by some advanced economies and the attendant ramp up of capital inflows to emerging markets has required significant modifications to the CBRT's strategy. Macroprudential measures were needed because short-term capital inflows have strengthened the divergence between domestic and foreign demand causing the current account deficit to widen rapidly. Since core inflation trends were in line with medium-term inflation targets, the monetary policy was able to focus on financial stability.

The new monetary policy strategy envisions the use of multiple instruments to manage both internal and external balances. In this context, policy rates, liquidity management facilities, and reserve requirement ratios are concurrently used to ensure price stability and financial stability. Therefore, the Monetary Policy Committee is of the opinion that given the economic situation, the combination of a lower policy rate, a wider interest rate corridor and higher reserve requirement ratios is the most appropriate policy mix in terms of jointly upholding financial stability and price stability.

In this respect, the policy rate -the one-week repo auction rate – was reduced from percent to 6.25 percent in the last two months. In addition to the policy rate cuts, the CBRT decreased the overnight borrowing rate by 450 basis points to 1.5 percent. The corridor between the overnight lending and borrowing rates was widened to allow fluctuations in short-term interest rates, when needed (Figure 10). All these decisions aim to extend the maturity of short-term capital inflows as well as to prevent the Turkish lira from following trends that are detached from economic fundamentals.

Figure 10: CBRT Interest Rates



Source: CBRT.

Another issue taken into consideration when formulating the new policy mix was to limit rapid credit growth, an important factor contributing to the widening of the current account. In this context, reserve requirement ratios are used as active policy instruments with an aim to decelerate the credit growth and to extend maturities of banks' liabilities. As illustrated on the slide, in December, the weighted average of the reserve requirement ratios were remarkably raised by differentiating the ratios such that they are lower for longer maturities (Table 1). Moreover, the reserve requirement base has been expanded to include funds received by banks through repurchase agreement (repo) transactions from foreign and domestic customers, except for those funds received from repo transactions with the Central Bank and those among domestic banks. Finally, with the decision we made yesterday, TL reserve requirement ratios were re-increased for the short-term deposit/participation fund and other liabilities. Hence, the weighted average reserve requirement ratio calculated by taking the share of liabilities into consideration has increased by 4.4 percentage points since 23 September 2010.

Table 1: Decisions on Required Reserve Ratios

(Percent)

Date of Decision	*Demand Deposits*	*Up to 1-month maturity*	*Up to 3-month maturity*	*Up to 6-month maturity*	*Up to 1-year maturity*	*With 1 year and longer maturity*	*Cumulative*	*Liabilities other than deposits/ participation funds**	*Weighted Average*
16 October 2009	5	5	5	5	5	5	5	5	**5**
23 September 2010	5.5	5.5	5.5	5.5	5.5	5.5	5.5	5.5	**5.5**
12 November 2010	6	6	6	6	6	6	6	6	**6**
17 December 2010	8	8	7	7	6	5	5	8	**7.4**
24 January 2011	12	10	9	7	6	5	5	9	**9.4**

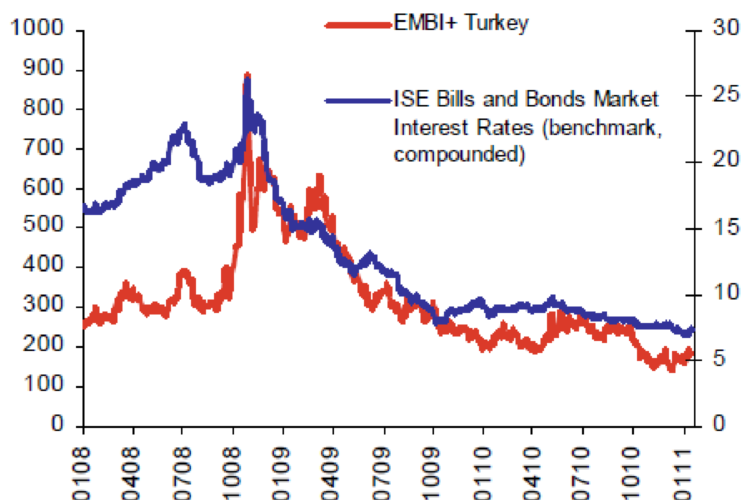
*With a regulation dated 17 December 2010, the reserve requirement base was expanded to include funds received by banks through repurchase agreement (repo) transactions, except for those funds received from repo transactions with the Central Bank and those among domestic banks.

Source: CBRT.

At this point, I would like to inform you about our evaluations regarding the effects of our recent decisions. The change in required reserves is expected to affect the credit market through cost and liquidity channels. With the said regulations, nearly a total of TL 22.5 billion a will have been withdrawn from the market. According to the recent data, this amount equals to approximately 5.8 percent of TL-denominated credits excluding financial sector. We believe that the monetary tightening implemented by increasing in the weighted average of reserve requirement ratios would more than offset the expansionary effects of the interest rate reductions. Therefore, we expect that the net impact of the monetary policy decisions we have taken recently will be tightening.

Despite the volatile global risk perceptions in the fourth quarter, market interest rates maintained their downward trend on the back of downward revisions to future policy rate expectations. Accordingly, the benchmark bond rate continued to hover around all-time lows (Figure 11). Meanwhile, we think that the fall in inflation expectations have contributed to the decline in market rates as well.

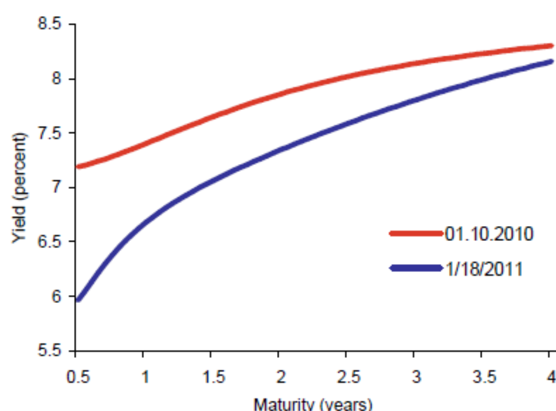
Figure 11: Interest Rate Developments



Source: Bloomberg, ISE.

The decline in market interest rates was more obvious for the shorter maturities during the final quarter, resulting in a steeper yield curve relative to the previous quarter. The CBRT's rate cuts over the last two months caused short-term market rates to fall quickly. On the other hand, longer-term interest rates displayed only a modest decline, since the CBRT did not provide any explicit signal about the future course of policy rates. Yet, despite the volatile global risk appetite, long term interest rates remained at historically low levels and relatively stable, reflecting prospects of a prolonged low-interest-rate environment in Turkey (Figure 12). The decline in nominal market rates also affected real interest rates, as real medium-term rates remained at unprecedented lows (Figure 13).

Figure 12: Yield Curve*



*Calculated from the compounded returns on bonds quoted in ISE Bills and Bonds Market by using Extended Nelson-Siegel (ENS) method.

Source: Bloomberg, CBRT.

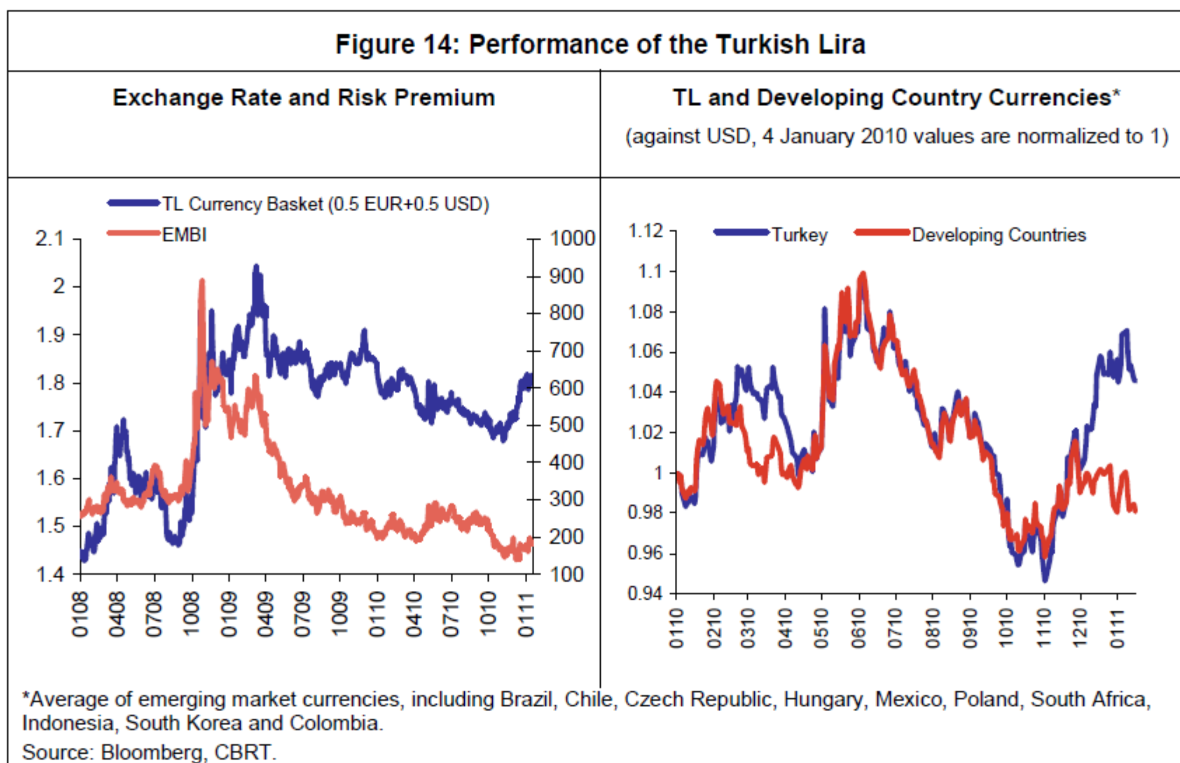
Figure 13: 2-Year Real Interest Rates Derived from Yield on GDBS*

(Percent)

*2-year real interest rates are calculated by using 2-year nominal interest rates derived from the ENS yield curve, and inflation expectations from the CBRT.

After following a similar trend seen across other emerging market currencies in the post-crisis period, the Turkish lira has recently taken a different path and experienced a relative depreciation. It is worthy of notice that this divergence started with the Rate cut signal in December and has become more obvious after the actual rate cuts (Figure 14).

Figure 14: Performance of the Turkish Lira



*Average of emerging market currencies, including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea and Colombia.

Source: Bloomberg, CBRT.

Factors such as low interest rates across the globe, easy access to external funds, and strong economic activity continued to help improve credit conditions in the final quarter of 2010. As a result, the gap between loan rates and deposit rates remained at historically low levels (Figure 15). Both the low loan rates and the improved credit risk indicators helped the credit volume continue to expand rapidly (Figure 16). As per sub-categories, both household loans and business loans continued to increase rapidly. At this point, I would like to once more emphasize that it is very important to closely monitor the upcoming course of loans and to take necessary macroprudential measures.

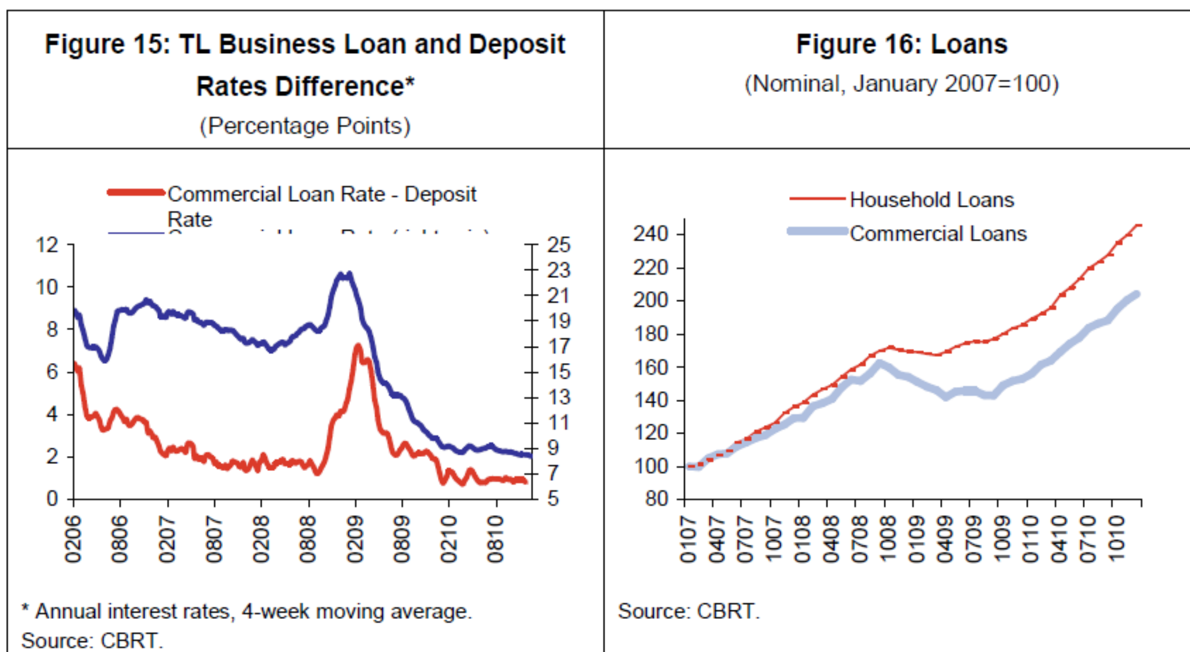


Figure 15: TL Business Loan and Deposit Rates Difference*
(Percentage Points)

* Annual interest rates, 4-week moving average.
Source: CBRT.

Figure 16: Loans
(Nominal, January 2007=100)

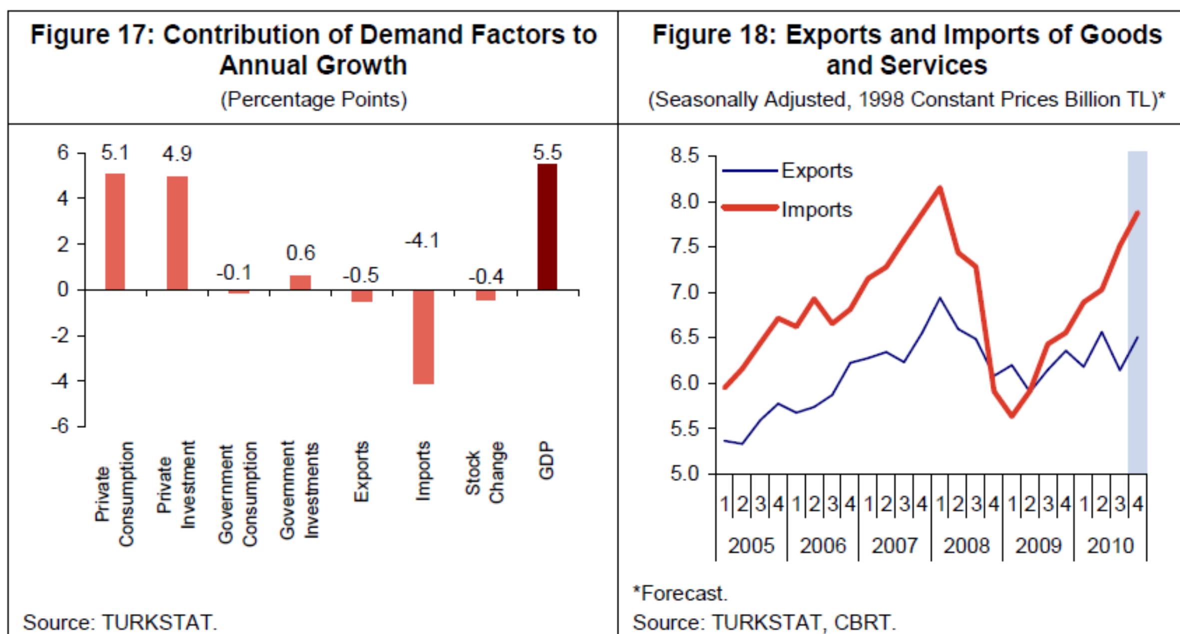
Source: CBRT.

In sum, monetary and financial conditions remained supportive of economic activity in the fourth quarter. Accordingly, the credit channel has maintained its expansionary effect on the consumption and investment demand.

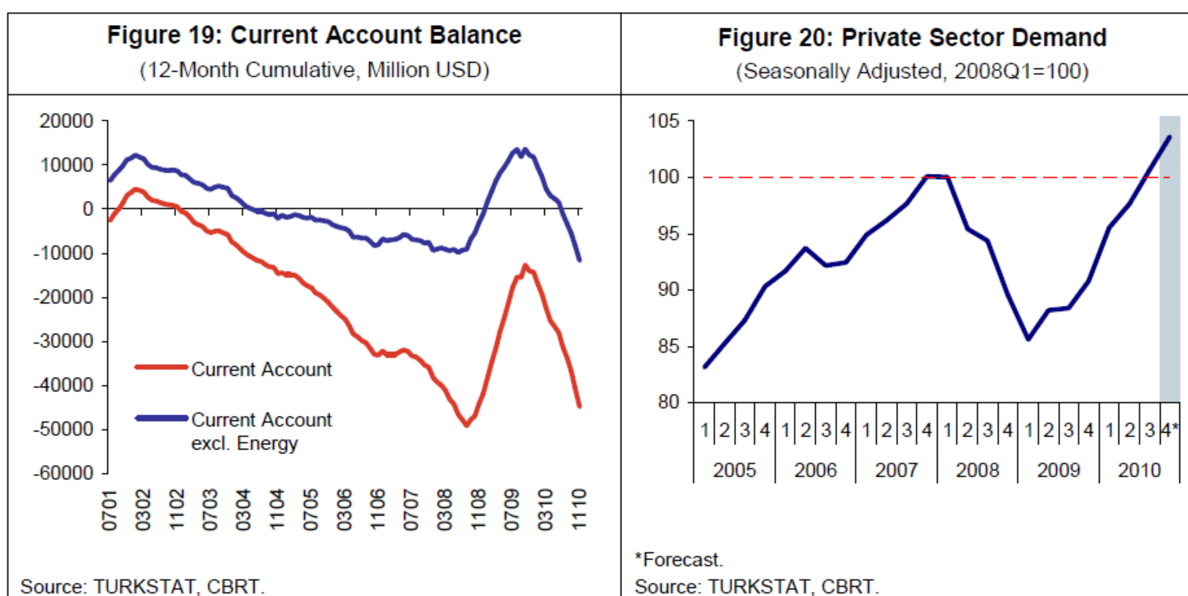
3. Inflation and monetary policy outlook

After summarizing our monetary policy stance and its impacts on the financial markets, I would now like to talk about the financial outlook and assumptions underlying our forecasts.

Third quarter national accounts data are consistent with the outlook presented in the October Inflation Report. Following the deepening debt crisis in European economies since May, the growth rate of Gross Domestic Product slowed down in the third quarter and displayed an increase of 5.5 percent year-on-year (Figure 17). The largest contribution to annual growth in the third quarter came from private sector demand through consumption and investment; whereas, due to the contraction in exports and the acceleration of demand for imported goods, the net foreign demand contributed to annual growth negatively. Thus, the divergence between domestic and foreign demand growth has become evident (Figure 18).



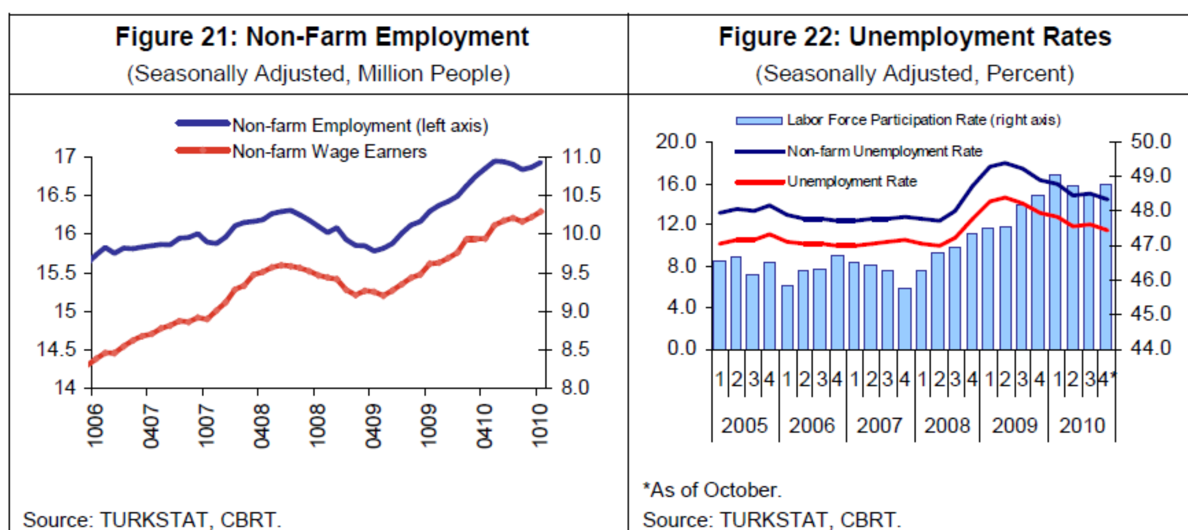
Recent data releases indicate that the third-quarter slowdown in economic activity is temporary. The composition of economic activity suggests that the divergence between domestic and foreign demand continued in the fourth quarter. Domestic demand for imported goods accelerated in the last quarter amid rapid credit expansion and lagged effects of the appreciation of the Turkish lira in the third quarter. As a result, the current account balance continued to deteriorate (Figure 19).



The slow recovery in the global economy continues to restrain economic activity, whereas the strong domestic demand bolsters aggregate demand growth. In fact, the sharp upward trend in private consumption and investment spending that started in the fourth quarter of 2009 continued into the fourth quarter of 2010 (Figure 20).

Continued economic recovery fueled by robust domestic demand has supported the gradual improvement in employment conditions. The rapid recovery in non-farm employment paused in the third quarter of 2010, which appears temporary, as suggested by leading indicators

(Figure 21). However, due to high labor force participation rates, it will take a while before unemployment rates come down to precrisis levels (Figure 22). Therefore, it is unlikely for unit labor costs to be subject to cost pressures in coming months.



In sum, monetary conditions remained supportive of domestic demand in the fourth quarter. Private demand recovered more rapidly amid increased consumption and investment spending, therefore aggregate demand conditions provided less support for disinflation than suggested in the October Inflation Report. Nevertheless, I would like to emphasize that the recent policy measures are expected to bring domestic demand back on to a more moderate growth path in the upcoming period.

Our inflation forecasts are based on the projections of the Medium-Term Program (MTP) as was the October Inflation Report. The use of a large fraction of the additional increases in tax revenues as a result of the stronger-than expected economic activity in the last quarter of 2010 has been the primary driver of the slight upward revision to output gap forecasts. However, as the budget balance remained largely in line with MTP targets, the medium-term fiscal policy outlook was barely changed. Therefore, our forecasts are based on the assumption that the primary expenditure-to-GDP ratio would decline gradually, the debt-to-GDP ratio to decline further, and the risk premium to remain broadly unchanged over the forecast horizon. Moreover, I would like to note that we assume tax adjustments to be consistent with inflation targets and automatic pricing mechanisms.

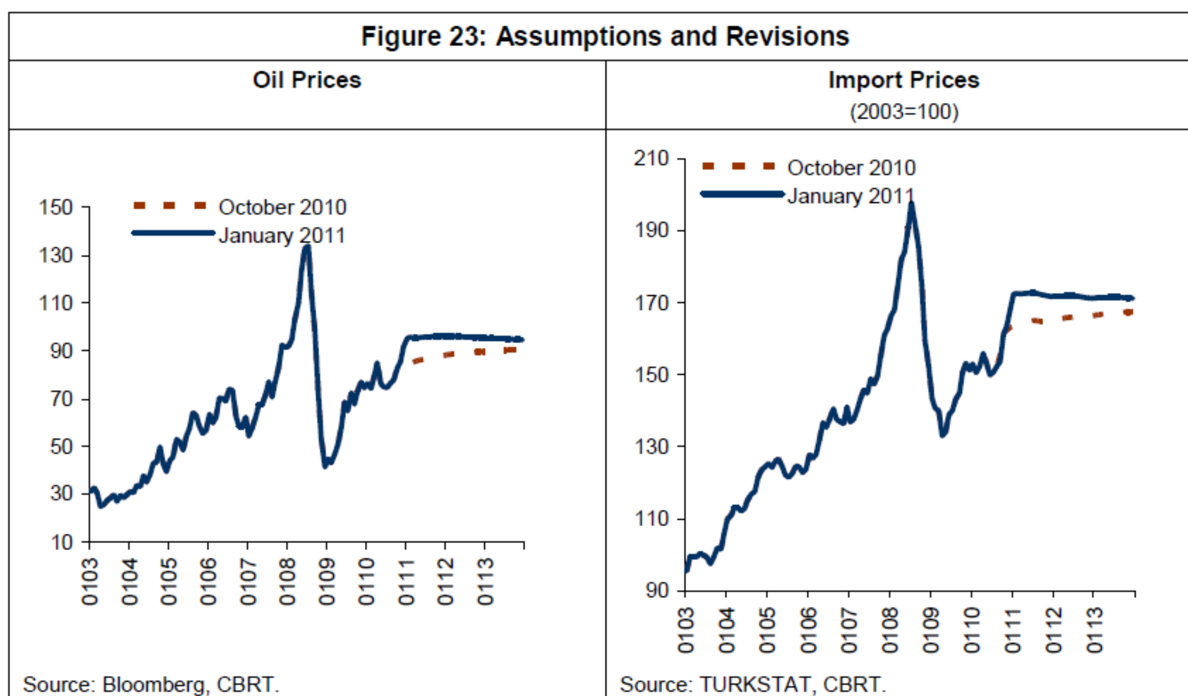
Now I would like to brief you about the assumptions underlying our inflation forecasts. The developments since the reporting period of the October Inflation Report urged us to revise our assumptions underlying our forecasts. I would like to elaborate on these factors to enable a better understanding of the forecasts.

The October Inflation Report envisaged food inflation to be 10.5 percent at end-2010, to fall gradually to 7 percent at end-2011 and to remain at these levels throughout the forecast horizon. As I stated at the beginning of my speech, the sharp decline in unprocessed food inflation during the fourth quarter resulted in lower-than-expected food inflation. However, the potential impact of the recent upsurge in agricultural commodity prices on processed food prices led to an upward revision in the assumption for food inflation from 7 percent to 7.5 percent, which had around basis points upside impact on 2011 inflation forecasts (Table 2).

Table 2: Revision of Assumptions for 2011		
	October 2010 IR	**January 2011 IR**
Food Prices (Annual Percentage Change)	7	7.5
Oil Prices (Annual Average, USD per barrel)	85	95
Import Prices (Annual Average Percentage Change)	6.1	10.9

In the October Inflation Report, oil prices were assumed to be USD 85 per barrel for 2011 and USD 90 per barrel for 2012 and beyond. Moreover, import prices were assumed to rise gradually over the forecast horizon, increasing by an average percent year-on-year in 2011. Commodity prices have accelerated further since the release of the October Inflation Report due to the ongoing quantitative easing in advanced economies and the strong growth in emerging economies. In this context, in view of the commodity futures prices for the first half of January, we raised our oil price assumption to USD 95 per barrel for 2011 and thereafter (Table 2). Furthermore, again considering the commodity futures prices, we assume that import prices will increase by about 10.9 percent in 2011 (Figure 23). The changes in our assumptions have led us to revise our inflation forecasts for end-2011 upwards by around 35 basis points.

Figure 23: Assumptions and Revisions



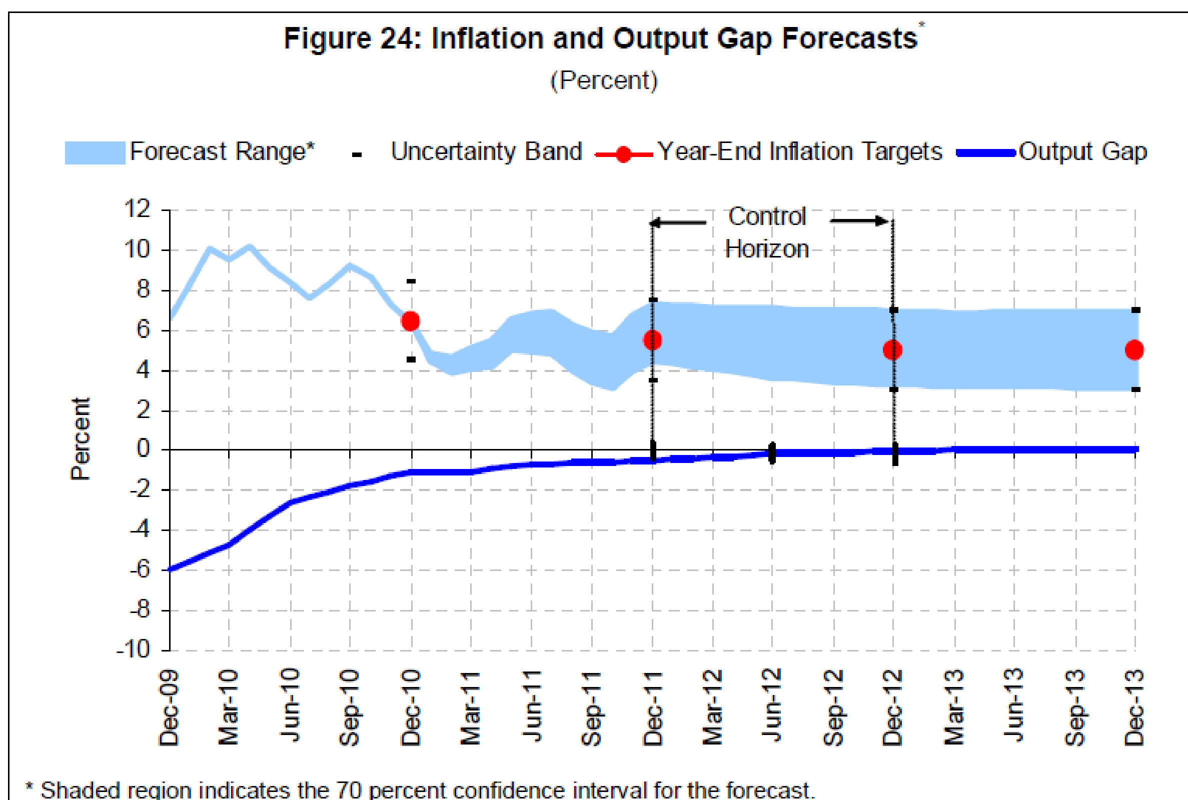
Source: Bloomberg, CBRT.

Source: TURKSTAT, CBRT.

Since the launch of inflation targeting in 2006, the CBRT has been announcing its medium-term inflation forecasts and providing a qualitative perspective regarding the outlook for policy rates. As I have mentioned earlier in my speech, the current economic climate prompted the CBRT to consider financial stability along with price stability, which in turn required the diversification of policy tools. Accordingly, we adopted a policy mix made up of required reserve ratios and liquidity management facilities, besides policy rates. Given the significant level of uncertainties concerning the global economic outlook in the upcoming

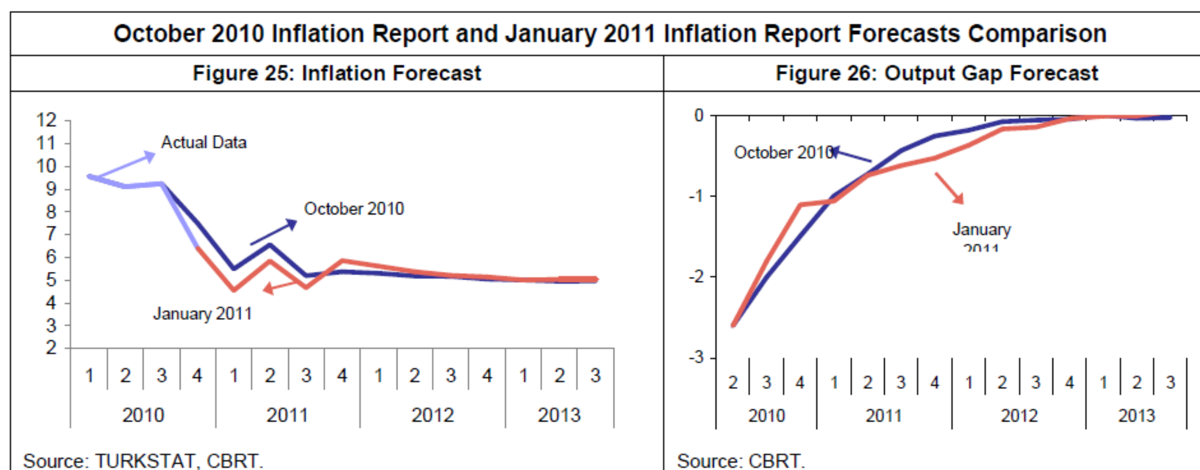
period, we believe that there should be flexibility regarding the direction and course of each instrument within the policy mix. Therefore, this Report will provide forecasts for the net effect of the policy combination, and will not outline any specific path regarding its sub-items.

Now, I would like to present our inflation and output gap forecasts produced within the framework outlined so far. Assuming that the policy mix is suited to deliver an additional limited monetary tightening during the rest of 2011, inflation is expected to be, with 70 percent probability, between 4.5 and 7.3 percent with a mid-point of 5.9 percent at end-2011, and between 3.3 and 6.9 percent with a mid-point of 5.1 percent by the end of 2012. Inflation is expected to stabilize around 5 percent in the medium term (Figure 24).



Hence, assuming that a limited monetary tightening will bring credit growth rate down to 20–25 percent in 2011, our revised forecasts indicate that inflation would be close to the target by the end of 2011. I would like to highlight that the envisaged monetary tightening in 2011 may be through various combinations of different policy tools. The monetary tightening could be implemented by either required reserve ratios or policy rates, or a combination of both. Moreover, during the tightening process, both instruments could move in either the same or the opposite direction. Yet, it should be emphasized that the baseline scenario envisages the net impact of the policy mix on credits and domestic demand to be on the tightening side.

We believe that evaluating our forecasts in comparison with those presented in the previous Report would serve to provide a better understanding of the changes in forecasts. As I have mentioned earlier, the rapid decline in unprocessed Food Prices pulled short-term inflation forecasts down, while the upward revision of oil and other commodity price assumptions drove end-2011 inflation forecasts higher (Figure 25). The output gap has been revised slightly upward for the last quarter of 2010 (Figure 26). Moreover, taking into account the lagged effects of monetary tightening, the output gap is assumed to close slower than what was suggested in the previous report.



October 2010 Inflation Report and January 2011 Inflation Report Forecasts Comparison

Figure 25: Inflation Forecast — Source: TURKSTAT, CBRT.

Figure 26: Output Gap Forecast — Source: CBRT.

Given the correction in unprocessed food prices and the high base effect from the first months of 2010, inflation is expected to fall markedly in the short term, below medium-term targets, and remain volatile thereafter. Inflation is expected to reach the medium-term target of 5 percent by mid-2012 once the effects of rising commodity prices wear off.

It should be emphasized that any new data or information may lead to a change in the monetary policy stance. Therefore, assumptions regarding the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

4. Risks

In the last part of my speech, I would like to elaborate on the risks regarding the inflation outlook in the upcoming period and the prospective monetary policy strategies to be implemented should these risks materialize.

In the baseline scenario, which is the basis of our medium-term forecasts, it is envisaged that the policy mix composed of policy rates and reserve requirement ratios should be determined in a way to achieve a limited monetary tightening, in order to make sure that inflation remains consistent with the targets. Such a tightening aims to keep inflation under control by slowing down credit growth and domestic demand and to reduce the risks surrounding financial stability. We expect the impact of the measures we took in December and January to contain credit supply to be observed in the near term. However, the time lag and the extent of the impact of the policy measures may vary depending on developments beyond the control of the monetary policy. Therefore, the CBRT will closely monitor the effects of the policy measures and take further actions should the credit growth rate or the inflation rate deviates from desired levels.

Developments regarding the global economy remain central for the domestic inflation and monetary policy outlook. Under current conditions, we employ several instruments to maintain both price stability and financial stability. Therefore, unlike previously, global developments would affect not only the direction, but also the composition of our policy. Accordingly, global developments will be assessed with respect to their effects on the growth rate of aggregate demand as well as its composition.

Although there has been some improvement in the expectations pertaining to the US economy, uncertainties driven by debt sustainability problems across the euro area peripheral economies still persist. Ongoing problems in credit, real estate, and labor markets across advanced economies and uncertainties regarding the impact of potential fiscal consolidations continue to pose downside risks to the pace of global economic recovery. The possibility of a longer-than-anticipated period of anemic global growth and the likelihood of a

long period of quantitative easing by advanced economies not only creates downside risks regarding foreign demand but also suggests that capital inflows to Turkey may continue at a faster pace. Should such a scenario materialize, a policy mix of low policy rate and high reserve requirement ratios may be implemented for a long period, both to balance domestic and foreign demand and for macroprudential purposes. If global economic problems further aggravate and domestic economic activity assumes a stagnation trend, we may have to utilize all policy instruments with their effect being on the easing side. Although downside risks persist, there are also upside risks regarding global economy, particularly driven by the lagged impacts of the exceptionally loose policies implemented by the advanced economies over the past two years. If the global economy assumes a faster-than-expected recovery, global inflationary pressures may occur and thus trigger a tightening in the monetary policies of advanced economies. The materialization of such a scenario would mean higher global interest rates and domestic demand-driven inflationary pressures, and thus necessitate increasing both policy rates and reserve requirements.

Oil and other commodity prices have displayed rapid increases in the recent period. If the rise in commodity prices persists, this may have implications on the general pricing behavior given the strong pace of domestic demand. Should such a risk materialize in the upcoming period and hamper the attainment of medium-term inflation targets, there may be stronger tightening than was envisaged in the baseline scenario. However, the policy mix may vary depending on the developments regarding foreign demand, capital flows, and the outlook for credit growth.

We will continue to closely monitor fiscal policy developments while formulating our monetary policy. Under current circumstances, increasing government savings and adhering to fiscal discipline are essential to control the risks brought about by the current account deficit rising on the back of the decoupling between domestic and foreign demand. Our inflation forecasts take the fiscal projections of the MTP as given. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, having an adverse effect on the inflation outlook.

In the upcoming period, monetary policy will continue to focus on sustaining price stability. To this end, we will meticulously evaluate the impact of macroprudential measures taken by the CBRT and other institutions on the inflation outlook. Fulfilling commitments to fiscal discipline in the medium-term and strengthening the structural reform process would facilitate the relative improvement in Turkey's sovereign risk, and thus bolster macroeconomic and price stability. Maintaining fiscal discipline will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates at low levels permanently. In this respect, timely implementation of the structural reforms envisaged by the MTP and the European Union accession process remains to be of utmost importance.

Thank you for your attention.