Erdem Başçi: Recent economic and financial developments in Turkey

Speech by Mr Erdem Başçi, Governor of the Central Bank of the Republic of Turkey, at the press conference for the presentation of the April 2011 Inflation Report, Ankara, 28 April 2011.

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Distinguished Members of the Press, Esteemed Guests,

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

The Report summarizes the economic outlook underlying monetary policy decisions, shares our evaluations on global and domestic macroeconomic developments and presents the medium-term inflation forecasts which have been revised in view of the last quarter developments, along with our monetary policy stance. Moreover, the communication and impact of our new monetary policy implementation are extensively analyzed in the Report through Boxes.

Distinguished Members of the Press,

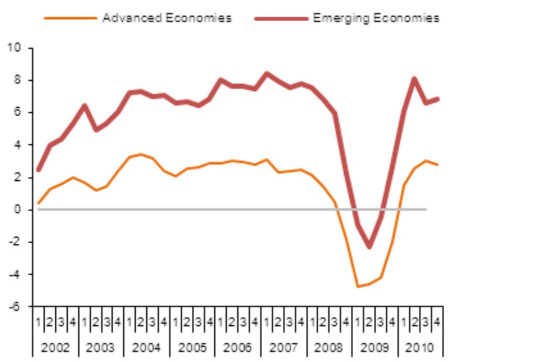
In the first part of my speech, I would like to very briefly summarize the global economic developments and provide you with a short reminder of the new policy stance that we have recently introduced.

The global economy continued to recover in the first quarter of 2011, while the growth dynamics between advanced and emerging economies continue to diverge (Chart 1). Downside risks in advanced economies remain critical, causing these economies to maintain expansionary monetary policies, while domestic demand remains strong in emerging economies amid accelerated capital inflows.

Chart 1.

Aggregated Growth Rates*

(Annual Percent Change)



* Weighted by each country's share in global GDP.

Source: Bloomberg, CBRT.

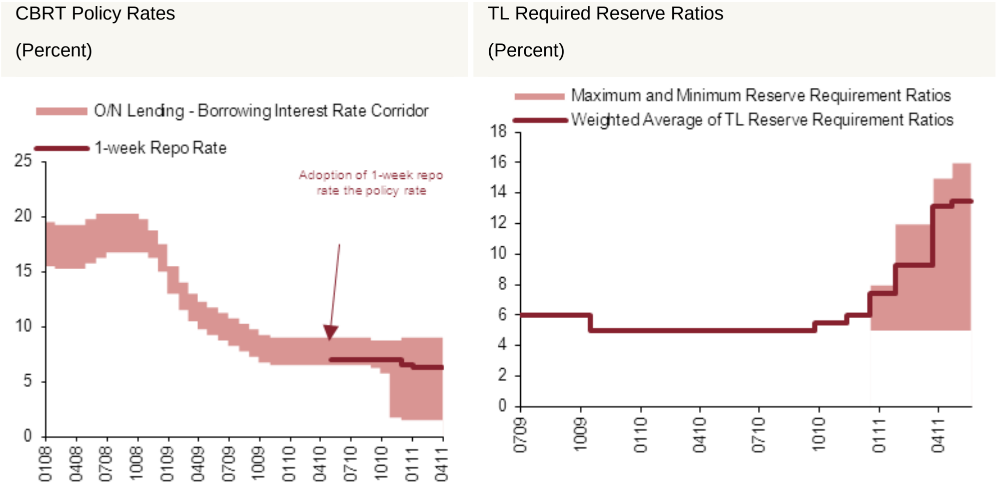
1. Monetary policy developments and monetary conditions

The mentioned discrepancy between advanced and emerging economies accelerates capital flows into countries, such as Turkey, with strong economic fundamentals and relatively low risk. Rapid credit expansion and widening current account deficit fueled by short-term capital inflows increase risks to financial stability and carry the potential to hamper price stability over the medium term. This gives rise to adopting different approaches that incorporate financial stability into the monetary policy framework.

As you have been following very closely, we have designed and adopted a new policy strategy as of the end of 2010. While our new policy approach maintains the priority of price stability, we also observe financial stability as a supporting objective. In this context, in addition to policy rates, we jointly use complementary tools such as reserve requirement ratios and the interest rate corridor. The primary objective of this new approach is to contain the negative effects of the ongoing global imbalances on the Turkish economy.

Now, I would like to summarize the decisions that we have made within the new policy strategy. The downtrend in inflation during the last quarter of 2010 allowed the CBRT to give relatively more weight to financial stability during this period. In this respect, in order to reduce short-term capital inflows, we lowered policy rates on one hand and raised the volatility in short-term interest rates by widening the interest rate corridor on the other hand. Moreover, in order to slow down credit expansion, we increased required reserve ratios (Chart 2). Meanwhile, in order to enhance financial stability by extending maturity of the banking sector liabilities, we differentiated reserve requirements across maturities, with higher reserve requirements for short-term liabilities. These measures led to a fall in net short-term capital inflows, stopped the acceleration of credit growth and extended maturities for deposits.

Chart 2. CBRT Policy Mix



Source: CBRT. Source: CBRT.

In the first quarter of 2011, both the faster-than-expected increases in oil prices and the robust domestic demand required a more cautious stance regarding the inflation outlook. Specifically, oil prices hovering significantly above our January Inflation Report's assumptions led to an increase in cost pressures. Moreover, the ongoing rapid growth in private consumption and private investment spending added to the need to contain domestic demand in order to avoid secondary effects of the increases in oil and other commodity prices.

Notwithstanding historically low inflation at 4 percent in the first quarter, I would like to emphasize that we have acted with a medium-term perspective and started to highlight the upside risks to inflation since February. Accordingly, in order to eliminate the risk of deterioration in general pricing behavior, we have adopted a stronger monetary tightening than was envisaged in the January Inflation Report's baseline scenario. Accordingly, the policy rate has been kept constant since February, while the weighted average of reserve requirement ratios for Turkish lira liabilities was hiked by 410 basis points in March and April

(Table 1). Meanwhile, in April, FX reserve requirement ratios were differentiated by maturity where short-term FX reserve requirement ratios were increased slightly. Thus, the policy mix composed of policy rates and reserve requirement ratios has been adjusted to deliver a monetary tightening, implying a more cautious monetary stance (Chart 2).

Table 1.

Weighted Average of TL and FX Required Reserve Ratios

(Percent)

Decision Date	TL Weighted Average	FX Weighted Average
January 24, 2011	9.4	11
March 23, 2011	13.2	11
April 21, 2011	13.5	12

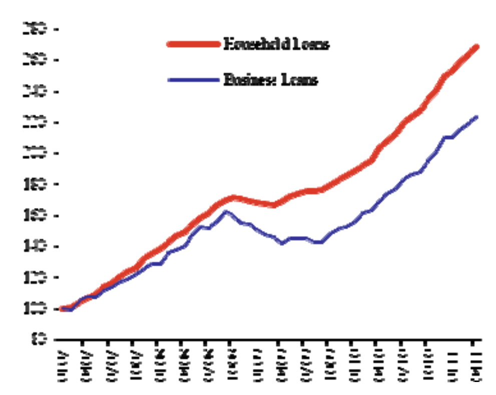
Source: CBRT.

Although credit growth slowed quarter-on-quarter in the first quarter, the rate of increase in loans has yet to fall to levels compatible with financial stability (Chart 3). The upward trend in loans is driven by both supply and demand side factors. While intense competition is effective on the supply side; the favorable economic outlook and the improvement in employment conditions help to keep demand for loans robust. However, we expect that credit utilization will continue to lose pace in the second quarter due to the lagged effects of the current monetary tightening.

Chart 3.

Loans

(Nominal, January 2007=100)

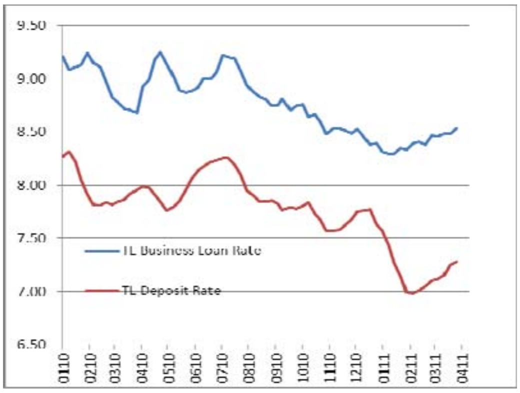


Source: CBRT.

Chart 4.

TL Business Loan and Deposit Rates

(Annual, Percent, 4-week Average)



Source: CBRT.

2. Inflation and monetary policy outlook

Distinguished Members of the Press, Esteemed Guests,

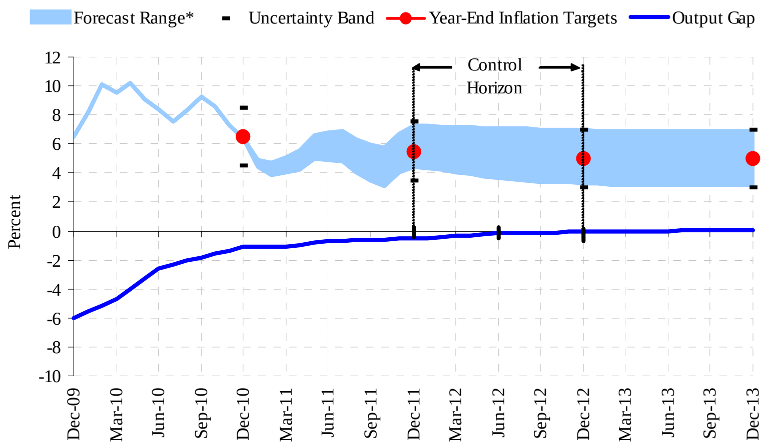
Having summarized our monetary policy stance and the impact of this stance on financial markets, I would now like to talk about the macroeconomic outlook and assumptions underlying our forecasts.

First, I would like to summarize the recent inflation developments and then I will compare our short-term forecasts with the actual data recorded in the first quarter. As you might recall, in the October 2010 Inflation Report, we drew attention to the price hikes due to increases in unprocessed food and tobacco prices, which are beyond the control of the CBRT, and concluded that these items would leave sizeable room for disinflation. In fact, during the subsequent two quarters, inflation declined by 5.2 percentage points and dropped to

4 percent in March, a level close to the lower bound of our January Inflation Report forecast (Chart 5).

Chart 5.

January 2011 Inflation Forecasts and Realizations



* Shaded region indicates the 70 percent confidence interval for the forecast.

An analysis of inflation developments in terms of sub-categories reveals that the rapid decline in inflation was mainly driven by the waning base effects from unprocessed food, energy and tobacco prices and the favorable course of services prices (Chart 6). Meanwhile, the rapid increase in import prices and the depreciation of the Turkish lira caused prices of core goods to accelerate. Indeed, the rate of change across all subcategories of the CPI, except core goods, remained below past year averages during the first quarter (Chart 7).

Chart 6.

Contribution to Annual CPI Inflation

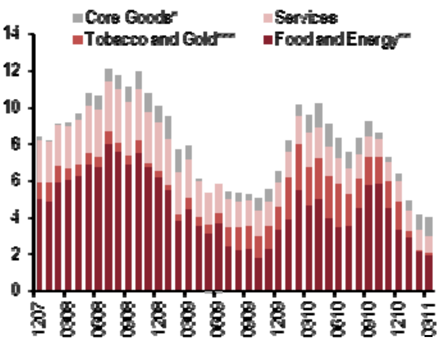
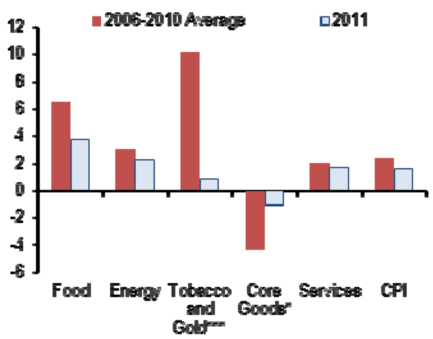


Chart 7.

CPI by Subcategories

(First Quarter Percent Change)



* Core Goods: Goods excluding food, energy, alcoholic beverages, tobacco and gold.

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

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

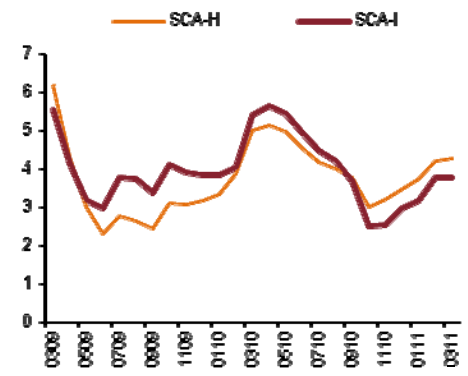
Source: TurkStat, CBRT.

While inflationary pressures by producer prices grew stronger in the first quarter, aggregate demand conditions provided less support for disinflation compared to previous quarters. Meanwhile, core goods inflation posted an increase, albeit remaining low (Chart 8). On the back of these developments, medium-term inflation expectations registered a limited increase in the first quarter (Chart 9).

Chart 8.

Core Inflation Indicators H and I

(Annual Percent Change)

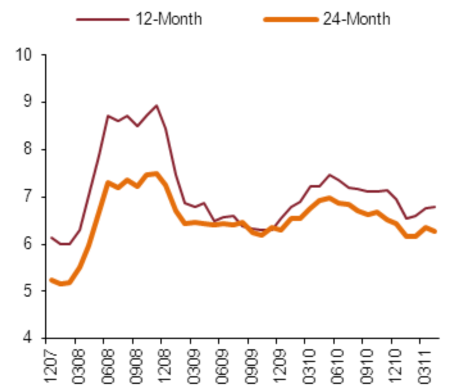


Source: TurkStat, CBRT.

Chart 9.

12- and 24-Month Ahead CPI Expectations*

(Annual Percent Change)



*CBRT Survey of Expectations, second survey period results.

Source: CBRT.

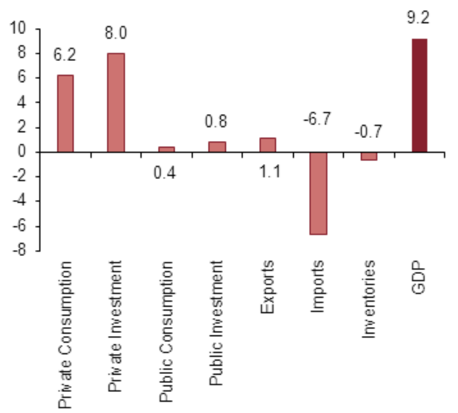
Esteemed Guests,

GDP data for the fourth-quarter of 2010 have been in line with the outlook presented in the January Inflation Report. The third-quarter slowdown turned out to be temporary as expected and economic activity expanded at a remarkable pace in the last quarter. Domestic demand became the main determinant of growth in the said period (Chart 10). Thus, the post-crisis divergence between domestic and external demand growth became more pronounced in this period, confirming the adoption of the new policy mix (Chart 11).

Chart 10.

Contributions to GDP Growth by Demand Components

(Percentage Points)

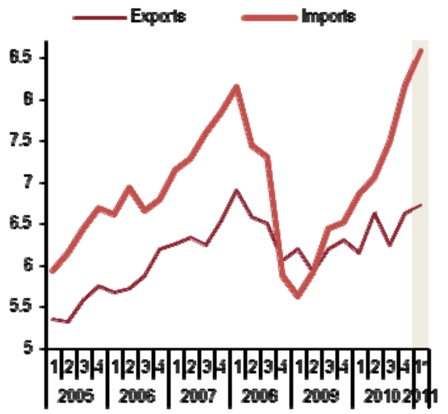


Source: TurkStat.

Chart 11.

Exports and Imports of Goods and Services

(Seasonally Adjusted, 1998 Prices, Billion TL)



* Estimate.

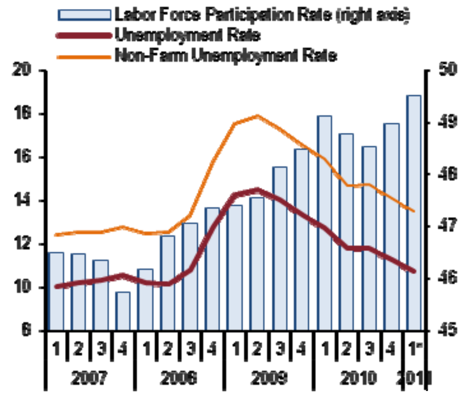
Source: TurkStat, CBRT.

In line with the robust course of economic activity, non-farm employment also maintained its upward trend; while unemployment rates displayed a notable decline (Chart 12). Leading indicators signal an ongoing recovery in employment conditions.

Chart 12.

Unemployment Rates

(Seasonally Adjusted, Percent)



* As of January.

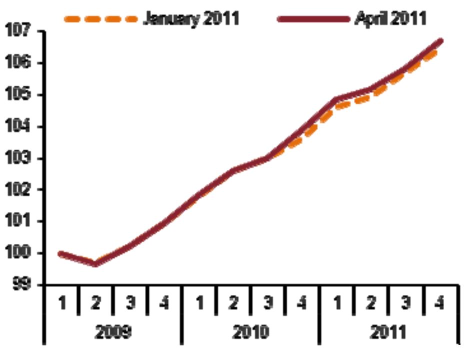
Source: TurkStat, CBRT.

Data for the first quarter of 2011 indicate that economic activity, driven by domestic demand, is more robust than expected. Accordingly, our revised forecasts are based on the assumption that aggregate demand conditions would provide less support for disinflation compared to the previous period. However, I would like to underline that given the capacity utilization rates which are still below pre-crisis levels and unemployment rates above pre-crisis levels, we assume an outlook where aggregate demand conditions do not impose a remarkable upward pressure on inflation by the first quarter of 2011.

The absence of signs for overheating in the economy is mainly owed to weak external demand. In particular, the weak course of economic activity the euro area puts a cap to growth of external demand. Therefore, our medium-term forecasts are based on the assumption that external demand will continue to recover gradually and slowly, as was the case in the previous Report. In fact, global economy forecasts do not imply any significant changes in external markets in the first quarter. Accordingly, Turkey's export-weighted growth index remained mainly unchanged from the previous reporting period (Chart 13).

Chart 13.

Export-Weighted Global Economic Activity Index*



* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".

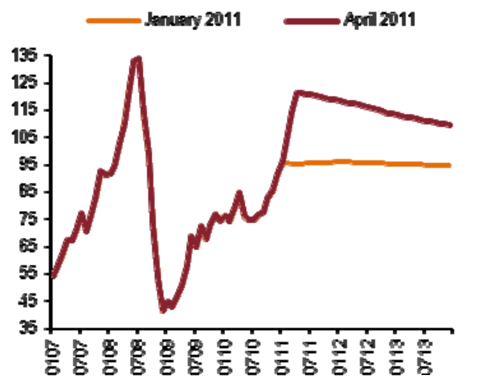
Source: Bloomberg, Consensus Forecasts, CBRT.

Fiscal policy forecasts are based on the Medium Term Program (MTP) projections. Since primary expenditures remained largely in line with MTP targets in the first quarter, the fiscal policy outlook remained broadly unchanged. Hence, our forecasts are based on the assumption primary expenditures and debt to GDP ratios would continue to decline gradually and the risk premium would remain broadly unchanged over the forecast horizon. Furthermore, tax adjustments are assumed to be consistent with inflation targets and automatic pricing mechanisms.

Chart 14.

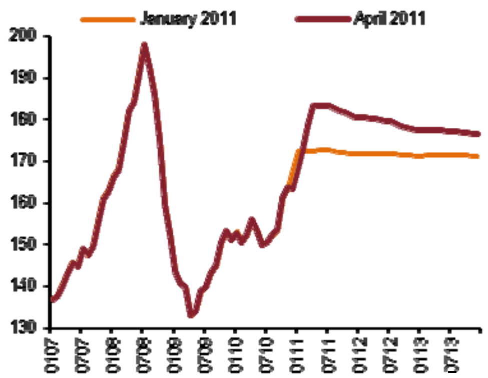
Revisions to Oil and Import Price Assumptions

Oil Prices (USD/bbl)



Source: Bloomberg, CBRT.

Import Prices (2003=100)



Source: TurkStat, CBRT.

Particularly due to supply-side developments, oil and other commodity prices remained considerably above our assumptions presented in the January Inflation Report (Chart 14). Hence, we revised our assumptions for oil and other commodity prices upwards (Table 2). As illustrated on the slide, these changes in assumptions led to an upward revision of about 50 basis points for the end-2011 inflation forecast and a slightly upward revision for the 2012 inflation forecast.

Table 2.

Revisions to 2011 Assumptions

	January 2011	April 2011
Oil Prices (Annual Average, USD)	95	115
Import Prices (Annual Percent Change)	10.9	16.2
Food Price Inflation (Year-end Percent Change)	7.5	7.5

Another factor affecting 2011 inflation forecasts has been the tariff hike on fabrics and apparels. Although major uncertainties exist about how this development will be reflected on prices, we assumed that this would add to year-end inflation by about 50 basis points while revising our forecasts.

Despite the recent benign course of food prices, we preserved our assumption regarding food inflation for end-2011 at 7.5 percent in view of the extreme volatility in unprocessed food prices and rapid increases in agricultural commodity prices (Table 2).

In sum, due to developments beyond the control of monetary policy, such as soaring energy prices and renewed tariffs, we revised the mid-point for our end-2011 inflation forecast up by 1 percentage point.

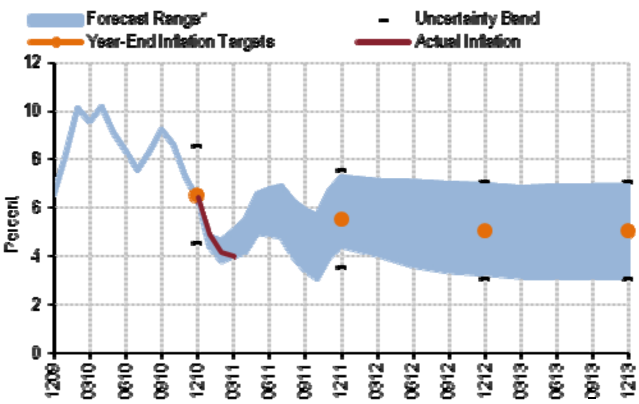
Distinguished Members of the Press,

Within the new policy framework, the question of how and which policy tools will be employed to change the policy stance is determined by factors affecting financial stability and price stability. Given the high level of uncertainty arising from global economic conditions, we believe that it would be more appropriate to remain flexible regarding the exact content of the policy mix. Therefore, in this Report, the monetary policy stance underlying our inflation forecasts will continue to be communicated using the term “monetary tightening”, and we will not provide any information about the explicit path for individual instruments.

Against this background, I now would like to share our inflation and output gap forecasts. Assuming an additional limited monetary tightening during the second half of 2011, which would bring credit growth to 20–25 percent at the end of 2011, inflation is expected to be, with 70 percent probability, between 5.6 and 8.2 percent with a mid-point of 6.9 percent at the end of 2011, and between 3.4 and 7.0 percent with a mid-point of 5.2 percent at the end of 2012. Inflation is expected to stabilize at around 5 percent in the medium term (Chart 15).

Chart 15.

Inflation and Output Gap Forecasts



* Shaded region indicates the 70 percent confidence interval for the forecast.

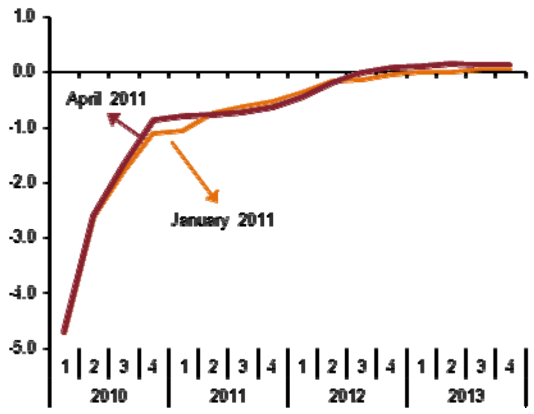
Revised forecasts suggest that credits should grow at a measured and vigorous pace to keep inflation in line with targets over the medium term. To this end, we provide a numerical range for the annual rate of credit growth in order to be more concrete. I would like to underline that these growth rates should not be perceived as strict targets for the CBRT. At this point, I would also like to emphasize that the nominal credit growth consistent with the medium-term inflation target may vary over the years depending on the course of factors such as inflation, growth and the composition of the aggregate demand.

As illustrated on the slide, over the next three quarters, inflation may display significant fluctuations mainly due to base effects driven by food prices. Accordingly, annual food inflation is expected to rise in the second quarter, decline in the third quarter, and increase markedly in the last quarter (Chart 15).

Comparison of January 2011 and April 2011 Inflation Report Forecasts

Chart 16.

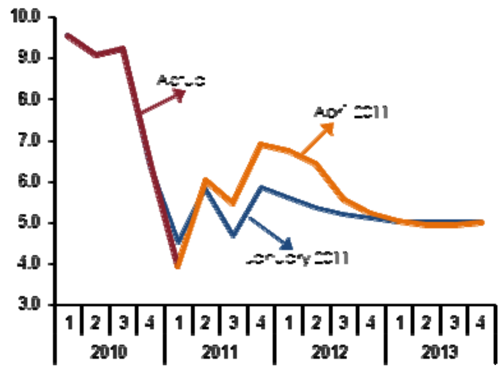
Output Gap Forecast



Source: CBRT.

Chart 17.

Inflation Forecast



Source: TurkStat, CBRT.

Comparing our current forecasts with those of the previous reporting period, I would like to reiterate that we revised the initial point of our output gap forecasts upwards due to the more-than-expected increase in the domestic demand in the last quarter of 2010 (Chart 16). However, taking into account the stronger-than-expected effects of the monetary tightening implemented in the first quarter, the output gap is expected to close at a slower pace compared to the previous period.

In sum, due to developments beyond the monetary policy control such as the significant surge in oil and other imports prices as well as the renewed tariffs, we have revised our inflation expectations upwards (Chart 17). In addition, I would like to remind you that we will not respond to first round effects of rising oil and other commodity prices, but second round effects will be closely monitored and deterioration in the pricing behavior will not be tolerated.

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

3. Risks and monetary policy

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

We envision that the impact of the ongoing monetary tightening on loans and domestic demand will be more apparent starting from the second quarter. However, the extent and the timing of the impact may vary depending on developments beyond the control of monetary policy. I would like to underline that as the Central Bank, we will closely monitor the lagged effects of our policy measures on price stability and financial stability, and will take additional measures if deemed necessary.

In assessing risk factors and related monetary policy measures under current circumstances, we adopt a framework where both price stability and financial stability are taken into account. Therefore, risk factors are not only assessed with respect to their impact on the level but also on the composition of the aggregate demand. This is because the level of aggregate demand is related to price stability, while its composition relates directly to financial stability. Therefore, we evaluate risk factors regarding the global economy against this backdrop.

Although downside risks regarding the global economy have decreased compared to the previous reporting period, they still remain significant. Problems in credit, real estate and labor markets in many advanced economies are yet to be completely solved. Moreover, uncertainties regarding debt sustainability and the impact of a possible fiscal consolidation persist. Meanwhile, rapid increases in oil prices may restrain global recovery. All these factors continue to feed downside risks regarding the pace of global growth. The possibility of prolonged period of slow global growth not only poses downside risks regarding external demand, but also keeps prospects for strong capital flows to Turkey vigorous. Should such a scenario materialize, a policy mix of low policy rate, high reserve requirement ratios and a wide interest rate corridor may be implemented for a long period. Moreover, an outcome whereby problems in advanced economies intensify, leading to contraction in domestic economic activity, may require an easing in all policy instruments. In other words, we may consider joint cuts in policy rates and reserve requirement ratios.

Although downside risks to global economy remain notable, upside risks are also becoming more significant. Major uncertainties exist regarding the lagged impacts of the exceptionally loose monetary policies implemented by advanced economies on global economic activity and inflation. If the global economy faces a faster-than-expected recovery in the upcoming period, inflationary pressures may arise sooner than envisaged in the advanced economies. Materialization of such a scenario would mean a tightening by using policy rates as well as reserve requirements against higher global policy rates and demand-pull inflationary pressure.

As I have previously emphasized, the outlook for oil and other commodity prices remains uncertain. Should the increases in commodity prices persist and impose risks on achieving medium-term inflation targets, additional tightening may be implemented sooner than implied by the baseline scenario. However, given that higher oil prices will also worsen the current account balance, a possible policy response will consider macro financial risks as well. Therefore, the exact content of the adopted policy mix may vary depending on the outlook for external demand, capital flows and the credit growth.

Esteemed Guests,

We will continue to monitor fiscal policy developments closely while formulating our monetary policy strategy. Our inflation forecasts assume that the ratio of fiscal expenditures to GDP will evolve as projected in the MTP. A revision in the monetary policy stance may be considered should the fiscal stance deviate significantly from this framework, and consequently has an adverse effect on the medium-term inflation outlook. Increasing government saving, thus sustaining fiscal discipline, under current circumstances is essential to control the current account deficit driven by the divergence between domestic and external demand. Therefore saving the extra tax revenues driven by the stronger-than-expected economic activity would not only reduce financial stability risks, but also enhance the effectiveness of the new policy mix.

Monetary policy in the period ahead will continue to focus on building price stability on a permanent basis. To this end, the impact of the macroprudential measures taken by CBRT and other institutions on the inflation outlook will also be assessed carefully. Fulfilling the commitment to maintain fiscal discipline and strengthening the structural reform agenda in the medium term would contribute to the improvement of Turkey's sovereign risk, and thus, enhance macroeconomic stability and the price stability. Maintaining fiscal discipline will also provide more room for monetary policy maneuver and support the social welfare by keeping interest rates permanently at low levels. I would like conclude my remarks by reiterating that implementation of the structural reforms envisaged by the MTP and the European Union accession process remains to be of the utmost importance.

Thank you for your attention.