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 July 2015 Inflation Report, Ankara, 30 July 2015.

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Accompanying charts can be found at the end of the speech.

Distinguished Guests,

Welcome to the briefing held to convey the main messages of the Inflation Report of July 2015.

The report typically summarizes the economic outlook underlying monetary policy decisions, shares our evaluations on macroeconomic developments and presents our medium-term inflation forecasts, which were revised in view of the developments in the last quarter, along with our monetary policy stance. In addition to the main text, the report includes six boxes entailing interesting and up-to-date analyses on various topics. These boxes in the Report look into the information content of credit in explaining inflation, scrutinize the taxation in the Turkish tobacco products market, analyze the export-inflation relationship in food products, examine the use of survey data in short-term GDP forecasts, elaborate on the effect of oil prices on exports, and present information on the government spending multiplier. The titles of the boxes are shown on the slide. All of these analyses shed light on noteworthy issues in the Turkish economy. I strongly recommend that you read these boxes, which will soon be published on our website.

I would like to commence my speech by reviewing the global economic outlook, given its undeniable influence on our policies. Global financial markets remained volatile in the second quarter of 2015, which was attributed to the continued divergence among global monetary policies, the uncertainty surrounding the Federal Reserve (Fed)'s normalization plans and developments regarding the Greek debt crisis. In this period, the volatility in long-term rates reached quite high levels, especially across advanced economies (Chart 1), which also affected emerging-market rates. Thus, portfolio flows to emerging-markets weakened (Chart 2). The global economic slowdown of 2014 continued into the first quarter of 2015 largely due to emerging economies. Despite signs of economic recovery in Europe, geopolitical tensions continued to restrain Turkey's external demand.

The volatility across global markets had implications for the Turkish economy as well, causing fluctuations in financial indicators amid domestic uncertainty. In this period of heightened volatility in long-term interest rates of advanced countries and added interest-rate sensitivity in emerging economies, the interest-rate corridor and the tight liquidity policy we have been implementing played a major role in shielding the economy against global shocks. Moreover, our structural and cyclical measures supporting FX liquidity, core liabilities and long-term borrowing strengthened the economy's resilience.

1. Monetary policy and financial conditions

In view of the uncertainty over global markets and the volatility in food and energy prices, we maintained a cautious monetary stance in the second quarter of 2015. In this period, we kept interest rates unchanged, but continued with the tight liquidity policy to contain risks to core inflation and inflation expectations. To meet the recently growing liquidity need, the weight of marginal funding was increased and, as a result, the CBRT average funding rate increased (Chart 3). The CBRT average funding rate has been hovering around 8.5 percent since mid-June (Chart 4). The BIST Interbank overnight rate, on the other hand, remained close to the upper bound of the corridor as in the previous reporting period.

Thanks to the cautious monetary stance, the yield curve remained nearly flat. Although the yield curve has remained basically unchanged since the publication of the previous Inflation Report, there was a slight increase in the market rates with more than two-year maturity (Chart 5). Thus, the spread between the overnight repo rates at the BIST Interbank Money Market and 5-year market rates has narrowed somewhat (Chart 6). I would like to reiterate that we will monitor inflation expectations, pricing behavior and other factors that affect inflation closely and maintain the cautious monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook in the upcoming period.

The wide interest rate corridor and the tight liquidity policy that we have been implementing reduce the economy's sensitivity to global shocks, thus supporting financial stability and facilitating the attainment of the price stability objective. In the post-crisis period, the unconventional policies of advanced economies and the ongoing uncertainties over global monetary policies caused long-term interest rates in these economies to fluctuate. In addition, emerging-market rates have become extremely sensitive to global monetary policy developments. To contain repercussions on the Turkish economy, we designed a monetary policy framework composed of a wide interest rate corridor and an active liquidity policy. The CBRT's wide interest rate corridor and the tight liquidity policy strengthened the resilience of the Turkish economy against global shocks and proved to be effective in pursuing the primary objective of price stability. The wide interest rate corridor enables us to raise short-term rates temporarily above long-term rates when faced with shocks and to keep the yield curve nearly flat or inverted. Accordingly, Turkish lira-denominated long-term rates remain more stable and the economy becomes less sensitive to global long-term interest rate shocks. Moreover, a flat or inverted yield curve constitutes an effective monetary policy stance that supports disinflation. In fact, especially following the strong monetary tightening of early 2014, we all saw that the sensitivity of domestic markets to global interest rates weakened substantially and core inflation indicators have improved significantly (Chart 7).

In the upcoming period, following the start of normalization of global monetary policies, volatility in long-term interest rates may decline permanently thanks to forward guidance policies. According to this baseline scenario, the need for a wide interest rate corridor in our country may diminish over time. In that case, we may simplify the operational framework of the CBRT's interest rate policy gradually.

In addition to the interest rate corridor and the tight liquidity policy, we continue to make efficient use of the policy tools developed in response to the global financial volatility. These measures we took with regard to the financial system are highly important in encouraging prudential borrowing and minimizing macrofinancial risks amid domestic and external uncertainty. The remuneration of Turkish lira required reserves at different rates depending on core liabilities was effective as of January 2015. As of the 8 May 2015 maintenance period, we raised the remuneration rate by 50 basis points. Additionally, the rise in FX required reserves ratios to extend the maturity of noncore liabilities appears to have contributed to the recent slowdown in the uptrend of the loan/deposit ratio (Chart 8). Furthermore, the decrease in the share of short-term non-deposit FX liabilities following changes in FX required reserves to stimulate long-term borrowing became more pronounced in the second quarter (Chart 9).

As another measure related to the FX liquidity, we have remunerated the USD denominated required reserves, reserve options and free reserves held at the CBRT as of 5 May 2015. We set and announce the remuneration rate to be applied on a daily basis by taking global and local financial market conditions into account. In addition, we reduced the annual commission rate of 0.02 basis points that had been applied since 1 February 2015 on euro-denominated accounts of banks and financing companies at the CBRT to a yearly 0.005 basis points as of 1 July 2015, and abolished it as of 27 July 2015 due to the recent developments in the euro area.

Thanks to the tight monetary policy stance and the macroprudential measures, loan growth continues to stay at reasonable levels. Adjusted for exchange rate changes, loans provided to the non-financial sector increased modestly by 18.1 percent year-on-year in the second quarter of 2015. A comparison of consumer and commercial loans shows that commercial loans continue to grow more at a higher rate than consumer loans, partly due to BRSA regulations. The annualized growth rate of commercial loans dropped to 15.1 percent at the end of the second quarter of 2015, whereas this rate was 21.6 percent for exchange rate-adjusted commercial loans. Likewise, comparing their growth trend to averages in past years, commercial loans are close to the average whereas consumer loans are significantly below the average (Charts 10 and 11). Due to the moderate economic activity and the recent tightening in financial conditions, loan growth is likely to slow somewhat in the forthcoming period.

2. Macroeconomic developments and main assumptions

Now, I will talk about the macroeconomic outlook and our assumptions on which our forecasts are based. First, I will summarize the recent inflation developments, and then continue with the domestic and foreign demand outlook upon which we based our projections.

In the second quarter of 2015, annual consumer inflation declined by about 0.4 points from end-first quarter to 7.20 percent, nearing the forecasts of the April Inflation Report (Charts 12 and 13). This improvement in inflation was mainly attributed to declining food inflation, while core inflation increased mostly due to exchange rate developments. In this period, the contribution of the food category to annual inflation was down to about 2.3 points amid a correction in food prices. Yet, the depreciation of the Turkish lira limited the decline in inflation.

The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). However, the lagged effects of the recent exchange rate developments delay the improvement in the inflation outlook. In fact, compared to the first quarter there was a notable deterioration in the underlying core inflation trend in the second quarter (Chart 14). This outlook was largely due to exchange rate-driven cost pressures that became stronger than that of the previous period. The cautious monetary stance and the moderate course of domestic demand continued to limit the spillover from cost pressures into prices.

As we projected in the April Inflation Report, food prices exhibited a remarkable correction amid the climatic conditions that accommodated supply in the second quarter. Annual food inflation, which makes up around 25 percent of the consumption basket, fell to 9.28 percent in June. Similarly, annual inflation in food and catering services posted a significant decline in this period. Also in this period, consumer inflation excluding food and catering services increased by 1 point to 5.82 percent in the inter-reporting period due to these cost pressures (Chart 15).

To sum up, food prices pulled inflation down in the second quarter, yet the depreciation in the Turkish lira restricted this decline, inhibiting the desired improvement in the inflation outlook. Owing to the expected partial recovery in food prices accompanied by the cautious monetary policy, we project the deterioration in the inflation outlook to remain limited and inflation to reach the target in the medium term.

According to the GDP data of the first quarter of 2015, economic activity proved more robust compared to the outlook presented in the April Inflation Report, and the GDP rose by 1.3 and 2.3 percent on a quarterly and annual basis, respectively (Chart 16). An analysis of national income components on the production side indicates that all sectors excluding construction exhibited increases in the first quarter compared to the previous-quarter averages. In this period, agriculture and net tax items regarding the GDP growth stood out, while industry and services maintained their mild trend of increase (Chart 17). Seasonally-adjusted data on the expenditures side reveal that final domestic demand increased owing to the rise in consumption expenditures in the first quarter. Investment expenditures contracted both in the public and the private sectors on a quarterly basis. According to the data on exports and imports of goods and services, exports posted an increase, but imports declined on a quarterly basis in the first quarter. Foreign trade data excluding gold indicate that the import quantity index posted a steady rise in line with the uptrend in domestic demand in this period, while exports declined amid the weak course of external demand.

Data on the second quarter of 2015 suggest that the economic activity continues to expand at a moderate pace. Industrial production rose by 1.0 percent in the April-May period compared to the previous quarter. Combined with the other indicators for June, we expect the industrial production to record a quarterly increase in the second quarter. Sales, production, and import indicators regarding domestic demand show that the final domestic demand will continue with an uptrend stemming from consumption demand. Investment indicators, on the other hand, signal that the weak outlook will remain in the second quarter. The export quantity index excluding gold increased at a modest rate in the April-May period following the contraction in the first quarter, while imports excluding gold maintained their uptrend suggesting that the contribution of external demand to economic growth may be limited in the second quarter (Chart 18).

The recovery in economic activity is projected to continue in the upcoming period, yet risks to growth exist. Downside risks regarding external demand persist due to geopolitical developments and troubles in Europe. Moreover, domestic uncertainties, the weak course of the confidence indices, and volatility in financial markets driven by global monetary policies may limit the contribution of final private demand to growth. Despite the existence of these factors keeping the downside risks alive, the robust employment performance following the global crisis along with low oil prices generate room for domestic demand and economic policies by improving the current account balance and the inflation outlook. In addition, the expected correction in the agricultural value added emerges as a factor that may support growth on the production side. Against this background, we project the second half of 2015 to witness a sustained moderate growth and demand conditions that support disinflation. In line with the favorable developments in the terms of trade coupled with the slowdown in consumer loans, the recovery trend in the current account balance is anticipated to continue in the upcoming period; yet the weak course of external demand may limit this recovery to some extent (Chart 19).

As you all know, food, energy and import prices also play a great role in inflation forecasts. Therefore, before moving on to forecasts, I will briefly talk about our assumptions regarding these variables.

In the second quarter of 2015, oil prices stood slightly above the path projected in the previous report, while USD-denominated import prices remained below projections (Chart 20). On an annual basis, we lowered average oil price assumption by 2 percent for 2015, and by around 6 percent for 2016. Accordingly, we revised assumptions for annual percentage changes in average import prices downwards by 1.7 points for 2015 and 1.4 points for 2016. Developments in food prices show that unprocessed food prices exhibited a notable correction in the second quarter of 2015 and the contribution of food prices to inflation witnessed a significant decline. Due to the projections that this correction will continue and the effects of measures taken by related institutions will materialize, we revised the food inflation assumption for end-2015 downwards from 9 percent to 8 percent.

Our medium-term projections are based on the assumption that tax adjustments and administered prices will not exceed inflation targets and be consistent with automatic pricing mechanisms. The medium-term fiscal policy stance is based on the Medium Term Program projections covering the 2015-2017 period. Accordingly, we assume that a cautious fiscal stance will be implemented and the primary expenditures to the GDP ratio will decrease gradually.

3. Inflation and the monetary policy outlook

Now, I would like to present our inflation and output gap forecasts based on the outlook I have described so far.

Our medium-term forecasts are based on a framework that a cautious monetary policy stance will be maintained by keeping the yield curve flat until there is a significant improvement in the inflation outlook. Moreover, we envisage that the annual loan growth rate will continue to hover around the recent reasonable levels in 2015, also thanks to the macroprudential measures. Accordingly, we expect inflation will be, with 70 percent probability, between 6.0 percent and 7.8 percent (with a mid-point of 6.9 percent) at end-2015 and between 3.7 percent and 7.3 percent (with a mid-point of 5.5 percent) at end-2016. We estimate that inflation will stabilize around 5 percent in the medium term (Chart 21).

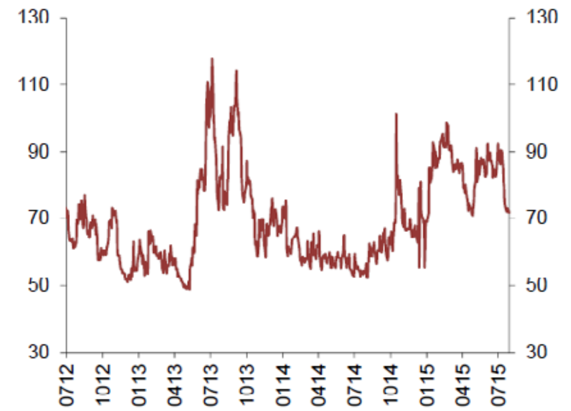
In the second quarter of 2015, exchange rate movements delayed the recovery in the core inflation trend, causing the year-end inflation forecast to be raised by 0.5 point. On the other hand, the improvement in import and food prices compared to the previous Report reduced the year-end inflation forecast by 0.1 point and 0.3 point, respectively. As a result, import and food prices are estimated to offset the adverse effects of core inflation figures in the second half of the year. Accordingly, we revised the end-2015 inflation forecast, which was set as 6.8 percent in the April Inflation report, upwards by 0.1 point. We kept the end-2016 inflation forecast, which was 5.5 percent in the previous report, unchanged. Considering that the downward revision in the average oil price assumption will pull down the end-2016 inflation by around 0.1 point, this effect will be compensated for by the effect coming from the rise in inflation forecast for end-2015, so we left the end-2016 inflation forecast intact (Chart 21).

We are of the opinion that base effects will continue to determine the course of inflation for the rest of 2015. Accordingly, we envisage inflation to decline until September, and increase slightly in September due to base effects. Then, following a fluctuating course, we project that it will reach 6.9 percent in the year-end.

In addition to these forecasts, we discuss alternative scenarios on the inflation outlook and the global economy in the Risks section of the Inflation Report. You can examine the Report for details.

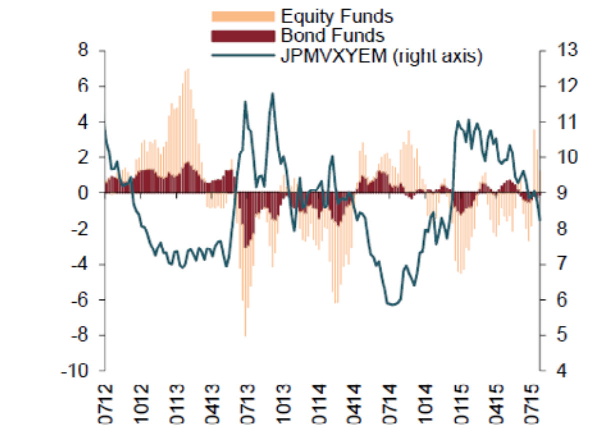
While concluding my remarks, I would like to thank all my colleagues who contributed to the Report, primarily those at the Research and Monetary Policy Department as well as the members of the Monetary Policy Committee, and thank every one of you for your participation.

Chart 1.
US Interest Rate Volatility (MOVE Index)
(Basis Points)



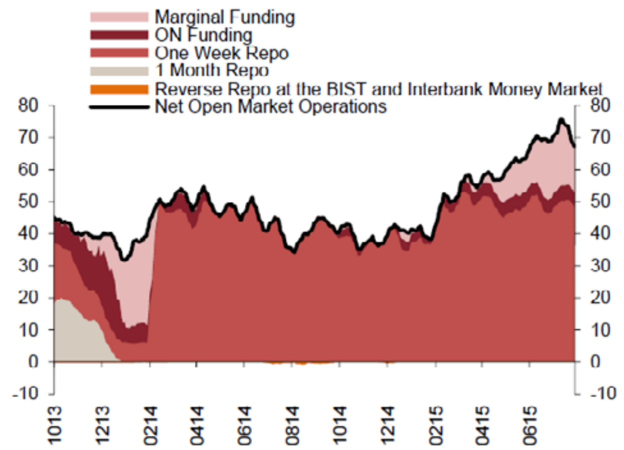
Source: Bloomberg.

Chart 2.
Emerging Market Fund Flows
(4 Week Moving Average, Billion US Dollar) and Volatility Index (JPMVXYEM) (Percent)



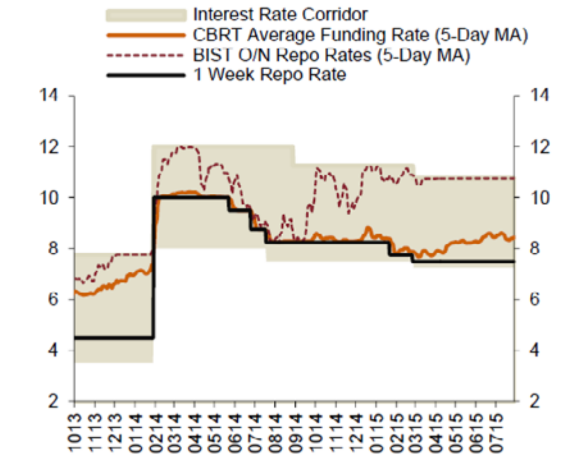
Source: EPFR, Bloomberg.

Chart 3.
CBRT Funding *
(2-Week Moving Average, Billion TL)



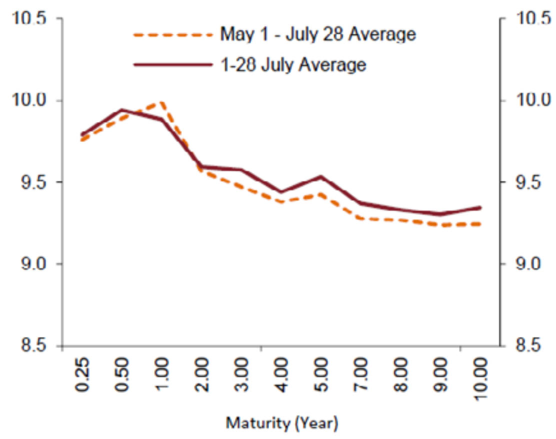
*Marginal funding is O/N funding
Source: BIST, CBRT.

Chart 4.
CBRT Rates and BIST Interbank O/N Rates
(Percent)



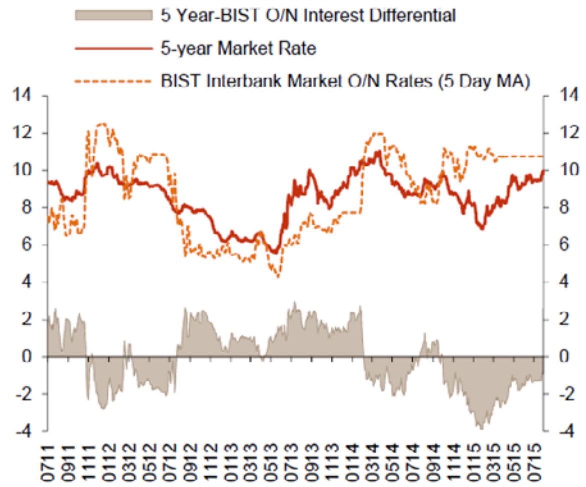
Source: BIST, CBRT.

Chart 5.
May 1 - July 28 Average Yield Curve
(Percent)



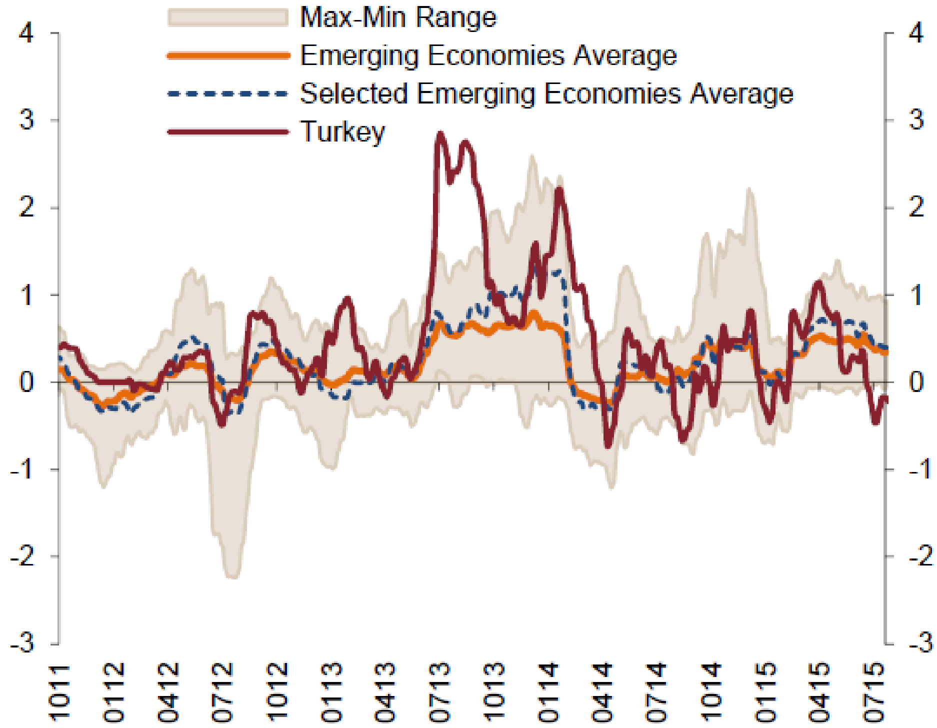
Source: Bloomberg,

Chart 6.
Market Rates
(Percent)



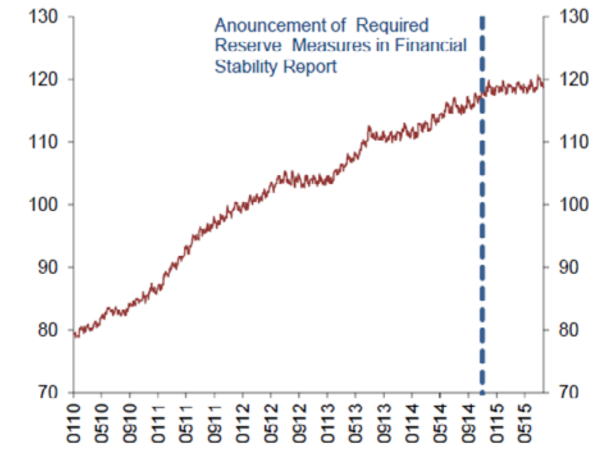
Source: Bloomberg CBRT.

Chart 7.
Regression Coefficient of EM 10-Year Interest Rate on US 10-Year Interest Rate (Weekly Changes, 60-Days Moving Window, 5 Day Moving Average)



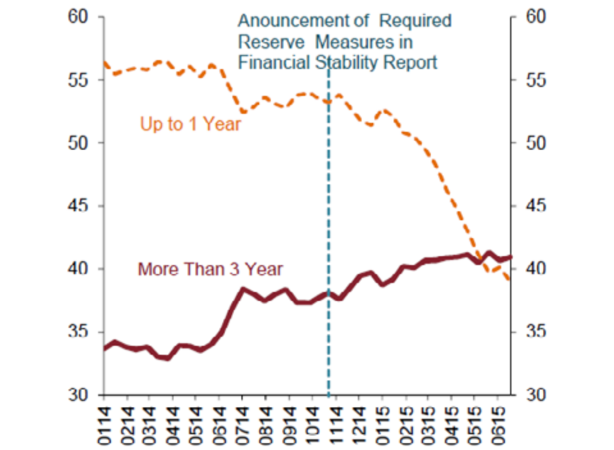
* EM Sample: Brazil, Chile, Hungary, Poland, Peru, S. Africa, Mexico, Malaysia, Columbia, China, South Korea, India, Israel, Romania, Indonesia, Czech R., Thailand and Philippines. Selected EM: Brazil, S. Africa, India, Indonesia. Regression: $\Delta EM10YearRate = \beta0 + \beta1 * \Delta USD10YearRate$.

Chart 8.
Credit/Deposit
(Percent)



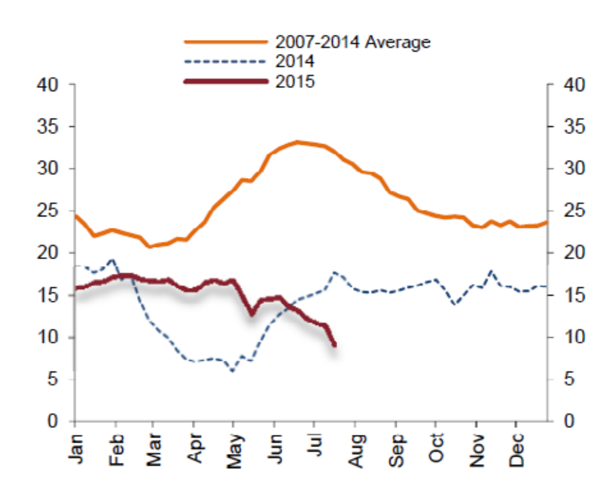
Source: CBRT.

Chart 9.
Maturities of Non-Deposit Liablities
(Percent)



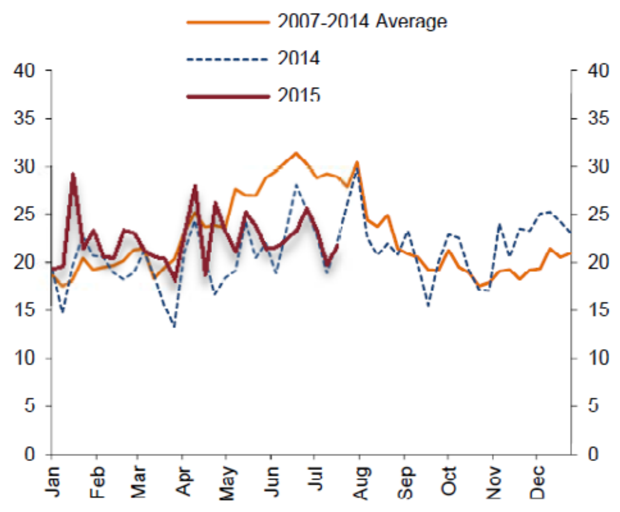
Source: CBRT.

Chart 10.
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)



Source: CBRT.

Chart 11.
Commercial Loan Growth (13-Week Moving Average, Adjusted for Exchange Rate,
Annualized, Percent)



Source: CBRT.

Chart 12.
April Inflation Forecasts and Realizations
(Percent)

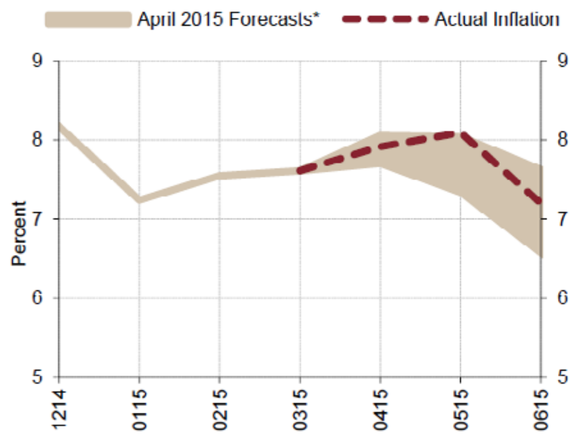
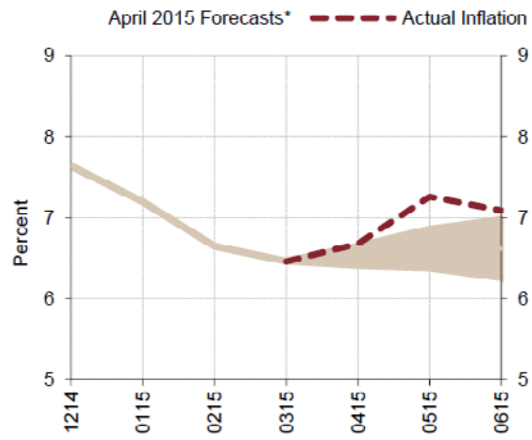
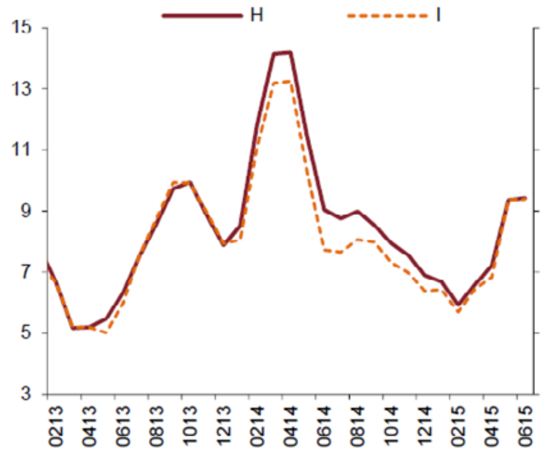


Chart 13.
April Inflation Forecasts and Realizations
Excluding Unprocessed Food and Tobacco (Percent)



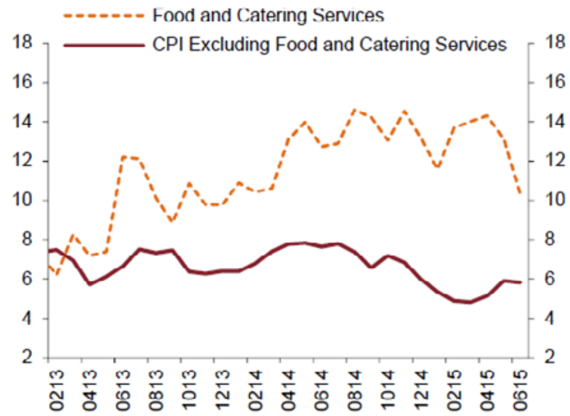
* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

Chart 14.
Core Inflation Indicators SCA-H and SCA-I (Seasonally Adjusted, Annualized 3 Month Average Percent Change)



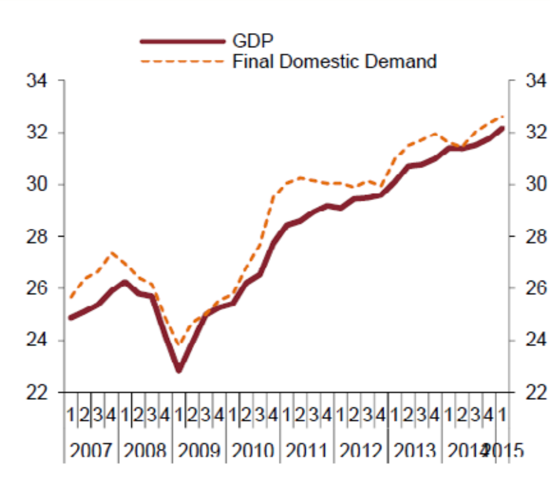
Source: TURKSTAT, CBRT.

Chart 15.
Food and Non-Food Prices
(Annual Percent Change)



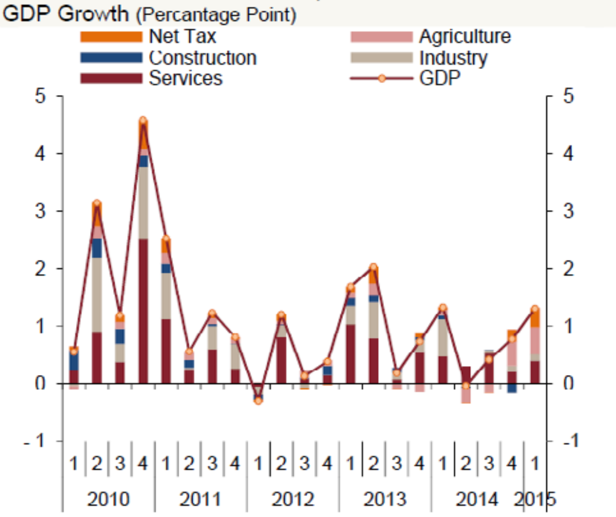
Source: TURKSTAT, CBRT.

Chart 16.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)



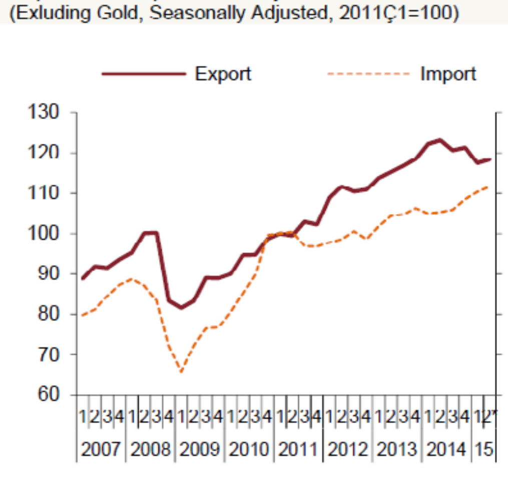
Source: TurkStat.

Chart 17.
Contribution of Production Components to Year-on-Year GDP Growth (Percantage Point)



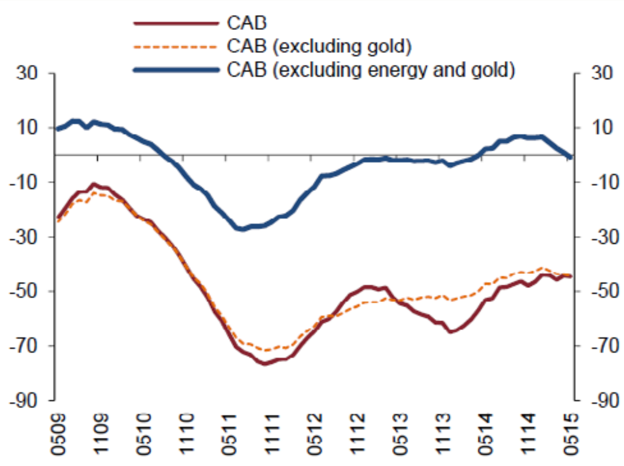
Source: TurkStat.

Chart 18.
Export and Import Quantity Indices
(Exluding Gold, Seasonally Adjusted, 2011Ç1=100)



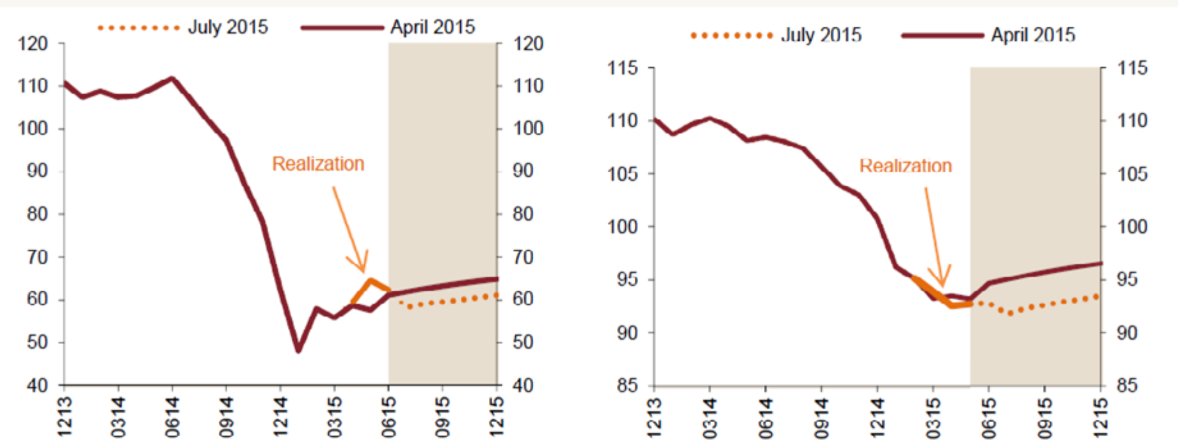
*April-May 2015
Source: TURKSTAT, CBRT.

Chart 19.
Current Account Balance (CAB)
(12-Month Cumulative, Billion USD)



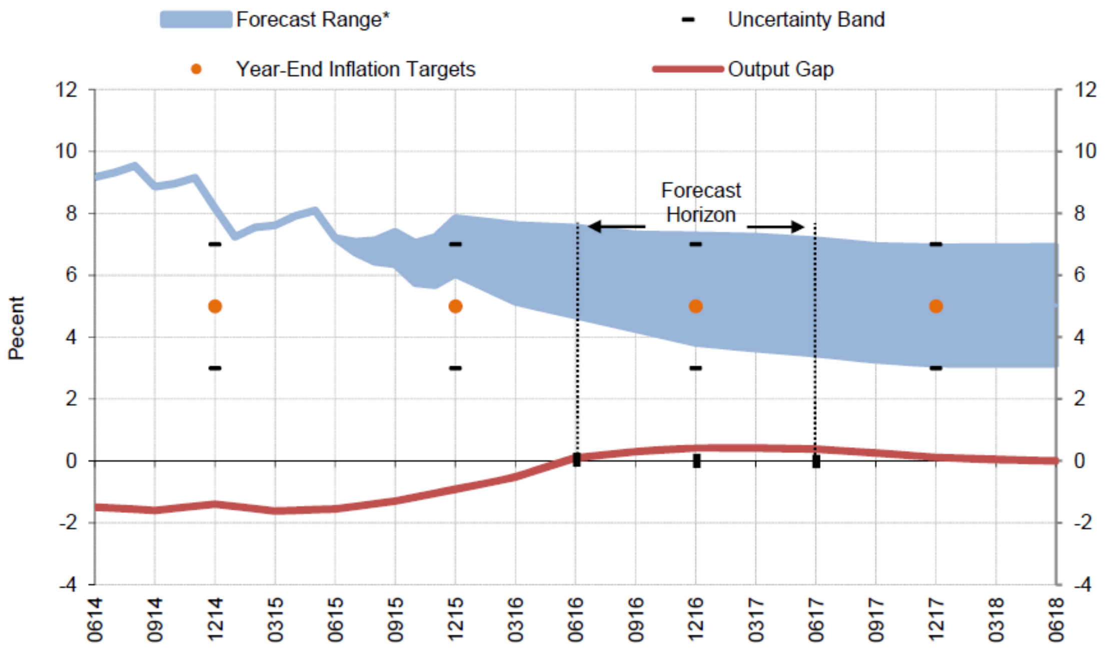
Source: CBRT.

Chart 20. Revisions to Oil and Import Price Assumptions



* Shaded area indicates the forecast horizon.
Source: Bloomberg, CBRT.

Chart 21.
Inflation and Output Gap Forecasts



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