TÜRKİYE CUMHURİYET MERKEZ BANKASI

BRIEFING ON APRIL 2016 INFLATION REPORT

Murat Çetinkaya

26 April 2016, İstanbul

Distinguished Guests,

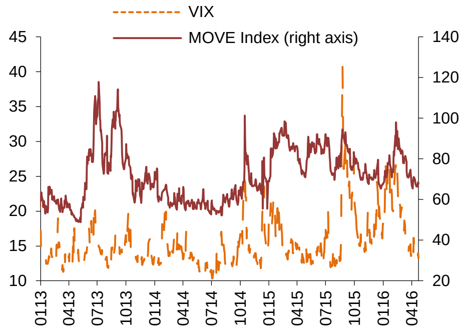
Welcome to the briefing held to convey the main messages of the Inflation Report of April 2016.

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. Moreover, at the end, I would like to talk about some evaluations regarding our approach towards price stability and the monetary policy.

In addition to the main text, the report includes five boxes entailing up-to-date and interesting analyses on various topics. There are boxes in this Report that analyze the factors affecting sovereign ratings of emerging and advanced economies, scrutinize the effect of Syrian immigrants on consumer prices, and look into the relationship between consumer loans excluding housing and the import of consumption goods. Moreover, the report also includes boxes that elaborate on the quality effect on house prices and analyze the effects of minimum wage hikes on retail loan utilization. The titles of the boxes are shown on the slide. All of these analyses shed light on noteworthy issues pertaining to the Turkish economy. I strongly recommend that you read these boxes, which will soon be published on our website.

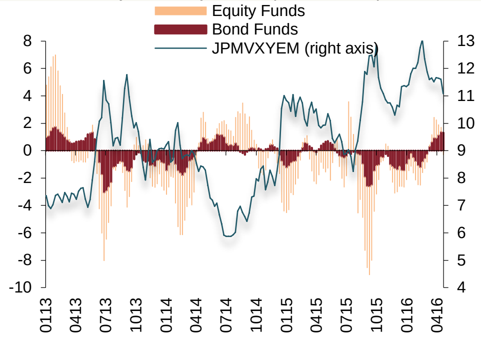
I would like to commence my speech by reviewing the global economic outlook, given its ongoing influence on our policies. Recently, decline in the global volatility has continued and global financial conditions have improved (Chart 1). The deceleration trend in global economic activity coupled with the ongoing low levels of inflation has led the central banks of advanced economies to continue with the accommodative policies. The US Federal Reserve (the Fed) stated that policy rate increases would be slower, while the European Central Bank (ECB) and the Bank of Japan announced new accommodative monetary policy measures. Moreover, uncertainties related to the Chinese economy have recently lessened. Against this background, financial conditions in emerging economies improved as well. Portfolio flows towards these countries posted a rebound, while risk premiums and market interest rates decreased and currencies saw an appreciation trend (Chart 2).

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



Source: Bloomberg.

Chart 2.
Portfolio Flows to Emerging Economies
(4-Week Moving Average, Billion USD)
and Currency Volatility Index (JPMVXYEM) (Percent)



Source: EPFR, Bloomberg.

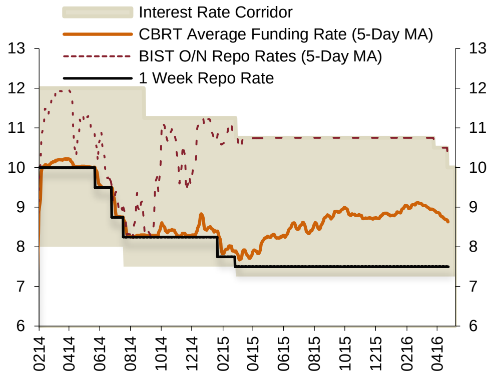
Favorable developments in global markets had positive reverberations on the Turkish economy as well. Moreover, the recently-released data disclose a sustained trend of recovery in macroeconomic indicators. Inflation saw a notable decline driven mostly by unprocessed food prices, while cumulative exchange rate effects eased, which led the core inflation trend to improve somewhat. The current account deficit continued to narrow in this period; and the recent data and leading indicators showed that economic activity displays a moderate and stable course of growth. Against these developments, the Central Bank of the Republic of Turkey (CBRT) maintained its policy stance, which is tight against the inflation outlook, stabilizing for the foreign exchange liquidity and supportive of financial stability. Meanwhile, steps were taken towards simplification of the monetary policy.

1. Monetary Policy and Financial Conditions

In the first quarter of 2016, the CBRT maintained the tight liquidity policy stance on account of inflation expectations, the pricing behavior and other factors affecting inflation. In addition to eased global volatilities, our effective use of policy tools mentioned in the road map released in August 2015 reduced the need for a wide interest rate corridor. Accordingly, we decided to take moderate steps towards simplification by reducing the marginal funding rate by 25 basis points in March and 50 basis points in April. We kept the one-week repo auction rate and the overnight borrowing rate unchanged at 7.5 and 7.25 percent, respectively (Chart 3).

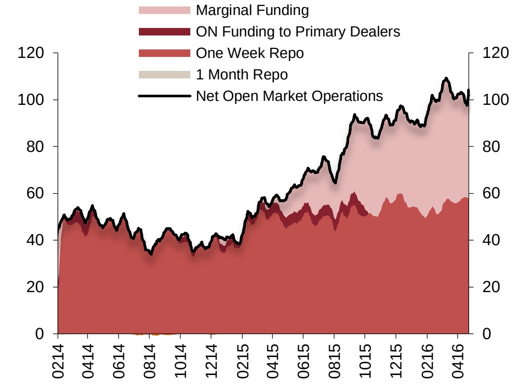
One-week repo auctions continued to be the main tool for the CBRT funding, while the share of the marginal funding remained high (Chart 4). The weighted average funding rate, which hit 9.1 percent in February 2016, receded to approximately 8.6 percent in April. Interbank overnight repo rates recorded a decline parallel to the reduction of a total 75 basis points in the upper band of the interest rate corridor. I would like to underline that in the upcoming period, the monetary policy stance will remain dependent on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, the CBRT will maintain the tight monetary policy stance as long as deemed necessary.

Chart 3.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



Source: BIST, CBRT.

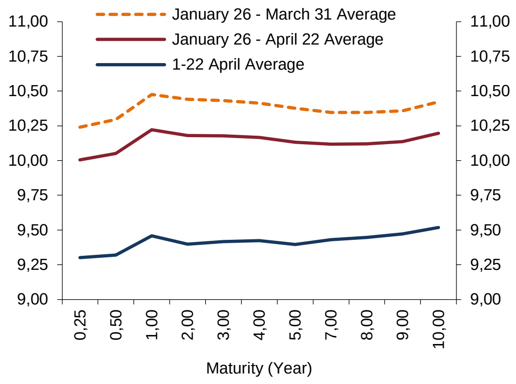
Chart 4.
CBRT Funding*
(2-Week Moving Average, Billion TL)



*Marginal funding is O/N funding quoted at the upper limit of the corridor.
Source: CBRT.

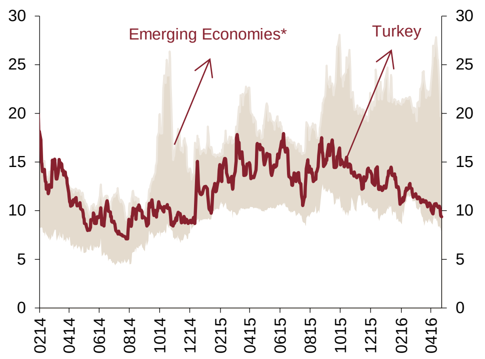
The yield curve has recently shifted downwards in all maturities (Chart 5). This was led by the sustained accommodative policy stances of the central banks of advanced economies, the strengthened perception that interest rates in these economies will remain low for a long period, waning global uncertainties and improvement in global financial conditions as global factors. The favorable course of macroeconomic indicators in Turkey, the fall in market-based and survey-based inflation expectations and reductions in the marginal funding rate also contributed to this development. The slope of the yield curve remained almost flat in this period.

Chart 5.
Yield Curve Between January 26 – April 22, 2016
(Percent)



Source: Bloomberg

Chart 6.
Implied FX Volatility
(1-month, Percent)

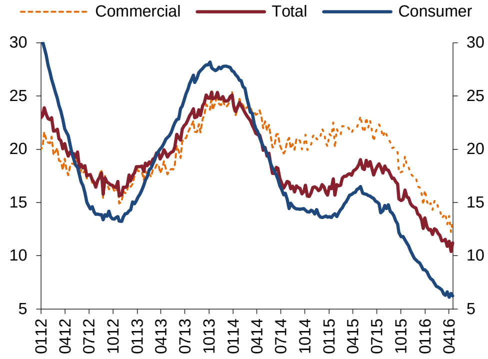


*Emerging economies include Brazil, Chile, Czech Republic, Hungary, India, Mexico, Poland, South Africa, Indonesia, Romania and Colombia.
Source: Bloomberg

It is important to contain negative spillovers of global developments into the Turkish economy. In terms of the fundamentals of the economy, we witnessed noteworthy developments that have reduced economic fragilities in recent years. Particularly, the monetary policy coupled with the macroprudential measures in effect offer significant contributions to the balancing of the economy. We are of the opinion that the maintenance of the fiscal discipline also stood among the main factors enhancing the resilience of the economy in this period. Moreover, the effective implementation of the measures laid out in the August road map alleviated the excessive fluctuations in exchange rates and loan rates (Chart 6). Our current tight monetary policy stance reduces the economy's sensitivity to global shocks, thus supporting financial stability. The CBRT may implement the monetary policy within a narrower interest rate corridor, should the global volatility decline persistently or policy measures to maintain and improve the gains in external balance and financial stability be implemented effectively. Given these factors, I would like to state that additional simplification steps may be taken in the upcoming period, should eligible circumstances occur.

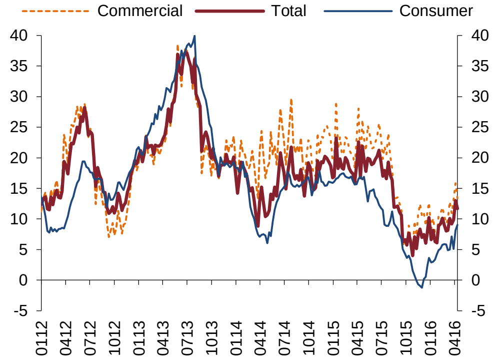
The annual growth rate of loans extended to the non-financial sector, which decelerated partly due to our tight monetary policy stance and the macroprudential measures introduced by the BRSA regarding consumer loans excluding mortgages, fell to 10.9 percent in the first quarter of 2016 (Chart 7). In this period, commercial loans continued to grow at a higher rate than consumer loans as they have since the start of 2014. These developments in loan growth and composition not only contribute to the rebalancing process and financial stability, but also limit the cost-side pressures on inflation. The annualized growth rates in 13-week averages show that both consumer and commercial loans have displayed a trend of rebound since early 2016 (Chart 8). The adjustments made to the risk weights of consumer loans, wage developments and improvement in financial conditions can support the credit growth in the upcoming period. However, owing to the tight monetary policy stance and macroprudential policy framework, annual loan growth rates are expected to remain at reasonable levels in the months to come.

Chart 7.
Annual Credit Growth Rates
(Adjusted for Exchange Rate, Percent)



Source: CBRT.

Chart 8.
Annualized Credit Growth Rates (Adjusted for Exchange Rate, 13-Week Moving Average, Percent)



Source: CBRT.

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 first quarter of 2016, consumer inflation fell by 1.35 points quarter-on-quarter to 7.46 percent, and stood below the January Inflation Report forecasts (Chart 9). The higher-than-expected fall in annual inflation was mainly driven by unprocessed food prices. In fact, inflation excluding unprocessed food and tobacco was consistent with the January Inflation Report forecast (Chart 10). In this period, effects of the cumulative depreciation in the Turkish lira on annual inflation continued to diminish and import prices remained low, leading to a limited decline in annual inflation in core goods and energy groups. On the other hand, adjustments to administered prices, high levels of inflation expectations and wage developments limited the fall in inflation.

Chart 9.
January Inflation Forecasts and Realizations
(Percent)

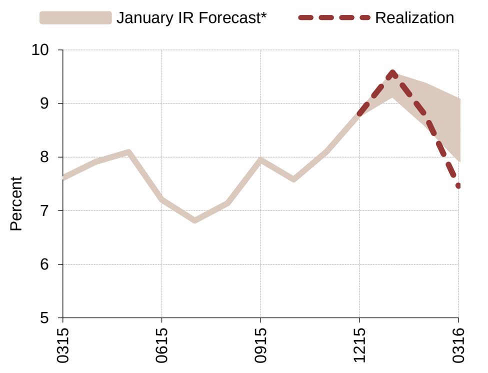
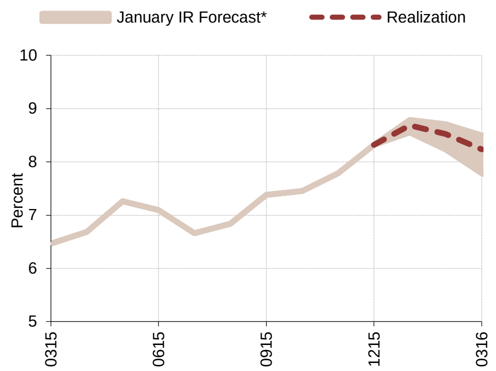


Chart 10.
January Inflation Forecasts and Realizations
Excluding Unprocessed Food and Tobacco
(Percent)

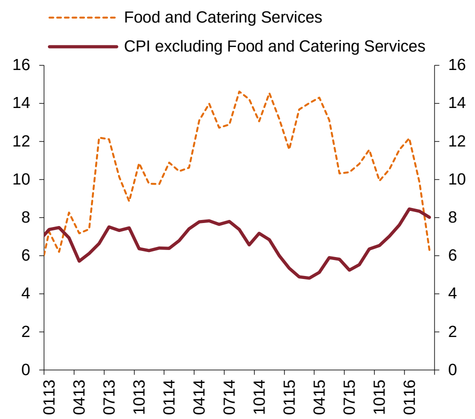


* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

Mild climatic conditions in the first quarter increased the supply of fresh fruits and vegetables, which pulled unprocessed food prices down remarkably. Unprocessed food products excluding fresh fruits and vegetables were also effective in this decline. This is also attributed to the measures taken regarding certain products, chiefly red meat. As a result, plummeting to 6.31 percent in the first quarter amid the sharp decrease in food inflation, annual inflation in the food and catering services group stood below the consumer inflation excluding food and catering services after three years (Chart 11).

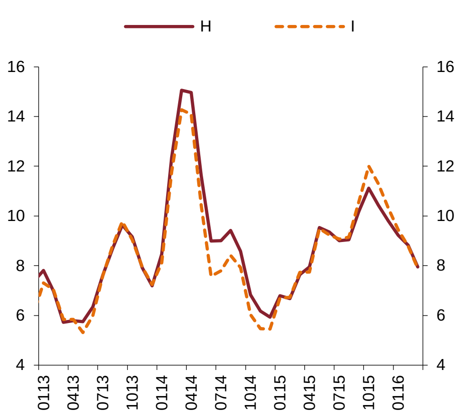
Due to the waning cumulative exchange rate effects in the first quarter, the core goods inflation trend exhibited a significant improvement. In the same period, the trend of services inflation continued its high course due to the increases in items sensitive to the exchange rate accompanied by wage developments and the rigidity caused by high levels of the headline inflation. Accordingly, the underlying trends of core inflation indicators witnessed a notable slowdown driven by the core goods group (Chart 12). In sum, improvement in food inflation coupled with the favorable course of import prices led to a marked decrease in the consumer inflation in the first quarter. However, due to the cumulative exchange rate effects and particularly the rigidities in the services inflation, the desired improvement in core indicators is yet to be seen.

Chart 11.
Food and Non-Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

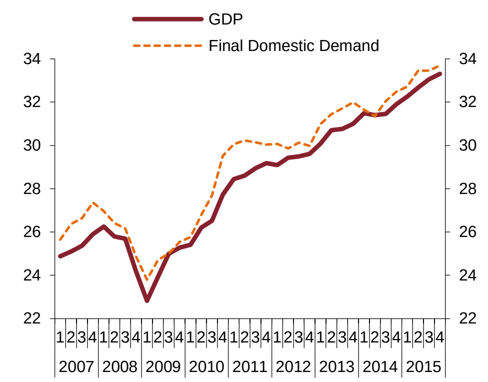
Chart 12.
Core Inflation Indicators H and I
(Seasonally Adjusted, Annualized 3 Month Average, Annual Percentage Change)



Source: TURKSTAT, CBRT.

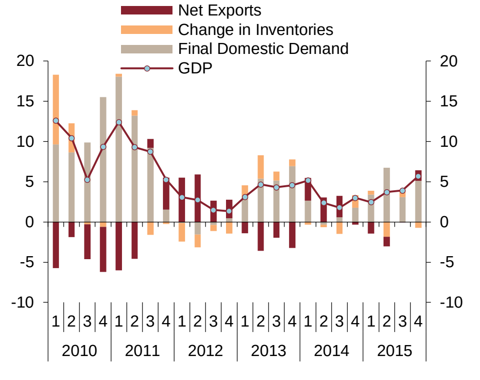
According to the GDP data of the fourth quarter of 2015, economic activity was in line with the outlook presented in the January Inflation Report, and the GDP grew by 0.7 and 5.7 percent in quarterly and annual terms, respectively (Chart 13). Thus, growth stood at 4.0 percent in 2015. On the spending front, final domestic demand was the main driver of growth in the last quarter, and net exports contributed positively to the GDP growth after a four-quarter break (Chart 14).

Chart 13.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)



Source: TURKSTAT.

Chart 14.
Contribution of Demand Components to Year-on-Year GDP Growth (Percentage Points)



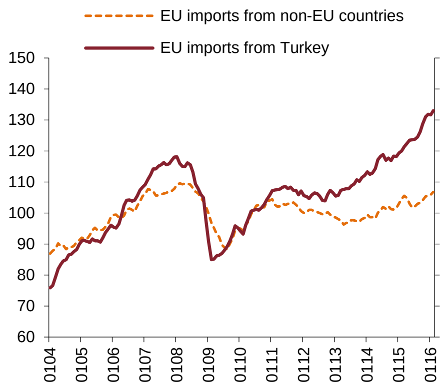
Source: TURKSTAT.

Data on the first quarter of 2016 indicate that the mild and steady increase in economic activity continues. Industrial production saw successive monthly increases in the December-February period. Thus, production stood 1.6 percent above the figures of the previous quarter in the January-February period. The first-quarter data disclose contributions to growth offered by both domestic and external demand.

Based on the demand outlook for 2016, economic activity is expected to be stronger than that of 2015. Owing to the strong employment performance following the global crisis and the raise in the minimum wage in early 2016, we expect that the income channel will support domestic demand. Amid waning domestic uncertainties compared to 2015, rising consumer and investor confidence may boost domestic demand. Sustained easing in global volatilities and the improvement in global financial conditions has a favorable effect on domestic financial conditions. Against this background, income and confidence channels and financial conditions are likely to support domestic demand in the upcoming period. Downside risks to exports of services have recently grown amid persisting risks to external demand due to geopolitical developments and languishing global growth. Rising demand from the EU, on the other hand, continues to support our exports at a stronger pace (Chart 15).

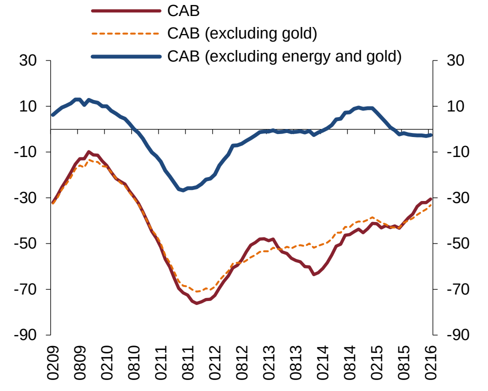
Overall, we expect domestic demand to be somewhat stronger in 2016 relative to 2015 while, despite geopolitical risks, external demand recovers on the back of rising EU demand. We anticipate that the current account deficit will narrow further thanks to ongoing macroprudential policy measures and favorable developments in the terms of trade (Chart 16). A narrower current account deficit and strong public finances provide room for policy responses against possible shocks.

Chart 15.
Imports by EU
(Real, Seasonally Adjusted, 3-Month Average 2010=100)



Source: Eurostat.

Chart 16.
Current Account Balance (CAB)
(12-Month Cumulative, Billion USD)

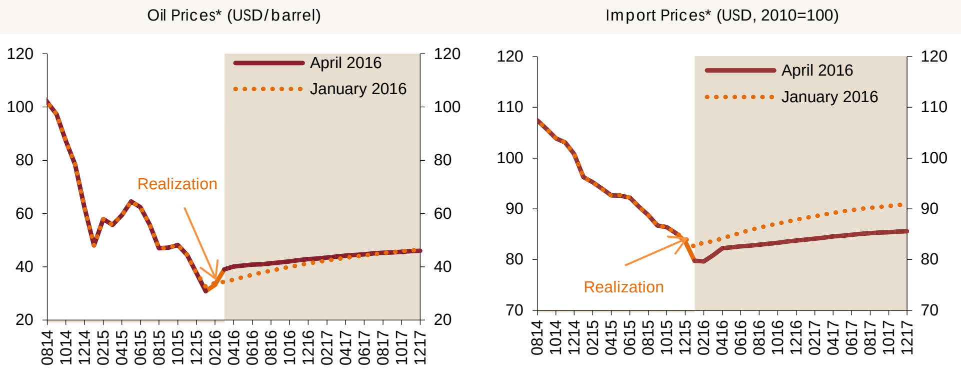


Source: CBRT.

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.

Oil prices edged up in the inter-reporting period, whereas the downtrend in international commodity prices continued into the first quarter of 2016. Thus, compared to January, we revised our assumptions for crude oil prices up and those for USD import prices down (Chart 17). With regard to annual averages, we increased our crude oil price assumption from 37 to 40 USD for 2016. We saw a marked decline in food inflation due to unprocessed food prices in the first quarter. We expect this fall to continue in the short term. However, given the high volatility in unprocessed food prices, we kept our assumption for food price inflation unchanged at 9 percent for 2016 and at 8 percent for 2017.

Chart 17. Revisions in Oil and Export Prices*



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

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

Our medium-term forecasts are based on an outlook that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. Our medium-term fiscal policy stance depends on the MTP projections covering the 2016-2018 period. We are closely monitoring the effects of the minimum wage rise at the beginning of 2016 on producer costs, aggregate demand and inflation.

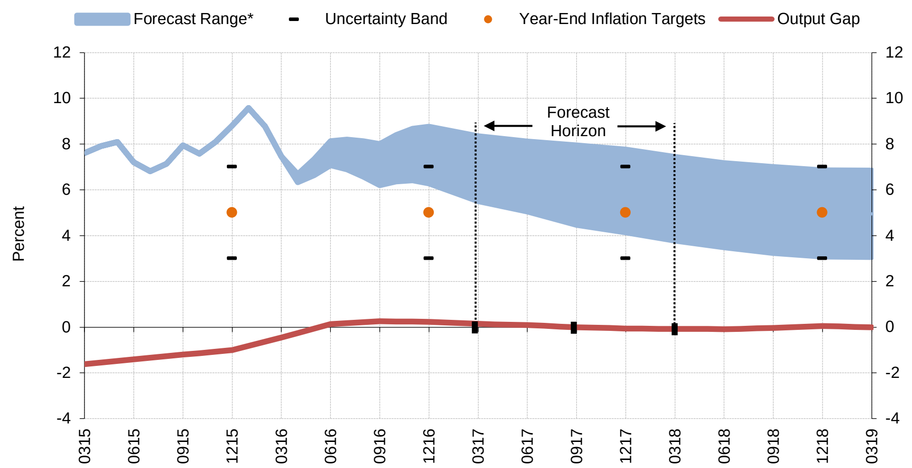
3. Inflation and Monetary Policy Outlook

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

In view of the above economic conditions, our policy stance and our assumptions, we left our inflation forecasts for the upcoming period unchanged from the previous report. Given a decisive policy stance that focuses on reducing inflation, we expect to achieve the 5-percent target gradually; we estimate inflation to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. Accordingly, we expect inflation to be, with 70 percent probability, between 6.3 percent and 8.7 percent (with a mid-point of 7.5 percent) at end- 2016 and between 4.2 percent and 7.8 percent (with a mid-point of 6 percent) at end-2017 (Chart 18).

Chart 18.

Inflation and Output Gap Forecasts



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

The Turkish lira maintained a steady pattern following the January Inflation Report, while oil prices inched up and import prices edged down. Accordingly, the impact of TL import prices was not significant enough to lead to any change in inflation forecasts. We expect food prices to drive consumer inflation down further in the short term. We predict that inflation will then rise amid base effects and remain volatile in the second half of 2016 before ending the year at 7.5 percent. Given the high volatility in food prices, assumptions for food inflation are preserved, yet it should be noted that there still remain downside risks posed by this group to the year-end inflation forecast.

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 read the Report for details.

Distinguished Guests,

Before concluding my first press conference as the Governor, I would like to share some thoughts regarding the forthcoming period.

Price stability will remain the main target for the Central Bank in the upcoming period. Long-lasting price stability enhances predictability in the economy, which boosts growth, investments and employment. Raising awareness about the importance of price stability for economic stability and about its benefits for all economic agents will be one of our priorities.

Despite many exogenous shocks in the previous periods, inflation was successfully kept at single-digit levels. However, price stability is yet to be fully achieved in Turkey.

Ten years of experience with inflation targeting has shown that the fight against inflation requires collaboration from all relevant parties.

Structural factors play a major role in the volatile course and above-target level of inflation. A deeper understanding of these factors and building a holistic approach to fight inflation will help to achieve the goal of long-lasting price stability. To this end, staying in close contact with the relevant parties, the Central Bank will embrace an outcome-oriented strategy in detecting price stability-related structural issues and developing solutions.

We group structural factors under two headings: first, those having a direct adverse impact on price stability through causing additional inertia and volatility in inflation; and second, those limiting the efficiency of monetary policy. Factors such as prices of agricultural products, competitiveness, the depth of financial markets, dollarization, the interaction between fiscal policy and monetary policy, the savings deficit and the macroprudential framework are all included in this context.

We are willing to work on these issues in detail and fight with inflation also on the structural front by raising public awareness and acting in coordination with relevant parties. We hold the view that this approach is likely to offer great contributions to achieve permanent price stability.

The recent efforts undertaken with the Food and Agricultural Products Markets Monitoring and Evaluation Committee constitute concrete and valuable examples of this. Advancing and extending such efforts are of great importance.

These endeavors are based on “the duty of acting as the economic advisor and the fiscal agent of the Government” as identified in the Law of the Central Bank.

We will favor a simpler and more foreseeable monetary policy in the new period. Our final goal is to achieve a system entailing a clearer and more foreseeable monetary policy stance.

We will take steps under a holistic approach that also considers macroeconomic factors and their interactions with the monetary policy in the upcoming period. As usual, we will strive to grasp the financial and corporate sector better in consideration of existing conditions as well as expectations of the future. We will be in an attempt to advance our previous efforts. Our final goal will be achieving price stability, reinforcing economic stability and reducing trade-offs.

While concluding my remarks, I hope that our efforts will serve the best interests of our country in this new period. 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.