

# Macronote

## Inflation report: Growth concern likely to prevent additional tightening

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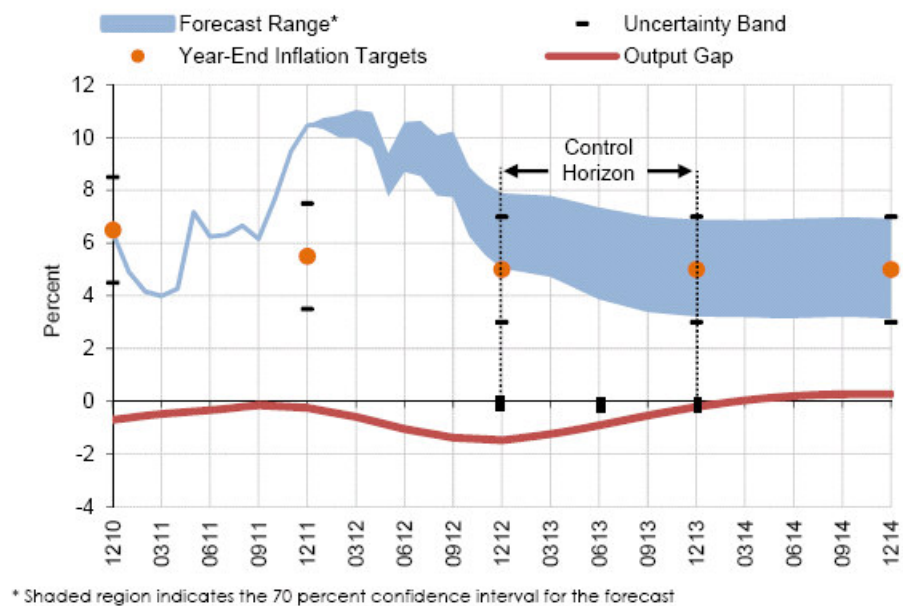
The CBRT introduced the first inflation report of the year today at a conference in Istanbul attended by the press and economists. The main messages of the report were: 1) The Bank's tight monetary stance should be maintained for a while in order to keep the inflation outlook consistent with medium-term targets, 2) Global economic uncertainties necessitate the continuation of flexible monetary policy with multiple instruments 3) Growth concern will likely prevent additional tightening should the lira outlook permit.

**CBRT revised up its inflation forecast for 2012 due to higher inflation in the beginning of the year as this will limit positive effects to help reach the target by year-end.** The Central Bank envisages annual inflation to end 2012 at 6.5% (within 5.1-7.9% range with a 70% probability), up from 5.2% in October's report. On the other hand, the CBRT forecasts 5.1% annual inflation for end-2013, and stabilization around 5% thereafter.

The Bank increased its oil price assumption for Brent crude to \$110 per barrel for 2012, and to \$105 for 2013 from \$100 in the final inflation report of 2011. Annual food price inflation has been maintained at 7.5% through the forecast horizon. Meanwhile, the Bank estimates that due to weaker external demand compared to previous report and further deceleration in economic activity in early 2012, aggregate demand conditions will provide stronger support for disinflation in the medium-term. Other than these, the continuation of the tight monetary stance for a while, annualized loan growth rate of 15% (FX-adjusted) and mild depreciation trend in the lira are other assumptions of the report. According to Governor Erdem Basci, the CBRT's exchange rate assumption is around today's level (basket: TRY 2.06). Basci added that we may see the positive effects on inflation if the lira appreciates further.

**CBRT provided an elevated inflation path compared to previous statements** The Bank envisages that inflation will remain flat in the first quarter and be on a gradual downtrend starting from the second quarter, which will bring inflation to 6.5% by year-end. This decline will accelerate in the last quarter due to base effects according to the bank. However, according to the graph below, which shows the Bank's inflation projections, annual inflation will hover around 9% during the first three quarters, which is in line with our projections and compares unfavorably with the path provided by the CBRT before, which envisaged a sharper drop in inflation starting in May. The CBRT will not react to volatility in food and energy prices due to hard winter conditions and potential supply problems, respectively. However, Basci said that deterioration in pricing behavior will not be permitted. According to the same graph, the output gap will continue until the first quarter of 2014.

Graph 1: CBRT's inflation and output gap forecasts



Source: CBRT

**No need for additional tightening for now** Governor Basci argued that monetary policy is currently tight as the average funding cost through repo funding (currently around 7.5%) is notably above 5.75% (one-week repo rate). Credit growth and movements in the lira are the two main factors for deciding the funding cost from the Bank, according to Basci, as these factors are respective signals for price and financial stability. The Bank sees no risk for price stability and financial stability as the depreciation pressure on the lira evaporated and credit growth trend (FX-adjusted, 13-week MA annualized) imply no need for additional monetary tightening. If the situation in one of them reverses, then we may see additional tightening, according to Basci.

In this report, the Bank continued to give precedence to price stability over financial stability, and depicted financial stability as a supplementary objective. According to Basci, the situation is different compared to end-2010 when inflation was below the target and the CBRT gave priority to financial stability.

**CBRT seems concerned over the growth outlook** The CBRT argues that bringing inflation to the 5% year-end target would cause unfavorable fluctuations in economic activity as it would necessitate undesirable monetary tightening. Therefore, inflation will decline to the target by mid-2013, and we interpret this as the CBRT signaling that it will not tighten monetary policy in the second half of the year if the lira outlook permits, which is in line with our expectations. In other words, the Bank will likely support growth in the second half of the year and permit inflation to overshoot its 5% target.

**The Bank leaves reaching target to excess appreciation of the lira** According to the CBRT, the target might be attained by the end of 2012, should the risk appetite improve markedly and capital flows lead to stronger appreciation of the lira than assumed. Basci stated that they would prefer inflation to approach the target due to the appreciation of the lira instead of additional tightening. However, at this point, we are not sure that the CBRT will permit a strong appreciation of the lira as the CAD will remain at elevated levels and excess appreciation may cause the erosion of

the lira's competitiveness. In fact, Basci made no comments on the possible monetary policy moves against a potential quantitative easing by the Fed in the Q&A session.

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