
Turkish Annual Inflation in 2007 Rate Doubles Target Improves Upon 2006 Level

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In December 2007, consumer prices grew only 0.22% month-on-month, facilitating the deceleration of annual inflation from 9.65% in 2006 as a whole to 8.39% in 2007 as a whole.

Price Growth

In December 2007, consumer price inflation came in below expectations, at 0.22% month-on-month (m/m). Overall consumer prices at the end of last year were boosted by a 1.46% m/m gain in communication prices and a 0.97% m/m increase in housing and utility prices. The latter category of prices continued to be negatively affected by a November upward shift in administratively controlled water prices. On the other hand, prices fell on clothing and footwear (down 1.25% m/m) and on transport goods and services (down 0.08% m/m), helping to offset the upward impetus elsewhere on overall consumer price inflation. The fall in clothing prices was seasonal in nature while transport prices edged downward as part of a correction after they surged in November due to the implementation of new consumption taxes on fuel.

Global Insight Perspective

Significance December monthly inflation came in below expectations, allowing the annual inflation rate to plateau as compared to November, ending 2007 at 8.39%. Although up from its earlier nadir, annual inflation nonetheless bested its 2006 level by more than a percentage point.

Implications End-year 2007 inflation was more than double the official target. Nonetheless, the central bank remains optimistic regarding the downward trend of inflation. As such, we anticipate that the Bank will continue to roll back interest rates. Outlook Upward changes in administrative prices that were initiated on 1 January 2008 will undoubtedly trigger a further acceleration of annual inflation in the first month or two of the year. However, throughout most of the year, we anticipate that annual inflation will slowly ease, falling to at or slightly above 6% by the end of 2008.

The lower-than-expected rise in consumer prices in December allowed end-year annual inflation to plateau at 8.39% instead of pushing up further from the November 12-month trailing rate, as had been anticipated. Nevertheless, annual inflation for 2007 was more than double the 4% target rate set by the Central Bank of the Republic of Turkey (CBRT). The annual inflation rate was also well up from its 2007 nadir of 6.90% in July, but was still below the previous year's end-year rate of 9.65%. Prices grew most vigorously over the course of 2007 on alcohol and tobacco (up 17.20%), the result of higher tax rates and other regulated prices. However, the greatest negative impact on overall consumer prices in 2007 was the 12.03% increase in food and non-alcoholic beverage prices. Accounting for 28.47% of the total consumer price index basket, poor agricultural conditions triggered a sharp rise in food prices across the region over the course of last year. The average rate of overall consumer price growth for 2007 was 8.76%, down from 9.60% in 2006. Average annual inflation hit a three-year peak of 10.30% in April and then slowly subsided over the remainder of 2007.

While annual consumer price inflation remained elevated in 2007, annual producer price inflation subsided much more substantially. After pushing to 11.58% as of the end of 2006, the annual rate of producer price growth decelerated to 5.94% by the end of 2007. However, producer price inflation had actually been much lower earlier in 2007, as low as 2.08% in July, but rising global energy prices in the final months of the year sent the annual rate of producer price inflation steadily upwards. Similar to the impact on consumer price inflation, global agricultural commodity prices negatively affected annual producer price inflation, with producer prices on agricultural goods and services having soared 15.70% over the course of 2007, accounting for 18.17% of the total producer price inflation basket.

The Central Bank

The CBRT has maintained its 4% end-year consumer price inflation target for 2008, even as the target seems overly optimistic given the state of global energy and food prices. The uncertainty band was maintained at two percentage points in either direction, the same as it was for 2007. The CBRT has retained the same target and uncertainty band as it had in 2007 and will keep until 2010 at the least, stating that it would only alter the target for what it would see as "sharp and long-term deviations" from the deceleration trend of inflation. The CBRT estimates that nearly half of the consumer price inflation basket comprises energy, food and administratively controlled prices. Given that the bank has little control over these prices, it focuses on the deceleration trend of all the rest of the consumer prices.

With the CBRT comfortable that the long-term trend of inflation in Turkey is decelerating, we anticipate that the Bank will continue to slowly reduce interest rates throughout 2008. Over the course of this year, Global Insight projects that the headline overnight borrowing rate will be reduced by 225 basis points. The recent aggressiveness with which interest rates have been reduced in recent months (down by 50 basis points at each regular Monetary Policy Committee meeting in October, November, and December) may be tempered in the first months of 2008, given the expected re-acceleration of headline consumer price inflation in January due to new tax and administrative price hikes implemented at the first of the year. However, the CBRT may still actually reduce interest rates even in the face of higher inflation, again re-emphasising the Bank's overall message that the increases in prices on goods and services not negatively affected by external factors are contained.

Outlook and Implications

As mentioned, annual consumer price inflation will almost certainly push upwards quite sharply in January 2008. At the beginning of the year, the government implemented new, higher prices on electricity, natural gas, gasoline (petrol), and some public transport. Energy prices will have the strongest impact, with natural gas prices up by 7.4% and 6.5% for household and industrial usage, respectively, and electricity prices up 15% and 10% for household and industrial usage, respectively. Offsetting these large price hikes somewhat is the implementation of lower value-added tax rates (from 18% to 8%) on some food and drinks that also went into effect on 1 January 2008. Even given the changes to the VAT rates, the net impact on prices of all of these changes taken together will be extremely inflationary. Exacerbating the situation, global oil prices reached \$100US a barrel at the beginning of the month, an acceleration that will surely pass through in Turkish prices. Annual inflation is expected to push above 9% in January, and slowly cool throughout the rest of 2008, ending the year at around 6%, at or above the upper edge of the CBRT's inflation target uncertainty band.

However, as discussed previously, the CBRT is expected to continue to roll back interest rates in spite of the early-year inflationary problems. All of the factors that will fuel consumer price growth in early 2008 will be seen

as external, with the CBRT continuing to view domestic price growth trending downward. Moreover, the CBRT will be under extreme pressure to help buoy economic growth. The government set a growth target rate of 5.5%, a level that may be difficult to achieve given the state of the global financial markets. Without a more expansionary monetary policy, there may not be enough capital to finance the targeted growth rate.
