MACRO BRIEF

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Taming of the Shrew (the Market, that is)

February inflation was particularly crucial as aggressive Central Bank (CBRT) policy rate cuts would either be vindicated or be subject to continuing intellectual attacks by those who had deemed previous cuts to be overaggressive/ overambitious/ ignorant of global and local environments. We had argued in contrast to this view and in defense of the CBRT, opining that the Bank was tactfully taking advantage of dire growth outlooks at home and abroad and other indicators all of which provide the proper incentive scheme for an easing policy of this sort. We had tried to elucidate in our Weekly publications that the Bank would indeed prefer to present its new mode of operation as a paradigm switch rather than an opportunistic move aiming at reducing interest rates as much as expectations and conditions allowed.

The Bank does not seem to have cared either about the adverse reactions it received in the aftermath of the initiation of the easing or about criticisms after the latest 150 bps cut which was regarded as excessive by most analysts (not including us from day one we need to mention). The data continues to prove the Bank right which displayed the audacity to jump ahead of the markets and ahead of the curve. There is still some room for cuts as the Governor himself proclaimed, and the decision making process on the part of the CBRT has only the following potentially problematic facet: how to take advantage of the recent credibility gain in revising inflation expectations further down and in convincing markets that the route chosen is one the risk/return ratio for which is diligently estimated by the CBRT? There is clearly a limit to surprising the markets and cashing in on the *realization-expectation* gap and the Bank will be careful not to try to abuse a policy proven to be fruitful so far.

Year on year inflation decreased to 7.7% thanks to a 0.34% decrease in January's CPI index while market expectation was pointing to a 0.3% increase. Bear in mind that YoY inflation was 12% only 4 months ago and that inflation currently stands at its lowest level since September 2007. PPI's monthly hike of 1.17% may look worrying, but its YoY increase still is a mere 6.43%.

There is a marked base-effect factor for the next three months as well as last year's March, April, and May inflation figures registered as 0.96%, 1.68%, and 1.49%, respectively. **We believe that the Bank will not go for cuts in all three of these months and choose to frontload whatever residual cut size it has left. Another 150 bps cut is as likely as a 100 bps one in March and any cut falling short of the latter size is quite unlikely. It would also be wrong signaling in the light of our assumed mentality on the part of the CBRT.**

The following charts clearly depict that the timing of the initiation of bold cuts was impeccable by the CBRT. The first one displays expectation vs. realization for month on month inflation figures and the latter the same for year on year inflation figures. With annual inflation peaking in October at 12.0% as result of the 2.6% monthly figure in the same month, the CBRT started cutting as of November and realization exceeded the expectation only in the month of January.

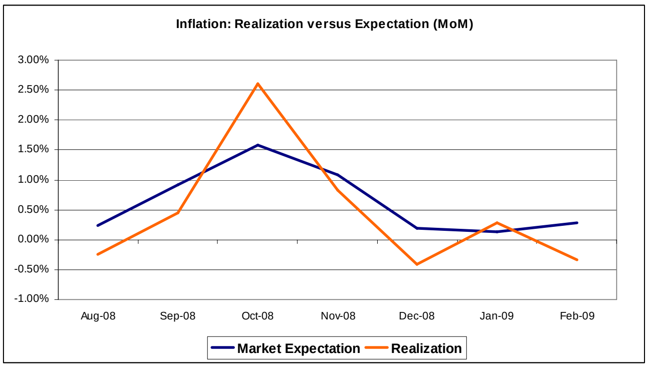


Figure.1

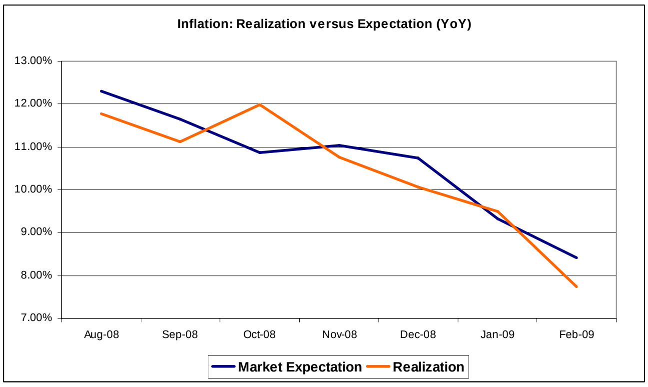


Figure.2

There is obviously an endogeneity as positive realization-expectation gaps recurring will lead to lower expectations and then to lower realizations in turn to the extent that some inertial component in inflation still exists.

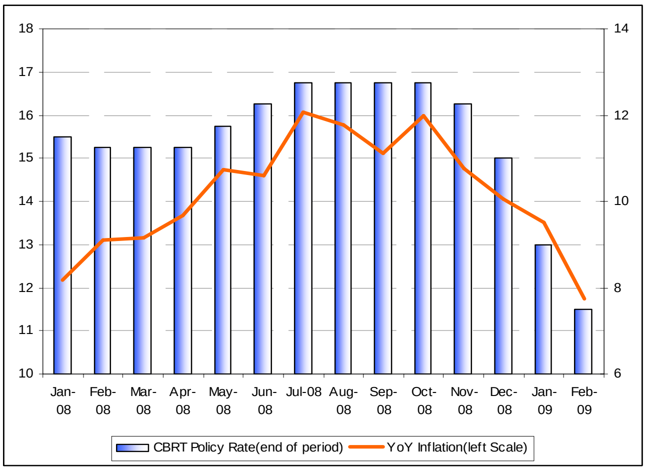


Figure.3

Year on year and month on month inflation figures (the latter seasonally adjusted as well) depicted in graphs below clearly show the strong disinflation trend that has been bolstered with growth outlook deteriorating globally and at home.

Figure.4

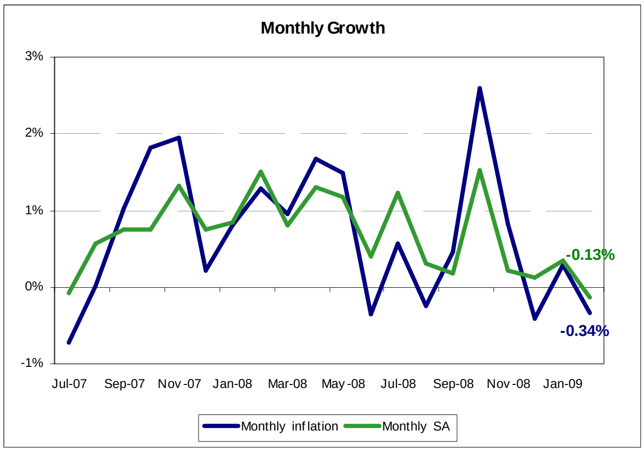


Figure.5

All Special CPI Indices displayed declines in YoY growth compared to January; “C” (CPI excl. energy), “E” (CPI excl. energy and liquor & tobacco) and “F” (CPI excl. energy, liquor & tobacco, administrated products, indirect taxes) experienced the highest decreases while “I” (CPI excl. energy, food and beverages, liquor & tobacco, gold) was the one with the lowest decrease.*

** The Special CPI yoy growth graphs are available in the appendix section.*

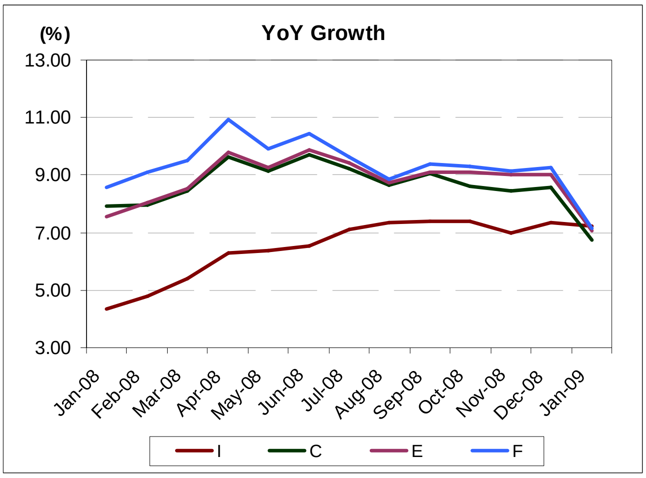


Figure.6

When we examine main expenditure groups' contributions to the monthly headline inflation figure, we spot Clothing and Footwear, Housing and Houseware expenditure groups pulling down the headline figure with -0.36, -0.17, and -0.07 percentage point contributions, respectively.

Party spoilers happen to be Transportation and Miscellaneous G.S. expenditure groups which had the highest positive contributions to the headline with 0.16 and 0.12 percentage points, respectively.

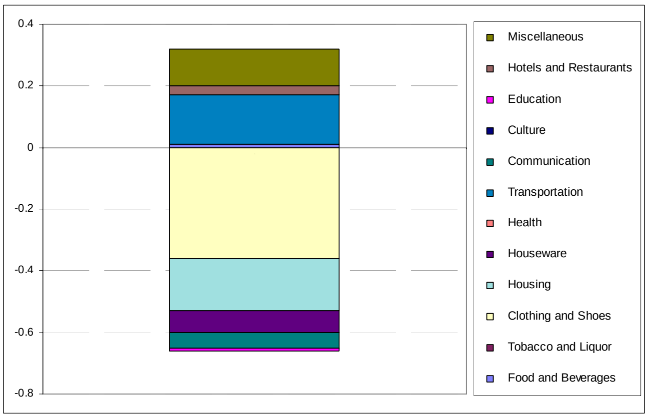


Figure.7

In the last few months, since October to be precise, most of the expenditure groups displayed drastic downturns in pricing behavior that are visible in YoY inflation reductions; housing from 27.1% to 17.4%, Food and Beverages from 11.5% to 6.16%, Transportation from 11.6% to 2.8%, Houseware from 10.4%to 7.4%, and Health from 6.9% to 0.4%. The only expenditure group with a steady upward trend is Miscellaneous G.S.**

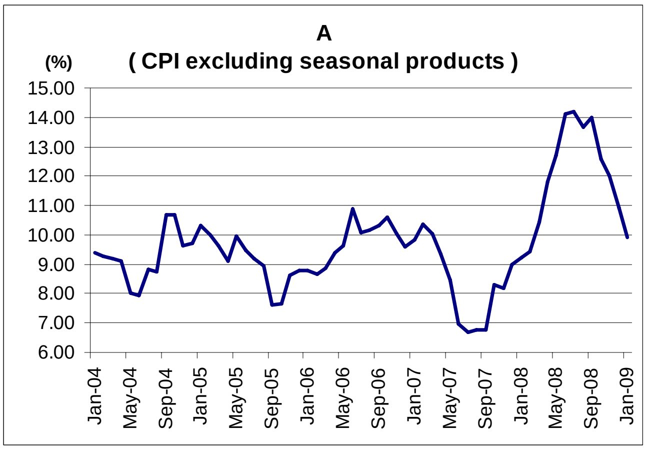
An environment of heightened uncertainty regarding permanent incomes and corporate earnings culminating in stagnant credit markets and shrinking aggregate demand inevitably depict a gloomy growth outlook. **Acting on this outlook need not necessarily imply that the objective function of the CBRT has changed; a Central Bank still inflation targeting and one that has switched to a dual optimization problem (inflation and growth together comprising the arguments of the objective function) are observationally equivalent under these circumstances. If one wants to test the claim that the objective function has assumed a different nature, a different set of circumstances will have to be awaited.**

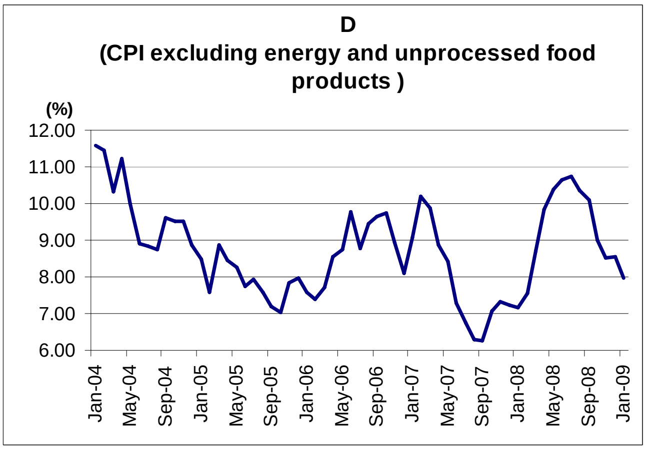
As we stated in the previous section, we expect the Bank to continue with *strong* signaling but *not for very long*.

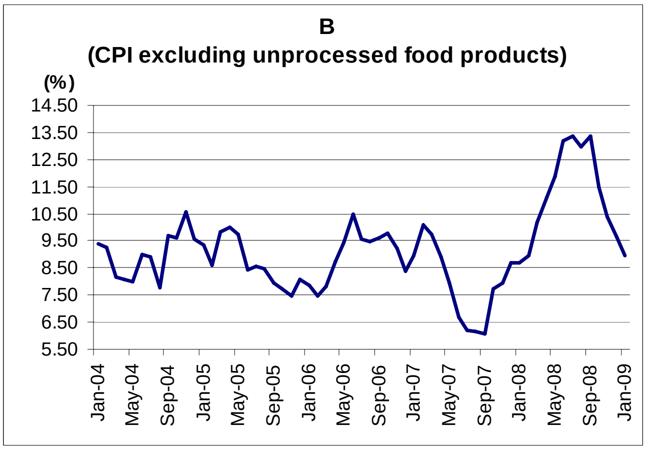
*** The expenditure groups' growth graphs are available in the appendix section.*

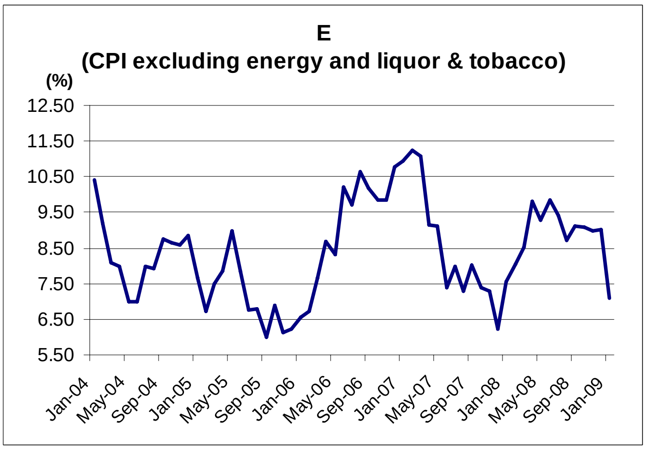
Appendix:

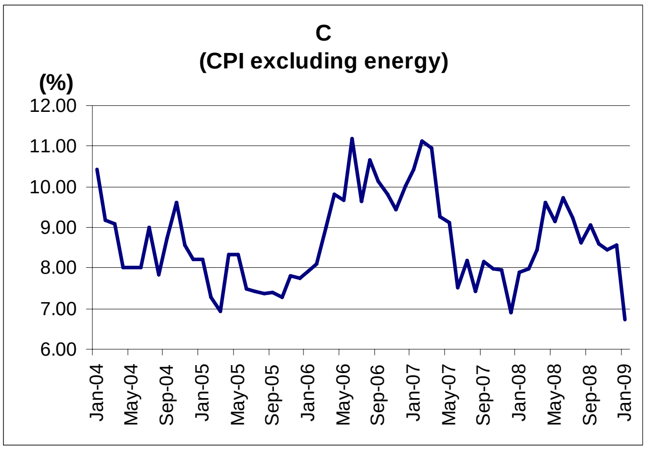
Special CPI Indices :

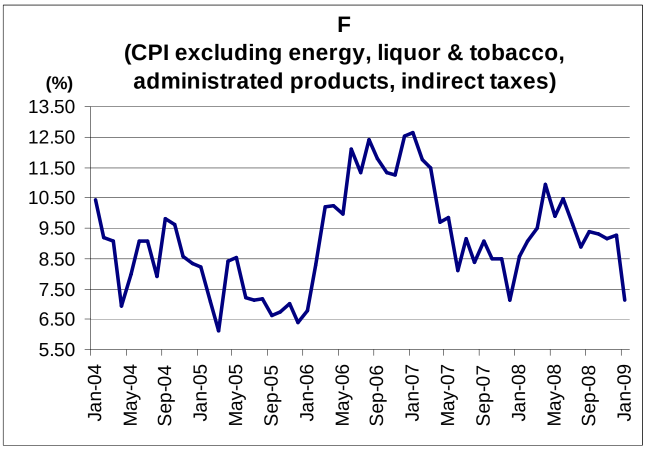


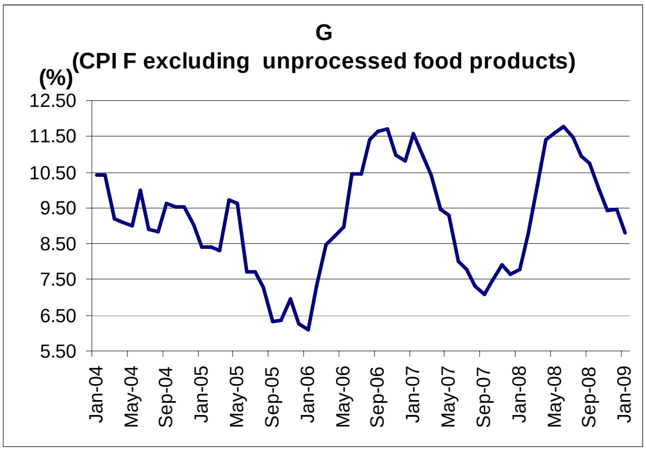











G
(CPI F excluding unprocessed food products)
(%)
12.50
11.50
10.50
9.50
8.50
7.50
6.50
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Jan-04
May-04
Sep-04
Jan-05
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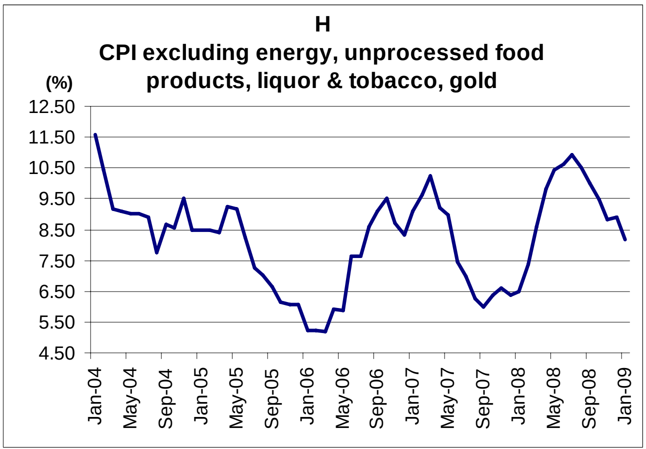
H
CPI excluding energy, unprocessed food products, liquor & tobacco, gold
(%)
12.50
11.50
10.50
9.50
8.50
7.50
6.50
5.50
4.50
Jan-04
May-04
Sep-04
Jan-05
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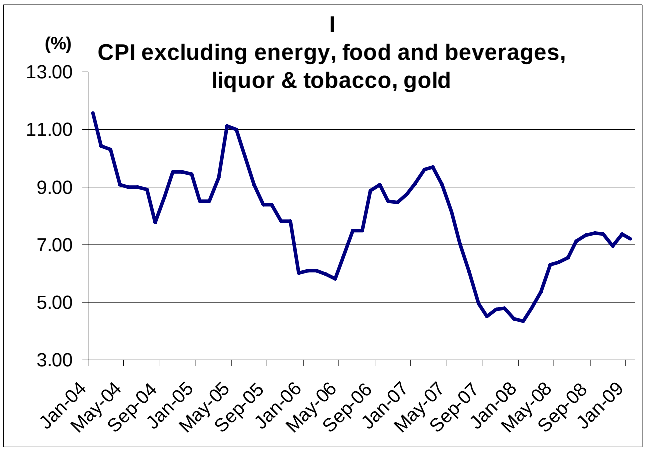
I
CPI excluding energy, food and beverages, liquor & tobacco, gold
(%)
13.00
11.00
9.00
7.00
5.00
3.00
Jan-04
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Jan-05
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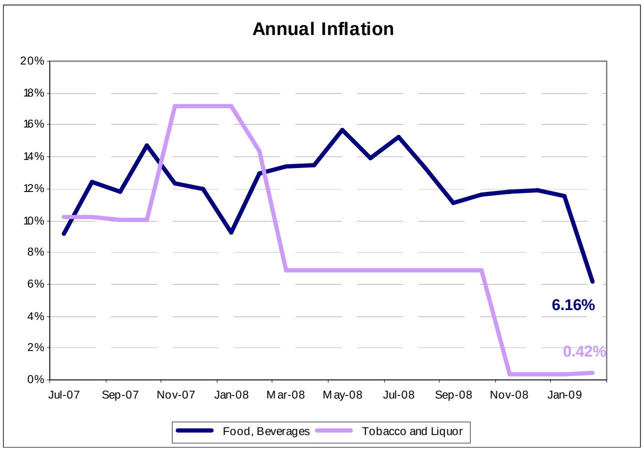
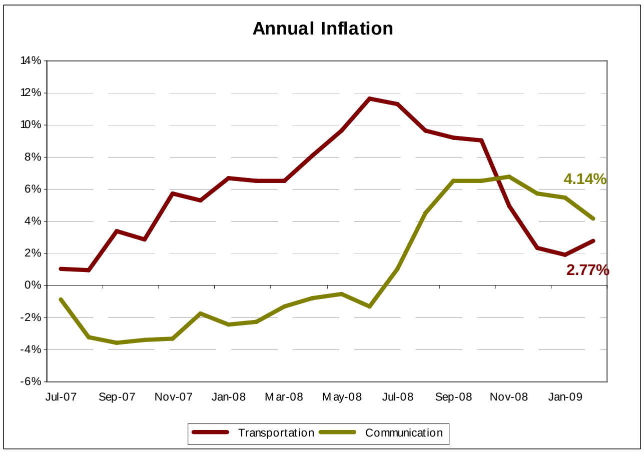
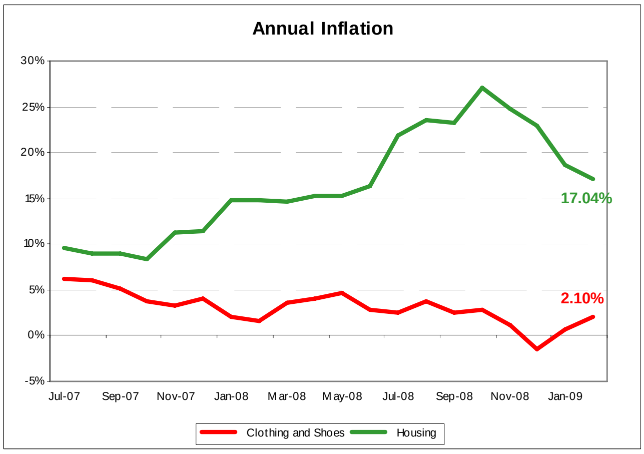
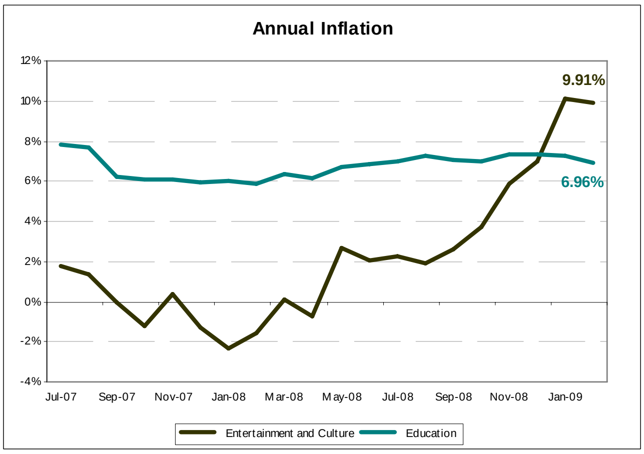
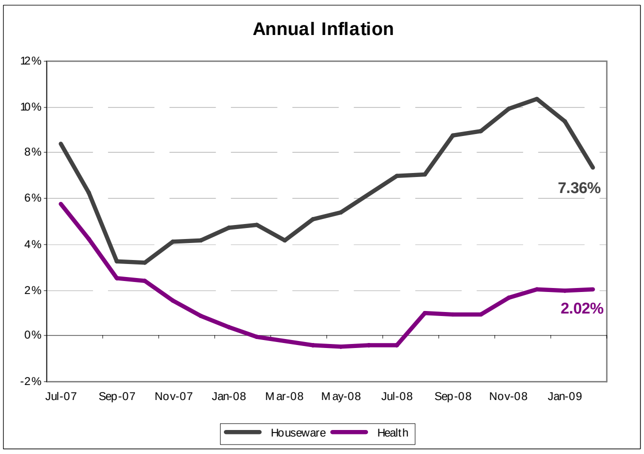
Expenditure Group-specific YoY Inflation Rates :

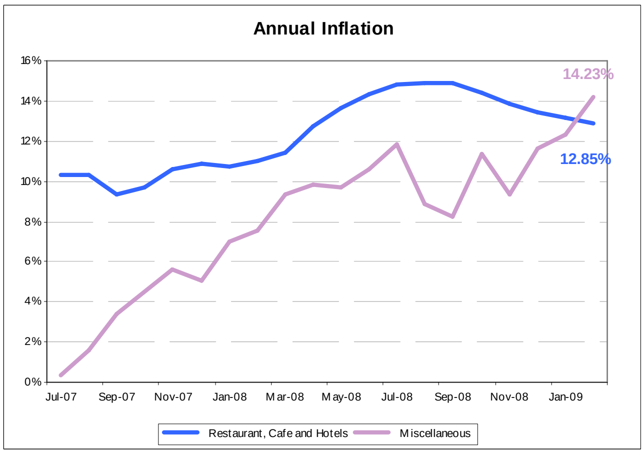












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