TÜRKİYE CUMHURİYET MERKEZ BANKASI

BRIEFING ON JANUARY 2016 INFLATION REPORT

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26 January 2016, Ankara

Distinguished Guests,

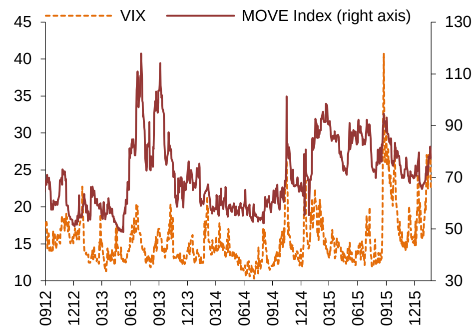
Welcome to the briefing held to convey the main messages of the Inflation Report of January 2016.

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. In addition to the main text, the report includes seven boxes entailing up-to-date and interesting analyses on various topics. The boxes in this Report look into the sources of the changes in end-2015 inflation forecasts, offer projections about the repercussions of base effects on inflation in 2016, and analyze the dynamics of inflation in Turkey. Moreover, there are boxes that elaborate on Turkey's changing export market share, study the relationship between consumer confidence indices and financial volatilities, analyze the effects of minimum wage hikes on overall wages, and scrutinize the relationship between loans and growth by sectors. 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 ongoing influence on our policies. Volatilities in financial markets continue amid uncertainties about global monetary policies and concerns over global growth. Interest rate volatility experienced some decline right after the anticipated first Fed rate hike in December 2015; however, volatilities began increasing as of early 2016 mainly due to worries about the Chinese economy and geopolitical developments (Chart 1). The global economic slowdown since 2014 continued into the second half of 2015, especially across emerging market economies. Commodity prices remained on the decrease as well. Developing economies were largely affected by the global fluctuations in this period. Portfolio inflows stayed weak and exchange rate volatilities remained high (Chart 2).

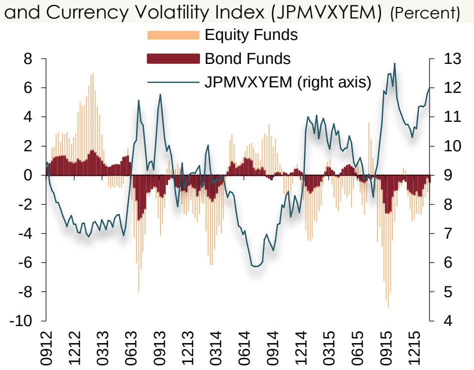
The effects of global market volatility were felt in the Turkish economy as well. However, reduced domestic uncertainty and the CBRT's tight monetary stance and other liquidity –and financial-stability– oriented policies limited these effects.

Chart 1.
VIX and US Interest Rate Volatility 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)



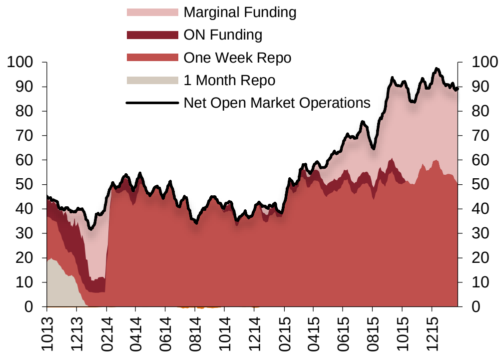
Source: EPFR, Bloomberg

1. Monetary Policy and Financial Conditions

As you all know, we released a road map on 18 August 2015 regarding the policies to be implemented before and after the normalization of global monetary policies. In line with this road map, we kept our policy stance tight against the inflation outlook, stabilizing for the FX liquidity, and supportive of financial stability. In order to simplify the operational framework of the liquidity policy, we terminated the lower interest rate on borrowing facilities provided for primary dealers by the CBRT and simplified collateral conditions following the announcement of the road map. We aimed to enhance the efficiency of banks' liquidity management by adopting the use of foreign exchange deposits as collaterals against Turkish lira transactions. Moreover, we took further steps to support foreign exchange liquidity, core liabilities and long-term borrowing.

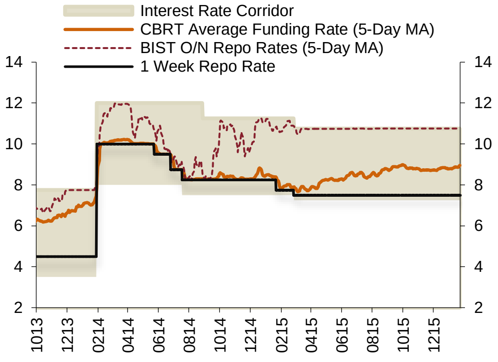
In view of inflation expectations, the pricing behavior and other factors affecting inflation, we maintained the tight monetary and liquidity stance throughout 2015. Accordingly, we kept the one-week repo rate, the overnight lending rate and the overnight borrowing rate unchanged at 7.5, 10.75 and 7.25 percent, respectively, during the last quarter of 2015 and the first month of 2016. One-week repo auctions continued to be the main tool for the CBRT funding, while the share of the marginal funding remained high (Chart 3). Thus, the average funding rate settled at around 8.9 percent as of January 2016, higher than the one-week repo rate. Additionally, we kept the interbank overnight repo rates at the upper band of the interest rate corridor (Chart 4). Our future monetary policy decisions will be conditional on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, we will maintain our tight monetary policy stance as long as deemed necessary.

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



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

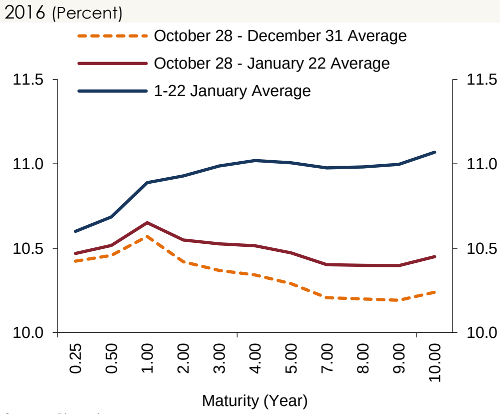
Chart 4.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



Source: BIST, CBRT.

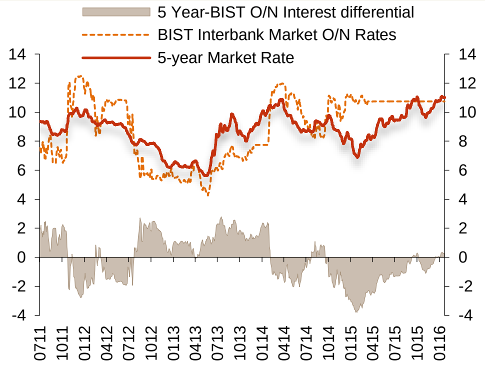
The yield curve, which was nearly flat in the last quarter of 2015 as in the entire year, assumed a positive slope in January 2016 (Chart 5). This was mainly due to long-term rates that rose amid the uncertainty surrounding global markets, geopolitical risks and heightened inflation expectations, which also affected the spread between 5-year market rates and the BIST overnight interbank rates. After remaining negative across the fourth quarter of 2015, the spread turned slightly positive in the first weeks of January as a result of rising 5-year market rates (Chart 6).

Chart 5.
Yield Curve Between October 28, 2015- January 22, 2016 (Percent)



Source: Bloomberg,

Chart 6.
Money Market Rates
(Percent, 5-Day MA)

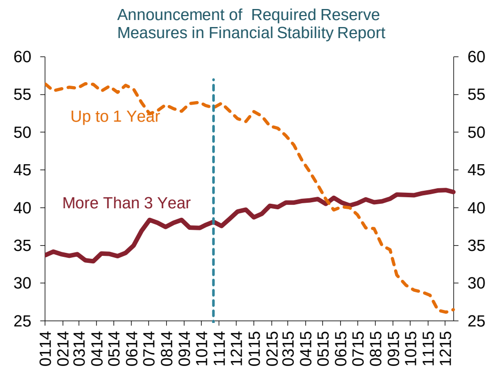


Source: Bloomberg, BIST.

Regarding our Turkish lira liquidity policy, there has been some decline in banks' FX swap deals with the market for short-term funds owing partly to changes we made to the guidelines for the use of FX deposits as collateral following the announcement of our road map. Considering that banks' need for FX swaps can be further reduced through a rise in the use of this option and in the limits allotted to banks, we increased these limits from USD 3 billion to USD 3.6 billion and from EUR 900 million to EUR 1.8 billion as of 7 January 2016. Moreover, we raised the maximum ratio of 50 percent that banks are able to pledge as FX-denominated collateral against their borrowings at the CBRT Interbank Money Market to 70 percent effective 13 January 2016. We expect this arrangement to play a stabilizing role against the stress likely to be experienced in credit risk pricing due to global factors and boost the demand for FX-denominated bonds issued abroad by the Treasury. Detailed information about our Turkish lira liquidity policy of 2016 can be found in the “Monetary and Exchange Rate Policy for 2016” we published on 9 December 2015.

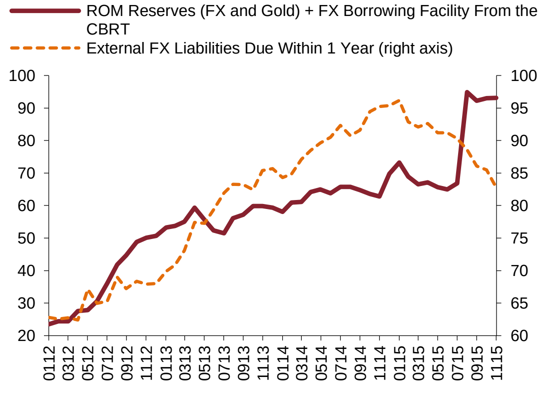
Besides interest rate and liquidity policies, we continue to promote prudential borrowing by employing other policy instruments that support financial stability. We have enacted a series of measures since end-2014 with regard to FX required reserves and remuneration rates on TL required reserves which aim to support core liabilities and extend the maturity of non-core liabilities. These policies have proved effective in extending the maturity of FX liabilities and suspending the upward trend in the loan to deposit ratio (Chart 7). In order to reduce the intermediation costs of the banking system and provide additional support to core liabilities, we raised the remuneration rates on TL required reserves by 50 basis points each month in September, October and December 2015. Additionally, we made some adjustments to the coverage of reserve requirements on 9 January 2016. Accordingly, some funds at participation and investment banks were made subject to reserve requirements and the coverage of non-core liabilities was expanded.

Chart 7.
Maturities of Non-Deposit Liabilities
(Percent)



Source: CBRT.

Chart 8.
ROM Reserves, FX Deposit Facility and External FX Liabilities of the Banking Sector Due in 1 Year
(Billion USD)



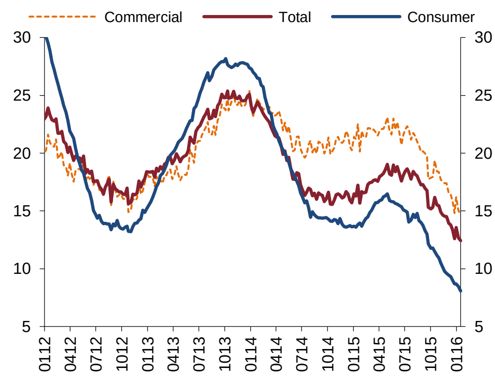
Source: CBRT.

In the road map released in August, we also included some measures to enhance the flexibility of the foreign exchange liquidity management. To this end, we hiked the transaction limits for banks at the CBRT Foreign Exchange and Banknotes Markets on 1 September 2015. Consequently, the sum of FX deposit limits allocated to banks and gold and foreign exchange assets held at the CBRT under the reserve option mechanism (ROM) reached a level that is considerably above the external debt payments of banks which are due within one year (Chart 8). Moreover, in the "Monetary and Exchange Rate Policy for 2016", we announced further steps to strengthen the stabilizing feature of the ROM. All these measures taken in line with the road map have increased Turkey's resilience against global volatility.

Amid an economic environment fraught with prolonged global uncertainties, it is important to contain negative spillovers into the Turkish economy. In terms of the fundamentals of the economy, the significant improvement in the current account balance over the past few years, reasonable growth rates in loans and a loan composition that supports price stability and financial stability all contributed to reducing economic fragilities. These developments were due to the tight monetary policy and the measures taken regarding financial stability as well as the sharp fall in commodity prices in the case of the current account balance. Moreover, the effective use of the measures presented in the August road map has alleviated the excessive fluctuations in exchange rates and loan rates. Our current tight monetary policy reduces the economy's sensitivity to global shocks, thus supporting financial stability. We maintain the view that the tight monetary policy may be implemented within a narrower interest rate corridor, should the global volatility decline persistently or policy measures that would maintain and improve the gains in external balance and financial stability be implemented effectively.

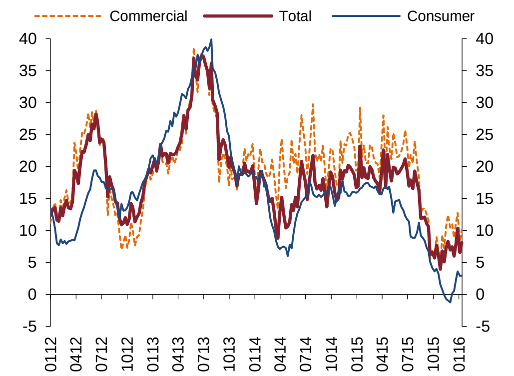
In 2015, the annual growth rate of loans extended to the non-financial sector, which decelerated partly due to our tight monetary policy stance, and the macroprudential measures introduced by the BRSA regarding consumer loans excluding mortgage, fell to 13.6 percent, adjusted for the effect of exchange rates. The noticeable slowdown across consumer and commercial loans that started in the third quarter continued into the fourth quarter, causing these loans to post an annual growth rate of 8.7 and 16.2 percent, respectively, at the end of the year (Chart 9). Thus, commercial loans continued to grow at a faster pace than consumer loans in the fourth quarter of 2015, following the same pattern since early 2014. We expect that these developments in loan growth and loan composition will contribute to the rebalancing process and financial stability as well as limit the effects of the recent cost pressures on inflation. The annualized growth rates of 13-week averages show that consumer and commercial loans lagged far behind past years' averages; the former across 2015, the latter mainly in the second half of 2015. However, as reflected by 13-week averages, both loans, particularly commercial loans, saw a modest rise during the last quarter of 2015 (Chart 10). The recent adjustments made to the risk weights of consumer loans are likely to support loan growth in the upcoming period. Yet, due to ongoing tight financial conditions, we expect annual loan growth rates to remain at reasonable levels in the coming months.

Chart 9.
Annual Credit Growth Rates
(Adjusted for Exchange Rate, Percent)



Source: CBRT.

Chart 10.
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 fourth quarter of 2015, consumer price inflation (CPI) increased by about 0.86 points quarter-on-quarter to 8.81 percent, overshooting both the projections of the October Inflation Report and the uncertainty band around the year-end inflation target (Chart 11). Unprocessed food prices were the main drivers of this higher-than-forecasted rise in annual inflation. In fact, inflation excluding unprocessed food and tobacco was close to the October Inflation Report forecast in this period (Chart 12). The lagged effects of the Turkish lira depreciation were particularly evident through the core goods channel. Yet, the continued fall of import prices in the fourth quarter limited the rise in CPI inflation.

Chart 11.
October Inflation Forecasts and Realizations (Percent)

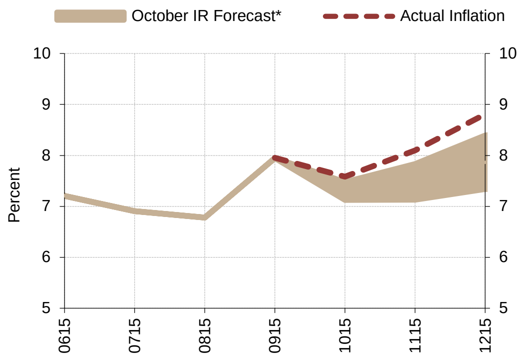
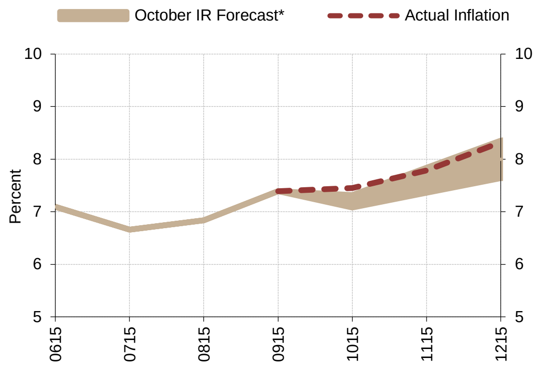


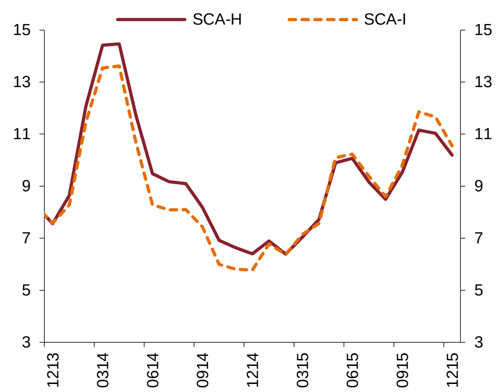
Chart 12.
October Inflation Forecasts and Realizations
Excluding Unprocessed Food and Tobacco (Percent)



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

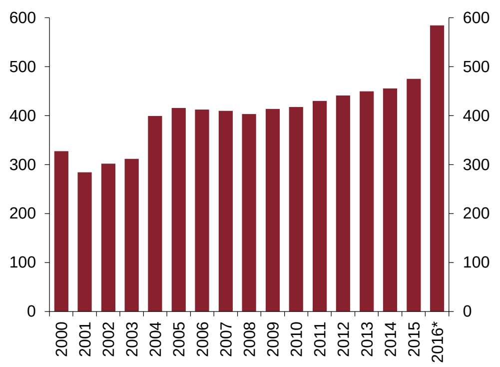
In the fourth quarter, despite the decline in USD-denominated import prices, cost pressures on inflation continued due to food prices and exchange rate developments. We see that these rising cost factors limit the improvement of the underlying trend of core inflation (Chart 13). Furthermore, we will monitor closely the effects of the adjustment in minimum wages on overall wages and on inflation (Chart 14).

Chart 13.
Core Inflation Indicators SCA-H and SCA-I
(Seasonally Adjusted, Annualized 3 Month Average, Annual Percentage Change)



Source: TURKSTAT, CBRT

Chart 14.
Real Gross Minimum Wage
(2003 Prices, TL)



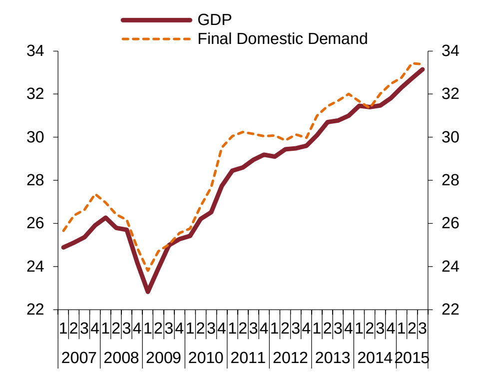
*Real gross minimum wage is obtained by dividing the average gross minimum wage at current prices to the consumer price index in a given year. Consumer price index is taken as 2003=1. Consumer prices in 2016 are based on January 2016 Inflation Report projections.
Source: Ministry of Labor and Social Security, TurkStat, CBRT.

In sum, annual inflation increased in the fourth quarter due to an ongoing rise in food prices as well as the lagged effects of the Turkish lira depreciation throughout 2015. We believe that the upcoming inflation outlook will depend on both the volatility in energy and unprocessed food prices and the effects of the global market uncertainty on inflation expectations. In addition, the large adjustment made to net minimum wages for 2016 will have an impact on inflation. Therefore, we expect inflation to remain elevated for some time. At this juncture, in addition to maintaining our tight monetary policy stance, fighting against the structural elements of inflation also remains important.

Notwithstanding the significant external shocks in recent years, we were able to limit the worsening in inflation and inflation expectations thanks to our current policy framework, but price stability is yet to be achieved. Ten years of experience with inflation targeting has shown that the fight against inflation requires collaboration from all relevant parties. We believe that government income and wage policies as well as structural issues related to food prices are important components in this endeavor. Moreover, macroprudential policies towards prudential borrowing also facilitate the fight against inflation by supporting a balanced growth. Thus, bringing inflation permanently down to the 5-percent target requires all institutions to continue resolutely with the efforts made in recent years.

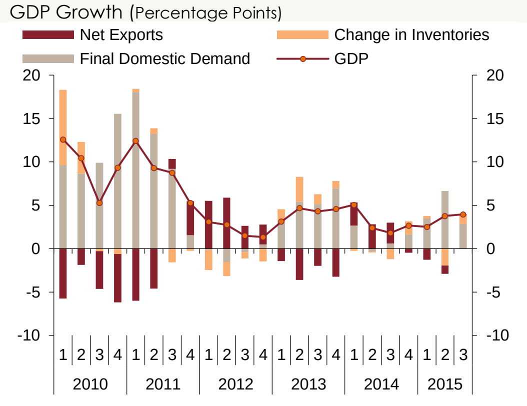
According to the GDP data of the third quarter of 2015, economic activity proved more robust compared to the outlook presented in the October Inflation Report, and the GDP grew steadily by 1.3 and 4 percent on quarterly and annual bases, respectively (Chart 15). On the spending front, final domestic demand increased modestly in the third quarter, while external demand contributed positively to the GDP after three quarters (Chart 16).

Chart 15.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)



Source: TURKSTAT.

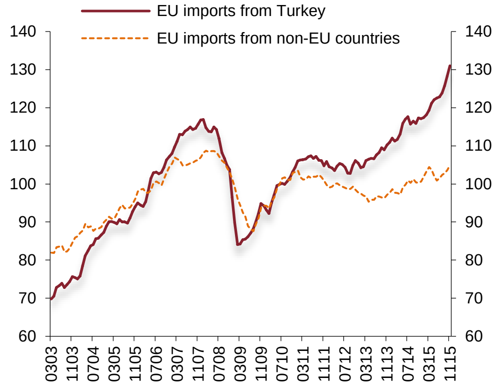
Chart 16.
Contribution of Demand Components to Year-on-Year GDP Growth (Percentage Points)



Source: TURKSTAT.

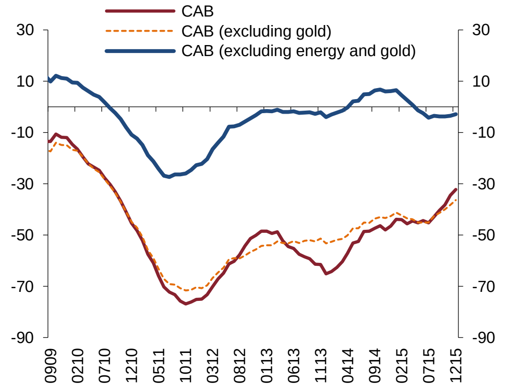
The demand outlook for 2016 leads to expectations of stronger economic activity compared to 2015. Amid waning domestic uncertainties, rising consumer and investor confidence may boost domestic demand. Revival of investments, at least partially, in 2016 that were delayed in 2015 due to domestic uncertainties and the effect of the strong post-crisis employment performance coupled with the recent wage developments on the income channel are likely to support domestic demand. Moreover, the projected fall in the current account deficit and the strong public finances also provide room for policy responses against possible shocks. The rebound in the EU economy continues to support our exports, while the uncertainties related to the Middle East and Russia constitute downside risks (Chart 17). Moreover, volatility in global financial markets and concerns over global growth may deteriorate financial conditions and foreign demand. In sum, we expect that in 2016, domestic demand will prove slightly stronger than 2015, while foreign demand will, despite the existence of geopolitical risks, recover owing to the recovery in the EU. Accordingly, we project that maintained macroprudential measures coupled with favorable developments in the terms of trade will support the ongoing improvement in the current account deficit (Chart 18).

Chart 17.
Imports by EU
(Real, Seasonally Adjusted, 3-Month Average 2010=100)



Source: Eurostat.

Chart 18.
Current Account Balance (CAB)
(12-Month Cumulative, Billion USD)

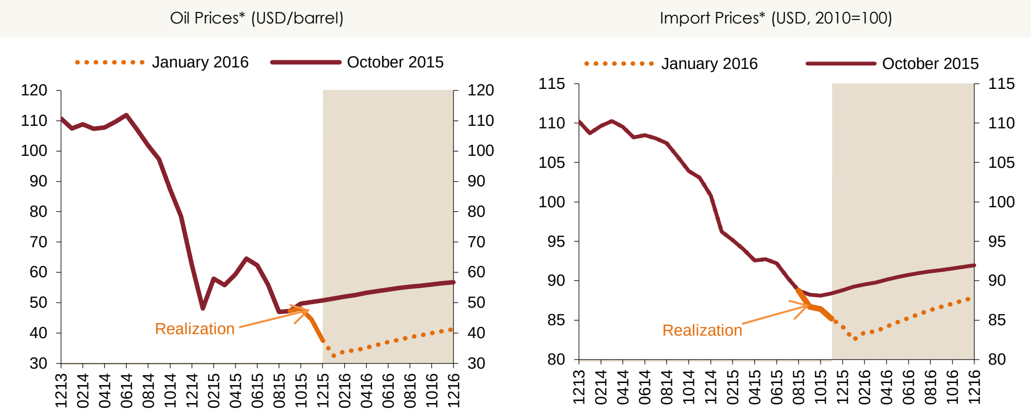


Source: CBRT.

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.

The downtrend in commodity prices in international markets, chiefly oil prices, continued in the last quarter of 2015 as well. Stemming mostly from the lack of demand from China and other developing economies, this trend caused import prices in the Turkish economy to recede in USD terms. Therefore, we made downward revisions to assumptions for crude oil prices and USD-denominated import prices With regard to annual averages, we reduced crude oil price assumptions from USD 54 to USD 37 for 2016. Also, we revised the assumptions for annual percentage changes in average import prices downwards by 4.9 points for 2016. We revised the assumed inflation for food prices upwards from 8 percent to 9 percent for 2016 due mostly to the effects of minimum wage adjustments on costs and demand (Chart 19).

Chart 19. Revisions in Oil and Export Prices*



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

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Source: Bloomberg, CBRT.

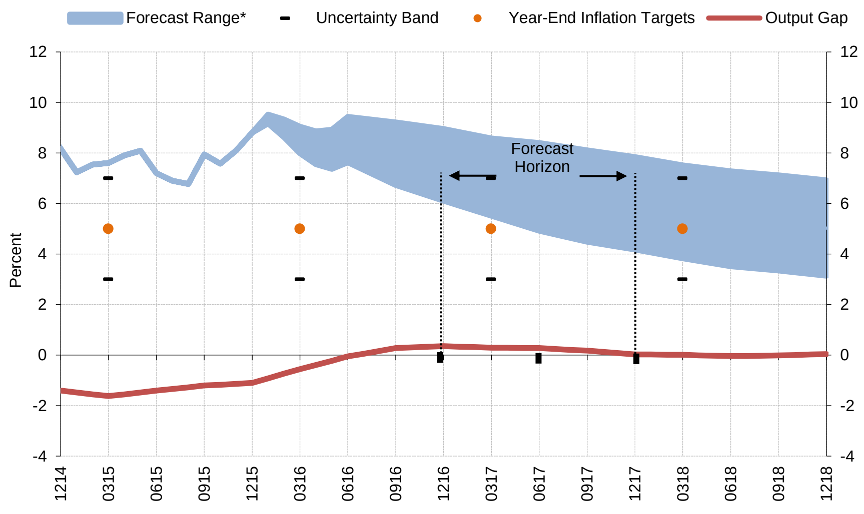
Effective as of January 2016, some items with administered prices saw price increases. We estimate that the additional effect on the year-end inflation of the portion of these increases that remain above 5 percent will be 0.4 points in 2016. In turn, we monitor meticulously how the rise in the minimum wage will affect the budget balance and tax adjustments. As the extent of the effect of wage developments on production costs, aggregate demand and inflation depends on the fiscal policy and the change in employment, we monitor the interaction between the rise in minimum wages and the fiscal policy closely. Our medium-term projections are based on an outlook that tax adjustments and administered prices, excluding those already announced in January, will not exceed the inflation target and will remain consistent with automatic pricing mechanisms. The medium-term fiscal policy stance is based on the Medium Term Program projections covering the 2016-2018 period. Conditional on this outlook, we expect inflation to improve gradually and reach the 5-percent target in the medium term.

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.

Given a decisive policy stance that focuses on bringing inflation down, the 5-percent target is expected to be achieved gradually; inflation is likely to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. In this context, inflation is expected to be, with 70 percent probability, between 6.1 percent and 8.9 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) (Chart 20).

Chart 20.
Inflation and Output Gap Forecasts



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

We revised the year-end inflation forecasts for 2016 and 2017 upwards by 1 point and 0.5 points, respectively, compared to the October Inflation Report forecasts. As I have just mentioned, driven mostly by oil prices, USD-denominated import prices have registered a considerable decline since October 2015. When analyzed jointly with exchange rate developments, the downward revision in the assumption for oil and import prices is expected to pull down the end-2016 inflation forecast by 0.6 points compared to the October Report forecast. On the other hand, the portion of January 2015 public price adjustments which exceeds the inflation target, is likely to push the end-2016 inflation forecast up by 0.4 points. Another influential factor on forecasts in this period proved to be the rise in net minimum wages. Given the announced support by the government and the effects of this minimum wage rise on demand and costs to the employer, we revised the end-2016 inflation forecast upwards by 1 point. Considering the effect of the minimum-wage-rise, we attribute 0.3 points of this to the food inflation, which we raised from 8 to 9 percent for 2016. Lastly, we estimate that a higher-than-projected actual inflation rate at end-2015 compared to the October Inflation Report forecast coupled with the rise in core inflation indicators will push the end-2016 inflation by 0.2 points. In short, of the total change in the year-end inflation forecast for 2016 compared to the previous reporting period, 1 point stemmed from the minimum-wage-hike, 0.4 points from administered price changes that are over and above the inflation target and 0.2 points from the rise in the underlying trend of inflation. Meanwhile, the revision in the assumptions for TL-denominated oil and import prices had a downward effect by 0.6 points.

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.