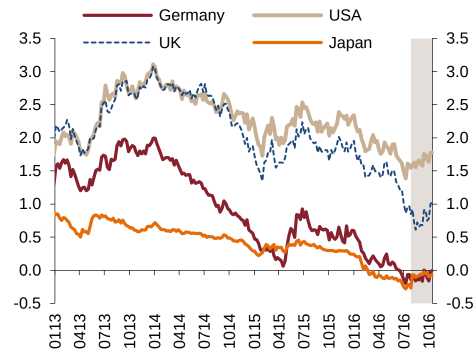
# 1. Overview

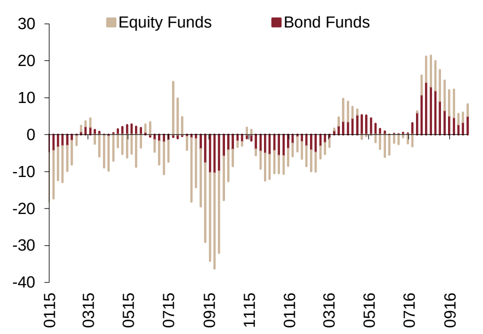
In the third quarter of 2016, monetary policy developments in advanced economies were the major factor feeding into volatility in global markets. In this period, major central banks continued with monetary easing, yet growing expectations of a possible Fed rate hike and uncertainties surrounding monetary policies of central banks in advanced economies stopped the ongoing decline in bond yields (Chart 1.1). Thus, after a marked upsurge following the previous reporting period, portfolio flows into emerging economies have recently started to decelerate again (Chart 1.2).

**Chart 1.1.**
10-Year Treasury Bond Yields
(Percent)




Source: Bloomberg.

**Chart 1.2.**
Portfolio Flows to Emerging Economies
(4-Week Cumulative, Billion USD)




Source: EPFR, Bloomberg.

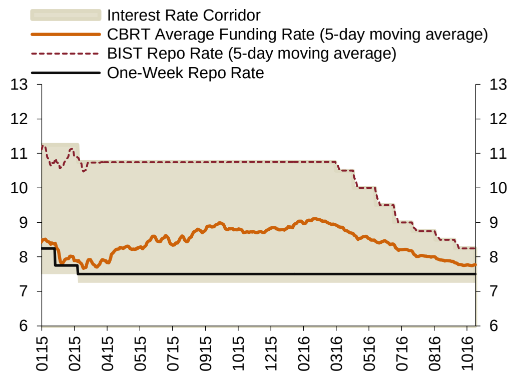
In addition to the volatility in global markets, both geopolitical developments and decisions of credit rating agencies caused domestic financial markets to fluctuate over the third quarter of 2016. In this period, Turkey attracted less portfolio flows than other emerging economies, while the Turkish lira depreciated against the US dollar and the country risk premium inched up. Overall financial conditions were supported by reduced tightness in monetary conditions, thanks to the CBRT's policy actions, and macroprudential measures. The gradual fall in the marginal funding rate has partially passed through to loan and deposit rates while consumer loans have edged up in recent months. Consumer inflation was in line with the forecasts of the July Inflation Report in the third quarter of 2016, with core goods and unprocessed food pulling underlying inflation down. Domestic demand was subdued in the third quarter but leading indicators signal that economic activity will pick up by the fourth quarter of the year. Moreover, despite downside risks to external demand due to geopolitical tensions, the external trade balance continues to improve amid increasing EU demand. On the other hand, developments regarding tourism revenues caused a slight widening in the current account deficit.

## 1.1. Monetary Policy and Financial Conditions

The CBRT continued with monetary policy simplification in the third quarter on the back of improved core inflation indicators, the favorable course of the global risk appetite and the effective use of monetary policy tools. Accordingly, the CBRT lowered the marginal funding rate to 8.25 percent by three consecutive reductions of 25 basis points in July, August and September. Policy rates were left unchanged in October in view of reduced tightness in financial conditions and possible spillovers of exchange rates and other costs to the inflation outlook. The marginal funding rate, one-week repo rate and the overnight borrowing rate were kept constant at 8.25, 7.5 and 7.25 percent, respectively (Chart 1.1.1).

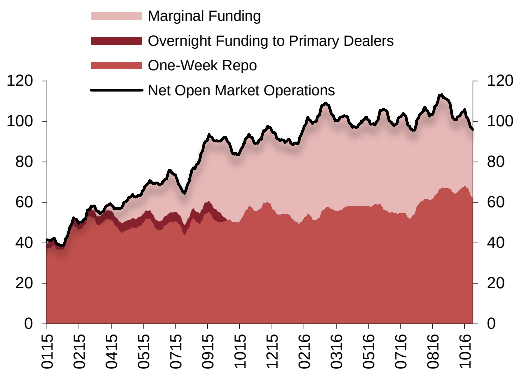
In this period, one-week repo auctions continued to be the main funding tool of the CBRT, while the share of marginal funding decreased (Chart 1.1.2). The weighted average funding rate dropped to around 7.8 percent in October. BIST repo rates remained on the decline in line with the reductions in the upper band of the interest rate corridor. In the upcoming period, the monetary policy stance will continue to depend on the inflation outlook. The CBRT will maintain its cautious monetary policy stance by taking into account the developments regarding inflation expectations, the pricing behavior and other factors affecting inflation.

**Chart 1.1.1.**
CBRT Policy Rates and BIST Repo Rate (Percent)




Source: BIST, CBRT.

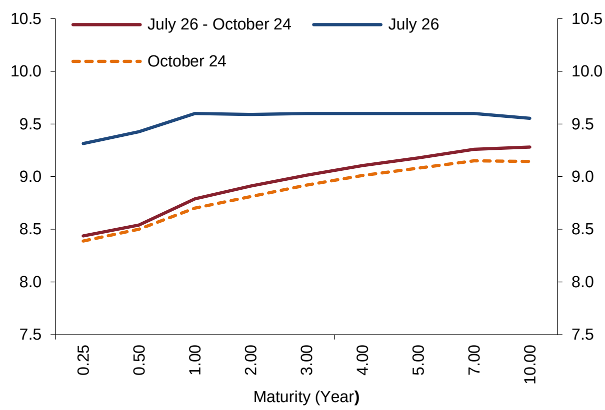
**Chart 1.1.2.**
CBRT Funding*
(2-Week Moving Average, Billion TL)




* Marginal funding is overnight funding quoted at the upper band of the interest rate corridor.
Source: CBRT.

Amid continued expectations for a prolonged low interest rate environment across advanced economies as well as the favorable course of domestic macroeconomic indicators and monetary policy simplification, the yield curve shifted downwards in all maturities from the previous reporting period (Chart 1.1.3). The fall was more pronounced in short-term rates due to the decline in the CBRT funding rate.

**Chart 1.1.3.**
Yield Curve on Currency Swaps
(Percent)




Source: Bloomberg.

The slide in the annual growth rate of loans extended to the non-financial sector came to a halt in the third quarter of 2016 owing to reduced tightness in monetary conditions, the accommodative macroprudential measures and government incentives (Chart 1.1.4). Commercial loans, which have been growing faster than consumer loans since the start of 2014, continued to increase at a higher rate in this period as well. Although the gradual fall in the CBRT marginal funding rate partially passed through to loan and deposit rates, loan standards remained tight in the third quarter. However, consumer loans have recently rebounded amid the adoption of macroprudential measures and the liquidity policy, which improved banks' domestic funding conditions (Chart 1.1.5).

**Chart 1.1.4.**
Annual Loan Growth
(Adjusted for Exchange Rate, Percent)

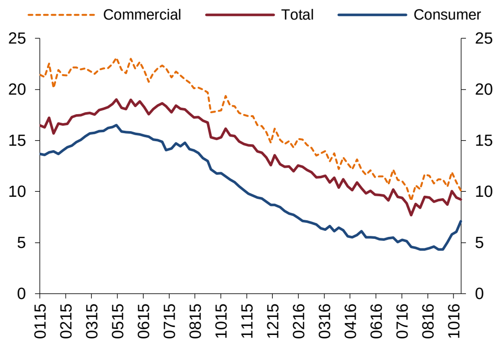
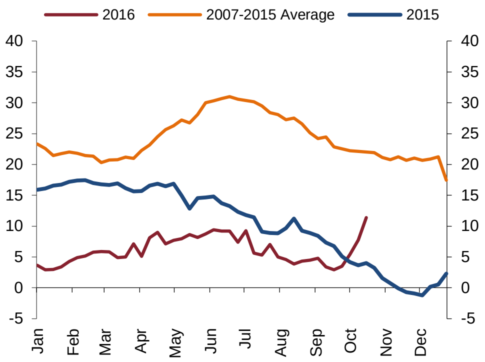



**Chart 1.1.5.**
Annualized Consumer Loan Growth
(13-Week Moving Average, Percent)




Source: CBRT.

## 1.2. Macroeconomic Developments and Main Assumptions

### Inflation

Consumer inflation ended the third quarter at 7.28 percent, remaining consistent with the lower bound of the July Inflation Report forecast (Chart 1.2.1). The fall in inflation was mostly driven by prices of core goods and unprocessed food, whereas annual inflation in tobacco and energy was up. Thus, inflation excluding unprocessed food and tobacco posted a smaller decline and ended up near the upper bound of the July Inflation Report forecast (Chart 1.2.2). The inflation outlook remained benign amid waning cumulative exchange rate effects, weakening demand conditions and modest import prices. Cost pressures driven by producer prices remained subdued in this period. On the other hand, rising tobacco prices and adjustments in fuel taxes hampered the improvement in inflation. Therefore, consumer inflation fluctuated while annual core inflation remained on a downward track through the third quarter.

**Chart 1.2.1.**
Inflation Forecasts and Realizations*
(Percent)

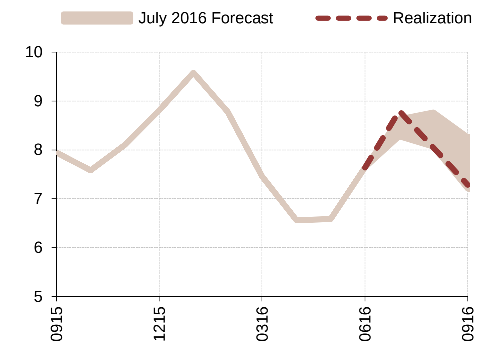
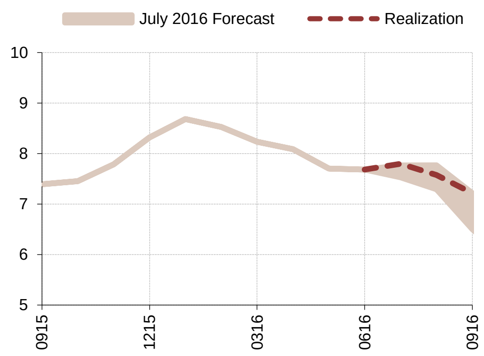



**Chart 1.2.2.**
Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco*
(Percent)




* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

After a slight increase in the second quarter, annual food inflation recorded a sharp drop in the third quarter, standing far below the path projected in the July Inflation Report. The slowing food inflation was attributed to the waning tourism demand, the contraction in exports to Russia and the measures placed on red meat. Food inflation excluding fresh fruits and vegetables fell to a five-year low of 4.78 percent in September (Chart 1.2.3). Meanwhile, despite the sluggish economic activity and slowing food inflation, services inflation remained high mostly due to rising real unit labor costs and rent.

**Chart 1.2.3.**
Food Prices
(Annual Percent Change)

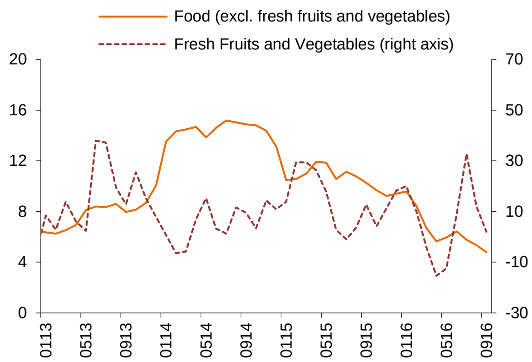
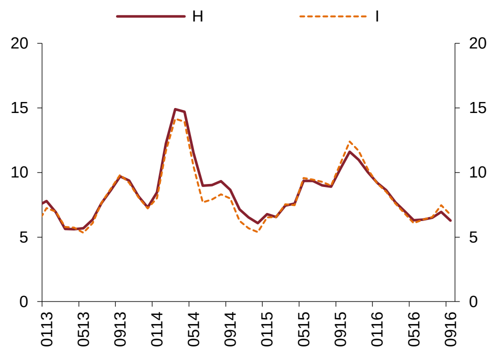



**Chart 1.2.4.**
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)




Source: TURKSTAT, CBRT.

The underlying core goods inflation slowed in the third quarter as a result of moderate exchange rates and weakening domestic demand. On the other hand, the underlying services inflation increased. Accordingly, the underlying core inflation indicators remained largely flat compared to the previous quarter (Chart 1.2.4). Meanwhile, the tendency to increase prices was down quarter-on-quarter as implied by the diffusion indices for core indicators, while alternative core inflation indicators followed by the CBRT posted a more solid decline. In sum, considering all indicators capturing the underlying trend and the pricing behavior, underlying inflation continued to improve in the third quarter.

## Supply and Demand

Economic activity slowed in the second quarter as predicted in the July Inflation Report. The GDP grew by 0.3 and 3.1 percent in quarter-on-quarter and year-on-year terms, respectively (Chart 1.2.5). The main driver of annual growth was final domestic demand, whereas net exports provided a more negative contribution to growth due to the tourism slump (Chart 1.2.6). The contribution of final domestic demand to growth was through both public and private consumption, while investments remained subdued. Public spending provided a large (1.7 points) contribution to growth as in the first quarter. On the other hand, value added gains were limited in industrial and services sectors with strong linkages to tourism.

**Chart 1.2.5.**
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)

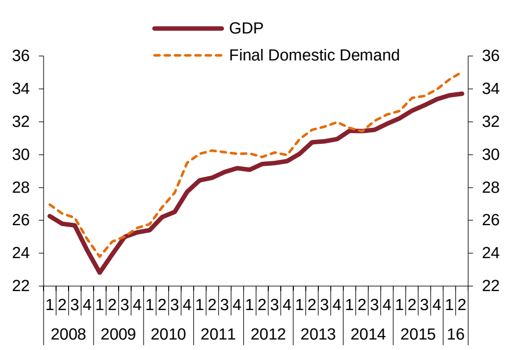
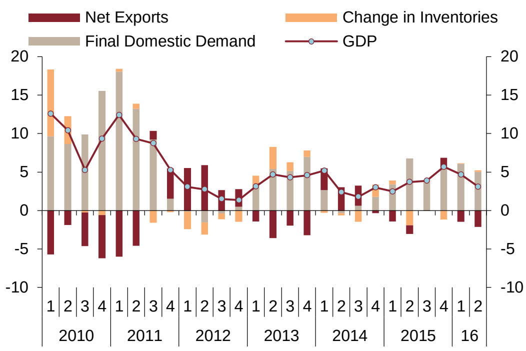



**Chart 1.2.6.**
Annual GDP Growth and Contributions from the Expenditure Side (Percentage Points)

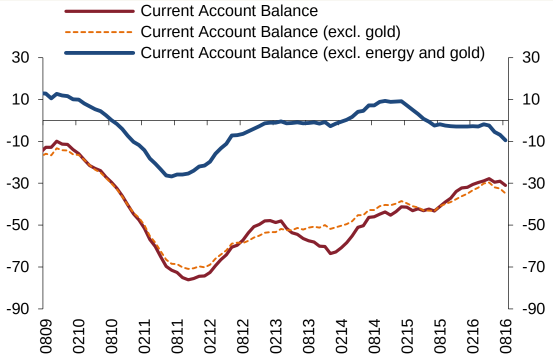



Source: TURKSTAT.

Indicators for the third quarter of 2016 point to further deceleration in economic activity. In addition to the deepening tourism slump, the mid-July domestic turbulence and working day losses due to religious holidays dampened production activities. Therefore, although the sharp drop in July's industrial production was offset by a rapid recovery in August, production is expected to fall below the second-quarter level in the third quarter. Yet, working day losses caused by the religious holiday in September will make it difficult to track the underlying trend in production as in July. Despite weaker domestic demand, growing EU demand continued to bolster Turkey's exports in the third quarter. Turkey's market-shifting flexibility continues to cushion exports against the negative effects of geopolitical tensions on external demand.

Domestic demand and economic activity are expected to recover starting from the last quarter. Thanks to more accommodative monetary conditions and the adoption of other measures, the recovery in consumer loans in recent months supported the projected improvement for the last quarter of the year. Against this background, economic growth is expected to be mild in 2016, which has been marked by consecutive adverse shocks. In view of waning uncertainties in the upcoming period, producer and consumer confidence will be re-built, demand-stimulating policies will support consumption expenditures and negative contribution of net exports will fall, which will all contribute to economic recovery. In addition to the partial improvement both in tourism revenues and exports to Russia in the normalization process, recently released incentive packages are envisaged to support growth next year. On the other hand, uncertainties regarding the pace of global growth and monetary policies of advanced economies as well as the course of capital flows and geopolitical developments pose a downside risk to growth. Moreover, the persistent slump in tourism revenues and the gradual decline in the favorable effects of commodity prices are likely to cause some increase in the current account deficit in the short term (Chart 1.2.7).

**Chart 1.2.7.**
Current Account Balance
(12-Month Cumulative, Billion USD)



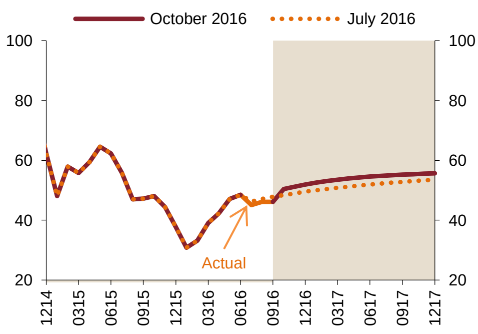

Source: CBRT.

### Oil, Import and Food Prices

Owing to the recent developments, assumptions for crude oil prices for the upcoming period were revised upwards compared to the July Inflation Report, while assumptions for USD-denominated import prices saw some downward revision (Charts 1.2.8 and 1.2.9). In terms of annual averages, the crude oil price assumption was kept unchanged at 44 USD for 2016, and increased to 54 USD for 2017.

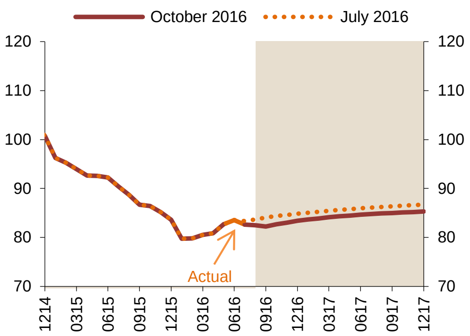
In the third quarter of 2016, food inflation remained far below the level envisaged in the July Inflation Report due to unprocessed food inflation. Taking into account the current trend of unprocessed food inflation as well as the decrease in the demand for food stemming from the fall in tourism revenues, food inflation, which was assumed to be 8 percent by end-2016 in the July Inflation Report, was revised downwards to 6 percent. Due to the measures taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee (Food Committee) and the ongoing weakness in food demand by the tourism sector, food price inflation is expected to be lower than its historical average in 2017 as well. Accordingly, the assumption for food price inflation was revised downwards from 8 percent to 7 percent for end-2017.

**Chart 1.2.8.**
Revisions in Oil Prices
(USD/bbl)




Source: Bloomberg, CBRT.

**Chart 1.2.9.**
Revisions in Import Prices
(2010=100)




Source: CBRT, TURKSTAT.

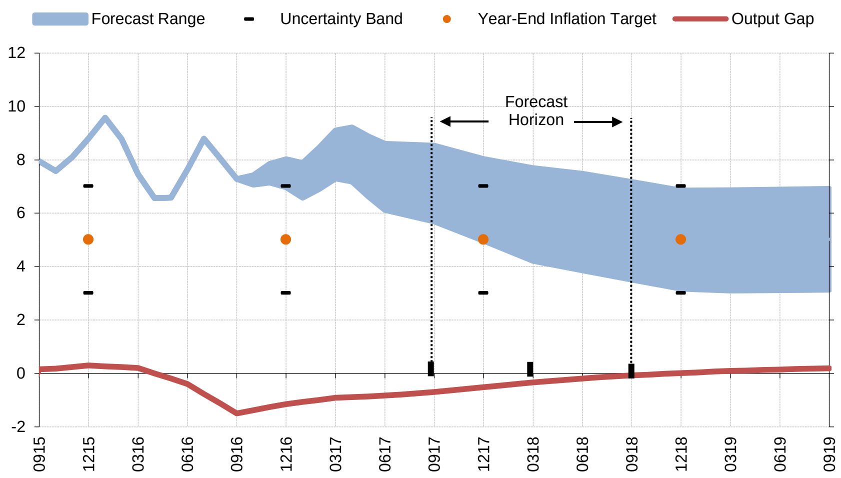
### Fiscal Policy and Tax Adjustments

Medium-term forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance depends on the MTP projections covering the 2017-2019 period.

## 1.3. Inflation and Monetary Policy Outlook

Given a cautious policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to stabilize around 5 percent in 2018 after falling to 7.5 percent in 2016 and 6.5 percent in 2017. Hence, inflation is expected to be, with 70 percent probability, between 7 percent and 8 percent (with a mid-point of 7.5 percent) at end-2016 and between 5 percent and 8 percent (with a mid-point of 6.5 percent) at end-2017 (Chart 1.3.1).

**Chart 1.3.1.**
Inflation and Output Gap Forecasts*
(Percent)




* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: CBRT.

The Turkish lira fluctuated following the July Inflation Report, while oil prices increased. In the upcoming period, TL-denominated import prices are estimated to be higher compared to the previous reporting period. On the other hand, the latest domestic developments are envisaged to curb domestic demand particularly in the short term. Accordingly, output gap forecasts were revised downwards. The year-end consumer inflation forecast for 2016 remained unchanged as downside and upside effects on inflation cancelled out each other. On the other hand, end-2017 consumer inflation forecast was revised upwards by 0.5 points as the upside effects driven by import prices outweighed the effects of the downward revision in the output gap and food inflation.

## 1.4. Risks and Monetary Policy

Overall financial conditions remain buoyed by reduced tightness in monetary conditions, thanks to the CBRT's policy actions, and macroprudential measures. The gradual fall in the marginal funding rate has partially passed through to loan and deposit rates. Supported also by the recently enforced macroprudential measures, consumer loans showed some recovery in the last couple of months. On the other hand, due to global and geopolitical developments that had effects on domestic financial markets, loan conditions still remain tight. As the end-September downgrade of Turkey's sovereign credit rating to non-investment grade was largely anticipated by markets, the reaction of financial markets remained limited. Even though this downgrade weighs on external funding costs, loan conditions are supported by liquidity measures, macroprudential arrangements and other incentives. On the other hand, the CBRT may introduce accommodative adjustments to required reserves and other liquidity instruments in case of a higher-than-expected tightness in financial conditions.

The latest data indicate a remarkable economic slowdown in the third quarter. Accommodative incentives and measures are projected to stimulate a rebound in domestic demand starting from the last quarter. Accordingly, the Turkish economy is expected to grow mildly in the remainder of 2016 and throughout 2017. However, economic activity is exposed to downside risks stemming from tourism revenues, the global economic outlook, uncertainties regarding the monetary policies of advanced economies and geopolitical developments. The CBRT will continue to closely monitor the impacts of the developments in economic activity on price stability and financial stability.

In the third quarter of the year, inflation recorded a decline on the back of improvements in unprocessed food and core inflation indicators. While the lagged effects of the cumulative exchange rate developments on annual inflation continued to wane, slowing aggregate demand supported disinflation and the underlying trend of core inflation displayed some recovery. However, the tax rise in fuel products restrained the improvement in inflation through energy and transport prices. Although the developments in TL-denominated import prices are expected to push inflation upwards, the mild course of aggregate demand is projected to support the gradual decline in core inflation. Moreover, forecasts are based on the assumption that the year-end food inflation in 2016 and 2017 will be lower than the projections of the previous Report amid the tourism-induced slowdown in food demand and the actions taken by the Food Committee.

Inflation forecasts accommodate both upside and downside risks. Inflation may settle on a lower-than-expected path, should economic activity recover at a slower-than-envisioned pace in the upcoming period. On the other hand, uncertainties regarding oil prices and global markets pose an upside risk to inflation through the cost channel. Meanwhile, the volatility in food prices pose risks in both directions for 2017. The CBRT will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.

Leading indicators for the third quarter of 2016 point to a mild improvement in global economic activity. However, the historically low levels of global growth and the trade volume lead to sustained environment of low interest rates in advanced economies. Accordingly, the risk appetite towards emerging economies has followed a robust course in recent months. On the other hand, uncertainties regarding global monetary policies cause fluctuations in portfolio inflows. In fact, amid strengthened perceptions about the Fed's possible rate hike coupled with the uncertainties regarding the monetary policies of other advanced economies, portfolio flows towards emerging economies have recently trended downwards after a surge following the previous reporting period.

Against this background, the marginal funding rate, which was lowered gradually under the simplification process as of March 2016, was kept constant in October. The completion of the simplification will ensure funding via a single rate, thereby bringing short-term market rates closer to the

CBRT funding rate. Simplification is believed to contribute to the effectiveness of the transmission mechanism by providing a more reliable assessment of the monetary policy stance. Therefore, simplification of the monetary policy will be finalized within a reasonable schedule. The direction and timing of simplification will depend on developments affecting the inflation outlook and financial stability.

Despite experiencing significant external shocks in recent years, the adopted policy framework proved successful in containing the deterioration in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience in inflation targeting showed that combatting inflation requires joint efforts. Thus, to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties under a holistic approach by also taking structural factors into account. In this respect, actions taken by the Food Committee set an invaluable precedent. In the upcoming period, the CBRT will bolster these efforts by undertaking extensive studies to raise awareness regarding structural issues in inflation dynamics.

Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

In recent years, sustaining fiscal discipline has contributed significantly to lowering the sensitivity of the Turkish economy against external shocks. In the current environment of highly uncertain global markets, the gains from maintaining and further advancing these achievements are significant. Any measure to provide permanent fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping the interest rates of long-term government securities at low levels.