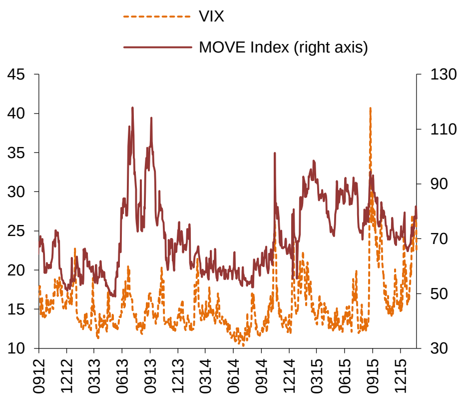
1. Overview

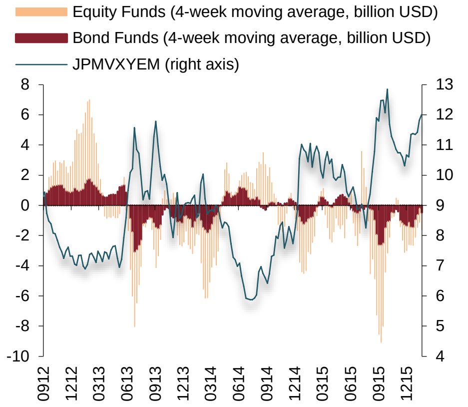
Volatilities in financial markets continue amid uncertainties about global monetary policies and concerns over global growth. Volatility indices declined slightly after the anticipated first Fed rate hike in December 2015; however, they started increasing as of early 2016 mainly due to concerns about the Chinese economy and geopolitical developments (Chart 1.1). The global economic slowdown since 2014 continued into the second half of 2015, especially in emerging market economies. Commodity prices have recently decreased as well. Emerging economies were largely affected by the global fluctuations in this period. Portfolio inflows stayed weak and exchange rate volatilities remained high (Chart 1.2).

Chart 1.1.
VIX and MOVE Volatility Indices
(Basis Points)



Source: Bloomberg.

Chart 1.2.
Portfolio Flows to Emerging Economies and JPMVXYEM Volatility Index



Source: EPFR, Bloomberg.

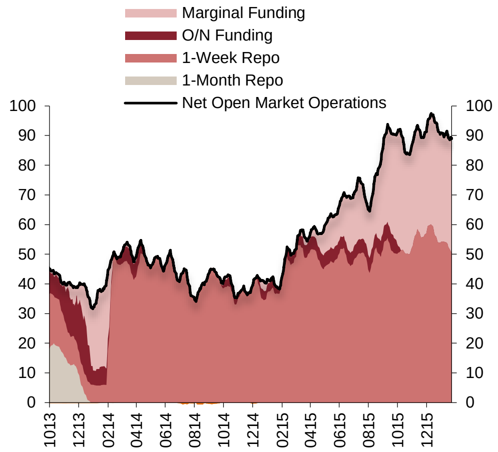
The effects of global market volatility were also felt in the Turkish economy. However, alleviated domestic uncertainty and the CBRT's tight monetary policy stance besides its liquidity policy and macroprudential measures contained these effects. The GDP has remained on a steady, moderate upward track. Demand from the EU economies continues to support exports despite elevated geopolitical risks in other export markets. On the inflation front, energy price developments affect inflation favorably, while other cost factors limit the improvement in the core inflation trend. The CBRT will maintain its tight monetary policy stance until there is a significant improvement in the inflation outlook.

1.1. Monetary Policy and Financial Conditions

As per the road map released in August 2015 regarding the policies to be implemented before and after the normalization of global monetary policies, the CBRT's policy stance remained tight against Turkish lira liquidity, stabilizing for the FX liquidity, and supportive of financial stability. In order to simplify the operational framework of the liquidity policy, the lower interest rate facility on borrowing provided for primary dealers by the CBRT was terminated and collateral conditions were simplified following the announcement of the road map. The newly adopted use of foreign exchange deposits as collateral against Turkish lira transactions aimed at enhancing the efficiency of banks' liquidity management. Moreover, the CBRT took further steps to support foreign exchange liquidity, core liabilities and long-term borrowing.

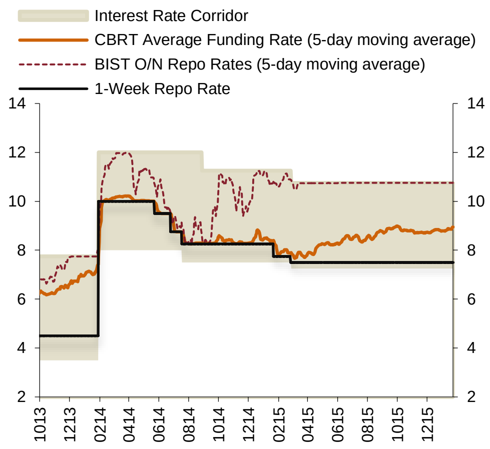
In view of inflation expectations, the pricing behavior and other factors affecting inflation, the CBRT maintained its tight monetary policy and liquidity stance throughout 2015. Accordingly, the one-week repo rate, the overnight lending rate and the overnight borrowing rate were kept unchanged at 7.5, 10.75 and 7.25 percent, respectively, during the last quarter of 2015 and in January 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 1.1.1). Thus, the average funding rate settled at around 8.9 percent as of January 2016, higher than the one-week repo rate. Additionally, the BIST overnight repo rates were kept at the upper band of the interest rate corridor (Chart 1.1.2). 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, the CBRT will maintain its tight monetary policy stance as long as deemed necessary.

Chart 1.1.1.
CBRT Funding*
(2-Week Moving Average, Billion TL)



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

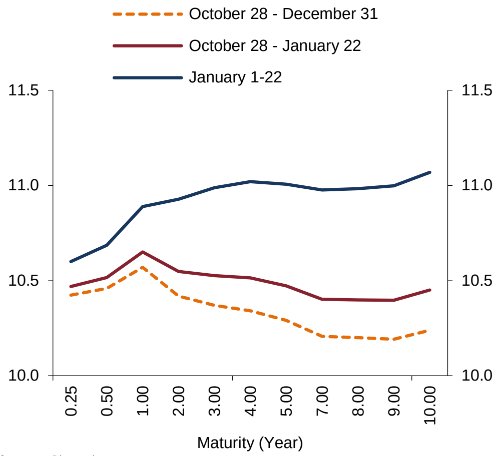
Chart 1.1.2.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



Source: BIST, CBRT.

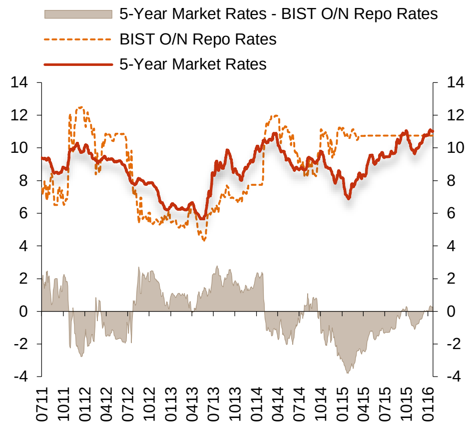
Having remained nearly flat in the last quarter of 2015 as well as throughout the whole year, the yield curve assumed a positive slope in January 2015 (Chart 1.1.3). This was mainly due to long-term rates that rose amid the uncertainty surrounding global markets, geopolitical risks and heightened inflation expectations, which also affected the spread between 5-year market rates and the BIST overnight repo rates. After remaining negative across the fourth quarter of 2015, the spread turned slightly positive in early January amid rising 5-year market rates (Chart 1.1.4).

Chart 1.1.3.
Yield Curve
(Percent)



Source: Bloomberg.

Chart 1.1.4.
Market Rates
(Percent)



Source: Bloomberg, BIST.

Regarding Turkish lira liquidity policy, there has been some decline in banks' FX swap transactions with the market for short-term funds owing partly to changes made to the guidelines for the use of FX deposits as collateral as per the road map. Considering that banks' need for FX swaps can be further reduced through higher use of FX deposits for collateral and by increased allowances, these limits were increased from 3 billion USD to 3.6 billion USD and from 900 million EUR to 1.8 billion EUR as of January 7. Moreover, 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 was raised to 70 percent effective January 13. This arrangement is expected to counterbalance the possible stress 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 the Turkish lira liquidity policy of 2016 can be found in the "Monetary and Exchange Rate Policy for 2016" published on December 9, 2015.

Besides interest rate and liquidity policies, the CBRT continues to promote prudential borrowing by employing other policy instruments that support financial stability. The CBRT has 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 decelerating the growth of loan-to-deposit ratio (Chart 1.1.5). In order to reduce the intermediation costs of the banking system and provide additional support to core liabilities, remuneration rates on TL required reserves were raised by 50 basis points each in September, October and December 2015. Additionally, some adjustments were made to the coverage of reserve requirements on January 9. Accordingly, certain funds at participation and investment banks were subjected to reserve requirements and the coverage of non-core liabilities was expanded.

Chart 1.1.5.
Non-Deposit FX Liabilities by Maturity
(Percent)

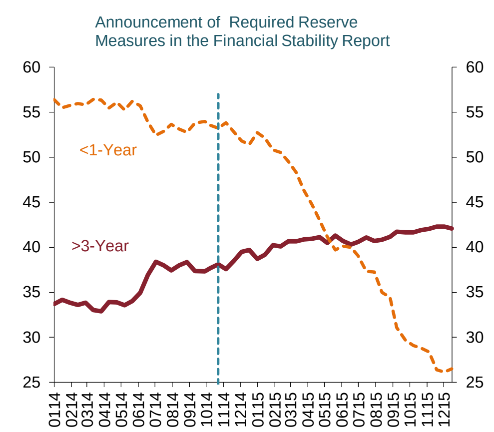
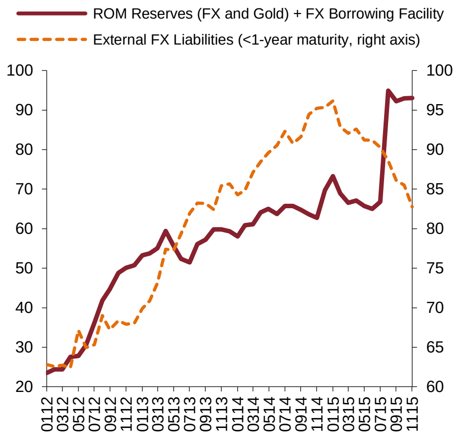


Chart 1.1.6.
ROM Reserves, FX Borrowing Facility and External FX Liabilities of Banks
(Billion USD)



Source: CBRT.

In the road map released in August, the CBRT also included some measures to enhance the flexibility of the foreign exchange liquidity management. To this end, transaction limits for banks at the CBRT Foreign Exchange and Banknotes Markets were raised on September 1. Consequently, the sum of ROM reserves and FX deposits of banks at the CBRT reached a level that is considerably above the external FX liabilities of banks with less than one-year maturity (Chart 1.1.6). Moreover, the "Monetary and Exchange Rate Policy for 2016" released on December 9 announced further steps to strengthen the stabilizing feature of the ROM. All these measures taken in line with the road map are assessed to have increased Turkey's resilience against global volatility.

In an economic environment fraught with prolonged global uncertainties, containing negative spillovers on the Turkish economy is important. In terms of economic fundamentals, significant achievements were made regarding the alleviation of fragilities. In particular, current account balance improved considerably over the past few years on the back of the tight monetary policy, the adopted macroprudential measures and the sharp fall in commodity prices, while loans continued to grow at reasonable levels with their composition changing in favor of price stability and financial stability. Moreover, the effective use of the measures presented in the August road map has alleviated the excessive fluctuations in exchange rates and loan rates. The current tight monetary policy leads to lower sensitivity to global shocks, thus supporting financial stability. The CBRT maintains 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 decelerated due to the CBRT's tight monetary policy stance and also the BRSA's macroprudential measures on non-mortgage consumer loans and fell to 13.6 percent in exchange rate adjusted terms. The noticeable slowdown in 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 1.1.7). 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. These developments in loan growth and loan composition are expected to contribute to the rebalancing process and financial stability as well as to limit the effects of the recent cost pressures on inflation. The annualized growth rates in 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 1.1.8). 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, annual loan growth rates are expected to remain at reasonable levels in the coming months.

Chart 1.1.7.
Annual Loan Growth
(Adjusted for Exchange Rate, Annual Percent Change)

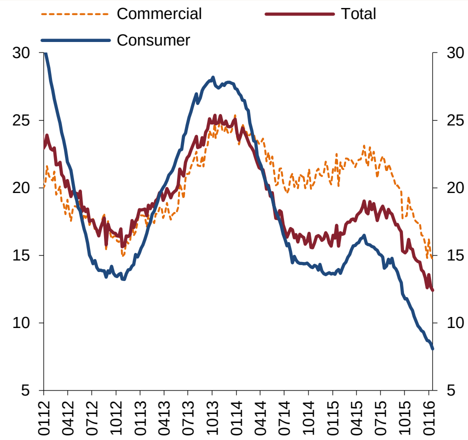
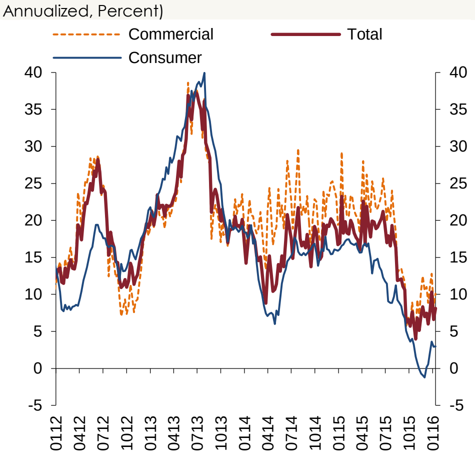


Chart 1.1.8.
Annualized Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the fourth quarter of 2015, consumer price inflation increased by about 0.86 percent 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 1.2.1). Unprocessed food prices were the main drivers of this higher-than-expected rise in annual inflation. In fact, inflation excluding unprocessed food and tobacco was close to the October Inflation Report forecast in this period (Chart 1.2.12). 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 1.2.1.
Inflation Forecasts and Realizations*
(Percent)

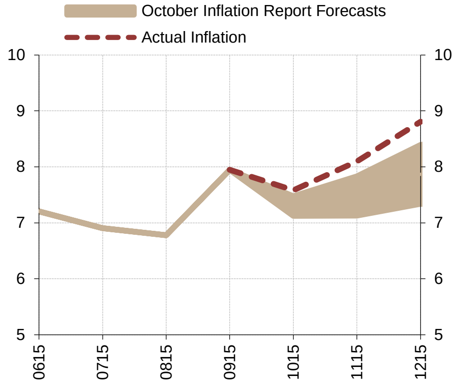
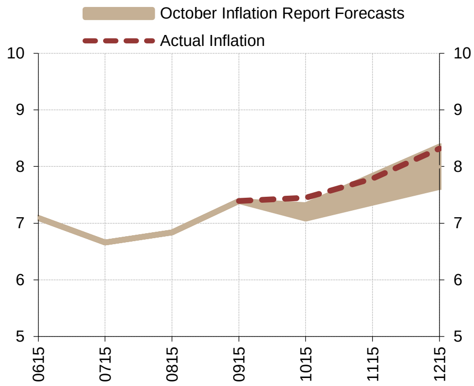


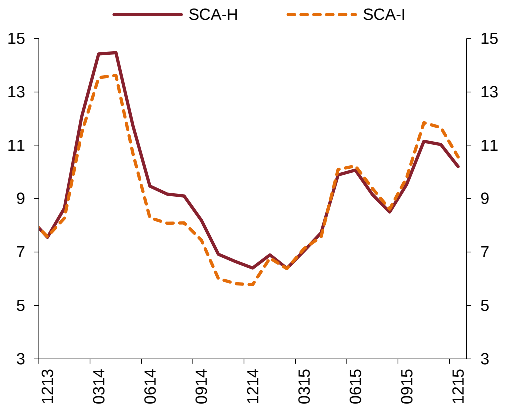
Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco* (Percent)



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

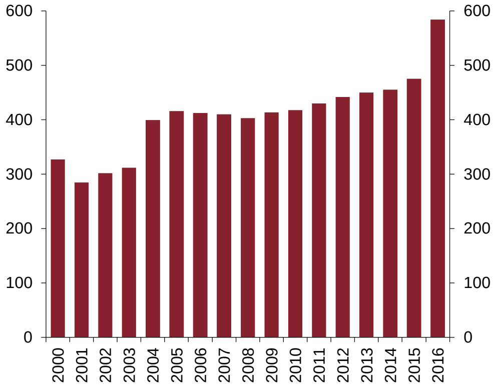
In the fourth quarter, despite the decline in USD-denominated import prices, cost pressures on inflation continued due to food prices and exchange rate developments. These rising cost factors limit the improvement in the underlying trend of core inflation (Chart 1.2.3). Furthermore, the effects of the adjustment in minimum wages on overall wages and inflation will be closely monitored (Chart 1.2.4).

Chart 1.2.3.
Core Inflation Indicators SCA-H and SCA-I
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



Source: TURKSTAT, CBRT.

Chart 1.2.4.
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 with base year 2003. Real gross minimum wage for 2016 is calculated by January 2016 Inflation Report forecasts.
Source: Ministry of Labor and Social Security, TurkStat, CBRT.

In sum, annual inflation increased in the fourth quarter due to ongoing rise in food prices as well as the lagged effects of the Turkish lira depreciation throughout 2015. The future course of inflation is expected to 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, inflation is expected to remain elevated for some time. At this point, fighting against structural inflation is deemed to be important besides maintaining a tight monetary policy stance.

The current policy framework managed to prevent further worsening in inflation and inflation expectations given significant external shocks in recent years. However, price stability is yet to be achieved. Ten years of experience with inflation targeting have shown that the fight against inflation requires collaboration from all relevant parties. Public revenue and wage policies as well as structural issues related to food prices are important elements of the fight against inflation. Moreover, macroprudential policies towards prudential borrowing also support the fight against inflation by contributing to a balanced growth. Thus, bringing inflation permanently down to the 5-percent target requires strong commitment from all institutions to maintain efforts made in the recent years.

Supply and Demand

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 in quarterly and annual terms, respectively (Chart 1.2.5). 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 1.2.6).

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

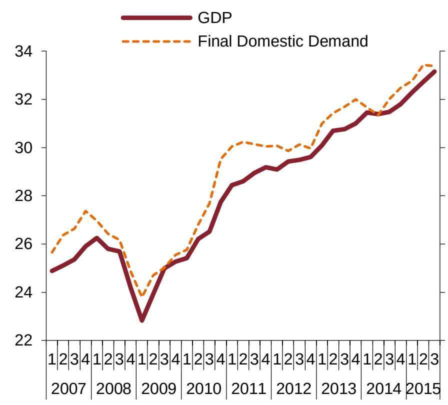
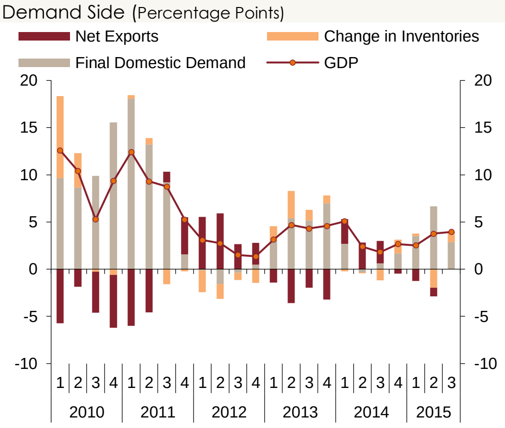


Chart 1.2.6.
Annual GDP Growth and Contributions from the Demand Side (Percentage Points)

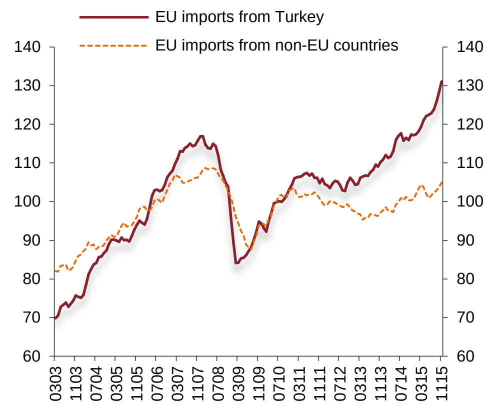


Source: TURKSTAT.

Current indicators hint at a milder course in consumption coupled with a slight rebound in investment in the fourth quarter of 2015 compared to the previous quarter. In the October-November period, industrial production stood 0.6 percent above the third-quarter average. As per the indicators for December, industrial production is expected to display a more moderate increase in the fourth quarter compared to the previous quarter. Similarly, sales, production, and import indicators regarding the domestic demand also suggest a modest contribution of the final domestic demand to growth. Foreign trade indicators excluding gold show a more robust increase in exports compared to imports in the October-November period. Geopolitical risks accompanied by the income effect that may emerge due to the adverse consequences of the ongoing decline in oil prices in Turkey's oil-exporting trading partners stand out as potential inhibitors of exports, while the rising demand from the EU countries continues to support exports.

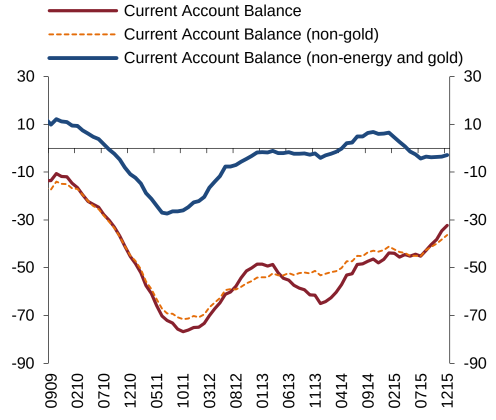
The demand outlook for 2016 leads to expectations of stronger economic activity compared to 2015. Amid waning domestic uncertainties, rising consumer and investor confidence may boost domestic demand. The deferred investments in 2015 due to domestic uncertainties to take place at least partially in 2016 and higher income on the back of the strong post-crisis employment performance as well as the recent wage developments are expected to support domestic demand. Moreover, the projected fall in the current account deficit and the robust public finances also provide room for policy maneuvering against possible shocks. The rebound in the EU economy continues to support Turkey's exports, while the uncertainties regarding the Middle East and Russia pose downside risks (Chart 1.2.7). Moreover, volatility in global financial markets and concerns over global growth may deteriorate financial conditions and external demand. In sum, it is expected that the domestic demand will prove slightly stronger than 2015, while the recovery in the EU will drive foreign demand higher in 2016 despite the existence of the geopolitical risks. Accordingly, adherence to macroprudential measures and the favorable developments in the terms of trade are projected to support the ongoing improvement in the current account deficit (Chart 1.2.8).

Chart 1.2.7.
EU Imports
(Real, Seasonally Adjusted, 3-Month Average, 2010=100)



Source: Eurostat.

Chart 1.2.8.
Current Account Balance
(12-Month Cumulative, Billion USD)



Source: CBRT.

Oil, Imports and Food Prices

International commodity prices, oil prices in particular, continued to trend downwards in the last quarter of 2015. Owing mostly to the insufficient demand in China and other emerging economies, this caused import prices in the Turkish economy to recede in USD-denominated terms. Hence, crude oil prices and USD-denominated import prices were revised downwards (Charts 1.2.9 and 1.2.10, Table 7.1.1). With regard to annual averages, crude oil price assumptions were reduced from 54 USD to 37 USD for 2016. Also, assumptions for annual percentage changes in average import prices were revised downwards by 4.9 percent for 2016. The assumption for food price inflation was revised upwards from 8 percent to 9 percent for 2016 mostly due to the effects of minimum wage adjustments on costs and demand.

Chart 1.2.9.
Revisions in Oil Prices*
(USD/bbl)

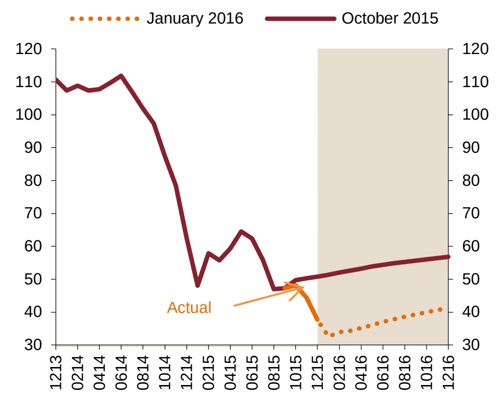
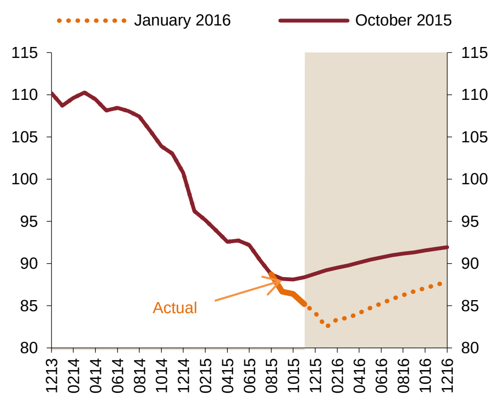


Chart 1.2.10.
Revisions in Import Prices*
(USD, 2010=100)



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

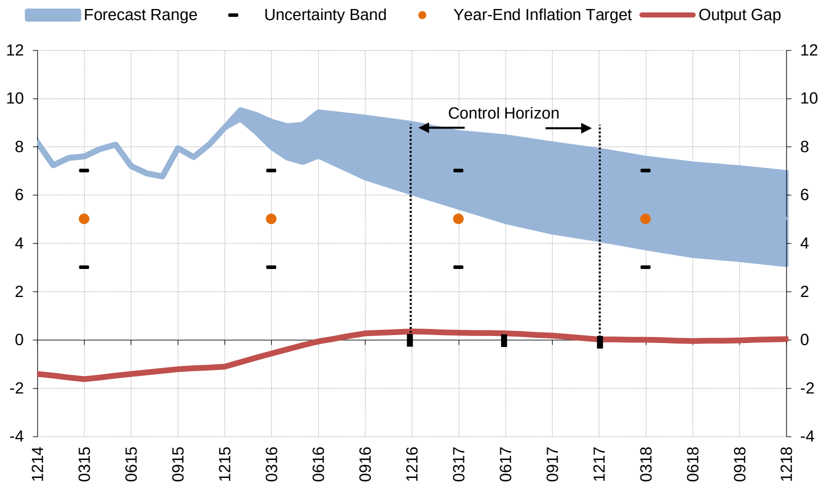
Fiscal Policy and Tax Adjustments

Effective as of January 2016, certain items with administered prices saw price increases. The additional effect on the year-end inflation of the portion of these increases that remain above 5 percent is estimated to be 0.4 percent in 2016. Meanwhile, the effect of the minimum wage rise on budget balance and tax adjustments is being carefully monitored. The effect of wage developments on production costs, aggregate demand and inflation depends on fiscal policy and the change in employment. Hence, the interaction of the minimum wage rise with the fiscal policy is also being closely monitored. The medium-term forecasts are based on an outlook that adjustments to taxes and administered prices, excluding those already announced in January, will be consistent with inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2016-2018 period. Conditional on this outlook, inflation is expected to improve gradually and reach the 5-percent target in the medium term.

1.3. Inflation and the Monetary Policy Outlook

Given a decisive policy stance that focuses on reducing inflation, 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. Accordingly, 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) 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 year-end inflation forecasts for 2016 and 2017 were revised upwards by 1 percent and 0.5 percent, respectively, compared to the October Inflation Report forecasts (Chart 7.2.2). As stated above, driven mostly by oil prices, USD-denominated import prices have registered a considerable decline since October 2015. Together with the exchange rate developments, the downward revision in the assumption for oil and import prices is expected to pull the end-2016 inflation forecast down by 0.6 percent compared to the October Inflation Report forecast. On the other hand, the portion of January 2015 public price adjustments which exceeds the inflation target is projected to push the end-2016 inflation forecast up by 0.4 percent. 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, the end-2016 inflation forecast was revised upwards by 1 percent. Of this estimated effect of the minimum wage rise, 0.3 percent is attributed to the food inflation that was raised from 8 to 9 percent for 2016. Lastly, a higher-than-projected actual inflation rate at the end of 2015 compared to the October Inflation Report forecast and the rise in core inflation indicators are estimated to push the end-2016 inflation by 0.2 percent. In sum, of the total change in the year-end inflation forecast for 2016 compared to the previous reporting period, 1 percent stemmed from the minimum wage hike, 0.4 percent was caused by administered price changes that are above the inflation target and 0.2 percent was owed to 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 percent.

Moreover, of the 0.5 percent upward revision to the end-2017 inflation forecast, which was stated as 5.5 percent in the October Inflation Report, 0.2 percent was caused by the lagged effects of the minimum wage increase and 0.3 percent stemmed from the upward revision in the end-2016 inflation forecast and the deterioration in the underlying trend of inflation (Table 7.2.1).

1.4. Risks and the Monetary Policy

Annual loan growth remains reasonable thanks to the tight monetary policy stance and the adopted macroprudential measures. Given its recent course, it can be observed that loan growth stayed below historical averages throughout 2015 for consumer loans and in the second half of the year for commercial loans. Recent arrangements in risk weights and minimum wages are considered to boost loan growth via loan supply and household income channels. On the other hand, the ongoing tightness in financial conditions is likely to keep the annual loan growth rates at reasonable levels. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This limits medium-term inflationary pressures and supports the improvement in the current account balance.

In the upcoming period, it is envisaged that the domestic demand will provide a slightly larger contribution to growth and the rising demand from the EU will continue to improve exports. The recovery in investor and consumer confidence fueled by waning domestic uncertainties, the room for spending amid the fall in oil prices and the effects of the recent wage developments on purchasing power are projected to boost domestic demand. Persisting global volatilities and the tightness in financial conditions stand out as the factors that limit the domestic demand increase. On the foreign demand front, geopolitical developments, which pose a downside risk on exports, are counterbalanced by the recovery in the European economies and the ability of Turkey to shift markets. In fact, recently, exports towards EU countries have accelerated remarkably. Moreover, improvements in the terms of trade mainly led by the sharp fall in commodity prices, accompanied by the sluggish course of consumer loans support the improvement in the current account balance. Accordingly, the current account deficit is expected to decline further in the upcoming period.

Energy price developments affect inflation favorably, while other cost factors limit the improvement in the core inflation trend. Food prices remain volatile mainly due to the unprocessed food prices. Lagged effects of the depreciation in the Turkish lira are evident particularly on the core goods inflation. Moreover, as the minimum wage hike passes through to overall wages, cost and demand pressures on inflation driven by wages are likely to increase in the upcoming period. Accordingly, core inflation indicators are expected to remain high for a while. The effect of the above-target inflation on expectations and the acceleration in wage increases require the pricing behavior in the overall economy to be monitored closely. In this respect, in view of the impact of wage developments and the uncertainty in global markets on inflation expectations and the pricing behavior, and in consideration of the volatility in energy and unprocessed food prices, the CBRT stated that the tight liquidity stance will be maintained as long as deemed necessary. Future monetary policy decisions will be conditional on the inflation outlook. Taking into account inflation expectations, pricing behavior and the course of other factors affecting inflation, the tight monetary policy stance will be maintained.

Uncertainties surrounding global monetary policies and concerns over global growth cause financial markets to remain volatile. Thus, portfolio flows to emerging market economies and risk indicators follow a highly volatile pattern. Exchange rates also display a quite fluctuating course. The CBRT assesses that the policy tools laid out in the road map announced in August 2015 strengthen the resilience of the economy against global shocks.

In the upcoming period, both global and domestic volatilities will be monitored closely and necessary measures will continue to be taken. Accordingly, should loan growth decelerate permanently and exchange rates face further upward pressure, the CBRT, while preserving the tight monetary policy stance, may take measures to support the Turkish lira and loan growth by revising the funding conditions for the use of foreign currency denominated collateral. In this respect, the CBRT's policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of the financial stability.

The CBRT stated that the wide interest rate corridor has contributed to containing exchange rate volatility in times of heightened global volatility. The need for such an instrument would be reduced, should the decline in global volatility prove persistent. Another factor reducing the need for a wide interest rate corridor is the effective use of policy instruments as per the road map published in August. Excessive fluctuations both in exchange rates and loans have waned owing to the launch and effective use of these instruments. The CBRT's assessment still prevails that the monetary policy may be implemented within a narrower and more standard interest rate corridor, should global volatilities see a permanent decline or the policy tools specified in the August road map permanently cap the effects of the global volatility on the Turkish economy.

Developments in the 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. The monetary policy stance may be reviewed should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. Any measure that would ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.