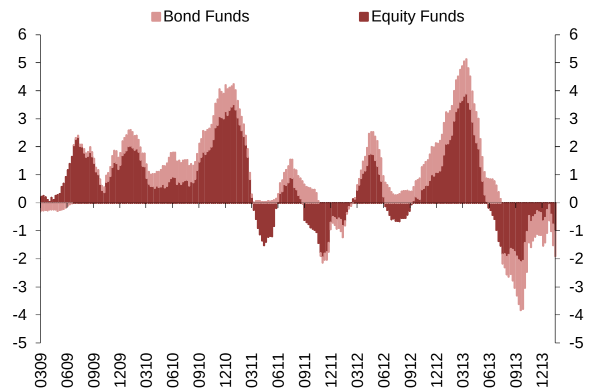
1. Overview

Capital flows into emerging economies remained weak in the last quarter of 2013. The Fed's announcement that the exit strategy from quantitative easing policy would be maintained was influential on this development and outflows were observed especially in portfolio investment (Chart 1.1). Since most of the re-pricing in financial assets was already completed in the early days following the announcement on the exit strategy from the quantitative easing, price movements were more limited during the actual exit. Although this shows that uncertainties about global monetary policies have partially been alleviated, ongoing risks to the pace of global economic recovery in the upcoming period elevate uncertainties about the quantitative easing exit process and other components of the monetary policy such as forward guidance.

Chart 1.1.
Portfolio Flows to Emerging Economies
(12-Week Moving Average, Billion USD)



Source: EPFR.

1.1. Monetary Policy and Financial Conditions

In the last quarter of 2013, inflation was well above the October forecast, mostly due to the higher-than-expected food inflation and exchange rate volatility. The cautious stance of the monetary policy was strengthened in order to contain the deteriorating effects of inflation on the pricing behavior. Accordingly, one-month repo auctions were terminated, the average cost of funding was kept above 6.75 percent, and the liquidity policy was adjusted so that the BIST Interbank O/N rates were kept around 7.75 percent (Charts 1.1.1 and 1.1.2).

Since the release of the latest Inflation Report, the CBRT has continued to provide FX liquidity to the market via FX selling auctions. The unsterilization of the FX selling auctions has increased the liquidity need of the financial system. In addition, the average maturity of the funds provided by the CBRT has been shortened. As a result, the CBRT average funding rate and the BIST Interbank O/N repo rates have increased (Chart 1.1.1).

Chart 1.1.1. O/N Rates at the BIST Interbank Repo and Reverse Repo Market*
(Percent)

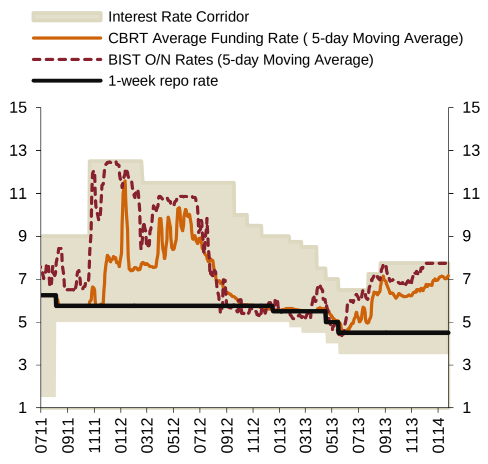
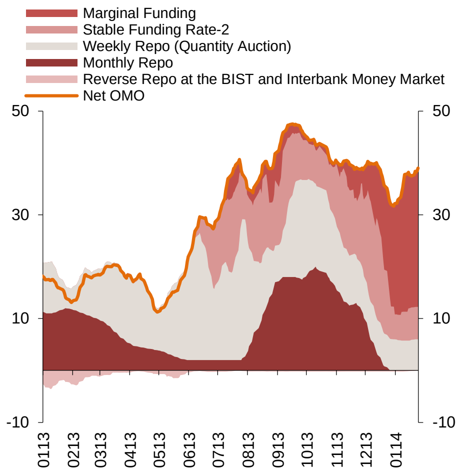


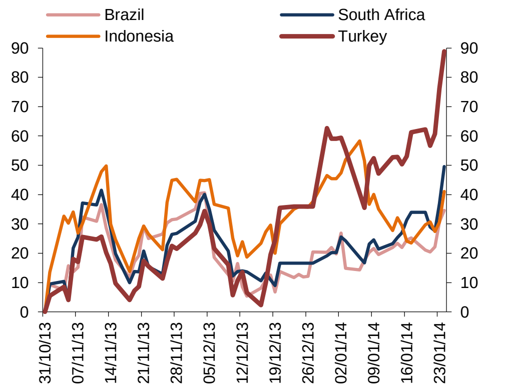
Chart 1.1.2. CBRT Funding**
(2-Week Moving Average, Billion TL)



* BIST O/N Rate is the O/N rate at the BIST Interbank Repo Market.
** Stable Funding Rate-2 is the O/N rate charged to primary dealers for funds provided within their limits, while marginal funding is O/N funding quoted at the upper limit of the corridor.
Source: BIST, CBRT.

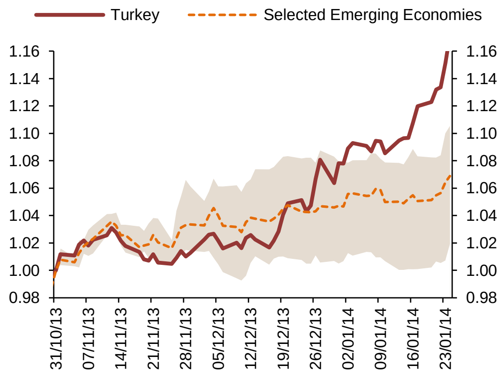
As a consequence of the domestic developments starting from the last quarter of the year, Turkey has slightly diverged from other emerging economies. In this period, Turkey's exchange rate depreciated more against the US dollar compared to economies with similar economic conditions and its relative risk increased (Charts 1.1.3 and 1.1.4). The exchange rate depreciation is expected to impose additional pressure on inflation in the upcoming period should the domestic uncertainty remain elevated for a long time. Meanwhile, aggregate demand conditions may put downward pressure on inflation amid rising risks and market rates. Therefore, how the domestic uncertainties will unfold in the upcoming period and their effect on the inflation outlook are crucial to the monetary policy stance.

Chart 1.1.3.
CDS Rates in Selected Emerging Markets*
(Basis Points)



* Change from October 31, 2013 to January 24, 2014.
Source: Bloomberg.

Chart 1.1.4.
TL and Selected Emerging Market Currencies vs USD*
(31.10.2013=1)



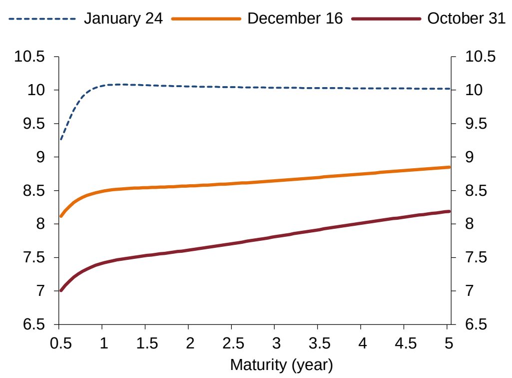
* Selected emerging economies include Brazil, South Africa, India, Indonesia and Turkey.
Source: Bloomberg.

Against this background, the CBRT assessed that it would be more appropriate to implement a flexible mechanism that can be enforced when deemed necessary. Thus, on days when additional monetary tightening is required, it was decided that the Interbank O/N rates would be kept around 9 percent instead of

7.75 percent (marginal funding rate). Accordingly, the increased flexibility of the policy framework allowed for a more prompt response to possible risk realizations.

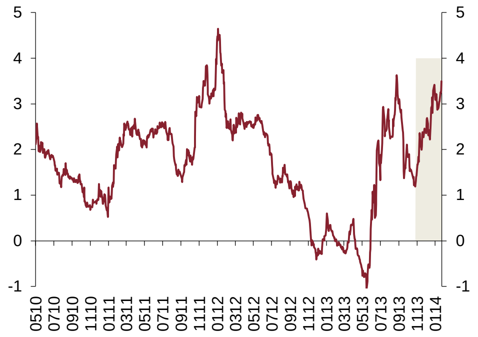
In the last quarter of the year, the cautious monetary policy stance, the tapering of the Fed's quantitative easing as well as the domestic uncertainties caused interest rates to rise across all maturities (Chart 1.1.5). As nominal interest rates increased more than inflation expectations, 2-year real interest rates posted an increase as well (Chart 1.1.6).

Chart 1.1.5. Yield Curve* (Percent)



* Calculated from the compounded returns on bonds quoted at the BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

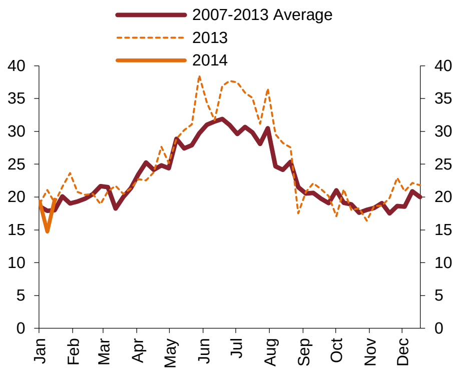
Chart 1.1.6. 2-Year Real Interest Rates for Turkey* (Percent)



* Calculated as the difference between 2-year discounted bond returns derived from the yield curve and the 24-month ahead inflation expectations derived from the CBRT Survey of Expectations.
Source: BIST.

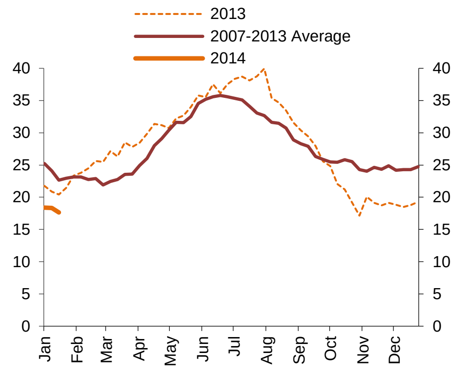
Amid higher market rates, banks' funding costs also soared, which were passed on to personal and commercial loan rates. The increase in loan rates and economic risks put pressure on both credit demand and credit supply, and slowed down growth rate of loans in the last quarter, consumer loans in particular (Charts 1.1.7and 1.1.8).

Chart 1.1.7.
Commercial Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

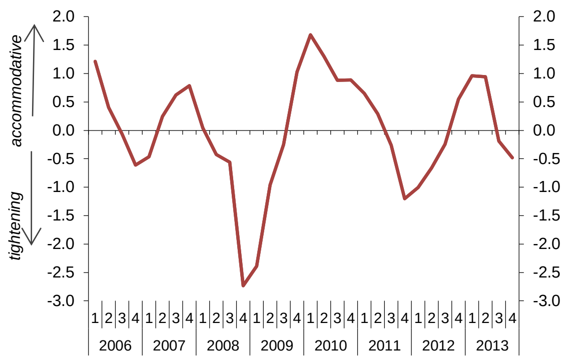
Chart 1.1.8.
Consumer Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

Following the macroprudential measures taken by the BRSA, the growth rates of personal loans and credit card debts are expected to slacken further in the forthcoming period. Moreover, the fact that the CBRT increased the funding need of the financial system and lowered the maturity of its funding will also contribute to the slowdown in consumer loans. In fact, there has been a significant tightening in financial conditions as of the last quarter of the year (Chart 1.1.9).

Chart 1.1.9.
Financial Conditions Index*



*For further details on financial conditions index, see the CBT Research Notes in Economics No. 12/31.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation increased by 1.2 points year-on-year to 7.4 percent in 2013, overshooting the uncertainty band around the target (Charts 1.2.1 and 1.2.2). Inflation, which soared on tax adjustments on tobacco at the beginning of 2013, followed a volatile path in the remaining part of the year due to developments in unprocessed food and energy prices. In the second half of the year, the depreciation of the Turkish lira caused core inflation indicators to rise particularly through the core goods group. In addition, the higher-than-envisaged yearly increase in food prices also affected inflation. The main factors that curbed the rise in inflation throughout the year were the relatively flat course of import prices and the moderate course of administered energy prices.

Chart 1.2.1.
October 2013 Inflation Forecasts and Realizations
(Percent)

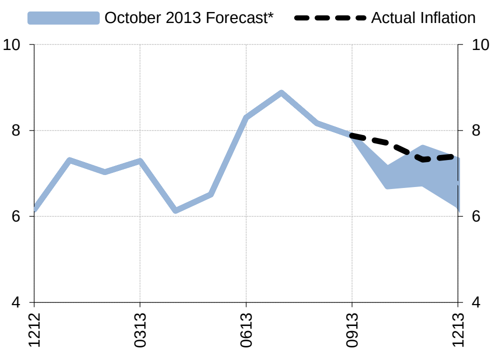
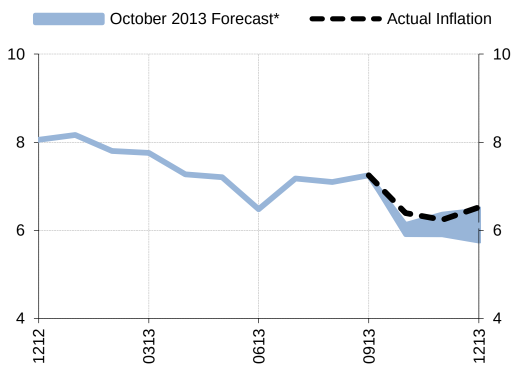


Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food, Tobacco and Alcoholic Beverages
(Percent)



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

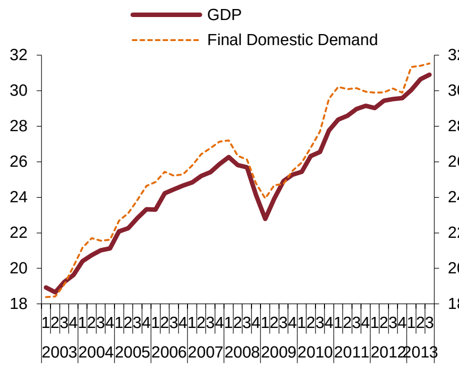
Across subcategories, the total contribution of food and energy to inflation remained unchanged in 2013 compared to the previous year, while the rise in inflation is attributed to core inflation indicators and tax adjustments. In this period, the contribution of services and core goods to inflation increased by 0.8 points, while that of the alcohol and tobacco was up 0.4 points. The increase in core goods was mostly driven by the exchange rate, while, excluding definitional differences and temporary movements, the outlook for services inflation changed merely from the previous year-end.

The 2014 outlook for core inflation indicators may change depending on the degree of pass-through from tax hikes to final prices as well as the course of exchange rates and the economic activity. As implied by the indicators in January, the effect of taxes and exchange rates are particularly evident on annual core goods inflation. The rapid deterioration of inflation expectations spurred by developments in supply and cost factors is another channel that has an adverse effect on the outlook. However, the extent to which the aggregate demand conditions will restrict inflationary pressures in the upcoming period will be determined by the duration of the current economic cycle.

Supply and Demand

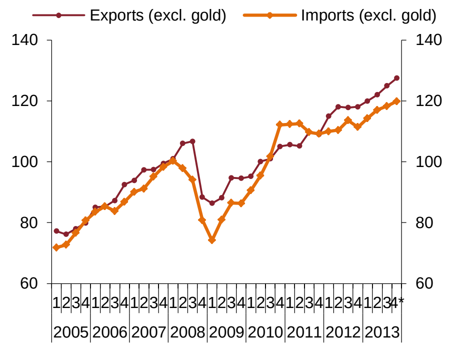
According to the GDP data for the third quarter of 2013, economic activity was largely consistent with the outlook presented in the October Inflation Report. Final domestic demand grew modestly in the third quarter (Chart 1.2.3). Analysis of the final domestic demand components shows that private demand continued to increase steadily, while public demand decreased for the second consecutive quarter after a strong first-quarter growth. Net exports provided a positive contribution to quarterly growth in this period.

Chart 1.2.3.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)



Source: TurkStat, CBRT.

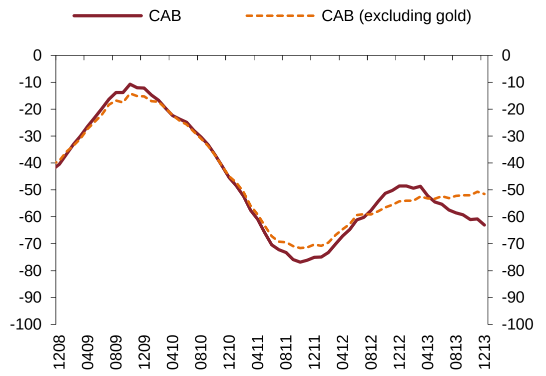
Chart 1.2.4.
Export and Import Quantity Indices
(Seasonally Adjusted, 2010=100)



* Estimate for December.
Source: TurkStat, CBRT.

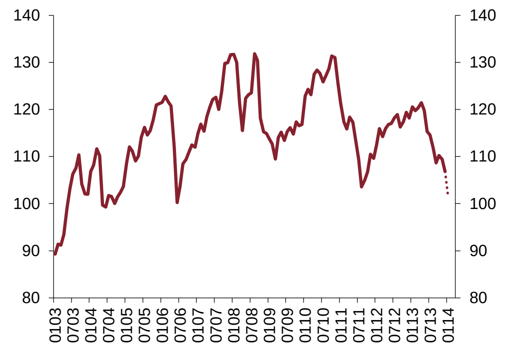
Data for the final quarter of 2013 suggest that economic activity continued to grow moderately. On the production side, the industrial production index was up in October-November from the third-quarter average, continuing on the steady quarterly growth trend. On the spending side, production, imports and survey data on both consumption and investment goods show that private demand maintained its stable growth momentum in the final quarter. Meanwhile, rebalancing of the goods trade excluding gold continued in the last quarter of 2013 (Chart 1.2.4). In this period, data on the current account balance were consistent with expectations. Excluding the recent temporary fluctuation of the gold trade, the 12-month cumulative non-gold deficit reflecting the underlying current account balance continued to improve (Chart 1.2.5). The real exchange rate, on the other hand, depreciated after May 2013 (Chart 1.2.6). This real depreciation is expected to support the improvement in the current account balance.

Chart 1.2.5.
Current Account Balance*
(12-Month Cumulative, Billion USD)



Source: TurkStat, CBRT.

Chart 1.2.6.
Real Effective Exchange Rate*
(2003=100)



* Estimate as of January 27, 2014.
Source: CBRT.

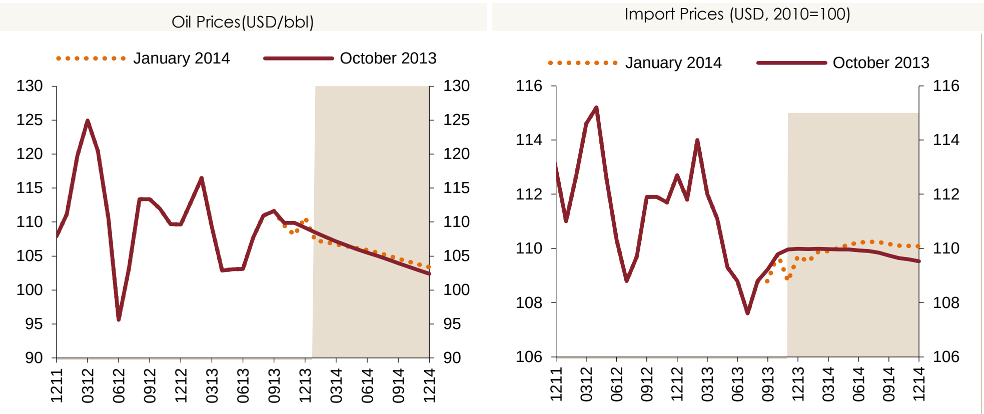
The Turkish lira has depreciated recently, while loan rates have increased and consumer confidence has declined. Accordingly, private sector demand is expected to recede in the first quarter amid falling expenditures on durable consumption goods and investment, which are sensitive to the exchange rate, financing conditions and confidence. In the forthcoming period, the course of private demand will depend on the level at which the exchange rate as well as consumer and investor confidence will stabilize and the time required to reach this level.

Under the assumption that the movements in the exchange rate, interest rate and confidence which have been driven by mounting domestic uncertainty are temporary, private sector demand is envisaged to continue improving in the second quarter of 2014 after a weak course in the first quarter. However, due to the cautious monetary policy stance, the recently adopted macroprudential measures and the weak course of capital flows, the increase in the final domestic demand is expected to remain moderate with risks to be more evident on the downside. Given this outlook, domestic demand developments are expected to partially contain the recent cost-push pressures on prices. Moreover, the expected slowdown in domestic demand is projected to support the recent improvement in the current account deficit and the rebalancing process. Exports are expected to grow further owing also to the recovery in the demand of European countries. Thus, the economy is envisioned to grow mildly and the demand components are expected to be favorably balanced in the upcoming period.

Energy, Imports and Food Prices

In the last quarter of the year, import prices remained slightly below the assumptions presented in the October Inflation Report, while oil prices proved consistent with the forecasts (Chart 1.2.7). The assumption for the average inflation of import prices in 2014 was revised slightly upwards. On the other hand, the average oil price assumption for 2014 was preserved as stated in the October Inflation Report. In other words, forecasts were built on the assumption that inflation would be subject to no significant pressure stemming from import prices in 2014. However, the exchange rate movements amid the external developments since the publication of the October Inflation Report are assumed to add 0.5 percentage points to the end-2014 inflation forecast.

Chart 1.2.7. Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.

Source: TurkStat, CBRT.

Given the recent adverse movements in food prices and the historical averages, the year-end food price inflation assumption was revised up to 8 percent. This revision pushed the end-2014 inflation forecast upwards by around 0.3 percentage points.

Fiscal Policy and Tax Adjustments

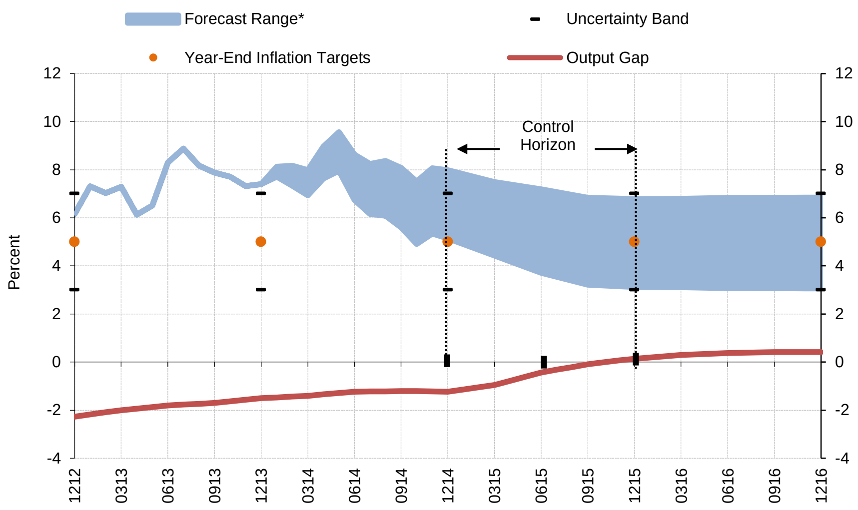
Tax hikes on automobile and tobacco prices in early January are expected to add around 0.5 percentage points to the year-end inflation in 2014. It is assumed that no additional adjustments will be imposed on these prices in the rest of the year, while price hikes to electricity and natural gas are assumed to be consistent with the inflation target.

The medium-term fiscal policy stance is based on the MTP projections covering the 2014-2016 period. Accordingly, it is assumed that the cautious fiscal stance will be maintained and primary expenditures will be kept under control.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on an outlook where the liquidity policy will mostly be tight by sustaining the cautious monetary policy stance and the annual loan growth rate will near the reference value of 15 percent as of the second half of 2014 on the back of the adopted macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 5.2 percent and 8 percent (with a mid-point of 6.6 percent) at end-2014 and between 3.1 percent and 6.9 percent (with a mid-point of 5 percent) at end-2015. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts
(Percent)



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

In sum, the year-end inflation forecast for 2014 was revised upwards by 1.3 percentage points compared to the October Inflation Report. Of this revision, 0.3 percentage points stemmed from the upward revision of the year-end food inflation assumption. Meanwhile, tax adjustments introduced in January will add around 0.5 percentage points to year-end inflation. Moreover, exchange rate movements driven by external developments in the inter-reporting period are expected to add around 0.5 percentage points to year-end inflation.

On account of the tax adjustments and the lagged effects of exchange rate developments, inflation is envisaged to fluctuate and remain considerably above the 5-percent target in the upcoming period. Starting from the second half of the year, inflation is expected to fall and reach at 6.6 percent at the year-end (Chart 1.3.1).

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and the Monetary Policy

Uncertainties regarding global monetary policies have been aggravated since May 2013. As a result, portfolio flows to emerging economies lost pace and financial assets were re-priced in the second half of the year. In the same period, external financing extended to the real sector and the banking sector in Turkey continued, while portfolio flows remained weak. Re-pricing of financial assets caused depreciation of the Turkish lira. Meanwhile, the domestic demand continued to grow mildly, while credits remained on an upward trend. Elevated external uncertainties were mainly influential on exchange rates rather than loans. Exchange rate developments coupled with the high course of food prices led the year-end inflation to considerably exceed the target. Furthermore, these developments also deteriorated inflation expectations. In this period, with a view to containing the risks to inflation and achieving a target-consistent inflation outlook in the medium term, the CBRT enhanced its cautious monetary policy stance and tightened the liquidity policy.

The CBRT closely monitors inflation expectations and the pricing behavior. The slowdown in domestic demand is expected to slightly restrict the effect of the cost-push shocks on inflation in the coming period. However, lagged effects of the exchange rate movements and the unfavorable course of food prices are likely to cause inflation to remain above the target for an extended period. This may result in higher persistence in expectations and stronger inflation inertia. Materialization of such a scenario and deterioration of the pricing behavior will prompt the MPC to implement the necessary tightening in the monetary policy stance.

In 2014, owing both to the expectation for a recovery in the demand of European countries and the real exchange rate developments, exports are expected to partially compensate for the projected fall in private sector demand. On the other hand, the public sector demand posted a notable correction following the robust increase in the first quarter of 2013. Accordingly, even if the private sector demand contracts in the first quarter and remains weak in the rest of the year, it should be noted that other demand components may prove more favorable, thereby balancing the risks to growth that stem from the private sector demand.

On the other hand, should these uncertainties and the heightening of the risk premium last for a long time, the economy may face a significant slowdown through the confidence and balance sheet channels. Should such a risk materialize, the CBRT will pursue a stabilizing policy by using its policy instruments to reduce the intermediation costs of the banks.

The MPC closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. Inflation forecasts presented in the baseline scenario take the framework outlined in the MTP as given. Accordingly, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes on administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

Maintaining the cautious stance in fiscal and financial sector policies is critical to the resilience of our economy against current uncertainties. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, implementation of the structural reforms required by the MTP remains to be of utmost importance.