TÜRKİYE CUMHURİYET MERKEZ BANKASI

BRIEFING ON

OCTOBER 2015 INFLATION REPORT

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28 October 2015, İstanbul

Distinguished Guests,

Welcome to the briefing held to convey the main messages of the Inflation Report of October 2015.

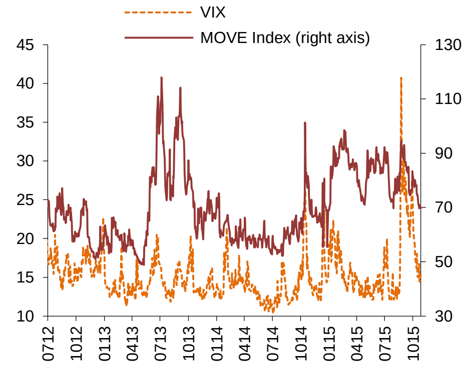
The report typically summarizes the economic outlook underlying monetary policy decisions, shares our evaluations on macroeconomic developments and presents our medium-term inflation forecasts, which were revised in view of the developments in the last quarter, along with our monetary policy stance. In addition to the main text, the report includes seven boxes entailing interesting and up-to-date analyses on various topics. The boxes in this Report look into the determinants of the consumer confidence index; scrutinize income and price elasticities of our exports; perform leading indicator analysis for unemployment rate forecasts and offer projections about the labor participation rate. Moreover, there are boxes that elaborate on the relationship between loans and private savings; exhibit findings on the relationship between consumer and commercial loans and the current account deficit in Turkey and other countries; and analyze public debt stock and budget realizations in Turkey through international comparisons. 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 undeniable influence on our policies. In the third quarter of 2015, volatility in global financial markets continued. Uncertainties in global monetary policies and concerns over global growth have been in the forefront in this quarter. Accordingly, long-term rates remained highly volatile in advanced economies and uncertainty indicators displayed an increase (Chart 1). In the late third quarter and early fourth quarter, volatilities in financial markets declined to some extent due to the growing perceptions that the first rate hike by the US Federal Reserve Bank (the Fed) would be postponed, the announcement that the European Central Bank (ECB) could continue with its monetary policy easing as well as the accommodative decisions taken by the People’s Bank of China.

Financial asset prices in emerging economies were also considerably affected by this volatility I just mentioned (Chart 2). The deceleration trend in global economic activity that started in 2014 continued through the second quarter of 2015. This trend is attributed to the slowdown in China and some other emerging economies.

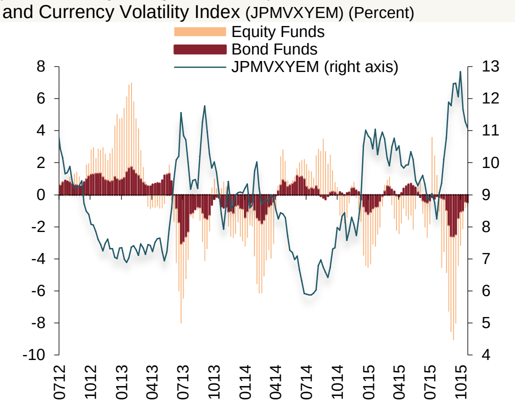
Due to this weak course in global economic activity, commodity prices recorded a decline in the third quarter.

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)



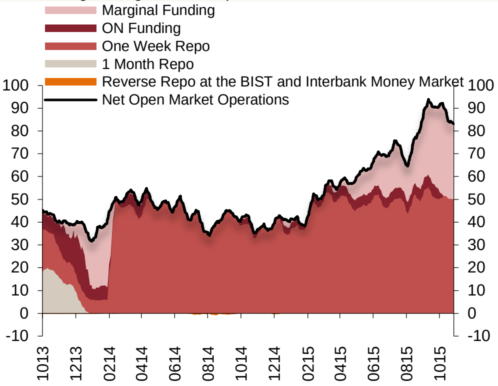
Source: EPFR, Bloomberg

In the third quarter, the volatility in global markets had repercussions also in the Turkish economy and financial indicators went through fluctuations amid domestic uncertainties. In this period, alongside the tight monetary policy stance maintained in consideration of the inflation outlook, the Central Bank of the Republic of Turkey (the CBRT) took steps to support financial stability and stabilize the foreign exchange liquidity along the lines of the road map announced in August.

1. Monetary Policy and Financial Conditions

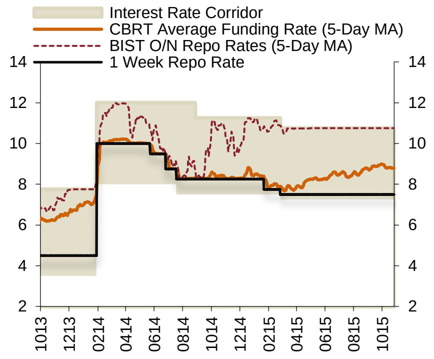
As you all know, we released a road map on 18 August 2015 regarding the policies to be implemented before and during the normalization of global monetary policies. We announced that the width of the corridor will be narrowed and the interest rate corridor will be made more symmetric around the one-week repo interest rate. This announcement also incorporated policies regarding Turkish lira liquidity, foreign exchange liquidity and financial stability to be implemented before and during the normalization. Thus, with respect to the Turkish lira liquidity, we terminated quotation of the interest rate on borrowing facilities provided for primary dealers via repo transactions and simplified collateral conditions for Turkish lira transactions as of 23 September 2015. In addition, we reiterated that foreign exchange deposits can be used as collateral against Turkish lira transactions, and announced new simplified rules regarding the use of this facility. With these arrangements put into effect on 28 September 2015, we aim at enhancing the efficiency of the banks' liquidity management.

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: BIST, CBRT.

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

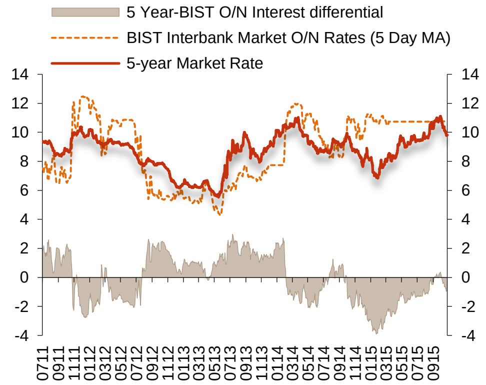


Source: BIST, CBRT.

With a view to limiting the effects of cumulative exchange rate movements recorded since early 2015 and volatilities in energy and food prices both on inflation and inflation expectations, we maintained the tight monetary policy stance in the third quarter of 2015. Owing to the tight liquidity policy we implemented in this period, we increased the average funding rate gradually (Charts 3 and 4). I would like to underline that future monetary policy decisions will be conditional on the inflation outlook. The Central Bank will monitor inflation expectations, the pricing behavior and other factors that affect inflation closely, and will maintain the tight monetary policy stance as long as deemed necessary.

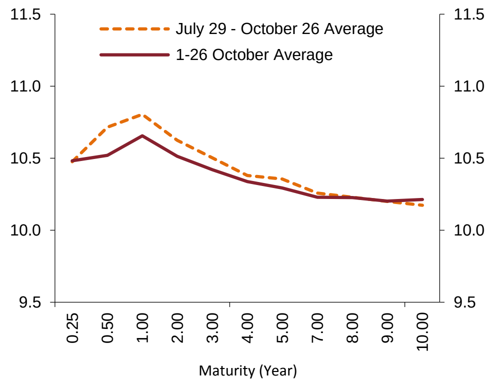
The spread between the 5-year market rate and the interbank overnight repo rate, which was negative across the year, neared zero in October 2015 (Chart 5). The yield curve remained almost flat in this quarter as well (Chart 6).

Chart 5.
Money Market Rates and CBRT Funding Rate (Percent)



Source: CBRT, BIST, Bloomberg.

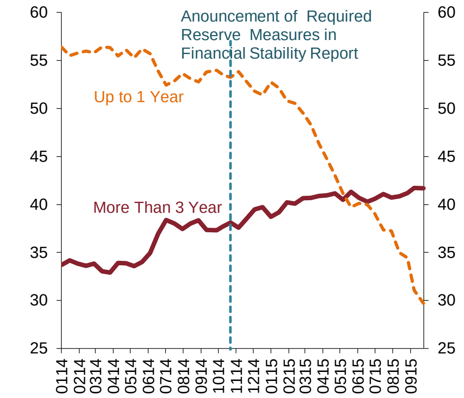
Chart 6.
Yield Curve
(Percent)



Source: Bloomberg.

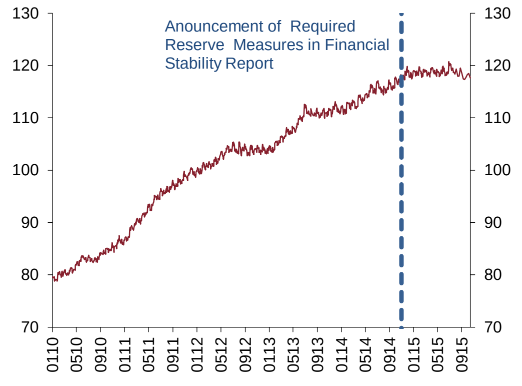
We took measures to enhance financial stability in line with the road map released in August. This change has supported the trend of maturity extension in non-core foreign exchange liabilities observed since November 2014. We attach great importance to the steady upward trend in maturities longer than three years with regard to financial stability (Chart 7). In a separate announcement made on 29 August 2015, we stated that the remuneration rate of Turkish lira required reserves would be increased by 50 basis points each in September, October and December. This arrangement will reduce the intermediation costs of the banking sector and offer an additional support to core liabilities. In fact, as you see on the slide, the Loan/Deposit ratio which was on an upward trend has been replaced by a flat course since the first release of this arrangement in November 2014 (Chart 8).

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



Source: CBRT.

Chart 8.
Credit/Deposit
(Percent)

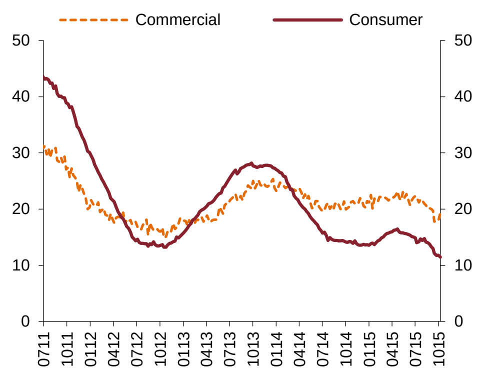


Source: CBRT.

In the road map regarding the steps to be taken during the normalization of global monetary policies, we also included some measures to enhance the flexibility of the foreign exchange liquidity management. In this regard, we raised transaction limits for banks on the CBRT Foreign Exchange and Banknotes Markets by around 130 percent to USD 50 billion on 1 September 2015. Consequently, the sum of deposit limits allocated to banks and gold and foreign exchange assets held at the CBRT under the Reserve Options Mechanism (ROM) reached a level that is considerably above the external debt payments of banks in one year's time. Moreover, we announced that due to the increased volatility in global financial markets, as of 19 August 2015, the amount of the foreign exchange sales auction may be increased by up to USD 70 million above the pre-announced minimum amount. Accordingly, we maintain the stabilizing stance regarding foreign exchange liquidity.

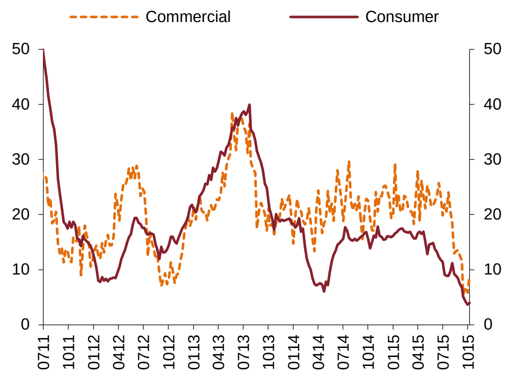
Annual loan growth continues at reasonable rates in response to our tight monetary policy stance and macroprudential measures. Growth rates of loans have recently registered an additional slowdown due to heightened domestic and global uncertainties. The annual growth rate of total credits adjusted for the exchange rate declined to 15.3 percent at the end of the third quarter. Both consumer and commercial loan growth rates registered a notable slowdown in this quarter. The annual growth rate of consumer loans declined to 12.2 percent, while that of commercial loans adjusted for the exchange rate effect fell to 17.8 percent in this period (Chart 9). These developments in the growth and composition of loans contribute both to the rebalancing process and to financial stability (Chart 10).

Chart 9.
Annual Loan Growth
(Adjusted for Exchange Rate, Annual Percent Change)



Source: CBRT

Chart 10.
Annualized Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, 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 third quarter of 2015, annual consumer inflation posted a quarterly increase of around 0.75 point compared to the previous quarter and rose to 7.95 percent, remaining above projections of the July Inflation Report (Charts 11 and 12). Food prices and exchange rate developments are the main drivers of this rise in annual inflation. Meanwhile, exchange rate developments had a limited effect on energy prices due to the decline in oil prices compared to other commodities.

Chart 11.
July Inflation Forecasts and Realizations
(Percent)

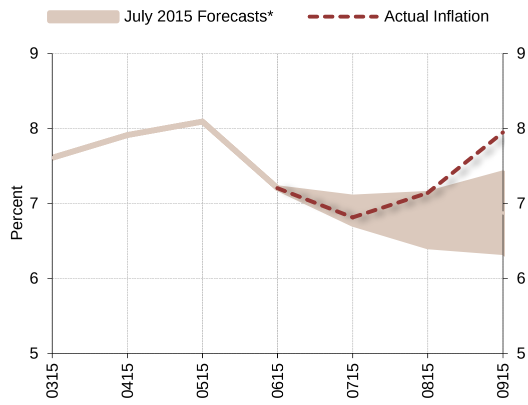
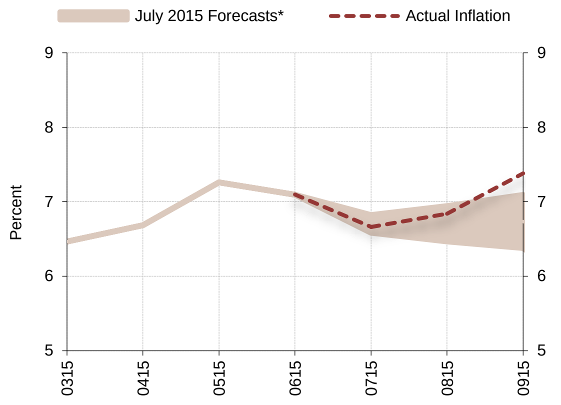


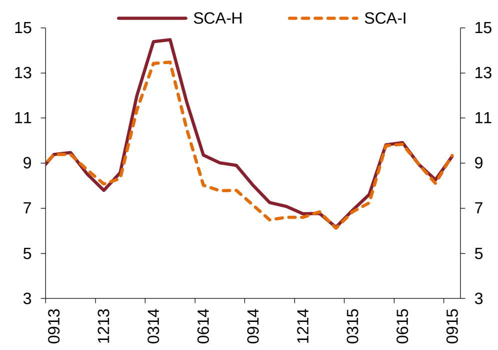
Chart 12.
July Inflation Forecasts and Realizations
Excluding Unprocessed Food and Tobacco (Percent)



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

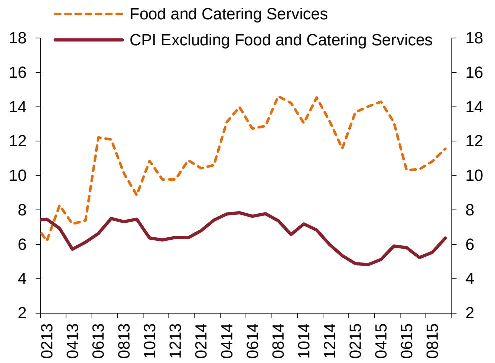
In this period, the underlying trend of core inflation indicators posted a slight decline compared to the previous quarter, yet remained at high levels (Chart 13). Meanwhile, we consider that our tight monetary policy stance and the mild course of domestic demand will limit the exchange rate pass-through to prices compared to similar episodes in the past. Along with the high course of food prices and its repercussions on prices of catering services, the rise in non-food cost factors led consumer inflation excluding food and catering services to increase by around 0.5 point to 6.36 percent in this quarter (Chart 14).

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



Source: TURKSTAT, CBRT.

Chart 14.
Food and Non-Food Prices
(Annual Percentage Change)



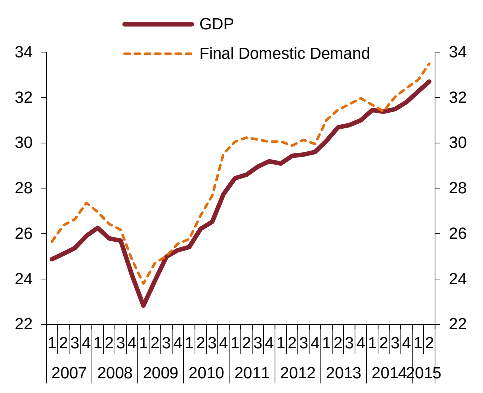
Source: TURKSTAT, CBRT.

Against this background, we expect inflation to hover around current levels for some time and start slowing down afterwards. Conditional on the public finance outlook, inflation is projected to reach the 5 percent target in the medium term.

According to the GDP data of the second quarter of 2015, economic activity proved more robust compared to the outlook presented in the July Inflation Report, and GDP rose by 1.3 and 3.8 percent on a quarterly and annual basis, respectively (Chart 15). An analysis of seasonally-adjusted national income components on the production side indicates that the industrial value added made the highest contribution to GDP, with other items also contributing positively to GDP (Chart 16).

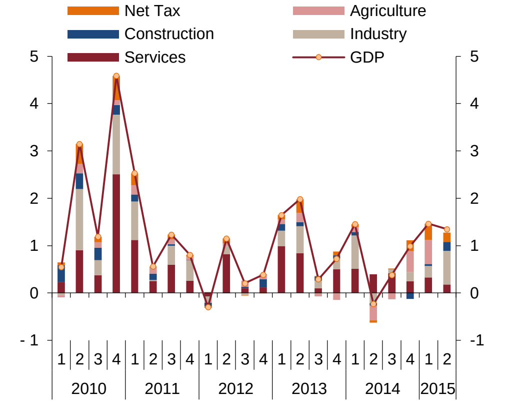
In the first half of 2015, domestic demand made a higher contribution to growth than external demand. Indicators for the third quarter hint at a moderate economic activity yet suggest that the growth composition might change in favor of net exports in the second half. Sales, production and imports indicators regarding industrial production and domestic demand show that final domestic demand will provide a moderate contribution to growth. Additionally, the rising demand from EU countries is expected to have a positive impact on Turkey's exports in the upcoming period. Thus, considering the likely slowdown in import demand based on domestic demand developments, we expect a rise in the contribution of external demand to growth in the second half.

Chart 15.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)



Source: TURKSTAT, CBRT.

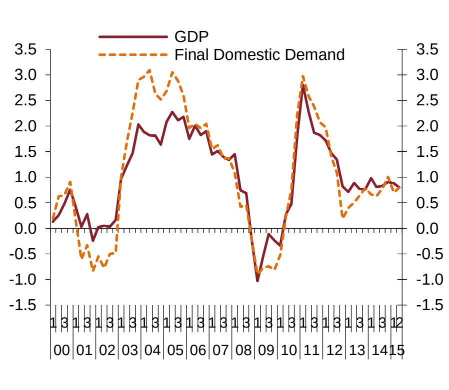
Chart 16.
Contribution of Production Components to Year-on-Year GDP Growth (Percentage Point)



Source: TURKSTAT, CBRT.

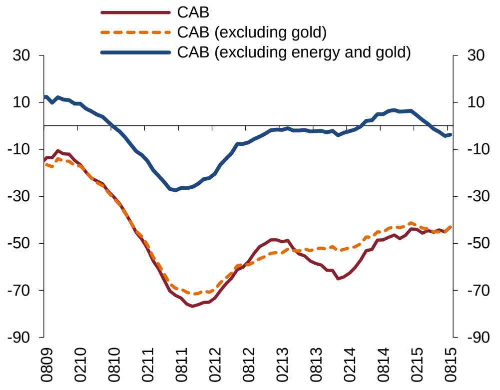
Thanks to the macroprudential policy framework in effect since 2011, GDP continues to grow at a moderate pace while final domestic demand has seen some recovery following the rebalancing process (Chart 17). The tightening in financial conditions due to domestic and international developments poses a downside risk to domestic demand, but this tightening may prove temporary with waning domestic uncertainty. Moreover, we believe that the robust post-crisis employment performance will support domestic demand via the income channel. In addition, the likely fall in the current account deficit and the strong public finances generate room for stabilizing economic policies to dampen the effects of possible shocks. Regarding Turkey's trading partners, the recovery in the EU is expected to support Turkey's exports, while uncertainties about exports to the MENA region, Russia and Iraq pose downside risks. Uncertainties about the effects of the Fed's policy decisions and the slowing Chinese economy on the world economy and about the sustainability of the European recovery also point to downside risks for external demand. In sum, 2016 is likely to witness a moderate growth in domestic demand, a recovery in external demand and a continued rebalancing in the growth composition. We expect the current account balance to improve further with the support of the moderate domestic demand, slowdown in consumer loans and favorable developments in the terms of trade (Chart 18).

Chart 17.
Average Growth of National Product and Final Domestic Demand (8 Quarter Moving Average)*



*X axis shows last quarter of moving average period. Source: TURKSTAT .

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

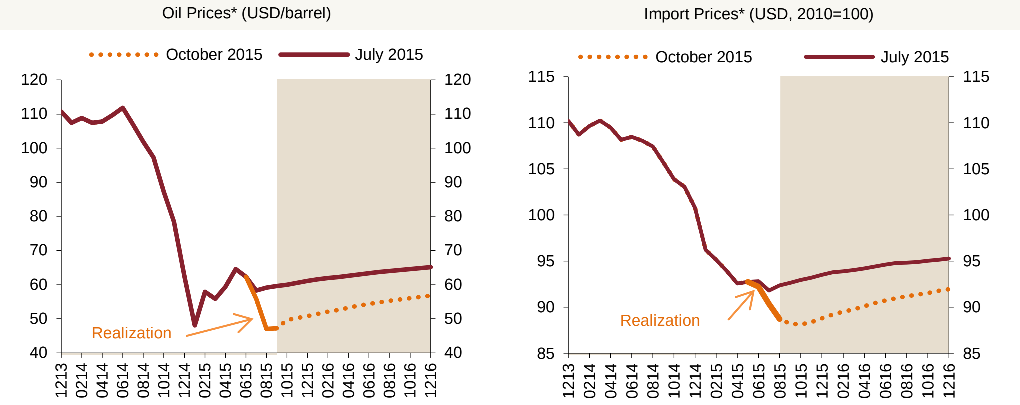


Source: TURKSTAT, CBRT.

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 fall in international commodity prices, especially energy, continued into the third quarter. Backed by the slowing economies of China and other emerging countries, this downtrend caused import prices in Turkey to decline in USD terms. Therefore, we revised our assumptions for crude oil prices and USD-denominated import prices downward (Chart 19). On an annual basis, we decreased our average crude oil price assumption from USD 59 to USD 54 for 2015, and from USD 63 to USD 54 for 2016. Meanwhile, we left our year-end projections for food prices unchanged, and kept our food inflation assumption at 8 percent for end-2015 and end-2016.

Chart 19. Revisions in Oil and Export Prices*



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

Our medium-term fiscal policy stance is based on the Medium Term Programme (MTP) projections covering the 2016-2018 period. Compared with the previous MTP, the new projections envisage slightly higher revenues and expenditures as a ratio of the GDP in 2015 and a somewhat slower decline in these ratios in the following years. Conditional on this outlook, we expect inflation to improve gradually and reach the 5 percent target in the medium term.

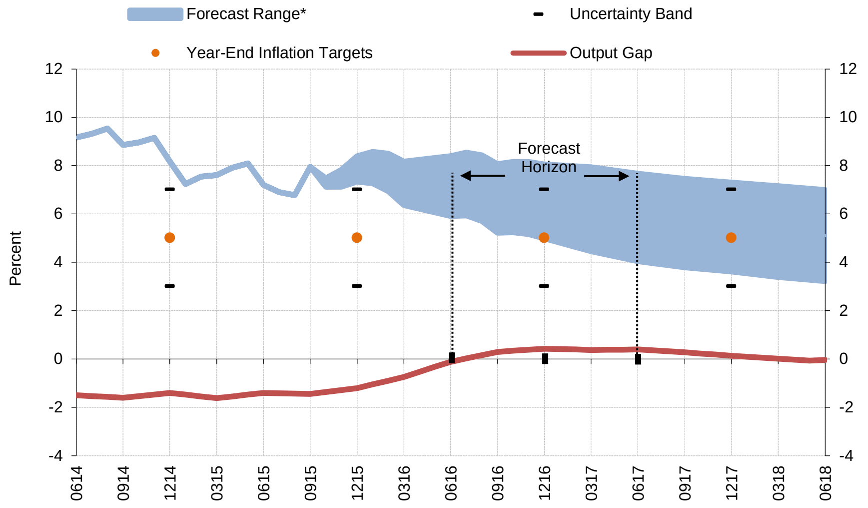
3. Inflation and the Monetary Policy Outlook

Now, I would like to present our inflation and output gap forecasts based on the outlook I have described so far.

Our medium-term forecasts are based on the framework that the tight monetary policy stance will be maintained until there is a significant improvement in the inflation outlook. Moreover, we envision the annual loan growth rate to hover around reasonable levels, also on the back of macroprudential measures. Accordingly, we expect inflation to be, with 70 percent probability, between 7.4 percent and 8.4 percent (with a mid-point of 7.9 percent) at end-2015 and between 5.0 percent and 8.0 percent (with a mid-point of 6.5 percent) at end-2016. We project inflation to be close to 5 percent at end-2017 and stabilize around 5 percent in the medium term (Chart 20).

Chart 20.

Inflation and Output Gap Forecasts



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

The rise in core inflation due to the exchange rate depreciation in the third quarter brought our end-2015 inflation forecast up by 1.2 points compared to the July Inflation Report forecast. Yet, the improvement in import prices in the inter-reporting period pulled down the year-end inflation forecast by 0.2 points. Accordingly, we revised our end-2015 inflation forecast, which was set as 6.9 percent in the July Inflation Report, upwards by 1 point (Chart 20).

Furthermore, we revised our end-2016 inflation forecast upward by 1 point to 6.5 percent from 5.5 percent in the July Inflation Report. We estimate that the upward revision in the end-2015 inflation forecast and the delayed effects of exchange rate movements will drive the end-2016 inflation forecast up by 0.6 and 0.8 points, respectively. However, the decline in the assumption for average import prices for 2016 and the small downward revision to the output gap forecast for 2016 brought the end-2016 inflation forecast down by 0.3 and 0.1 points, respectively, from the previous report.

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.