TÜRKİYE CUMHURİYET
MERKEZ BANKASI

HEAD OFFICE

Please refer to
B.02.2.TCM.0.00.00.00-

ANKARA, 27 January 2015

Ali BABACAN
DEPUTY PRIME MINISTER
ANKARA

As stipulated in the Article 42 of the Central Bank Law, in the case of a significant breach of the inflation target, the Central Bank of the Republic of Turkey (the Central Bank) is accountable for reporting to the Government and announcing to the public the reasons behind the breach of the target and the necessary measures to be taken. As stated in the main policy document titled "Monetary and Exchange Rate Policy in 2014", which was published on December 24, 2013; the inflation target for 2014 was set jointly with the Government as 5 percent. In the same document, it was also indicated that the Central Bank would write an open letter to the Government should end-year inflation exceed the target significantly (by more than 2 percentage points in either direction). Inflation reached 8.17 percent at end-2014, notably exceeding the target. This text elaborates on the reasons why the target was missed and explains the measures already taken—and to be taken—to bring inflation back to the target.

Factors Affecting Inflation in 2014

In the first Inflation Report of 2014 (IR 2014/I), the mid-point of the year-end inflation forecast was given as 6.6 percent. However, deviations from the underlying assumptions over the year and developments affecting the dynamics of inflation caused inflation to end the year above the uncertainty band.

The main factors causing inflation to exceed the target in 2014 are the cumulative increases in the exchange rate since mid-2013 and soaring food prices caused by adverse weather conditions. The food and exchange rate-driven prolonged pressures not only had direct impacts on inflation but also affected underlying inflation trend through the expectations channel. Adjustments to administered prices and taxes also had some impact, albeit limited, on the deviation from the inflation target in this period.

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Emerging market currencies have depreciated dramatically since mid-2013 amid heightened uncertainty over global monetary policies. The depreciation of the Turkish lira has affected core inflation, especially through prices of core goods. The high level of the accumulated increases in exchange rate had spillover effects on food and services as well. Although the ongoing moderate course of import prices was supported by decreasing international oil prices in the second half of 2014, exchange rate developments added about 1.5 points to end-2014 inflation.

Another factor causing inflation to remain above the projected level was the course of food prices. The annual food inflation, which was assumed as 8 percent at the start of the year, climbed to 12.7 percent at the end of the year. This was mainly attributed to hikes in both unprocessed and processed food prices, which caused inflation to deviate from the target by 1.2 points. In 2014, the net effect of administered prices, such as electricity, natural gas, alcoholic beverage and tobacco prices, on inflation exceeded the levels consistent with the forecasts presented in the January Inflation Report by 0.3 points.

As a result, while domestic demand and loan growth were contained by a tight monetary stance and macroprudential measures, inflation ended 2014 above the target due to exchange rate and food price developments as well as adjustments to administered prices. However, the downward trend in oil prices during the second half of 2014 has been a major factor to support the projected disinflation in 2015.

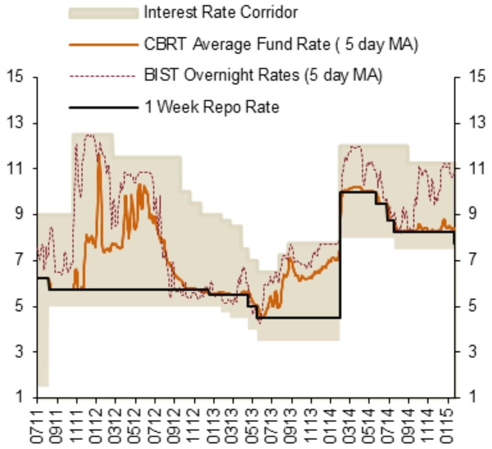
Measures Taken to Attain the Inflation Target

In order to contain any risks to the inflation outlook and macro-financial stability stemming from the noticeable increases in exchange rates and risk premiums caused by the deteriorated risk sentiment since end-2013, the Central Bank implemented a strong and front-loaded monetary tightening on 28 January 2014. In this regard, overnight borrowing and lending rates and weekly repo rates were raised substantially, while short-term market rates were hiked on par with policy rates (Chart 1). Following this strong tightening, the risk sentiment improved, the Turkish lira depreciation was partially offset and the relative exchange rate volatility decreased. These measures aimed to limit the negative effects on medium-term inflation expectations and the pricing behavior.

Considering the improvement both in global liquidity conditions and the risk premia and waning uncertainties in the succeeding period, the Central Bank implemented measured reductions in the 1-week repo rate and the overnight lending rate in the May-August period.

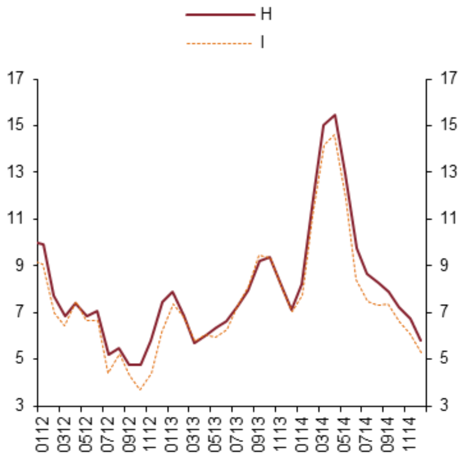
Sustaining the emphasis on inflation expectations and the pricing behavior, the Central Bank maintained its tight monetary policy stance by keeping the yield curve flat in this period. Liquidity policy was tightened against elevated geopolitical risks and the volatility in financial markets starting from September 2014 and the BIST overnight repo rates were kept around the upper limit of the interest rate corridor (Chart 1). The tight monetary policy stance prevents potential excessive volatilities in the Turkish lira and has a lowering effect on the long-term interest rates through reducing the expected inflation.

Chart 1
CBRT Rates and BIST O/N Repo Rates
(Percent)



Source: BIST, CBRT.

Chart 2
Core CPI H and I
(Seasonally Adjusted, Annualized, 3-month Average, Percentage Change)



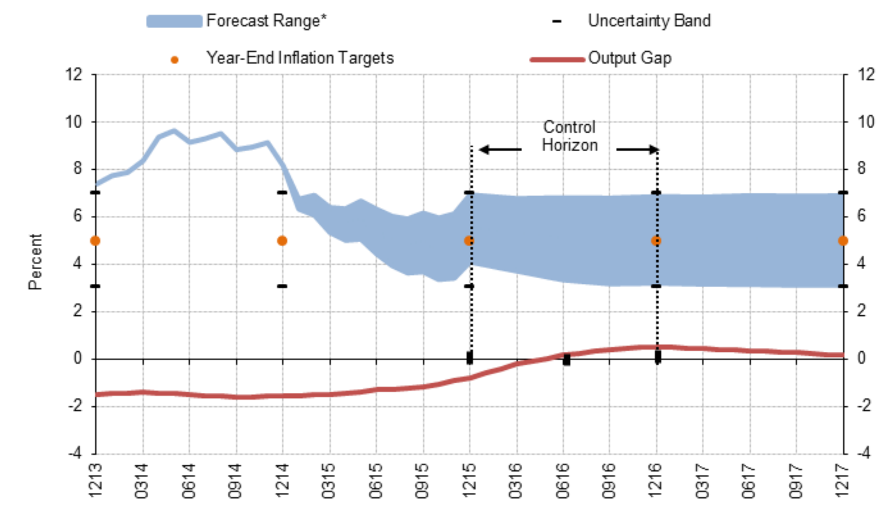
Source: CBRT.

To enhance the resilience of the Turkish economy against potential external shocks and to restrict the adverse effects of global uncertainties on inflation and macroeconomic stability, encouraging prudential borrowing is of great importance along with the improvements in inflation and the current account deficit. Accordingly, it is crucial that core liabilities are supported and maturities of external borrowing are extended. To this end, (i) to foster core liabilities, starting from 2015, the Central Bank decided to remunerate financial institutions with higher core liability ratios (ratio of deposits and equity to loans) than the sector average at a higher rate provided that they do not worsen their situation; and (ii) reserve requirement ratios of FX-denominated non-core liabilities of banks and financing firms were raised in a way to prompt the extension of maturities on 3 January 2015. Moreover, to strengthen the automatic stabilizing feature of the ROM, technical adjustments were made in reserve option tranches and coefficients.

The tight monetary policy stance and the macroprudential measures taken in early 2014 continue to have a positive effect on the core inflation trend. Reverting to the levels recorded before mid-2013, the time of the appearance of the exchange rate depreciation and unfavorable weather conditions, the core inflation trend approached the levels consistent with the target at end-2014 (Chart 2). In addition, receding oil prices underpinned disinflation, and inflation expectations have recently recorded a notable improvement. In 2015, a remarkable decline in inflation is projected due to the fading effects of cumulative exchange rate changes, the reverting of food inflation to past years' averages as well as the falling commodity prices, chiefly oil. Accordingly, inflation is projected to move towards the target in mid-2015.

Against this background, inflation is expected to reach the 5-percent target in the third quarter of 2015, but slightly increase to 5.5 percent in the last quarter due to base effects (Chart 3). Inflation is expected to stabilize around 5 percent as of 2016. The risks to the inflation outlook are analyzed in the January 2015 Inflation Report.

Chart 3
Inflation and Output Gap Forecasts



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

Conclusion

Inflation exceeded the target in 2014 due to the developments in the exchange rate and food prices besides the adjustments in administered prices. The Central Bank responded to the increase in inflation by a tight monetary policy stance, which was accompanied by the liquidity policy, when required. Effects of the enforced measures appeared as of the second half of 2014. The underlying trend in inflation has recently recorded a remarkable fall and there has been an evident improvement in expectations. In addition to the monetary policy and macroprudential measures, the fast decline in oil prices will considerably support disinflation in 2015. Accordingly, inflation is expected to display a notable decline and move towards the 5-percent target in 2015. The Central Bank will continue to monitor developments influencing the inflation outlook and take the necessary measures to retain the achievements on price stability. The Inflation Report, published today on our website, which comprehensively presents the developments regarding inflation and monetary policy as well as our medium-term forecasts, is enclosed for your information.

Yours Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Erdem Başçı	Mehmet Yörükoğlu
Governor	Deputy Governor

Enc: January 2015 Inflation Report

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