BRIEFING on

2014 OCTOBER INFLATION REPORT

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31 October 2014, Istanbul

Distinguished Guests,

Welcome to the briefing held to convey the main messages of the Inflation Report. I will now present an overview of the report, which will be published on our website soon.

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 six boxes entailing interesting and up-to-date analyses on various topics. For example, the report presents boxes that analyze how the determinants of bond flows into emerging economies change over time and the sensitivity of inflation to output gap and loans. Moreover, there are studies elaborating on current account fluctuations and current account deficit corrections, non-core liabilities, the correlation between capital flows and loan growth across a wide range of economies and the role of macroprudential measures in the elasticity of loans to capital flows. 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.

Distinguished Guests,

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 the year, the uncertainty over advanced country monetary policies led to a partial volatility increase in global financial markets. While the US Federal Reserve (Fed) ended its quantitative easing program, uncertainties regarding the timing and size of a policy rate hike continued. In this period, the European Central Bank (ECB) cut its policy rates against the risks of economic slowdown and deflation and announced a kind of quantitative easing program of buying covered bonds and asset-backed securities. In the second and third quarters of 2014, indicators for global economic activity performed lower than expected, causing growth forecasts for this year to be revised down. Financial market volatility and falling global growth rates led to some fluctuation in capital flows to emerging economies (Chart 1). Following the weakening global growth outlook, commodity prices dropped markedly as well.

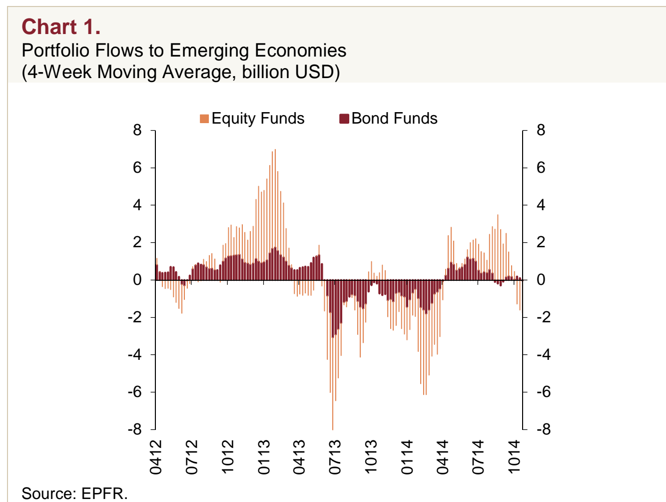


Chart 1.
Portfolio Flows to Emerging Economies
(4-Week Moving Average, billion USD)

Source: EPFR.

Regarding the developments in the Turkish economy, the recent global financial volatility appears to have affected Turkey in a way similar to other emerging economies. In the third quarter, Turkey's risk premium indicators fluctuated on par with those of other emerging economies (Chart 2). Economic activity lost some momentum after the first quarter. The slowing EU growth and geopolitical tensions have restrained external demand. Despite waning external demand, exports continue to support the balanced growth.

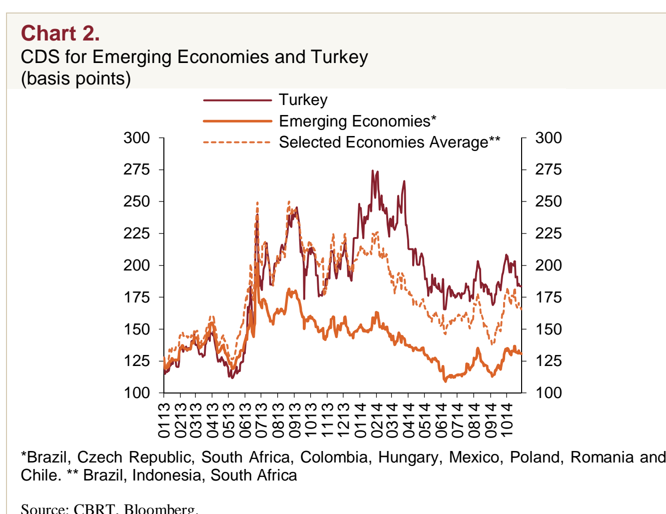


Chart 2.
CDS for Emerging Economies and Turkey
(basis points)

*Brazil, Czech Republic, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile. ** Brazil, Indonesia, South Africa

Source: CBRT, Bloomberg.

The macroprudential measures and our tight monetary stance have had positive implications for the core inflation trend. A sizable amount of the significant first-half increase in core inflation indicators was reversed in the third quarter. Annual core goods inflation continues to slow down as the negative effects from exchange rate changes diminish. Moreover, falling oil prices restrict the inflationary pressures on energy items. However, elevated food prices cause inflation to hover significantly above the target. We expect significant disinflation for the upcoming year. The continued decline in cumulative exchange rate effects, the return of food inflation to

the average level of previous years and the fall in commodity prices, especially oil, will be the main factors contributing to disinflation. Moreover, we believe that the tight fiscal stance set out in the Medium Term Program (MTP) will support the decline in inflation.

1. Monetary Policy and Monetary Conditions

Distinguished Guests,

The Central Bank implemented a front-loaded and strong monetary tightening in the first quarter of 2014 and then lowered policy rates gradually amid reduced domestic and external uncertainty in the second quarter. During the third quarter, we firstly cut the one-week repo auction rate from 8.75 to 8.25 percent, and the overnight borrowing rate from 8 to 7.5 percent in July. In August, to operate within a more symmetric interest rate corridor, we lowered the overnight lending rate from 12 to 11.25 percent, and the rate on borrowing facilities for primary dealers via repo transactions from 11.5 to 10.75 percent (Chart 3). In this period, we provided the CBRT funding primarily from one-week repo auctions (Chart 4). Thus, the average funding rate came close to the one-week repo rate. Yet, taking into account the geopolitical tensions and the financial market volatility, we have fortified our tight monetary stance with a tight liquidity policy since September. Accordingly, the BIST overnight repo rates, that neared the one-week repo auction rate in July and August, has lately followed a course close to the upper end of the interest rate corridor.

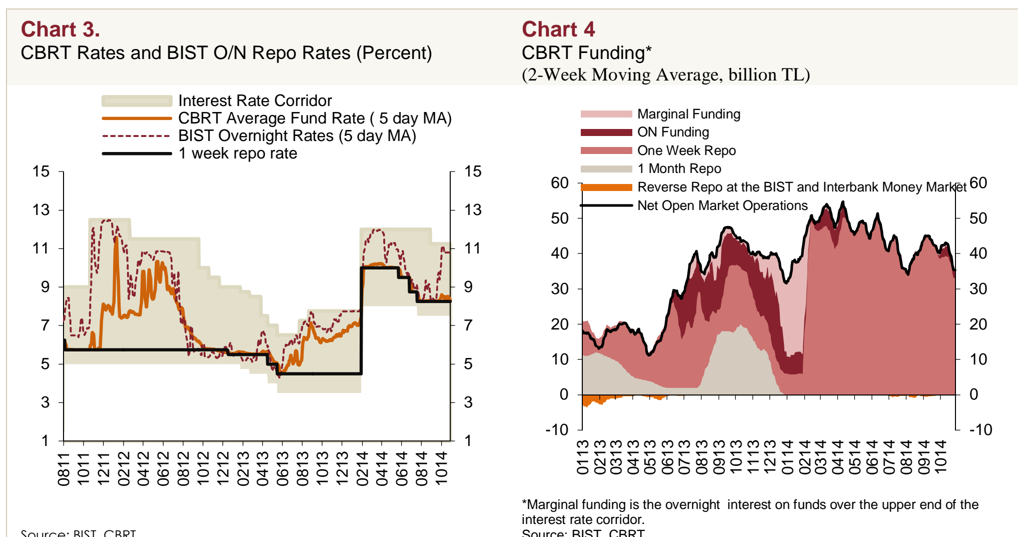


Chart 3.
CBRT Rates and BIST O/N Repo Rates (Percent)
Source: BIST, CBRT.

Chart 4
CBRT Funding*
(2-Week Moving Average, billion TL)
*Marginal funding is the overnight interest on funds over the upper end of the interest rate corridor.
Source: BIST, CBRT.

While we had measured rate cuts, we have maintained a tight monetary policy stance by keeping the yield curve nearly flat in this quarter as well. The spread

between 5-year market rates and the BIST Interbank Overnight Repo rates has been at negative levels as of October (Chart 5). In addition, as we have tightened our liquidity policy recently, short-term rates have risen substantially. Thus, we are able to keep the yield curve on a nearly flat course. On the other hand, the spread between long and short-term rates continues to hover below its historical levels (Chart 6). We will closely monitor inflation expectations, pricing behaviors and other factors affecting inflation in the upcoming period and maintain our tight monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook.

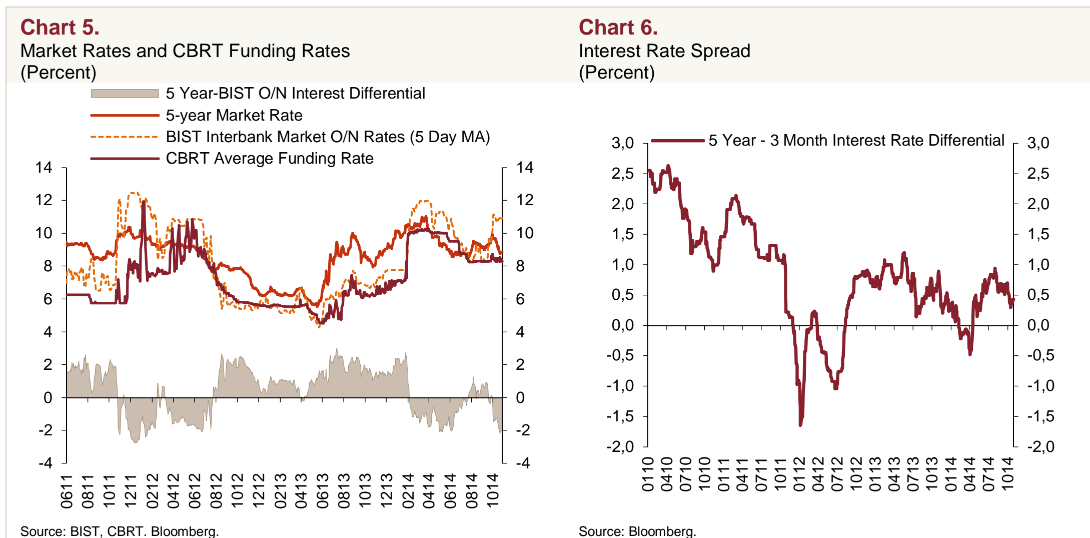


Chart 5.
Market Rates and CBRT Funding Rates
(Percent)

Source: BIST, CBRT. Bloomberg.

Chart 6.
Interest Rate Spread
(Percent)

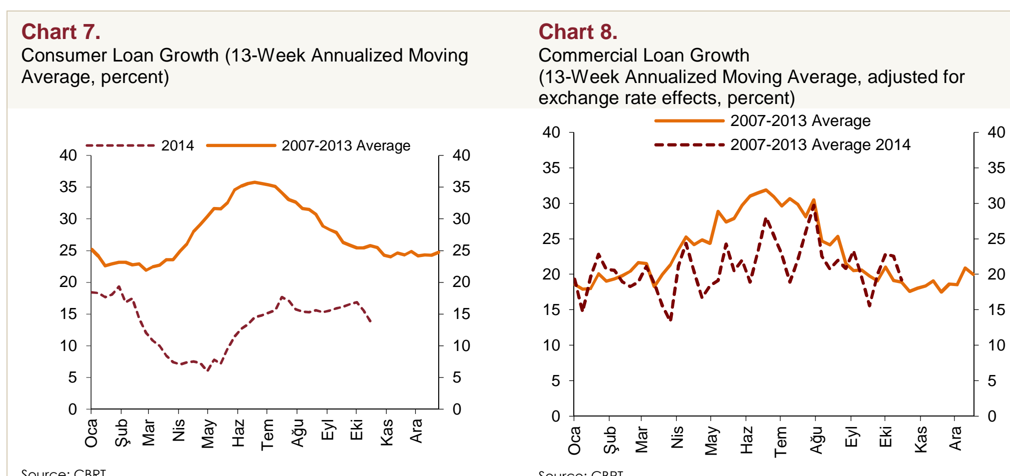
Source: Bloomberg.

We aim to support the continuity of the balanced growth and capital inflows in Turkey during the global monetary policy normalization. To this end, we have changed the foreign exchange deposit rates that the banks pay when they borrow from the CBRT within their limits through the Foreign Exchange Deposit Market. As of 9 October 2014, the rates applied to banks' one-week maturity borrowings from the CBRT as a last resort facility have been reduced from 10 percent to 7.5 percent for USD and from 10 percent to 6.5 percent for EUR. Moreover, considering the increase in the size of the banks' balance sheets and the CBRT's international reserves, we announced that we will revise the banks' USD 10.8 billion transaction limits in the Foreign Exchange and Banknotes Markets at the press meeting on "Monetary and Exchange Rate Policy for 2015". In addition, we stated that it is crucial to further strengthen the currently solid structure of the banking sector for financial stability purposes. In this context, we announced on 21 October 2014 that we will provide further support to core liabilities to spur balanced growth and domestic savings. As an incentive, we decided to remunerate the Turkish lira component of required reserves of financial institutions. Additionally, with this

arrangement, we aim to reduce the sensitivity of the costs of holding Turkish lira required reserves against the CBRT's policy rates and thus strengthen the automatic stabilization feature of the Reserve Option Mechanism.

Distinguished Guests,

As for the loans, we see that the macroprudential measures and our tight monetary stance have helped to keep the pace of loan growth at reasonable levels. The annual rate of total loan growth is 16 percent, below the 2007-2013 average of 23 percent, as of October 2014. In terms of loan trends, the annualized growth rate of consumer loans continues to hover at low levels while commercial loans remain relatively more robust (Charts 7 and 8). I would like to emphasize that this loan outlook will both restrain medium-term inflationary pressures and support the improvement of the current account balance.



2. Macroeconomic Developments and Assumptions

Distinguished Guests,

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.

Annual consumer inflation fell by 0.3 points quarter-on-quarter to 8.86 percent in the third quarter of 2014, while inflation excluding unprocessed food and tobacco at 8.37 percent was mostly consistent with our July Inflation Report forecasts (Charts 9 and 10). Due to adverse weather conditions and cumulative effects of exchange rate changes, food prices remained the subcategory making the greatest contribution to inflation. However, the main drivers of this third-quarter fall in

inflation were energy and core goods. Annual inflation continued to decline across the core goods category thanks to decreased negative effects of exchange rate developments. Regarding underlying inflation trends, there has been a significant improvement in the core goods category. Meanwhile, the services category produced a relatively negative outlook.

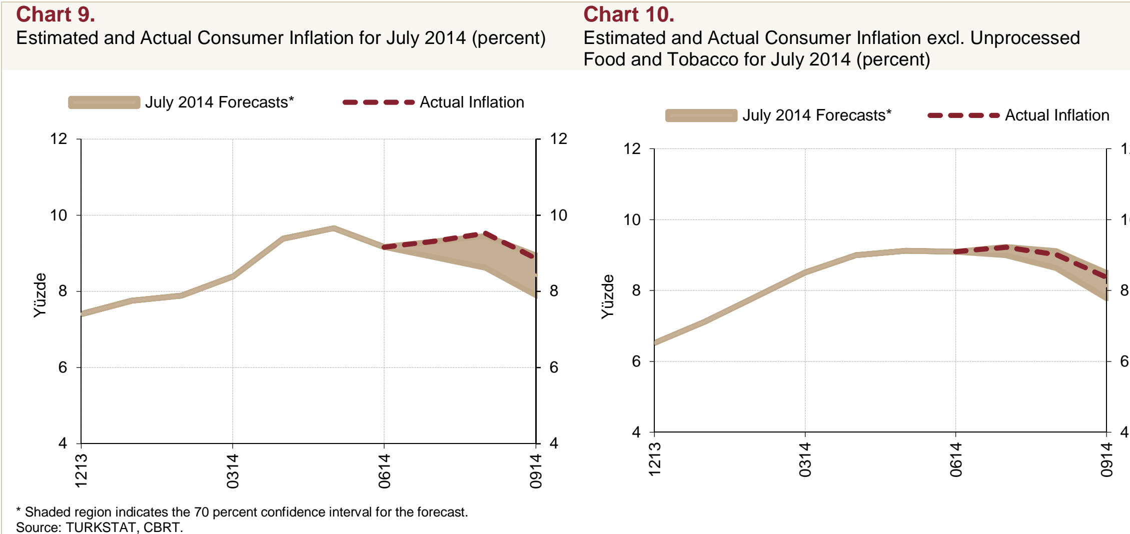


Chart 9.
Estimated and Actual Consumer Inflation for July 2014 (percent)

Chart 10.
Estimated and Actual Consumer Inflation excl. Unprocessed Food and Tobacco for July 2014 (percent)

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

In the third quarter, the core inflation trend recorded a decline following the favorable impact of the macroprudential measures and our tight monetary stance (Chart 11). Accordingly, the marked first-half inflation increase in core indicators was reversed in the third quarter. Yet, I would like to note that underlying trend indicators are still above the target-consistent levels. In this period, international commodity prices, especially oil, fell in line with the weak global growth outlook and USD-denominated import prices dropped. In addition to this favorable outlook of import costs, aggregate demand conditions and the relatively slow pace of growth in consumer loans alleviate the pressures on inflation. In fact, excluding food products and associated services subcategories, we see that annual consumer inflation declined considerably in the third quarter (Chart 12).

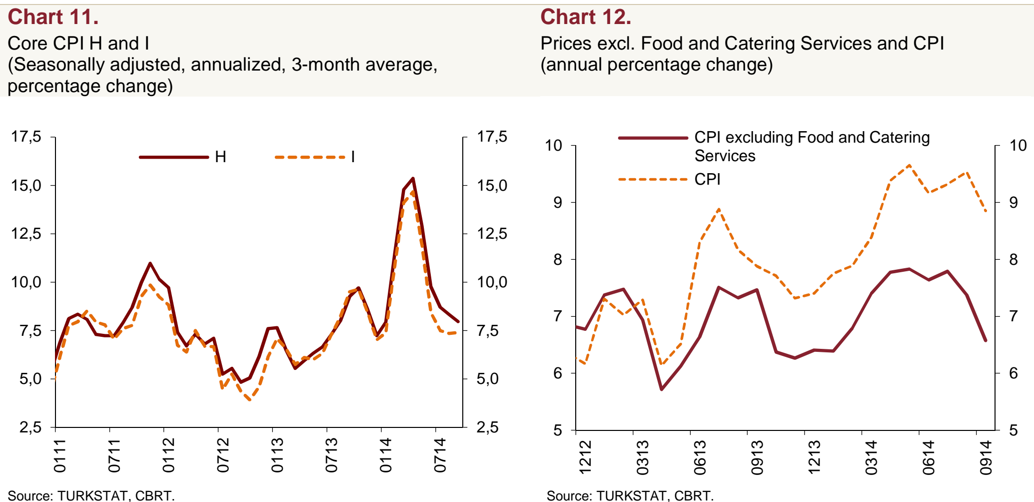


Chart 11.
Core CPI H and I
(Seasonally adjusted, annualized, 3-month average, percentage change)
Source: TURKSTAT, CBRT.

Chart 12.
Prices excl. Food and Catering Services and CPI
(annual percentage change)
Source: TURKSTAT, CBRT.

In sum, the negative effects of cumulative exchange rate developments continued to wane in the third quarter, yet food prices remained on a relatively unfavorable track. The prolonged high level of consumer inflation and the ongoing deterioration in inflation expectations adversely affect pricing behaviors in certain categories, particularly services.

We expect the fall in commodity prices, which is driven by the weak global demand, to bring consumer inflation down, and the awaited moderate pace of domestic demand to restrain the upside risks. Thus, we believe that underlying inflation will move downward in the forthcoming period.

Distinguished Guests,

Now, I would like to give a brief account of developments in economic activity and the short-term outlook on which the inflation forecasts are based. According to the GDP data of the second quarter of 2014, economic activity was relatively weaker compared to the outlook we presented in the July Inflation Report. In the second quarter, we saw that industrial production remained virtually unchanged quarter-on-quarter, while national income posted a decline after eight quarters in seasonally adjusted terms (Chart 13). This decline was mostly attributed to the agricultural sector, which made a 0.3 point negative contribution to quarterly growth. Therefore, national income growth lagged behind industrial production growth (Chart 14).

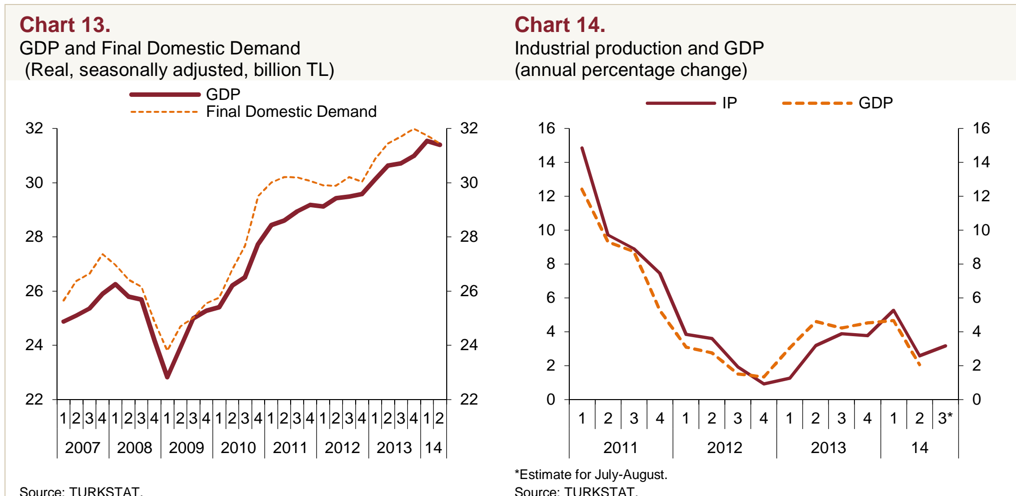


Chart 13.
GDP and Final Domestic Demand
(Real, seasonally adjusted, billion TL)
Source: TURKSTAT.

Chart 14.
Industrial production and GDP
(annual percentage change)
*Estimate for July-August.
Source: TURKSTAT.

Industrial production, which grew by 1.1 percent in the July-August period of 2014 compared to the preceding quarter, contributed to growth in the third quarter. On the other hand, we may see some decline in the agricultural value added. Thus, there are signals that GDP growth may fall short of the industrial production growth in this period as well. Factors like the slowdown in the European economic growth and geopolitical developments led the external demand to decelerate, inducing a marked slowdown in the growth of exports excluding gold (Chart 15). As a result, although we expect the slowdown in external demand in the third quarter to be partially offset by the rebound in domestic demand, I would like to emphasize that the third-quarter growth accommodates downside risks stemming from the agricultural sector.

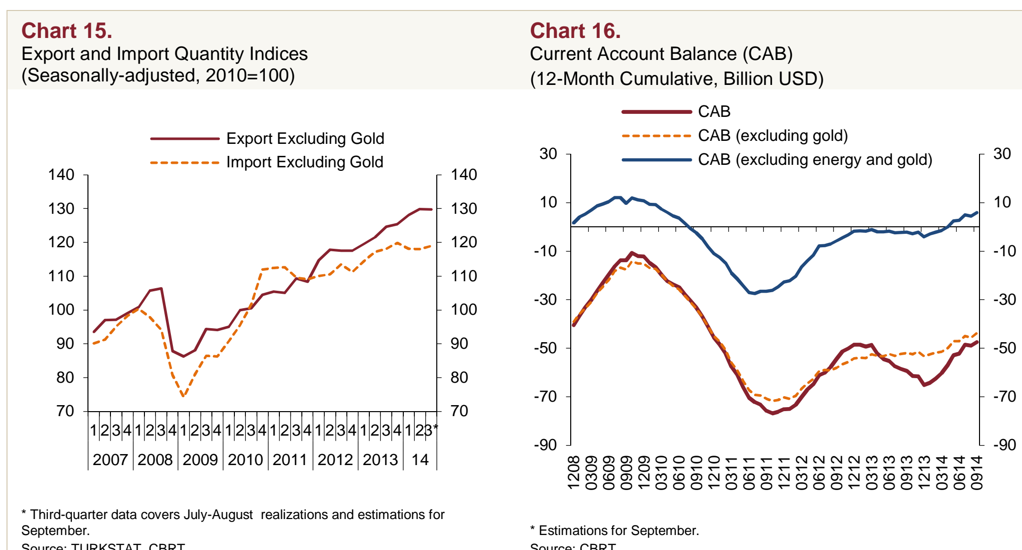


Chart 15.
Export and Import Quantity Indices
(Seasonally-adjusted, 2010=100)
* Third-quarter data covers July-August realizations and estimations for September.
Source: TURKSTAT, CBRT.

Chart 16.
Current Account Balance (CAB)
(12-Month Cumulative, Billion USD)
* Estimations for September.
Source: CBRT.

A steady recovery in consumer and investor confidence is yet to appear, suggesting that downside risks to domestic demand still persist. We believe that the deceleration trend in external demand will curb the rise in exports for a while.

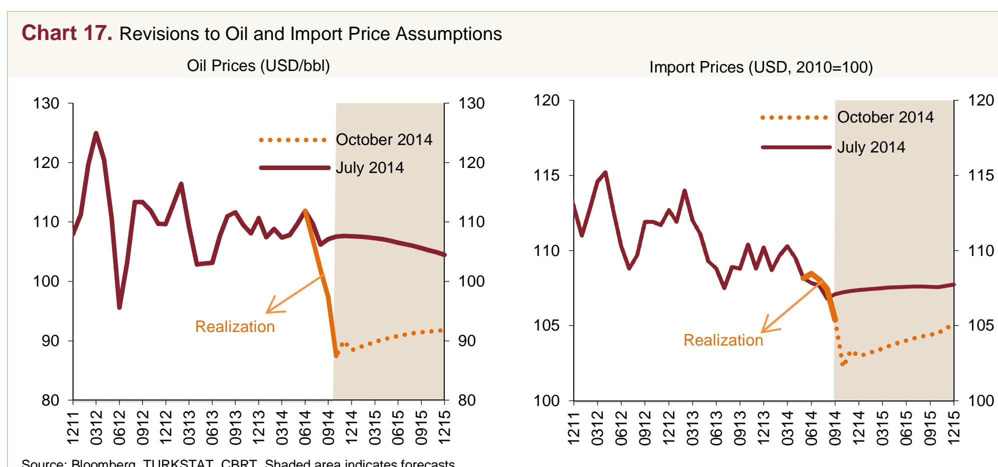
However, we expect falling commodity prices to contribute positively to the current account balance by reducing import costs (Chart 16).

Distinguished Guests,

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.

In the third quarter of the year, oil and import prices remained below the path we envisaged in the July Inflation Report (Chart 17). Accordingly, we revised our assumptions of average oil and import prices for 2014 and 2015 downwards. Given the current outlook, due to external prices, year-end inflation forecasts for 2014 and 2015 were revised downwards by 0.3 and 0.2 percentage points, respectively. Considering also the high course in food inflation in the third quarter, we revised our year-end inflation assumption for food prices upwards to 12.5 percent for 2014 and 9 percent for 2015. These revisions in food prices drove our year-end inflation forecasts for 2014 and 2015 higher by 0.8 and 0.3 percentage points, respectively.

Chart 17. Revisions to Oil and Import Price Assumptions



Source: Bloomberg, TURKSTAT, CBRT. Shaded area indicates forecasts.

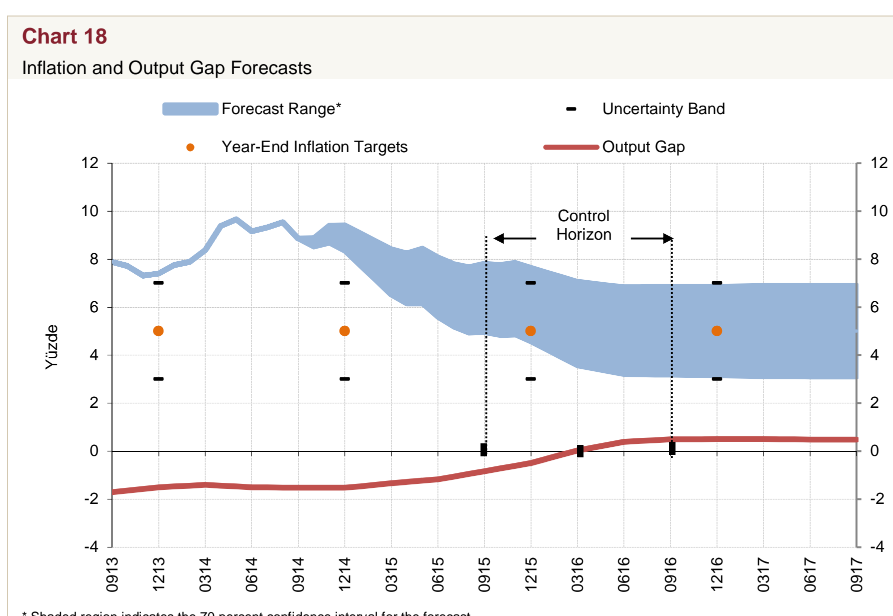
Our medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with inflation targets and automatic pricing mechanisms. Price increases in electricity and natural gas of 9 percent, which were released in early October, have slightly exceeded our assumptions in the July Inflation Report. Thus, our end-2014 inflation forecast was revised upwards by 0.2 percentage points. We based our assumptions about the medium-term fiscal policy stance on the MTP projections covering the 2015-2017 period. Accordingly, we assume that a tight fiscal stance will be implemented and the primary expenditures to GDP ratio will taper off.

3. Inflation and the Monetary Policy Outlook

Distinguished Guests,

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 assumption that our tight monetary policy stance will be maintained by keeping a flat yield curve. A further assumption is that the annual loan growth rate will reach nearly 15 percent by the end of 2014 and stabilize around these reasonable levels on the back of the macroprudential measures. Accordingly, we expect inflation to be, with 70 percent probability, between 8.4 percent and 9.4 percent (with a mid-point of 8.9 percent) at end-2014 and between 4.6 percent and 7.6 percent (with a mid-point of 6.1 percent) at end-2015. We expect inflation to stabilize around 5 percent in the medium term (Chart 18).



We expect inflation to considerably exceed the 5-percent target by the year-end, and decrease significantly as of the start of 2015 and fall to 6.1 percent at end-2015. This noticeable decline we forecast in inflation is driven by the projections that cumulative exchange rate effects will continue to taper off, food inflation will recede to past year averages and commodity prices, chiefly oil, will stay at expected lower levels. Moreover, we believe that demand conditions and the announced tight fiscal policy stance will support the decline in inflation in this period. The fluctuating course in 2015 inflation forecasts that you see on the slide stems from the base effects (Chart 18).

Distinguished Guests,

In addition to these forecasts, alternative scenarios on the inflation outlook and the global economy are discussed 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.