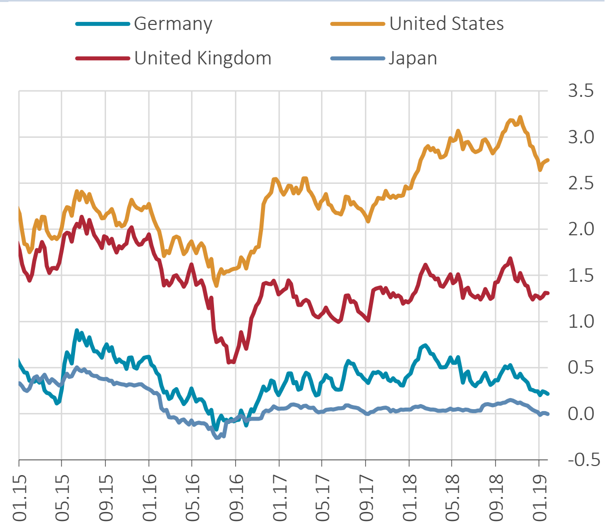
1. Overview

The deceleration in global economic activity in the second quarter of 2018 persisted into the third quarter due to the simultaneous slowdown seen in the growth rates of advanced and emerging economies. Despite the favorable growth performance in the US and the UK, the ongoing deceleration in the Euro Area in particular became quite visible. Increased protectionist trends are anticipated to weigh on the global growth outlook in the upcoming period by exacerbating the uncertainty over global economic policies. Industrial metal prices continued to decline in the fourth quarter due to the price implications driven by the expectation that the US-imposed restrictions on international trade would curb demand. On account of lower crude oil prices, the headline inflation in advanced and emerging economies receded in the last quarter.

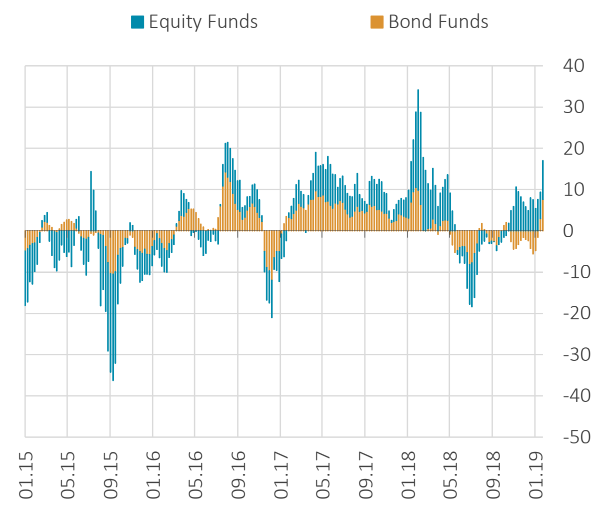
The gradual monetary tightening by central banks of advanced economies also persisted in the fourth quarter of 2018. In this period, the slowdown in global growth and increased uncertainty related to the global economy gave way to the expectation that the ongoing policy normalization in advanced economies would decelerate and led to a decline in bond yields (Chart 1.1). Due to the recently-strengthened expectation that the Federal Reserve's (Fed) monetary policy normalization process may proceed more slowly, portfolio flows towards emerging economies have somewhat recovered since September (Chart 1.2). Nevertheless, regional risk premiums of emerging economies rose due to heightened volatility in financial markets and weakened global risk appetite. Risk premiums of emerging economies, which have been volatile partly due to geopolitical risks, started to recede since January in tandem with the rise in the global risk appetite.

Chart 1.1: 10-Year Bond Yields (%)



Source: Bloomberg.

Chart 1.2: Portfolio Flows to Emerging Economies (Billion USD, 4-Week Cumulative)



Source: EPFR.

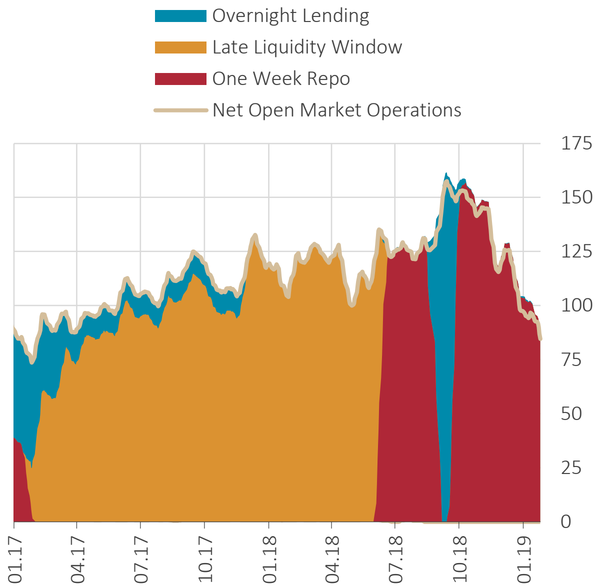
Despite the geopolitical developments and global volatilities experienced during the period following the October Inflation Report, there has been a slight improvement in domestic financial indicators partly due to the Central Bank of the Republic of Turkey's (CBRT) maintaining of its tight monetary policy stance and the improving inflation outlook. In the period from November through to December 2018, the Turkish lira diverged positively from other emerging economy currencies, and the short- and medium-term market rates decreased, partly as a result of the fall in the country risk premium. Following the tightening seen in the credit market in the third quarter of 2018, the slowdown in loan growth rates became more discernible in the final quarter of 2018.

Consumer inflation receded to 20.3% at the end of 2018. The decline in oil and other commodity prices, the tax cuts in a number of products, and the weak domestic demand, as well as the tight monetary policy stance, were behind the disinflation in this period. Despite the fall in producer price inflation owing to the decline in exchange rates and energy prices, producer price-driven cost pressures on consumer prices remained strong. Economic activity decelerated in the third quarter of 2018 in line with the projections of the October Inflation Report. The volatility in financial markets and the tightening in financial conditions in this period led to a contraction in domestic demand driven by consumption and investment. Strong net exports backed by favorable external demand conditions and the cumulative depreciation in the real exchange rate restrained the domestic-demand driven deceleration in growth. Indicators related to this period signal that the contribution of aggregate demand conditions to disinflation became more pronounced.

1.1 Monetary Policy and Financial Markets

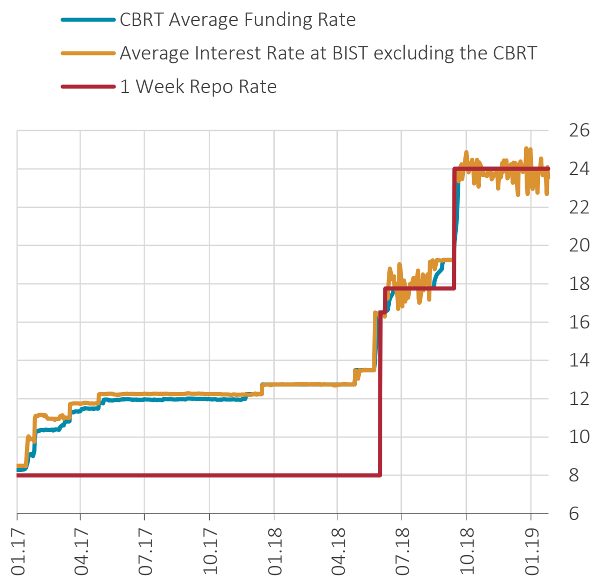
Following the strong monetary tightening it delivered in September to support price stability, the CBRT maintained its tight monetary policy stance in December and January, highlighting the risks to price stability. The entirety of CBRT funding has been provided via weekly repo auctions since the Monetary Policy Committee (MPC) meeting of September (Chart 1.1.1). Consequently, the average interest rate at the BIST Interbank Repo market, calculated excluding CBRT transactions, fluctuated around the one-week repo auction rate of 24% (Chart 1.1.2).

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



Source: CBRT.

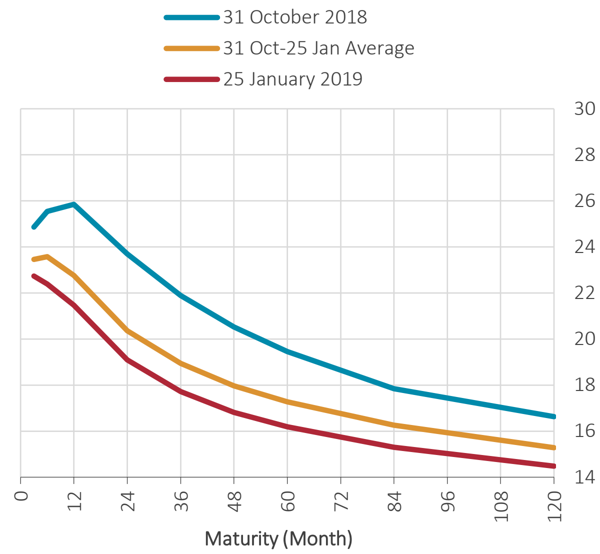
Chart 1.1.2: Short-Term Interest Rates (%)



Source: BIST, CBRT.

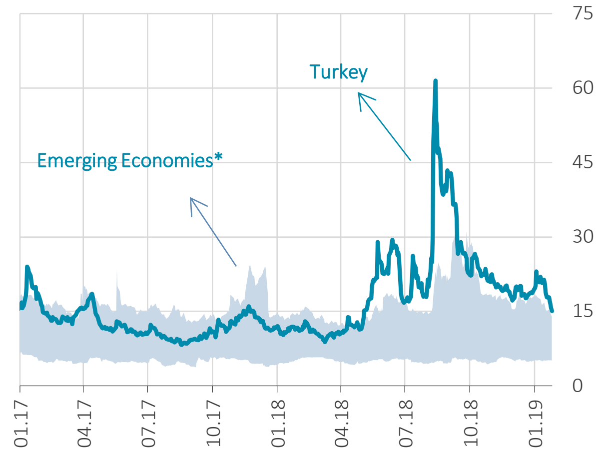
Due to the strong monetary tightening in September and the decline in the country risk premium, currency swap rates have decreased across all maturities since the previous reporting period. In response to the maintenance of the strong tightening, short-term currency swap yields continued to hover above the yields on long-term currency swaps (Chart 1.1.3). The implied volatility of the Turkish lira has declined (Chart 1.1.4).

Chart 1.1.3: Swap Yield Curve (%)



Source: Bloomberg.

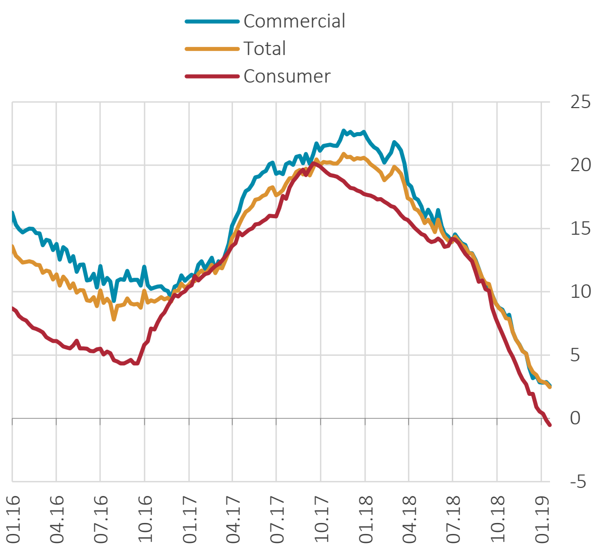
Chart 1.1.4: Implied FX Volatility (1-Month Ahead, %)



Source: Bloomberg.
* Emerging economies include Brazil, Chile, Colombia, Mexico, Poland, the Philippines, Malaysia, South Africa, Indonesia, Romania and Hungary.

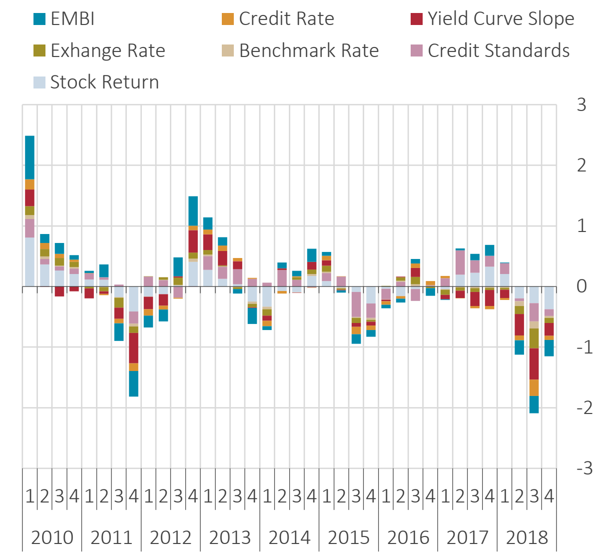
The downward trend in credit growth driven by the subdued credit demand due to tightening credit conditions of banks and the slowdown in economic activity in the third quarter of 2018 became more significant in the last quarter (Chart 1.1.5). All financial components of the Financial Conditions Index (FCI) contributed in the tightening direction in the last quarter, yet at a relatively limited rate compared to the previous period (Chart 1.1.6).

Chart 1.1.5: Annual Loan Growth (Adjusted for Exchange Rates, YoY % Change)



Source: CBRT.

Chart 1.1.6: Contributions to FCI*



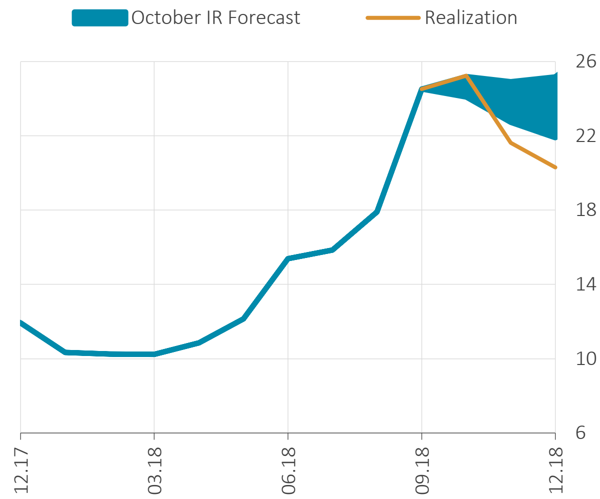
Source: CBRT.
* For further details on measuring the FCI, see the CBRT Working Paper No. 15/13.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation decreased by 4.2 points from the end of the third quarter to 20.30% in the last quarter of 2018, a level below the October Inflation Report forecast (Chart 1.2.1). A similar pattern was also observed in the forecast for the CPI excluding unprocessed food, energy, alcohol-tobacco and gold (Chart 1.2.2). The fall in inflation was driven by the appreciation in the Turkish lira, the decline in commodity prices, the tax cuts on certain durable consumption goods, and the weak course of demand conditions.

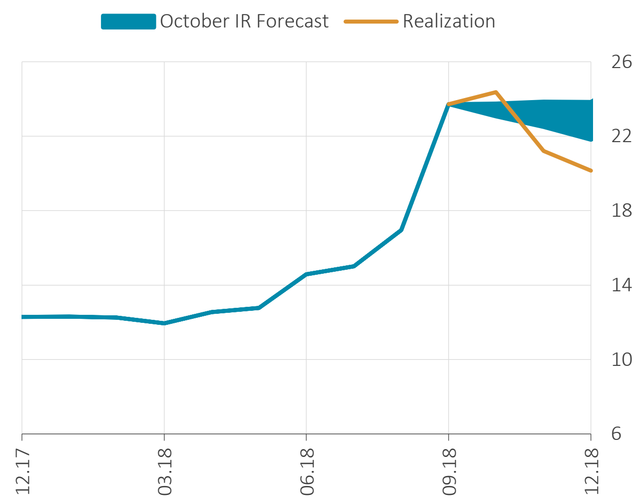
Chart 1.2.1: October Inflation Forecast and Actual Inflation * (%)



Source: CBRT, TURKSTAT.

* Shaded area denotes the 70% confidence interval for the forecast.

Chart 1.2.2: October Forecast and Actual Rates for Inflation excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold * (%)



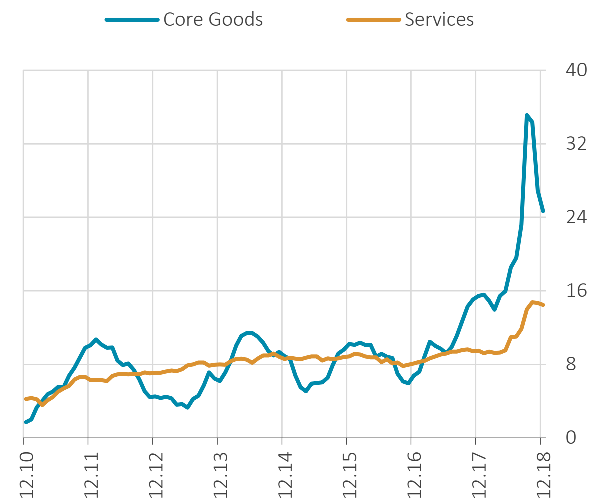
Source: CBRT, TURKSTAT.

* Shaded area denotes the 70% confidence interval for the forecast.

Core goods and energy were the main drivers of the decline in annual inflation through the final quarter of the year. Both the recovering Turkish lira and the tax cuts on automobiles, furniture and home appliances since November had a significant impact on core goods. The energy group, on the other hand, benefited from lower international oil prices. Annual food inflation remained high. Meanwhile, annual services inflation continued to climb due to the cumulative increase in costs (Chart 1.2.3).

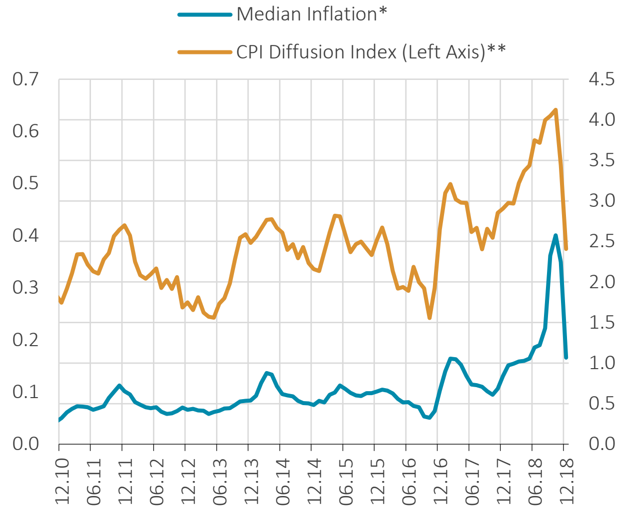
Although PPI inflation fell in the fourth quarter, costs continue to put strong upward pressure on consumer prices. On the other hand, with weak domestic demand remaining a drag on inflation, the pricing behavior has seen some improvement after having deteriorated dramatically in the third quarter. As suggested by diffusion indices, economic agents seem less inclined to hike prices than in the previous quarter and the median inflation rate is back to its second-quarter level (Chart 1.2.4). However, trend and pricing behavior-related indicators are still historically high.

Chart 1.2.3: Prices of Core Goods and Services (Annual % Change)



Source: TURKSTAT.

Chart 1.2.4: Diffusion Index and Median Inflation (Seasonally Adjusted 3-Month Average)

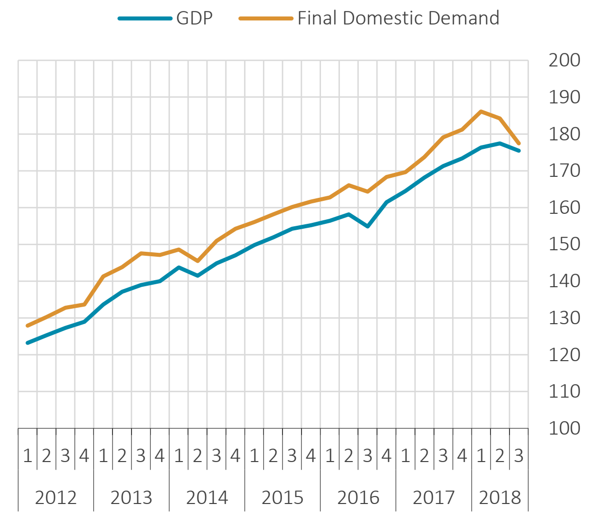


Sources: CBRT, TURKSTAT.

Supply and Demand

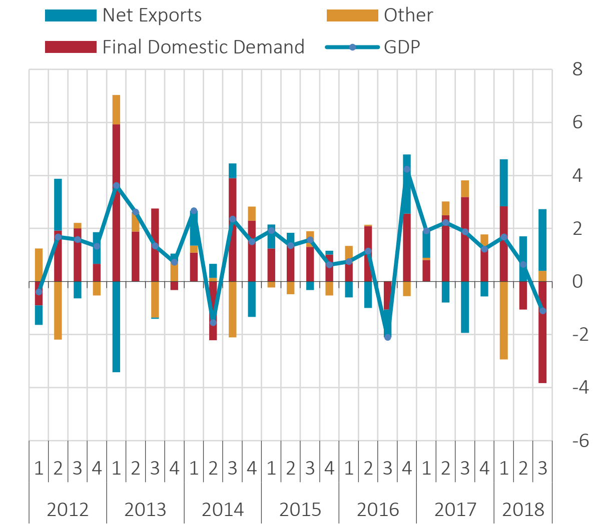
Economic activity slowed in the third quarter of 2018 as projected in the October Inflation Report, and the rebalancing process became more significant (Chart 1.2.5). In this period, the gross domestic product (GDP) narrowed by 1.1% quarter-on-quarter but grew by 1.6% year-on-year. The strong third-quarter contribution from net exports limited the negative effects of the domestic-demand-contraction on growth (Chart 1.2.6). This was largely due to the robust, tourism-led exports of goods and services as well as the declining import demand caused by the exchange rate developments and lower domestic demand.

Chart 1.2.5: GDP and Domestic Demand (Real, Seasonally Adjusted, 2009=100)



Sources: CBRT, TURKSTAT.

Chart 1.2.6: Contributions to Annual GDP Growth by Expenditure (% Points)



Sources: CBRT, TURKSTAT.

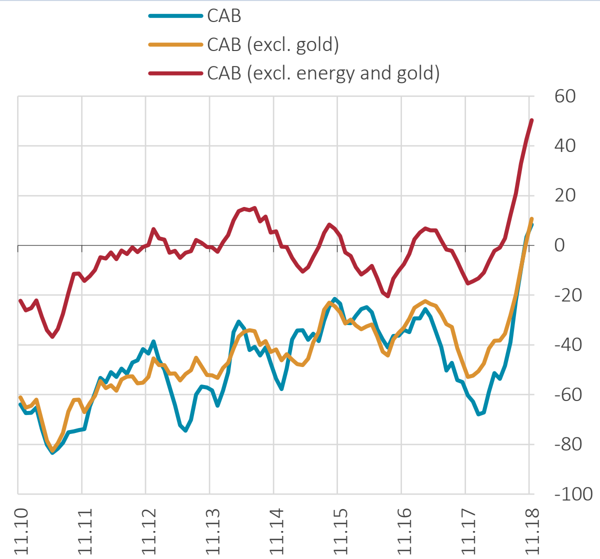
* Other includes changes in inventories and statistical discrepancy due to the use of chain-linked index.

Demand composition saw a more marked rebalancing in the fourth quarter of 2018. Tax incentives available for durable goods since November and other measures somewhat mitigated the decline in domestic demand. However, the partial recovery of the private consumption demand was largely met by drawing down inventories, thus limiting the effect on production.

In the fourth quarter, net exports continued to make a large contribution to growth. Despite signs of slowing global growth, external demand remains robust. Firms' orientation towards external markets amid sluggish domestic demand and the cumulative real exchange rate depreciation, and their flexibility in market diversification continue to stimulate exports of goods. In addition, while the course of revenues from tourism and other services remained favorable, import demand continued to shrink due to weak domestic demand and the depreciation of the Turkish lira. Hence, the current account balance improved rapidly in the last quarter (Chart 1.2.7). Meanwhile, the slowdown in the economic activity affected the labor market (Chart 1.2.8).

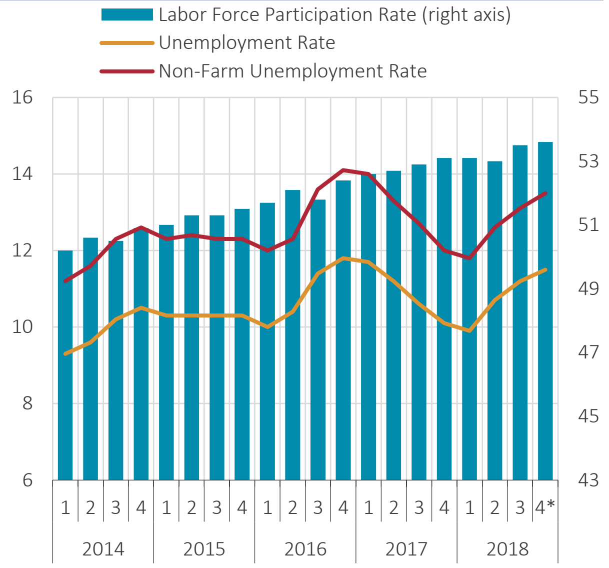
In sum, the economic rebalancing that started in the second quarter continued into the third quarter and became more significant in the fourth quarter. While financial conditions are expected to support a mild recovery of the domestic demand amid the improving inflation outlook and the declining country risk premium, the contribution of net exports to growth is expected to continue as well in 2019.

Chart 1.2.7: Current Account Balance (CAB) (Seasonally Adjusted, 3-Month Moving Average, Annualized, Billion USD)



Source: CBRT.

Chart 1.2.8: Unemployment Rates (Seasonally Adjusted, %)



Source: TURKSTAT.

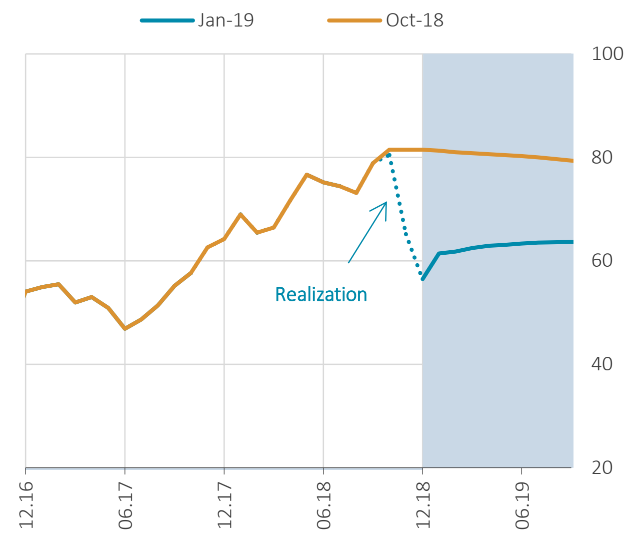
* October period.

Oil, Import and Food Prices

The downtrend in crude oil prices accelerated in recent months. Thus, actual prices were lower than the assumptions made in the October Inflation Report. Given the recent fall in crude oil prices on spot and futures markets and assessments of future crude oil prices, the October assumption of 80 USD/bbl is revised down to 63 USD/bbl for 2019 (Chart 1.2.9). The assumption for the average annual increase in USD-denominated import prices for 2019 is also revised downward, albeit by a much smaller margin than the oil price assumption (Chart 1.2.10).

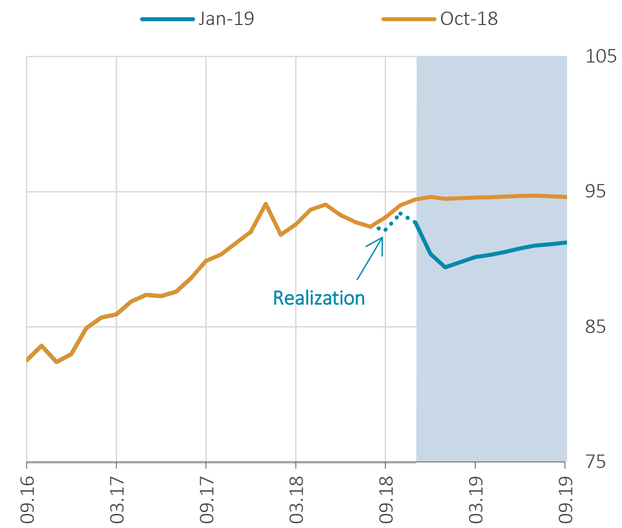
Despite ending the fourth quarter of 2018 below the October forecast, unprocessed food inflation remained high at 27.1%. The year-end food inflation forecasts are kept unchanged at 13% and 10% for 2019 and 2020, respectively.

Chart 1.2.9: Revisions to Oil Price Assumptions (USD/bbl)



Sources: Bloomberg, CBRT.
Shaded area denotes the forecast period.

Chart 1.2.10: Revisions to Import Price Assumptions (Index, 2010=100)



Sources: Bloomberg, CBRT.
Shaded area denotes the forecast period.

Fiscal Policy and Tax Adjustments

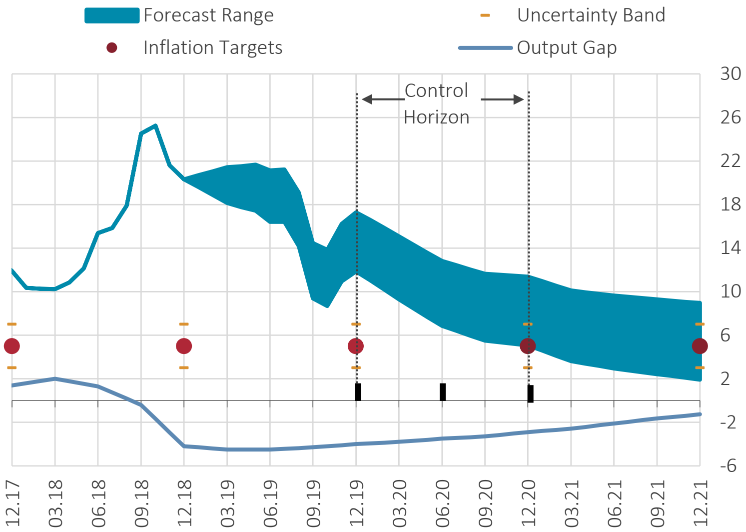
Fiscal policy contributed to the rebalancing process in economic activity in the fourth quarter, in line with the forecasts of the October Inflation Report. The early-January electricity and natural gas tariff cuts, as well as the lessened need to make upward revisions to energy prices thanks to the stable exchange rates and lower oil prices, prompted a substantial downward revision to the energy inflation assumption for 2019 compared to the previous reporting period. The SCT change for tobacco products increased the tobacco-driven upside risks to inflation. Medium-term projections are based on an outlook where macroeconomic policies are determined with a medium-term perspective and in a coordinated manner with a focus on bringing inflation down. In this context, the current projections are based on the assumption that fiscal policy will remain supportive of economic rebalancing in 2019 and that the administered prices will be set to support disinflation.[1] The strong policy coordination to lower inflation and achieve macroeconomic rebalancing is envisaged to gradually improve the risk premium and reduce the perception of uncertainty.

1.3 Inflation and the Monetary Policy Outlook

Under a tight policy stance and enhanced policy coordination focused on bringing inflation down, inflation is projected to converge gradually to the target. Accordingly, inflation is projected to be 14.6% at the end of 2019 and then fall to 8.2% at the end of 2020 and 5.4% at the end of 2021, before stabilizing around 5% over the medium term. Thus, with a 70% probability, inflation is expected to be between 11.9% and 17.3% (with a mid-point of 14.6%) at end-2019 and between 5.1% and 11.3% (with a mid-point of 8.2%) at end-2020 (Chart 1.3.1).

[1] Box 7.2 presents a theoretical perspective on the role of fiscal policy in lowering the output gap and inflation volatility.

Chart 1.3.1: Inflation and Output Gap Forecasts*



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

After the October Inflation Report, import prices in Turkish liras decreased on the back of the appreciation of the Turkish lira and the drop in crude oil prices, and the underlying trend of inflation decelerated owing to tax cuts in some goods and the subdued domestic demand. The increased contribution from demand conditions to disinflation, the deceleration in the underlying trend of inflation as well as the significant decrease in oil and import prices assumptions together played an important role in the downward revision in inflation forecasts for 2019.

The inflation forecast for end-2019 has been revised downwards to 14.6% from 15.2%. The decline in the assumption for import prices in terms of Turkish liras had a decreasing impact of 0.5 points on the end-year inflation forecast. The 3.2-point-lower consumer inflation realization in the final quarter of 2018 than previously forecast in the October Inflation Report and the decline in the underlying trend of inflation excluding the tax-cut effect reduced the end-2019 inflation forecast by 0.4 points. Moreover, the revision in the assumptions for the tax adjustments and administered prices had an upward effect of 0.2 points on the year-end inflation forecast. The output gap, which is expected to make a greater contribution to disinflation in the upcoming period, was forecasted to have a 0.3-point downward impact on the inflation forecast for end-2019. Nevertheless, unit labor costs are expected to exert an upward impact of 0.4 points to end-year inflation forecast. Consequently, the end-2019 inflation forecast has been revised downwards by 0.6 points compared to the October Inflation Report.

Meanwhile, the inflation forecast for 2020 has been decreased to 8.2% from 9.3%. Of the 1.1-point revision in the inflation forecast compared to the previous report period, 0.4 points came from the downward revision in the 2019 inflation forecast and the expected improvement in the underlying trend of inflation. Demand conditions, which from the second quarter of 2019 onwards are expected to be weaker compared to the October Report, are likely to be disinflationary throughout 2020. Accordingly, the revision in output gap forecasts brings down end-2020 inflation forecast by 0.4 points compared to the previous report period. Assuming that oil prices will continue to decrease and the appreciation in Turkish lira will continue, import prices in terms of Turkish liras are estimated to draw down the end-2020 inflation forecast by 0.3 points.

The above-mentioned forecasts are based on a framework in which there would be no additional deterioration in the global risk appetite and the recent recovery in the country risk premium would continue moderately. Projections rely on an outlook in which decisive implementation of a tight monetary policy stance would continue, and the monetary policy will focus on bringing down inflation to single digit figures in the second quarter of 2020 and ultimately to the 5% target. The tight monetary policy stance coupled with the rebalancing process expected to continue in the current account deficit would contribute to the improvement in the country risk premium, thereby containing exchange rate volatility.

Accordingly, the determinants of the fall in inflation in 2019 are judged to be the moderation of cost pressures driven by a modest appreciation trend in the real exchange rate and the expected slowdown in domestic demand. Under a tight monetary policy stance and strengthened policy coordination, it is forecasted that consumer inflation will come down to single-digit figures in the second quarter of 2020 and come closer to the 5% target by the end of 2021 (Chart 1.3.1). Breaking the backward-indexation behavior with the support of the stable course of exchange rates and strengthened macro-policy coordination targeting disinflation, and pulling medium-term inflation expectations to levels consistent with forecasts and targets are crucial for the success of the disinflation efforts.

1.4 Key Risks to Inflation Forecasts and the Likely Monetary Policy Response

The outlook underlying the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions. Nevertheless, various risks to these factors may affect the inflation outlook and necessitate changes in the monetary policy stance envisaged in the baseline scenario.

The major macroeconomic risks that have the potential to change the outlook of the baseline scenario are as follows:[2]

- Uncertainties over pricing behavior and rigidity in expectations;
- Risks to the coordination between monetary and fiscal policies (administered prices, tax adjustments);
- Uncertainties pertaining to backward-indexation behavior;
- Possible volatility in food prices;
- The course of capital flows towards emerging market economies;
- Supply-side tightening in bank loans;
- Volatility in international crude oil prices.

Recently released data show that the real adjustment in economic activity continues and rebalancing has become more noticeable. The impact of weak demand conditions on inflation has become stronger and is likely to support disinflation throughout 2019; nevertheless, several factors such as the elevated level of inflation expectations, volatility in exchange rates and deferred cost pressures keep upside risks to the inflation outlook in place.

The recent fall in inflation is attributed to the weakened aggregate demand and tightened monetary policy as well as the tax cuts of the last quarter of 2018 that are projected to expire in the first quarter of 2019 and some transitory factors that appeared in the short term. The outlook for the short-term inflation path to emerge while these temporary effects are taken back will be largely dependent on the firms' pricing behavior.

The impact of the surge in inflation on wage increases in 2019 remains as a risk factor for the medium-term inflation outlook. Wage increases in 2019 may push inflation up through the aggregate demand channel. However, it is projected that further state subsidies to employers would limit potential cost pressures to some extent. Despite the alleviating effect of the slowdown in economic activity and weak

[2] Evaluations of how and through which channel these risks will affect inflation forecasts are summarized in Table 7.3.1.

employment opportunities on wages other than the minimum wage, the strong backward-indexation behavior in wages may slow the decline in inflation.

Elevated levels of inflation and inflation expectations remain as risk factors to the inflation outlook through the pricing behavior channel. Economic agents have not yet fully attributed the recent improvement in inflation to the medium-term trend of inflation.[3] These developments in expectations sustain the upside risks to the inflation outlook through the channels of wage adjustments and the pricing behavior.

In addition to the support that the macroeconomic rebalancing process offers to inflation, a decline in the indexation to past inflation in administered pries, taxes and wage adjustments that would weaken the backward-indexation mechanisms by anchoring expectations is significant to achieving a permanent fall in inflation.

Due to the persisting risks to price stability despite the partial improvement in recent months, the CBRT decided to maintain the tight monetary policy stance until the inflation outlook records a significant improvement. The essential element to shape the monetary policy decisions in the short term will be a trend of decline in inflation that can be considered as permanent.

There are also risks stemming from global monetary policies and risk appetite developments that may reduce capital flows towards emerging economies and feed into exchange rate volatility. In the last quarter of 2018, expectations became stronger that the subdued global growth and increased uncertainties regarding the global economy may lead to a normalization path in monetary policies of advanced economies that implies less tight policy stances compared to the previous period. This indicates that portfolio flows towards emerging economies may follow a more favorable course in 2019. However, blurred global economic policies, high volatility in financial markets of advanced economies, and persisting geopolitical problems keep downside risk to portfolio flows to emerging economies brisk.

In the case of excessive market volatility due to fluctuations in global liquidity conditions and the risk sentiment, the CBRT may use liquidity measures intended for providing the market with the needed FX liquidity in a timely, controlled and effective manner. In addition, it may introduce additional tightening in monetary policy to contain the impact of these risks on inflation and inflation expectations.

Following a significantly stronger tightening than historical averages due to increased risk premiums in the third quarter of the year, credit conditions have registered a gradual easing since October. The rate and extent of this normalization are important to the prospects for economic activity. As cash flows and balance sheets of firms have been adversely affected by the increase in exchange rates and loan rates as well as the slowdown in economic activity, conducting the necessary assessments and analyses related to the asset quality of firms will have a role in shaping the credit market. Therefore, establishing coordination between the financial sector policies that restrict the balance sheet effects of the corporate sector and the monetary policy that focuses on inflation are crucial to prevent financial conditions from being caught in an inefficient tightening cycle.

The recent deceleration in economic activity driven by domestic demand indicates the presence of downside risks to inflation as well. Recently-mounting uncertainties over monetary policies of advanced economies and the prospects for global economic activity pose a downside risks to growth through the capital flows and foreign trade channels.

A weaker coordination between the monetary policy and the fiscal policy than envisaged in the baseline scenario is regarded as a risk with respect to disinflation and macroeconomic rebalancing. The fiscal policy outlook, on which the medium-term projections in the Inflation Report are based, incorporates a policy stance that focuses on disinflation and macroeconomic rebalancing and is coordinated with the

[3] Developments in indicators of perceived inflation uncertainty are analyzed in Box 3.1.

monetary policy in line with the New Economy Program announced in September. Accordingly, the projections rest on an outlook where the fiscal policy implements a tight fiscal discipline, as envisaged in the New Economy Program. Moreover, it is assumed that administered prices and tax adjustments will be formulated in a way that will help reduce the backward-indexation behavior. If the fiscal policy significantly deviates from this framework leading to an adverse impact on the medium-term inflation outlook, the monetary policy stance may be revised.

The course of prices of crude oil and other commodities also constitute risks to inflation in the upcoming period. Although crude oil prices have recently plunged, the sustained sharp uptrend in the US shale oil production coupled with projections for muted global economic activity pose a downside risk to crude oil prices. Meanwhile, geopolitical developments as well as the persisting volatility in global financial markets is an upside risk factor for crude oil prices. On the other hand, increased protectionism in global trade stands out as a downward risk factor for commodity prices due to its possible adverse effect on global growth. If the trade negotiations between the US and China yield a positive outcome in the upcoming period, crude oil, some industrial metals and agricultural prices may register an upside movement due to the increased demand from China. Accordingly, the monetary policy response will be determined in such a way to curb a possible deterioration in inflation expectations and pricing behavior, taking into account the direct and secondary effects of respective risks on inflation.