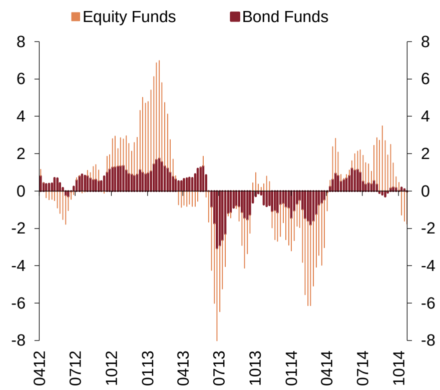
1. Overview

In the third quarter of 2014, the policy uncertainty in advanced economies led to a somewhat heightened volatility in global financial markets. While the Fed ended its quantitative easing program, uncertainties regarding the timing and the magnitude of the policy rate hike have continued. Meanwhile, amid weak economic activity in the EU and the growing risk of deflation, the ECB cut the policy rate in this period and announced a quantitative easing program that entailed the purchase of covered bonds and asset-backed securities. In the second and third quarters of 2014, indicators for global economic activity performed weaker than expected, causing growth forecasts for end-2014 to be revised down. Financial market volatility and falling global growth rates led to some fluctuation in emerging market capital inflows (Chart 1.1). In the meantime, commodity prices dropped markedly due to slower global growth.

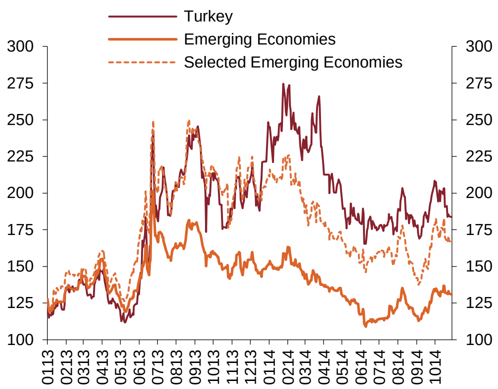
On the domestic economy front, Turkey was affected adversely by the recent global financial volatility like its emerging market peers. In the third quarter, Turkey's risk premium indicators fluctuated on par with those of other emerging economies (Chart 1.2). Economic activity lost some momentum after the first quarter. The slowdown in EU growth and geopolitical tensions restrained external demand. Despite weakening external demand, exports continued to balance growth.

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



Source: EPFR.

Chart 1.2.
CDS for Emerging Economies and Turkey*
(Basis Points)



* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile. Selected emerging economies are Brazil, Indonesia and South Africa.
Source: CBRT, Bloomberg.

The macroprudential measures and the tight monetary policy stance have positive effects on core inflation, leading to a considerable compensation for the significant first-half increase in the third quarter. Annual core inflation continues to slow down as adverse effects of pass-through from exchange rate diminish. Moreover, falling oil prices contain the inflationary pressures on energy items. However, elevated food prices cause inflation to hover significantly above the target. With the continued decline in cumulative exchange rate effects and the fall in commodity prices, oil prices in particular, inflation is estimated to fall significantly in 2015 also as food inflation reverts back to previous years' average. Moreover, the tight fiscal stance set out in the MTP is expected to support disinflation as well.

1.1. Monetary Policy and Financial Conditions

After the front-loaded and strong monetary tightening implemented in the first quarter of 2014, the CBRT lowered policy rates gradually amid alleviated domestic and external uncertainties in the second quarter. During the third quarter, the one-week repo auction rate was cut from 8.75 to 8.25 percent in July, while the overnight borrowing rate was lowered from 8 to 7.5 percent. Furthermore, in order to ensure the symmetry of the interest rate corridor, the overnight lending rate was lowered from 12 to 11.25 percent, while the rate on borrowing facilities for primary dealers via repo transactions was cut from 11.5 to 10.75 percent in August. (Chart 1.1.1). Since the July Inflation Report, the CBRT continued to fund the market primarily via the one-week repo rate following the decision made at January's interim MPC meeting that simplified the operational framework of monetary policy (Chart 1.1.2). The provision of liquidity primarily by one-week repo auctions enabled the CBRT average funding rate to near the weekly funding rate. Meanwhile, in view of the heightened geopolitical tensions and the financial market volatility, the tight monetary policy stance has been invigorated by a tight liquidity policy since September. Thus, the BIST overnight repo rates that hovered around the one-week repo auction rate in July and August have lately settled close to the upper end of the interest rate corridor.

Chart 1.1.1.
CBRT Rates and BIST O/N Repo Rates
(Percent)

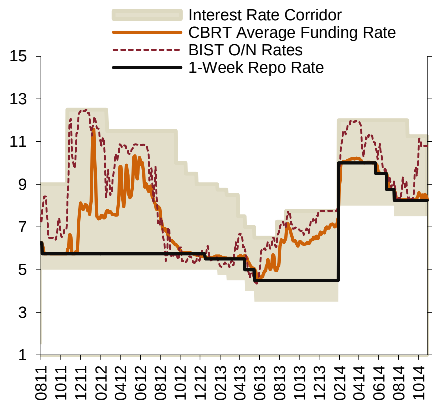
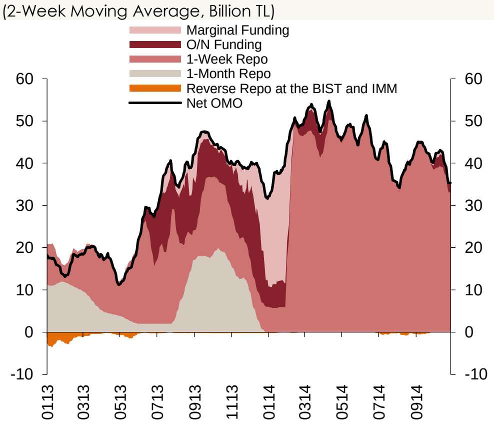


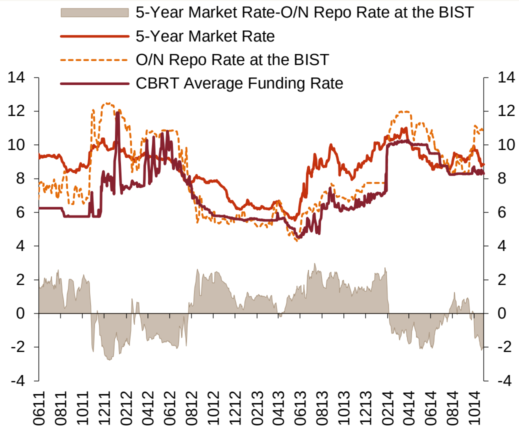
Chart 1.1.2.
CBRT Funding
(2-Week Moving Average, Billion TL)



Source: BIST, CBRT.

Despite implementing measured rate cuts, the CBRT has maintained a tight monetary policy stance by keeping the yield curve nearly flat. The spread between 5-year market rates and the BIST overnight repo rates has taken negative values as of October (Chart 1.1.3). In addition, with the recent tightening in the liquidity policy imposed by the CBRT, short-term rates rose substantially, while the yield curve remained flat. Thus, the spread between long and short-term rates continued to hover below historical averages. (Chart 1.1.4). The CBRT will closely monitor inflation expectations, pricing behavior and other factors affecting inflation in the upcoming period and maintain its tight monetary policy stance by keeping the yield curve flat until there is a significant improvement in the inflation outlook.

Chart 1.1.3.
Market Rates and the CBRT Funding Rate
(Percent)



Source: BIST, Bloomberg, CBRT.

Chart 1.1.4.
Interest Rate Spread*
(Percent)

Source: Bloomberg.

In order to maintain balanced growth and capital inflows during the normalization of the global monetary policy, the CBRT has changed the foreign exchange deposit rates that apply to banks for their borrowing from the CBRT within their limits through the Foreign Exchange Deposit Market. As of October 9, the rates for 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 euro. Moreover, considering the increase in banks' balance sheets and the CBRT's international reserves, it was announced that banks' transaction limits at the Foreign Exchange and Banknotes Markets, which are currently 10.8 billion USD, will be revised at the press meeting for the release of Monetary and Exchange Rate Policy for 2015. In addition, the CBRT also stated that it is crucial to further strengthen the currently robust structure of the banking sector for enhancing financial stability. Consequently, the CBRT announced on October 21 that it will provide additional support to core liabilities in order to stimulate balanced growth and domestic savings. To this end, the CBRT decided to remunerate the Turkish lira component of required reserves of financial institutions as an incentive, which will also reduce the sensitivity of the cost of Turkish lira required reserve holdings against the policy rate and thus strengthen the automatic stabilization feature of the ROM.

As for the loans, the macroprudential measures and the tight monetary policy stance have helped to keep the pace of loan growth at reasonable levels. In this regard, the annual rate of total loan growth is 16 percent, below the 2007-2013 average of 23 percent, as of October 2014. With an average growth rate of 22 percent for the same period, commercial loans increased by 20 percent in annual terms in October, while consumer loans increased by 14 percent with an average growth rate of 27 percent. In terms of long-term trends, the annualized growth rate of consumer loans continues to stay low, whereas commercial loans remain relatively more robust (Charts 1.1.5 and 1.1.6). This outlook is expected to both restrain medium-term inflationary pressures and support the improvement of the current account balance.

Chart 1.1.5.
Consumer Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)

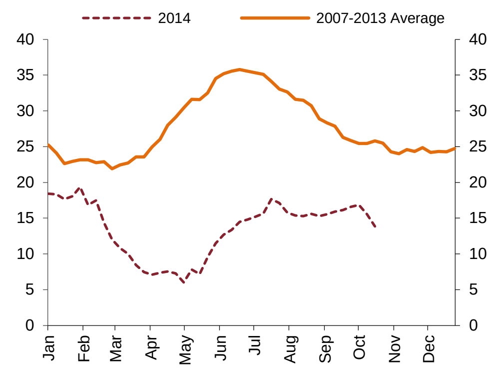
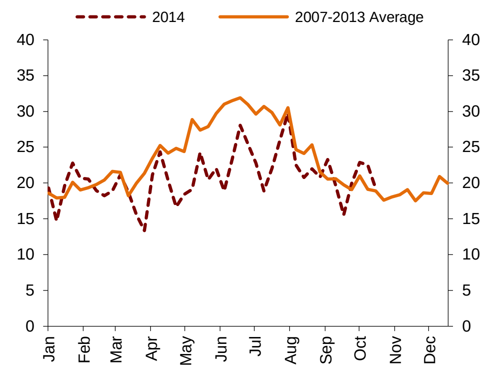


Chart 1.1.6.
Commercial Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

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 the July Inflation Report forecasts (Charts 1.2.1 and 1.2.2). Due to adverse weather conditions and cumulative effects of exchange rate changes, food prices continued to be the subcategory with the highest contribution to inflation. On the other hand, the main drivers of the third-quarter fall in inflation were energy and core goods prices. Annual inflation continued to decline across the core goods category thanks to waning adverse effects of exchange rate. In terms of underlying trend of inflation, there has been a significant improvement in the core goods category, while the services category produced a relatively negative outlook.

Chart 1.2.1.
July 2014 Inflation Forecasts and Realizations
(Percent)

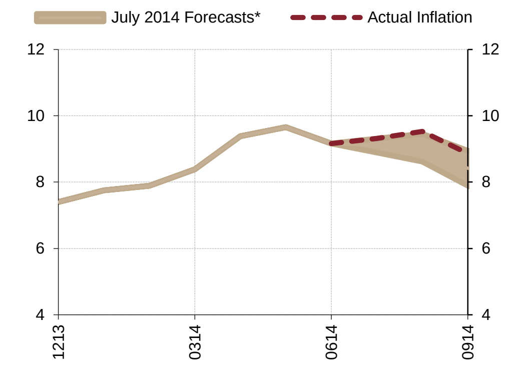
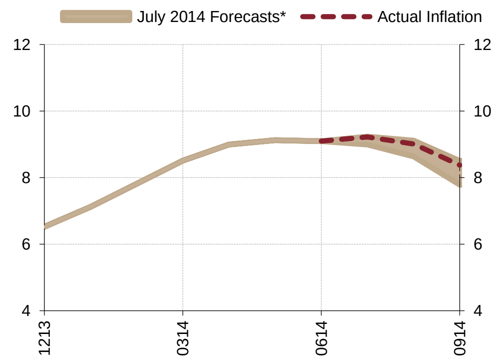


Chart 1.2.2.
July 2014 Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco (Percent)



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

In the third quarter, core inflation recorded a decline as the adopted macroprudential measures and the tight monetary policy stance proved favorable (Chart 1.2.3). Accordingly, the marked first-half increase in core inflation was offset in the third quarter. Yet, it should be noted that underlying trend indicators are still above the target-consistent levels. In this period, USD-denominated import prices dropped and international commodity prices, oil prices in particular, fell in line with the weak global growth outlook. In addition to this favorable outlook in cost of imports, aggregate demand conditions and the relatively slow pace of growth in consumer loans also alleviate inflationary pressures. In fact, excluding food products and the associated services subcategories, annual consumer inflation declined considerably in the third quarter (Chart 1.2.4).

Chart 1.2.3.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized)

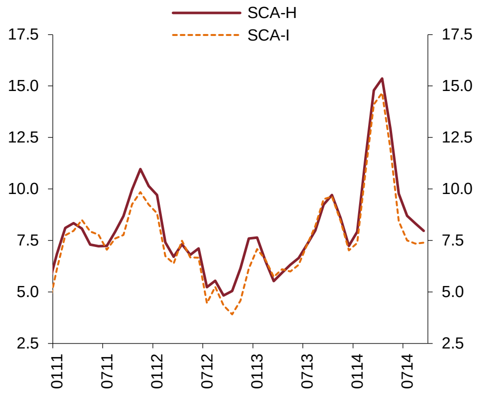
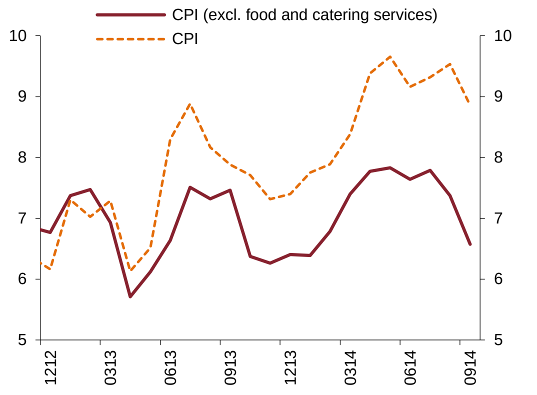


Chart 1.2.4.
CPI Excluding Food and Catering Services
(Annual Percent Change)



Source: TurkStat, CBRT.

In sum, the negative effects of cumulative exchange rate changes continued to wane in the third quarter, yet food prices remained on a relatively unfavorable track. The persistent elevation in consumer inflation and the deterioration in expectations affect pricing behavior in certain categories, particularly services, adversely. The fall in commodity prices driven by weak global demand is expected to bring consumer inflation down, while the anticipated moderate pace of domestic demand is likely to restrain the upside risks. Thus, underlying inflation is expected to move downwards in the forthcoming period.

Supply and Demand

According to the GDP data of the second quarter of 2014, economic activity was relatively weaker compared to the outlook presented in the July Inflation Report. In the second quarter, industrial production remained virtually unchanged quarter-on-quarter, while seasonally adjusted national income posted a decline after eight consecutive quarters (Chart 1.2.5). This decline was mostly attributed to the agricultural sector with a negative 0.3 point contribution to quarterly growth. On the other hand, the construction sector fails to make positive contribution to growth for three successive quarters. Therefore, national income growth lagged behind industrial production growth (Chart 1.2.6). Final domestic demand decreased in the second quarter at a similar pace to the first quarter both due to reduced public spending and the weaker private demand.

Chart 1.2.5.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)

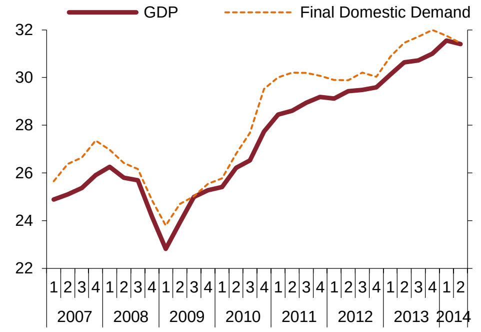
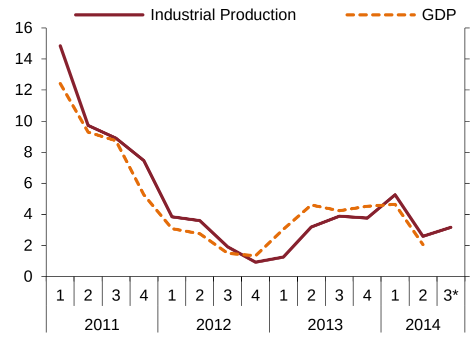


Chart 1.2.6.
Industrial Production and GDP
(Annual Percent Change)

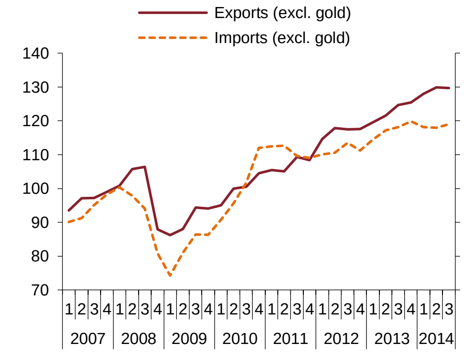


*Estimate for July-August.
Source: TurkStat.

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, envisaged decline in the agricultural value added, and a downturn in the construction value added signaled by the developments in the manufacturing of mineral products and employment suggest that GDP growth may fall short of the industrial production growth in this period as well. Third-quarter data of 2014 reveal that consumption demand registered a quarter-on-quarter increase; machinery and equipment investments are yet to recover permanently and the weakness in construction investments have become more apparent. Factors such as the EU slowdown and geopolitical developments also weighed on external demand, inducing a slowdown in the growth of exports (Chart 1.2.7). As a result, the slowdown in external demand in the third quarter is expected to be partially offset by the rebound in domestic demand, while the third-quarter growth accommodates downside risks stemming from the agricultural sector.

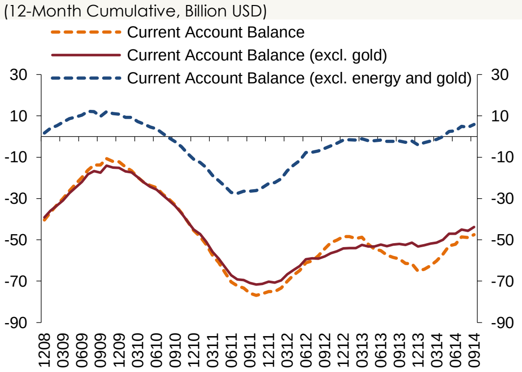
A permanent recovery in consumer and investor confidence is yet to appear, implying that downside risks to domestic demand still persist. The weakening external demand is expected to curb export growth for a while. Although this slowdown poses a risk to the recovery of the current account deficit and rebalancing of growth, the reasonable levels of loan growth as well as the relatively slow growth in consumer loans are expected to support the correction of the current account deficit (Chart 1.2.8). Moreover, falling commodity prices amid decelerating global demand may limit the import growth and contribute positively to the current account balance.

Chart 1.2.7.
Export and Import Quantity Indices*
(Seasonally Adjusted, 2010=100)



* Estimate for September.
Source: TurkStat, CBRT.

Chart 1.2.8.
Current Account Balance*
(12-Month Cumulative, Billion USD)

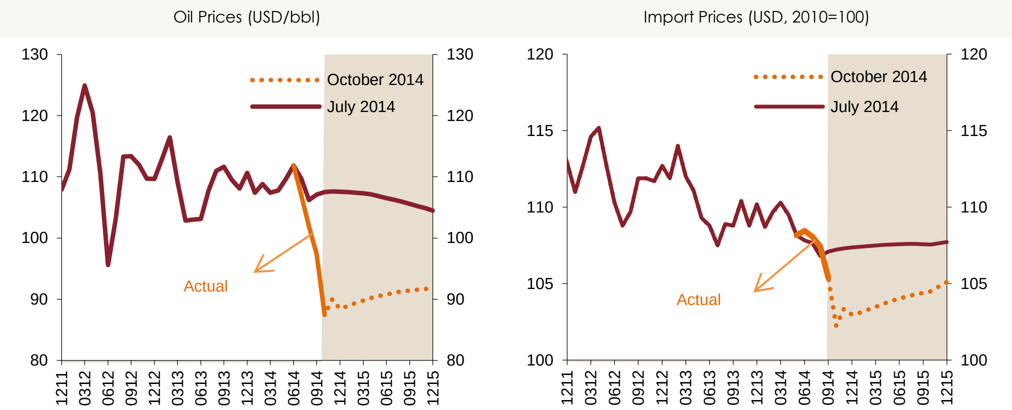


* Estimate for September.
Source: CBRT.

Oil, Import and Food Prices

In the third quarter of the year, oil and import prices remained below the projections of the July Inflation Report (Chart 1.2.9). Accordingly, oil and import price assumptions for 2014 and 2015 were revised downwards (Table 7.1.1). Given the current outlook for 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 of food inflation in the third quarter, year-end inflation assumption for food prices were revised upwards to 12.5 percent for 2014 and 9 percent for 2015 (Table 7.1.1). These revisions in food prices drove year-end inflation forecasts for 2014 and 2015 by 0.8 and 0.3 percentage points, respectively.

Chart 1.2.9. Revisions to Oil and Import Price Assumptions



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

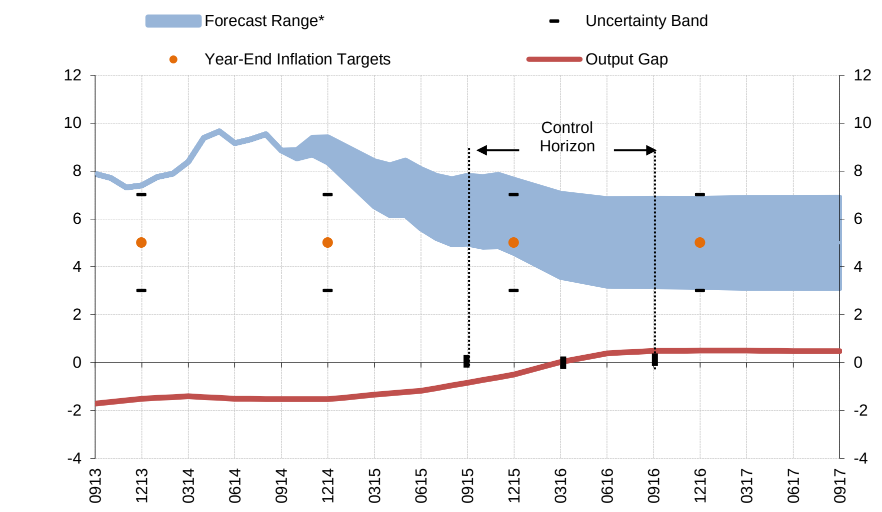
Fiscal Policy and Tax Adjustments

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 announced in early October, exceeded the assumptions in the July Inflation Report. This led to a 0.2 percentage point upward revision of the end-2014 inflation forecast. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a tight fiscal stance will be implemented and the primary expenditures to GDP ratio will decrease gradually.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the assumption that the tight monetary policy stance will be maintained by keeping the yield curve flat. A further assumption is that the annual loan growth rate will near 15 percent towards the end of 2014 and will stabilize around these reasonable levels on the back of the macroprudential measures. Accordingly, inflation is expected 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. Inflation is projected 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.

Inflation is envisioned 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 in inflation projections is driven by lower commodity prices, oil prices in particular, and projections that cumulative exchange rate effects will continue to taper off and food price inflation will recede to past years' average. Moreover, demand conditions and the announced tight fiscal policy stance are assessed to support the decline in inflation in this period. The fluctuating course in 2015 inflation forecasts stem from the base effects (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 Monetary Policy

Global financial markets have recently followed a volatile course. While, the Fed terminated its quantitative easing program, which has been implemented for quite some time, the timing and the magnitude of the policy rate hike remained uncertain. The ECB reduced policy rates against economic slowdown and risks of deflation and announced a new quantitative easing program that entailed the purchases of covered bonds and asset-backed securities. Persisting uncertainties regarding global monetary policies and the downturn in global economic activity may cause emerging market capital inflows and risk indicators to fluctuate. To maintain balanced growth and capital inflows during the normalization of global monetary policies, the CBRT has reduced the foreign exchange deposit rates that apply to banks for their borrowing from the CBRT within their limits through the Foreign Exchange Deposit Market and also announced that limits will be revised. Under current circumstances, it is critical that the currently robust structure of the banking sector should be strengthened. Accordingly, to stimulate balanced growth and domestic savings, the CBRT decided to introduce an additional support to core liabilities of financial institutions through remuneration of required reserves, which are held in Turkish lira.

Elevated food prices put a cap on bringing down inflation. Unfavorable developments in food prices throughout the year were mainly driven by supply conditions. There will be a considerable room for decline in inflation should supply conditions exert no upside pressure in 2015 and food inflation nears past years' average. Amid the recent weakening in global demand, falling commodity prices, oil prices in particular, are expected to support the envisioned fall in inflation in 2015. Despite these positive developments, medium-term expectations are affected adversely by the currently high levels of inflation and cumulating upside risks on pricing behavior. Accordingly, the CBRT will closely monitor inflation expectations, pricing behavior and other factors that affect inflation, and maintain a tight monetary policy stance by keeping the yield curve flat until there is a significant improvement in the inflation outlook.

Growth rates and composition of loans evolve in the desired direction, owing to the tight monetary policy stance and adopted macroprudential measures. Consumer loan growth followed a weak course, while commercial loan growth was relatively more robust. This outlook contributes to disinflation and also supports rebalancing of the current account. Additional tightening measures will be taken should credit growth accelerate to pose upside risks to inflation and aggravate financial risks by distorting the rebalancing process.

Recently released data point to a deceleration in economic activity. The global economic activity slowed down in the second and third quarters of 2014. Languishing external demand due to stalling growth in the European countries, the largest export market of Turkey, besides geopolitical developments in neighboring countries limit the growth of exports. Falling commodity prices due to the weak global demand are expected to restrict growth in imports and improve the current account balance. Meanwhile, due to persisting volatility in financial markets and the sluggish course of confidence indices, private demand does not exhibit a permanent recovery. Therefore, it is expected that the projected recovery in economic activity will be gradual and aggregate demand developments will support the disinflation process. In the case of an additional slowdown in external demand and a sizeable decline in global growth rates, the decrease in commodity prices will pull inflation down. Nevertheless, domestic economic activity may witness notable adverse effects at the same time. Under such circumstances, the CBRT will employ policy tools to support the economy.

Macroprudential measures taken at the beginning of the year besides the tight monetary policy stance have a favorable effect on the trend of core inflation. Core inflation indicators SCA-H and SCA-I have recently displayed an improvement, which compensated for most of the significant increase in early 2014. Accordingly, the adverse impact of cumulative exchange rate developments on annual inflation is also tapering off. The exchange rate channel is envisioned to provide inflation with a considerable room for decline in 2015. However, the second-round effects and inflation expectations need to be closely monitored. In the event that additional deterioration occurs in the medium-term inflation outlook, liquidity policy will be tightened besides the monetary policy.

The CBRT closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption 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.

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 the interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms envisaged by the MTP remains to be of utmost importance.