

HEAD OFFICE

ANKARA, 30 January 2019

Please refer to:

TCMB.98422658-

Dr. Berat ALBAYRAK
Minister of Treasury and Finance
ANKARA

As stipulated in Article 42 of the Central Bank Law No. 1211, if the inflation target is not attained, the Central Bank of the Republic of Turkey (CBRT) is accountable for reporting to the Government and announcing to the public the reasons for the deviation from the inflation target and the necessary measures to be taken. As stated in the main policy document “Monetary and Exchange Rate Policy for 2018”, which was published on 5 December 2017, the inflation target for 2018 was set jointly with the Government at 5%. In the same document, it was also indicated that the CBRT would write an open letter to the Government should the year-end inflation deviate from the target range (by more than two percentage points from the target in either direction). The year-end inflation stood above the target range in 2018. This document elaborates on the reasons for the deviation of inflation from the target and explains the measures already taken -and to be taken- to bring inflation back to the target.

Factors Affecting Inflation in 2018

The depreciation of the Turkish lira and the resulting deterioration in pricing behavior constituted the main factors causing inflation to overshoot the target in 2018. Strong demand conditions in the first half of the year also added to the upward trend in inflation.

The impact of the increase in Turkish lira-denominated import prices was evident particularly in core goods and energy groups. The core goods group, which is characterized by high and relatively rapid exchange rate pass-through, was among the main drivers of the rise in inflation.

On the other hand, tax cuts in durable goods and the sliding-scale tariff system in fuel curbed the inflation in core goods and energy. Meanwhile, administered energy prices posted increases throughout the year. In the recent period, the partial appreciation in the Turkish lira and the deceleration in international oil prices had a downward effect on core goods and energy inflation.

Another major contribution to the rise in inflation came from food prices. Food inflation ended 2018 at 25.11%, a level above the general consumer inflation, due to cost pressures, adverse supply conditions for some products and the brisk course of tourism. Inflation in tobacco products, on the other hand, remained considerably below consumer price increases in the same period.

In 2018, annual inflation in the services group rose due to the depreciation of the Turkish lira, backward indexation, stronger cost pressures in sectors related to food and energy, and demand-side effects driven by the robust course in tourism, and became 14.46% at the end of the year. Meanwhile, price hikes in this group slowed owing to the weakening economic activity in the last quarter.

In sum, the depreciation in the Turkish lira and the deterioration in pricing behavior drove inflation above the target in 2018. Economic activity that was relatively strong in the first half of the year started to weaken in the third quarter and demand conditions pulled inflation down in the last quarter in particular. Partial appreciation in the Turkish lira, the decline in oil prices and favorable effects of tax cuts on a number of durable consumption goods were the other factors that contributed to the fall in inflation in the last quarter of the year.

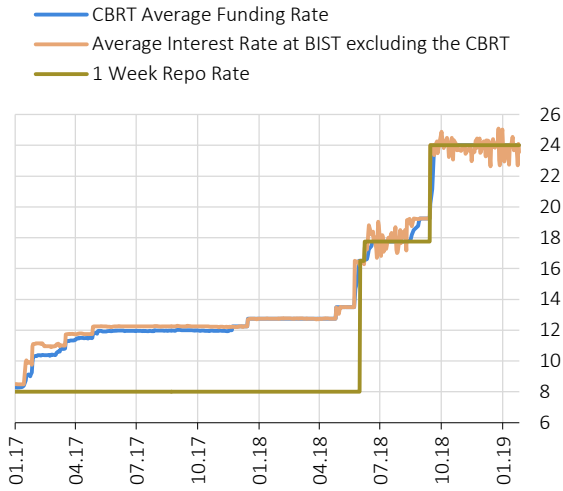
Measures Taken to Reach the Inflation Target

The CBRT delivered a strong monetary tightening in 2018 to support price stability in the face of deterioration in pricing behavior and risks to inflation outlook (Chart 1). Additionally, the CBRT completed the simplification process regarding the operational framework of the monetary policy, thereby improving the predictability of its monetary policy to a significant extent.

Tight monetary policy stance was maintained during the January–March 2018 period, followed by a measured monetary tightening in April to support price stability. In May, the CBRT strengthened its tight stance in monetary policy taking into account the risks to general pricing

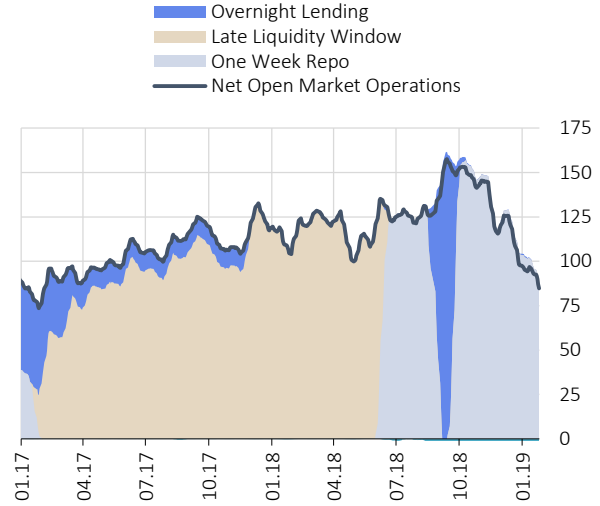
behavior posed by unhealthy price formations in markets and the ongoing rise in inflation expectations.

Chart 1: Short-Term Interest Rates (%)



Source: BIST, CBRT.

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



Source: CBRT.

Meanwhile, along with the reserve options mechanism (ROM), other instruments were used to support the FX liquidity. In addition, repayments of rediscount credits for export and FX earning services were allowed to be made in Turkish liras, provided that they were paid at maturity. These measures regarding foreign exchange and Turkish lira liquidity management as well as the monetary tightening and the decision to finalize the simplification process in May helped mitigate the volatility in financial markets.

In June, the simplification process regarding the operational framework of the monetary policy was completed. Accordingly, the policy rate of the CBRT became the one-week repo rate. Moreover, it was decided that the CBRT's overnight borrowing and lending rates would be determined at 150 basis points below/above the one-week repo rate. In the new operational framework, the CBRT started to provide entire funding via weekly repo auctions (Chart 2). As a result, the monetary transmission mechanism was substantially strengthened.

In early August, to avoid excessive volatility in financial markets and to ensure efficient operation of markets, the CBRT introduced a series of financial stability-oriented measures that supported Turkish lira and foreign exchange liquidity management. The upper limit for the FX maintenance facility within the ROM was lowered, liquidity injections were made through reduced Turkish lira and FX reserve requirement ratios, banks' collateral conditions were made more flexible, and weekly repo auctions were temporarily suspended. In this period of elevated financial market volatility, cost-side pressures and the deterioration in pricing behavior affected the inflation outlook adversely. In this regard, the CBRT implemented a strong monetary tightening in September to support price stability in which the one-week repo rate was raised to 24%. In view of ongoing risks to price stability, the Bank retained its tight monetary policy stance in the following period.

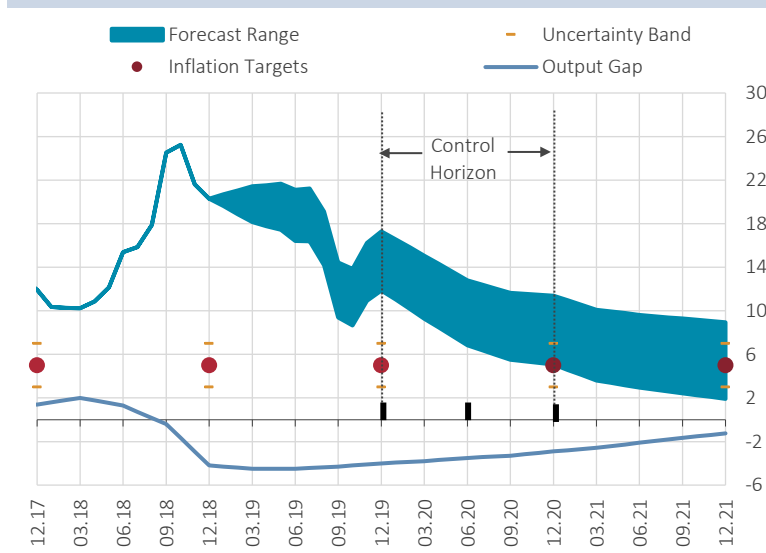
In 2018, considering the increased exchange rate volatility and unhealthy price formations, the CBRT widened its set of tools to ensure efficient functioning of the markets and to support the transmission mechanism. Accordingly, Turkish lira-Settled Forward Foreign Exchange transactions were launched at the Derivatives Market (VIOP) operating under Borsa İstanbul (BIST). Additionally, the Turkish Lira Currency Swap Market was opened. The aim of these steps was to contribute to the deepening of the Turkish derivatives market and to the foreign exchange risk management of the corporate sector.

Monetary measures coupled with coordinated steps in economic policies lowered the market volatility considerably. In the last quarter of the year, pricing behavior started to normalize, and the inflation outlook improved gradually. Nevertheless, the tight monetary stance is preserved due to the persistently high levels in inflation and risks to price stability.

Under a tight monetary policy stance and enhanced policy coordination focused on bringing inflation down, inflation is projected to converge gradually to the targets. 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 to 5.4% at the end of 2021, before stabilizing around 5% in 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 3).

Chart 3: Inflation and Output Gap Forecasts* (%)



Source: TURKSTAT, CBRT.

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

Maintained coordination in macro policies and the rebalancing process in the economy are expected to contribute to the improvement in the country's risk premium, and contain the volatility in financial markets. Against this background, the gradually improving pricing behavior accompanied by waning cumulative cost effects will be the drivers of the fall in inflation. Moreover, demand conditions are also expected to contribute further to the disinflation process. On the other hand, breaking the backward-indexation behavior is critical for success in the fight against inflation.

Conclusion

Inflation increased significantly following the exchange rate movements in 2018. In addition to the monetary policy actions, the implementation of an economy program focusing on rebalancing helped contain the deterioration in inflation expectations and pricing behavior. However, the current level of inflation and global uncertainties keep risks to price stability in place and call for a cautious policy stance.

In the upcoming period, the CBRT will continue to use all available instruments in pursuit of the price stability objective. Monetary policy stance will be geared towards maintaining a sustained disinflation process by bringing inflation down to a single digit figure at the initial stage, and to 5 percent target afterwards. The CBRT will closely monitor inflation expectations, pricing behavior and developments in other factors affecting inflation and deliver further monetary tightening, if needed.

The recent coordinated macro policy steps have underpinned the improvement in risk perceptions and helped bring inflation back on downtrend. Maintaining a tight monetary policy stance and strong policy coordination are crucial for reducing inflation inertia, limiting risks to pricing behavior and achieving the inflation target. Against this backdrop, it is envisaged that risk perceptions will continue to improve, and the confidence channel and the credit channel will gradually support economic recovery.

The CBRT will continue to support studies on structural issues to achieve lasting price stability. Continued implementation of reforms towards alleviating inertia and volatility in inflation will provide significant contribution to price stability and social welfare. In this context, the CBRT will maintain its efforts to contribute to the analysis of structural factors and to the design of macroprudential policies.

The January 2019 Inflation Report, published today on our website, is enclosed for your information to provide a comprehensive account of the developments regarding inflation and monetary policy as well as our medium-term forecasts.

Yours sincerely,

THE CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Murat Çetinkaya
Governor

Dr. Uğur Namık Küçük
Deputy Governor

Enc: January 2019 Inflation Report