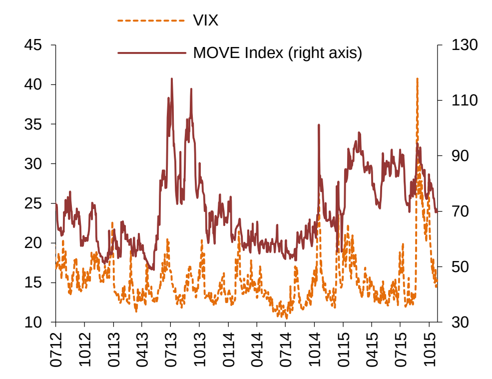
1. Overview

Volatilities in global financial markets continued in the third quarter of 2015. Uncertainties in global monetary policies and concerns over global growth have been in the forefront in this quarter. Accordingly, long-term rates remained highly volatile in advanced economies and uncertainty indicators displayed an increase (Chart 1.1). In the late third quarter and early fourth quarter, volatilities in financial markets declined slightly on the back of the growing perception about the postponement of the Fed's policy rate hike, and also owing to the ECB's statement for a continued easing in monetary policy as well as the accommodative steps taken by the People's Bank of China.

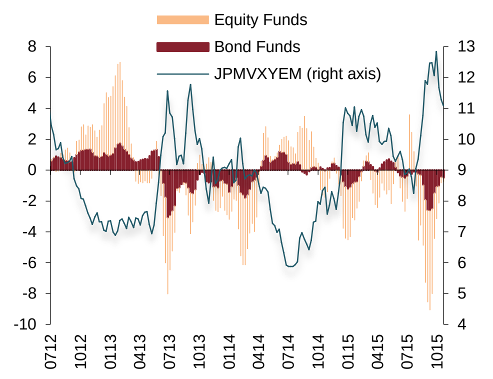
Financial asset prices in emerging economies were also affected notably by this volatility. In the third quarter, risk premium indicators of emerging economies deteriorated; long-term rates increased; and domestic currencies depreciated. Moreover, portfolio flows towards these countries exhibited the weakest outlook and exchange rate volatilities hit the peak of recent years (Chart 1.2). In the early fourth quarter, financial asset prices saw partial improvement in emerging economies amid the alleviated volatility in global financial markets. Risk premium indicators and long-term rates registered a decline and depreciation in domestic currencies was partially reversed. The global economic activity, which has started to lose pace in 2014, slowed down further through the second quarter of 2015 due to the deceleration in China and some other emerging economies. Meanwhile, the weak course of the global economic activity led to a decline in commodity prices in the third quarter.

Chart 1.1.
VIX and US Interest Rate Volatility
(Basis Points)



Source: Bloomberg.

Chart 1.2.
Portfolio Flows to Emerging Economies (4-Week Moving Average, Billion USD) and JPMVXYEM Volatility Index (Percent)



Source: EPFR, Bloomberg.

Volatility in global markets had repercussions on the Turkish economy as well and financial indicators went through fluctuations amid domestic uncertainties. In the third quarter, similar to other emerging economies, risk premium indicators and long-term rates in Turkey also increased and the Turkish lira depreciated. However, more recently, all financial asset prices have registered an improvement. In this period, in addition to implementing a tight monetary policy stance in consideration of the inflation outlook, the CBRT also took steps to support financial stability and stabilize the foreign exchange liquidity along the lines of the road map announced in August.

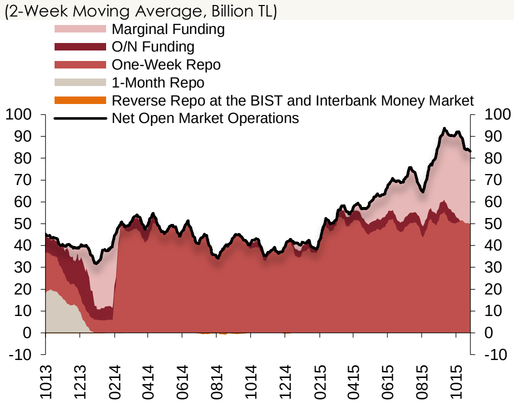
In the second quarter of 2015, economic activity recorded an increase owing to domestic demand. Third-quarter indicators signal a mild course in economic activity, while growth composition is expected to turn in favor of net exports in the second half of the year. Domestic and external uncertainties pose a downward risk to the economy, whereas the rising demand from the EU countries supports our exports. Accordingly, it is assessed that domestic demand will remain moderate in the upcoming period, while external demand will recover and the re-balancing in growth composition will continue.

In the third quarter of 2015, inflation rose amid developments in food prices and the exchange rate. Due to the cumulative depreciation in the Turkish lira, annual core goods inflation surged in this period and the core inflation remained elevated. In addition to the changes in exchange rate and food prices, wage developments and medium-term inflation expectations will also be effective on the course of the inflation outlook in the upcoming period. Accordingly, inflation is expected to hover around current levels for a while due to the exchange rate effects, and then trend downwards. Conditional on the fiscal policy regarding revenues and expenditures, inflation is projected to reach the 5-percent target in the medium term.

1.1. Monetary Policy and Financial Conditions

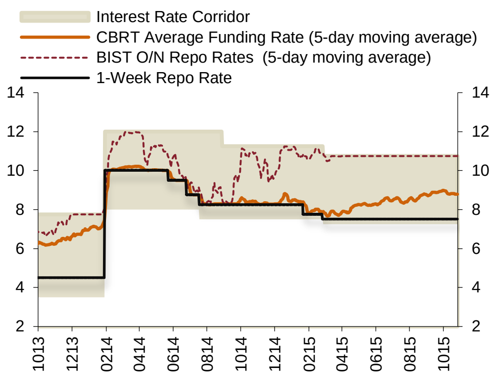
The CBRT released a road map on 18 August 2015 concerning the policies to be implemented before and during the normalization of global monetary policies. Accordingly, it was announced that the width of the interest rate corridor will be narrowed and the corridor will be made more symmetric around the one-week repo rate. During the simplification process, adjustments will be made in the funding composition to preserve the required degree of tightness in the monetary policy. Moreover, the road map also addressed policies to be implemented before and during the normalization regarding Turkish lira liquidity, foreign exchange liquidity and financial stability. Thus, with respect to the Turkish lira liquidity, quotation on the interest rate on borrowing facilities provided for primary dealers via repo transactions was terminated and collateral conditions for Turkish lira transactions were simplified as of 23 September 2015. In addition, it was reminded that foreign exchange deposits can be used as collaterals against Turkish lira transactions, and new simplified rules were announced regarding the use of this facility. The aim of these arrangements that were put into effect on 28 September 2015 is to enhance the efficiency of banks' liquidity management.

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



Source: BIST, CBRT.

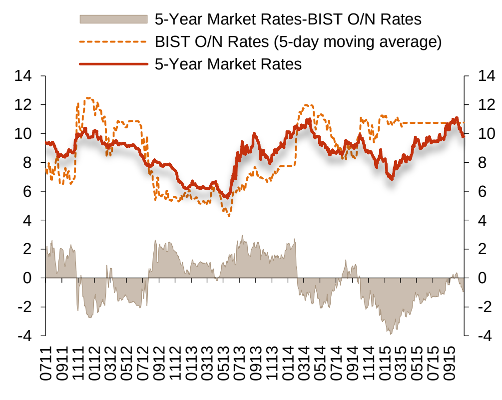
Chart 1.1.2.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



In the third quarter of 2015, the CBRT maintained its tight monetary policy stance in order to contain the adverse effects of exchange rate movements and the volatility in energy and food prices on inflation and inflation expectations. Accordingly, the average funding rate was increased gradually in line with the tight liquidity policy. The CBRT continued to provide funding mainly through one-week repo auctions, while the share of marginal funding was gradually increased (Chart 1.1.1). Consequently, the average funding rate, which was 8.5 percent in the July Inflation Report, has recently hovered around 8.75 percent. Moreover, interbank overnight repo rates were formed at the upper band of the interest rate corridor in the third quarter, as in previous quarters of 2015 (Chart 1.1.2). In the period ahead, monetary policy decisions will be conditional on the inflation outlook. Inflation expectations, the pricing behavior and other factors that affect inflation will be monitored closely and the tight monetary policy stance will be maintained as deemed necessary.

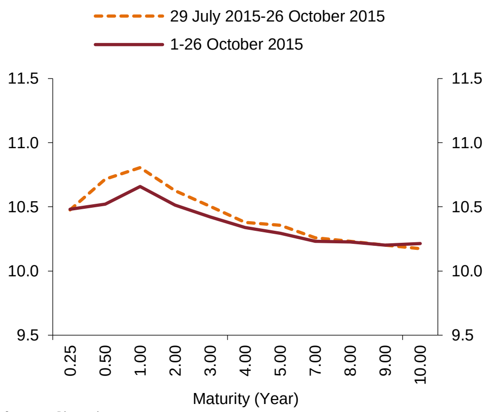
The spread between the 5-year market rates and the BIST overnight rates, which was negative across the year, neared zero in October 2015 (Chart 1.1.3). The yield curve remained almost flat in this quarter as well (Chart 1.1.4).

Chart 1.1.3.
Money Market Rates (Percent)



Source: Bloomberg, CBRT.

Chart 1.1.4.
Yield Curve (Percent)



Source: Bloomberg.

Measures were taken to enhance financial stability in line with the road map released in August. In addition to the changes in required reserves made in the first quarter of 2015, which aimed to foster maturity extension in foreign exchange non-core liabilities of banks and financing companies, required reserve ratios were changed for new foreign exchange non-core liabilities to originate after 28 August 2015 with a view to provide incentive for maturities longer than three years. This change has supported the maturity extension of non-core foreign exchange liabilities, which has been observed since November 2014. The steady upward trend in maturities longer than three years is deemed particularly important for financial stability (Chart 1.1.5). Furthermore, the CBRT stated on 29 August 2015 that the remuneration rate of Turkish lira required reserves would be increased by 50 basis points each in September, October and December. This arrangement will reduce the intermediation costs of the banking sector and offer an additional support to core liabilities. In fact, the loans-to-deposits ratio, which was on an upward trend, has stabilized since the first arrangement in November 2014 (Chart 1.1.6).

Chart 1.1.5.
Maturity of Non-Deposit Liabilities
(Percent)

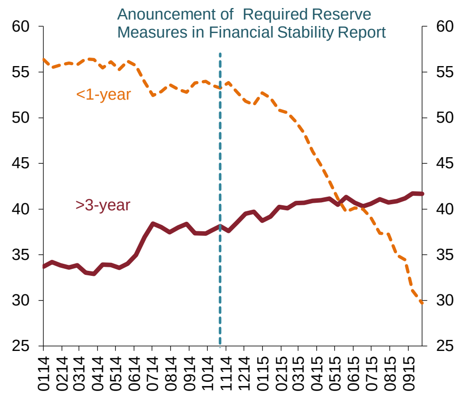
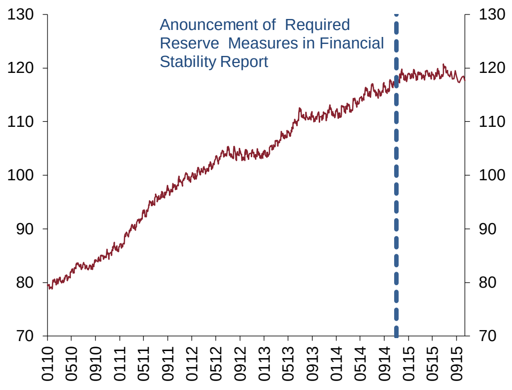


Chart 1.1.6.
Loans/Deposits
(Percent)



Source: CBRT.

As part of the steps to be taken during the normalization of global monetary policies, the CBRT also included some measures in the road map to enhance the flexibility of the FX liquidity management. In this regard, transaction limits for banks at the CBRT Foreign Exchange and Banknotes Markets were raised by around 130 percent to 50 billion USD on 1 September 2015. Consequently, the sum of deposit limits allocated to banks and gold and foreign exchange assets held at the CBRT under the ROM reached a level that more than meets banks' external debt payments in the upcoming year. Moreover, the CBRT announced that due to the increased volatility in global financial markets, as of 19 August 2015, the amount of the foreign exchange sales auction may be increased by up to 70 million USD above the pre-announced minimum amount. Accordingly, the CBRT has maintained its stabilizing stance regarding the foreign exchange liquidity.

Annual loan growth remains reasonable on the back of the tight monetary policy stance and macroprudential measures. Recently, loan growth rates have decelerated further due to heightened domestic and global uncertainties. The annual growth rate of total loans adjusted for the exchange rate declined to 15.3 percent at the end of the third quarter. Both consumer and commercial loan growth rates slowed down notably in this quarter. The annual growth rate of consumer loans declined to 12.2 percent, while that of commercial loans adjusted for exchange rate fell to 17.8 percent in this period (Chart 1.1.7). These developments on the growth and composition of loans contribute both to the re-balancing process and financial stability. The recent course of loan growth reflected by 13-week moving averages suggests that annualized growth rates dropped and lagged far behind past years' averages in both consumer and commercial loans (Chart 1.1.8). An analysis of consumer loans by sub-items reveals that all loan types decelerated except for automobile loans; while in the commercial loans front, the slowdown in FX-denominated loans proved more apparent than that in TL-denominated loans. In addition to moderate growth of economic activity, hikes in consumer and commercial loan rates in the third quarter and tightening in other financial conditions point out that loan growth may remain low compared to historical averages in the upcoming period as well.

Chart 1.1.7.
Annual Loan Growth
(Adjusted for Exchange Rate, Annual Percent Change)

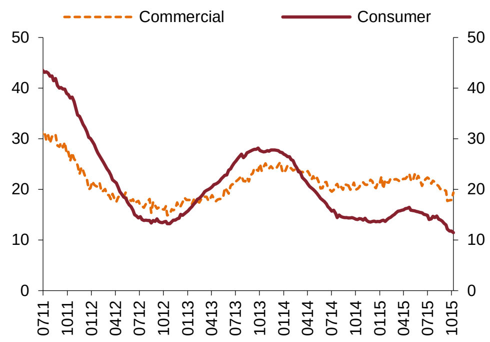
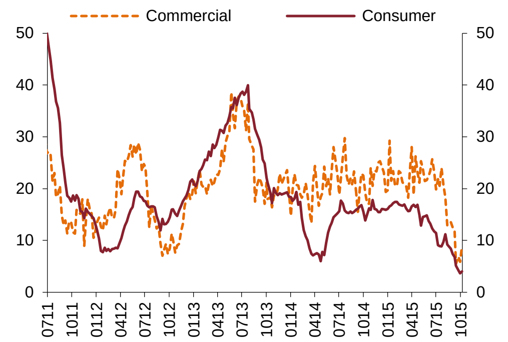


Chart 1.1.8.
Annualized Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the third quarter of 2015, annual consumer inflation posted a quarterly increase of around 0.75 points compared to the previous quarter and rose to 7.95 percent, remaining above projections of the July Inflation Report (Charts 1.2.1 and 1.2.2). The food prices and exchange rate developments are the main drivers of this rise in annual inflation. Due to the course of the unprocessed food prices, the contribution of food prices to inflation increased again in this quarter. Moreover, annual core goods inflation posted an upsurge owing to the cumulative depreciation in the Turkish lira. Meanwhile, exchange rate developments had a limited effect on energy prices due to the decline in oil prices.

Chart 1.2.1.
Inflation Forecasts and Realizations*
(Percent)

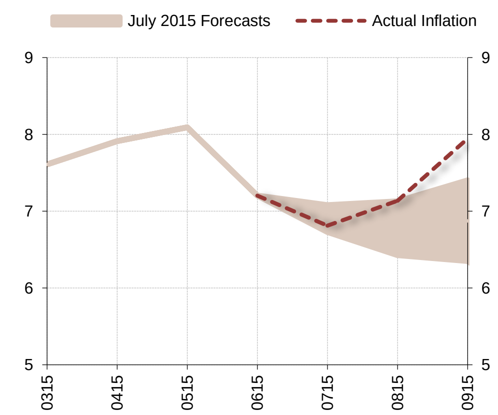
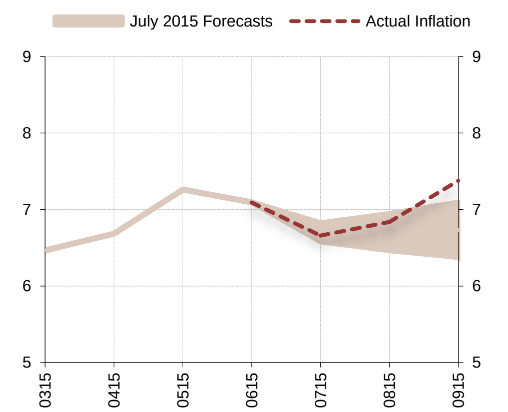


Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco* (Percent)



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

In the third quarter of the year, despite the decline in USD-denominated import prices, cost pressures on inflation increased due to food prices and exchange rate developments. In this period, the underlying trend of core inflation indicators posted a slight decline compared to the previous quarter, yet remained elevated (Chart 1.2.3). Meanwhile, the tight monetary policy stance and the mild course of domestic demand are considered to have limited the pass-through from exchange rates to prices compared to similar episodes in the past. Along with the high course of food prices and its repercussions on prices of catering services, the rise in non-food cost factors led consumer inflation excluding food and catering services to increase by around 0.5 points to 6.36 percent in this quarter (Chart 1.2.4).

Chart 1.2.3.
Core Inflation Indicators SCA-H and SCA-I
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)

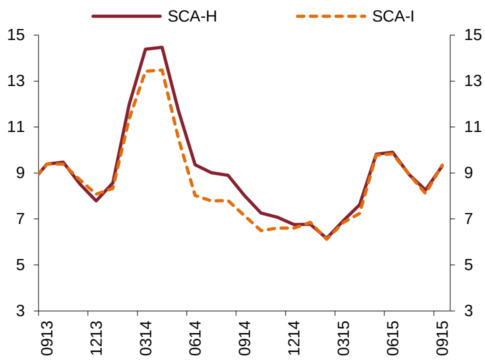
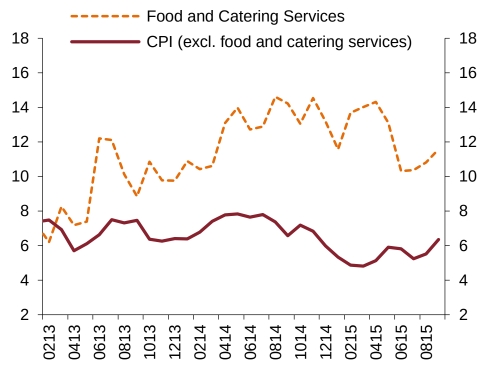


Chart 1.2.4.
Food and Non-Food Prices
(Annual Percent Change)



Source: TURKSTAT, CBRT.

In addition to the exchange rates, which are likely to be driven by domestic and global uncertainties, the course of food inflation, medium-term inflation expectations and repercussions of wage developments on inflation will be critical for the inflation outlook over the upcoming period. The establishment of the Committee on Monitoring and Evaluating Food and Agricultural Product Markets has been an important structural reform regarding inflation. The measures to be adopted in coordination with this committee may provide structural and cyclical support to bring food inflation down. Against this background, inflation is expected to hover around current levels for some time due to exchange rate effects and start slowing down afterwards. Conditional on the fiscal policy regarding revenues and expenditures, inflation is projected to reach the 5-percent target in the medium term.

Supply and Demand

According to the GDP data of the second quarter of 2015, economic activity proved more robust compared to the outlook presented in the July Inflation Report, and the GDP rose by 1.3 and 3.8 percent on a quarterly and annual basis, respectively (Chart 1.2.5). An analysis of seasonally adjusted national income components on the production side indicates that the industrial value added provided the highest contribution to the GDP, with other items also contributing positively to the GDP (Chart 1.2.6). Second-quarter seasonally adjusted data on the expenditures side reveal that final domestic demand grew due to both consumption and investment expenditures.

In the first half of 2015, domestic demand made a higher contribution to growth than external demand. Indicators for the third quarter hint at a moderate economic activity, while also suggesting that the growth composition might change in favor of net exports in the second half. Sales, production and import indicators regarding industrial production and domestic demand show that final domestic demand will provide a modest contribution to growth. Additionally, the rising demand from EU countries is expected to have a positive impact on Turkey's exports in the upcoming period. Thus, considering the likely slowdown in import demand based on domestic demand developments, the contribution of external demand to growth is expected to increase in the second half.

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

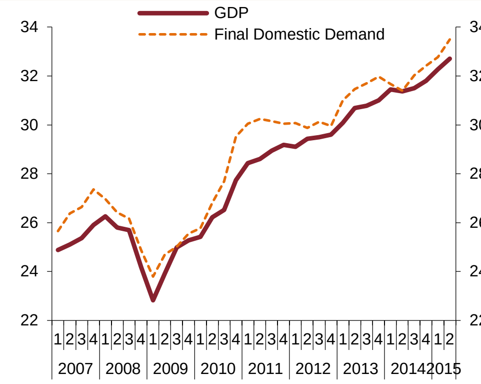
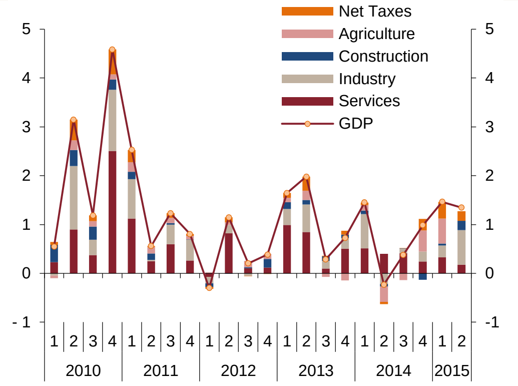


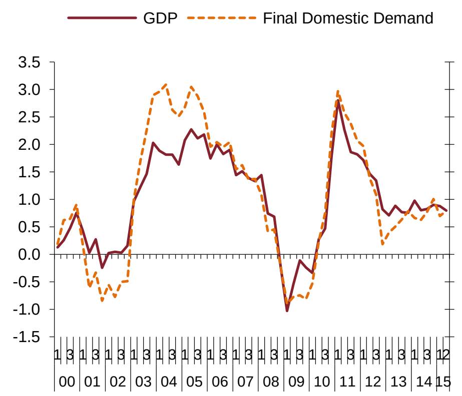
Chart 1.2.6.
Annual GDP Growth and Contributions from the Production Side (Percentage Points)



Source: TURKSTAT, CBRT.

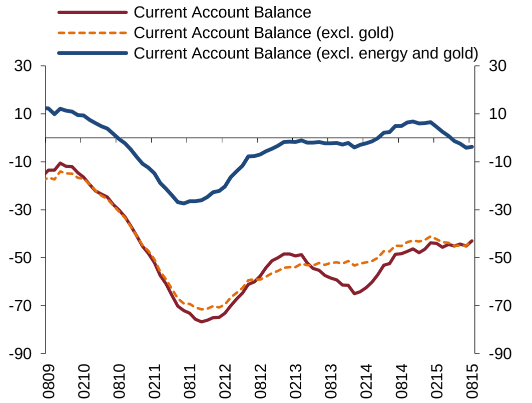
Thanks to the macroprudential policy framework in effect since 2011, the GDP continues to grow at a moderate pace while the final domestic demand has seen some recovery following the re-balancing process (Chart 1.2.7). Tightening in financial conditions due to domestic and international developments poses a downside risk to domestic demand, but this tightening may prove temporary with waning domestic uncertainty. Moreover, the robust post-crisis employment performance is expected to support domestic demand via the income channel. In addition, the likely fall in the current account deficit and the strong public finance generate room for stabilizing economic policies to dampen the effects of possible shocks. Regarding Turkey's trading partners; the recovery in the EU is expected to support Turkey's exports, while ambiguities about exports to the MENA region, Russia and Iraq pose downside risks. Uncertainties about the effects of the Fed's policy decisions and the slowing Chinese economy on the global economy as well as concerns related to the sustainability of the European recovery also point to downside risks for external demand. In sum, 2016 is expected to witness a moderate growth in domestic demand, a recovery in external demand and a continued re-balancing in the growth composition. The current account balance is anticipated to improve further with the support of the moderate domestic demand, slowdown in consumer loans and favorable developments in the terms of trade (Chart 1.2.8).

Chart 1.2.7.
GDP and Final Domestic Demand Growth
(8-Quarter Moving Average)



Source: TURKSTAT.

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



Source: CBRT.

Oil, Import and Food Prices

The fall in international commodity prices, especially energy, continued into the third quarter. Backed by the slowing economies of China and other emerging countries, this downtrend caused import prices in Turkey to decline in USD terms. Therefore, assumptions for crude oil prices and USD-denominated import prices were revised downward (Charts 1.2.9 and 1.2.10). On an annual basis, the average crude oil price assumption was decreased from 59 USD to 54 USD for 2015 and from 63 USD to 54 USD for 2016. Additionally, assumptions for annual percentage changes in average import prices were revised downwards by 1.9 points for 2015 and 2016. Meanwhile, year-end projections for food prices were left unchanged, with the food inflation assumption remaining at 8 percent for end-2015 and end-2016.

Chart 1.2.9.
Revisions in Oil Prices*
(USD/bbl)

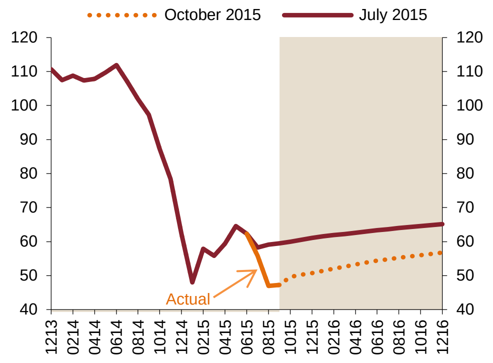
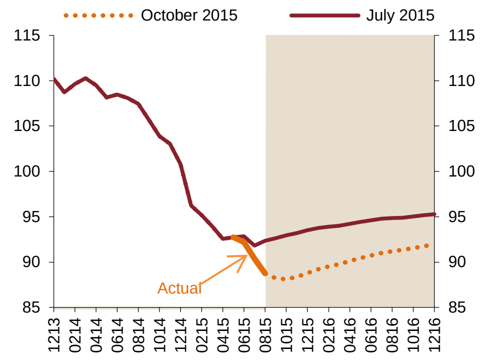


Chart 1.2.10.
Revisions in Import Prices*
(USD, 2010=100)



* Shaded area denotes the forecast horizon.
Source: Bloomberg, CBRT.

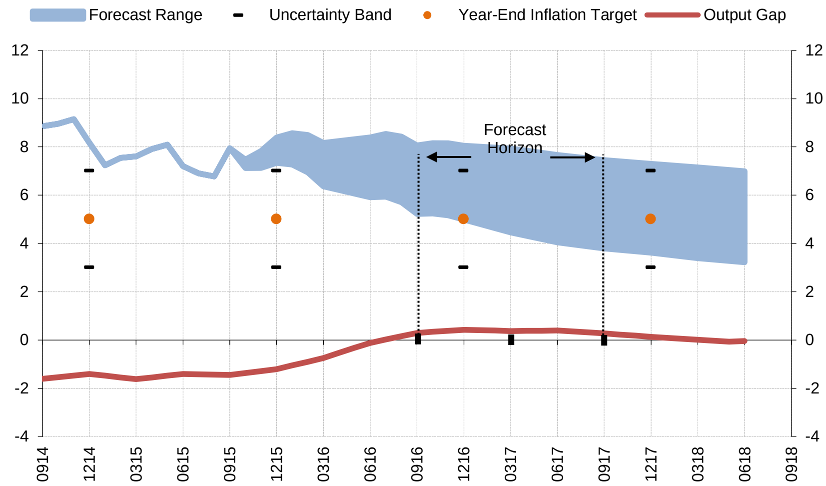
Fiscal Policy and Tax Adjustments

The medium-term fiscal policy stance is based on the MTP projections covering the 2016-2018 period. Compared with the previous MTP, the new projections envisage slightly higher revenues and expenditures as a ratio of the GDP in 2015 and a somewhat slower decline in these ratios in the following years. Conditional on this outlook, inflation is expected to improve gradually and reach the 5-percent target in the medium term.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the framework that the tight monetary policy stance will be maintained until there is a significant improvement in the inflation outlook. Moreover, the annual loan growth rate is envisioned to hover around reasonable levels, also on the back of macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 7.4 percent and 8.4 percent (with a mid-point of 7.9 percent) at end-2015 and between 5.0 percent and 8.0 percent (with a mid-point of 6.5 percent) at end-2016. Inflation is projected to near 5 percent at end-2017 and stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: CBRT.

The rise in core inflation due to the exchange rate depreciation in the third quarter brought the end-2015 inflation forecast up by 1.2 points compared to the July Inflation Report forecast. Yet, the improvement in import prices in the inter-reporting period pulled down the year-end inflation forecast by 0.2 points. Accordingly, the end-2015 inflation forecast, which was set as 6.9 percent in the July Inflation Report, was revised upwards by 1 point (Chart 1.3.1).

The end-2016 inflation forecast was revised upward by 1 point to 6.5 percent from 5.5 percent in the July Inflation Report. The upward revision in the end-2015 inflation forecast and the delayed effects of exchange rate movements are expected to drive the end-2016 inflation forecast up by 0.6 and 0.8 points, respectively. However, the decline in the assumption for average import prices for 2016 and the small downward revision to the output gap forecast for 2016 brought the end-2016 inflation forecast down by 0.3 and 0.1 points, respectively, from the previous reporting period.

1.4. Risks and the Monetary Policy

Loans continue to grow at reasonable levels in annualized terms in response to the tight monetary policy stance and macroprudential measures. The CBRT highlighted that loan growth has displayed a notable deceleration due to tighter financial conditions caused by recently elevated domestic and external uncertainties. Specifically, commercial loans denominated in foreign currency and consumer loans have lost significant momentum. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This composition not only limits medium-term inflationary pressures, but also helps to improve the current account balance. In addition to the moderate economic activity, rising loan rates and the tightening of other financial conditions also signal that loan growth may remain lower than past years' averages in the upcoming period.

Final domestic demand was the main driver of growth in the first half of 2015, while external demand remained weak. Indicators for the third-quarter point to a moderate economic activity, whereas the composition of growth hints at a slight slowdown in domestic demand and a recovery in exports. The weak consumer confidence and tighter financial conditions curb private consumption and investment demand. The slowing domestic demand and the changes in real exchange rates drive imports lower. On the exports front, despite the negative impact of geopolitical developments, the rising demand from EU members affects Turkey's exports positively. Against this background, the CBRT expects the growth composition to shift gradually in favor of net exports in the upcoming period. This shift is expected to have a positive impact on the current account balance. Moreover, the favorable developments in the terms of trade and the sluggish course of consumer loans contribute to the improvement in the current account balance. Accordingly, the improvement in the current account balance, which became evident with the August figures, is expected to continue.

Energy price developments continue to affect inflation favorably. The negative impact of cumulative exchange rate developments since early 2015 on the inflation outlook is partly offset by lower oil prices. Food prices, on the other hand, remain volatile mainly due to unprocessed food prices, which pose both upside and downside risks to the year-end inflation forecast. The cumulative Turkish lira depreciation caused the annual core goods inflation to rise and the core inflation to deteriorate slightly. However, the tight monetary policy stance and the moderate domestic demand cause the pass-through from the exchange rate to prices to remain limited compared to similar periods in previous years. Accordingly, considering the impact of the uncertainty in domestic and global markets on inflation expectations and taking into account the volatility in energy and food prices, the CBRT decided to maintain the tight liquidity stance as long as deemed necessary. Future monetary policy decisions will be conditional on the inflation outlook. Taking inflation expectations, pricing behavior and the course of other factors affecting inflation into consideration, the tight monetary policy stance will be maintained.

Uncertainties surrounding global monetary policies and concerns over global growth cause financial markets to remain volatile. Thus, portfolio flows to emerging economies and risk indicators follow a highly volatile pattern. The measures announced in the CBRT's road map, which will be followed during the normalization of global monetary policies, strengthen the resilience of the economy against global shocks. The current monetary policy stance remains tight against the inflation outlook, stabilizing for the FX liquidity, and supportive of financial stability.

Should the decline in loan growth rates become permanent and exchange rates continue to face upward pressure over the upcoming period, the CBRT will preserve the tight monetary policy stance, and also take measures to support the Turkish lira and loan growth by easing the conditions for the use of foreign currency denominated collateral.

Developments in the fiscal policy and tax adjustments are monitored closely 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 in administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. Any measure that would ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.