

HEAD OFFICE

ANKARA, 28 January 2014

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**Ali BABACAN
DEPUTY PRIME MINISTER
ANKARA**

As stipulated in the Article 42 of the Central Bank Law, in the case of a significant breach of the inflation target, the Central Bank of the Republic of Turkey (the Central Bank) is required to report to the Government and announce to the public the reasons behind the breach of the target and the necessary measures to be taken. As stated in the main policy document titled “Monetary and Exchange Rate Policy in 2013”, which was published on December 25, 2012; the inflation target for 2013 was set jointly with the Government as 5 percent. In the same document, it was also indicated that the Central Bank would write an open letter to the Government should end-year inflation exceed the target significantly (by more than 2 percentage points in either direction). Inflation reached 7.40 percent at end-2013, notably exceeding the target. This text elaborates on the reasons why the target was missed and explains the measures taken—and to be taken—to bring inflation back to the target.

Factors Affecting Inflation in 2013

In the first Inflation Report of 2013 (IR 2013/I), the mid-point of inflation forecast for the year-end was given as 5.3 percent. However, deviations from this projection across the year caused inflation to remain above the uncertainty band at the year-end.

The main factor causing inflation to exceed the target significantly in 2013 is the increases in the exchange rate in the second half of the year. The depreciation of the Turkish lira amid the movements in the currencies of emerging economies due to the global uncertainties regarding monetary policies had an impact on the core inflation particularly through core goods prices. Despite the relatively mild course of import prices in 2013, the effect of exchange rate developments on inflation reached 1.5 percentage points by the year end.

Another factor causing inflation to remain above the projected level is the course of food prices. The annual food inflation, which was assumed as 7 percent at the start of the year, climbed to 9.7 percent at the end of the year. This was mainly attributed to hikes in unprocessed food prices, which caused inflation to deviate from the target by 0.6 percentage points. The net effect of administered prices on inflation proved consistent with the forecasts presented in the Inflation Report of January 2013.

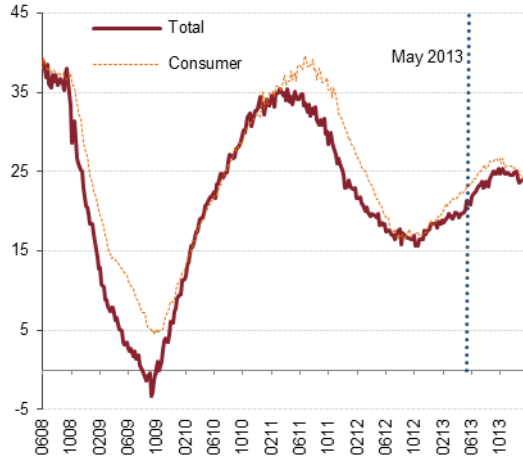
As a result, inflation exceeded the target due to the developments in the exchange rate and food prices.

Measures Taken to Attain the Inflation Target

Main determinants of inflation dynamics are demand and cost factors besides inflation expectations. Analysis of these factors suggests that the mild course of economic activity in 2013 has prevented the occurrence of demand-driven pressures on inflation. The rise in inflation in the second half of the year was mainly caused by the cost-side effect of the exchange rate developments stemming from external uncertainties besides the high course of unprocessed food prices that is beyond the control of the monetary policy.

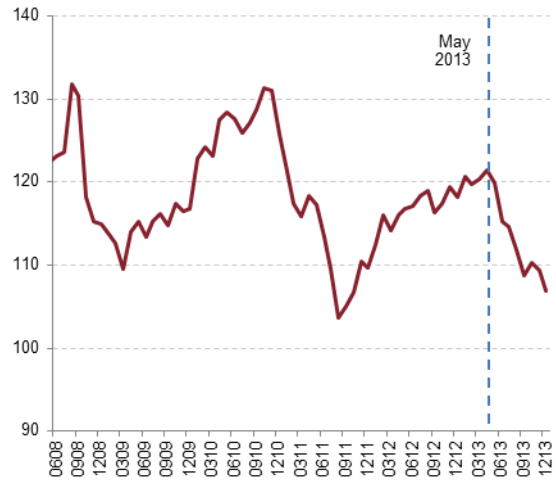
Uncertainties regarding global monetary policies have grown since May 2013, which caused portfolio flow towards emerging economies to lose pace and financial assets to be re-priced in the second half of the year. In the same period, foreign financing extended to the real sector and the banking sector in Turkey continued, while portfolio flows remained weak. Re-pricing of financial assets led the Turkish lira to depreciate. The mild growth in domestic demand and the uptrend in credits continued in this period (Chart 1). Elevated external uncertainties mainly influenced exchange rates rather than loans (Chart 2).

Chart 1.
Annual Growth Rates Total and Consumer Loans
(Adjusted for the Exchange Rate Effect, Annual Change, Percent)



Source: CBRT

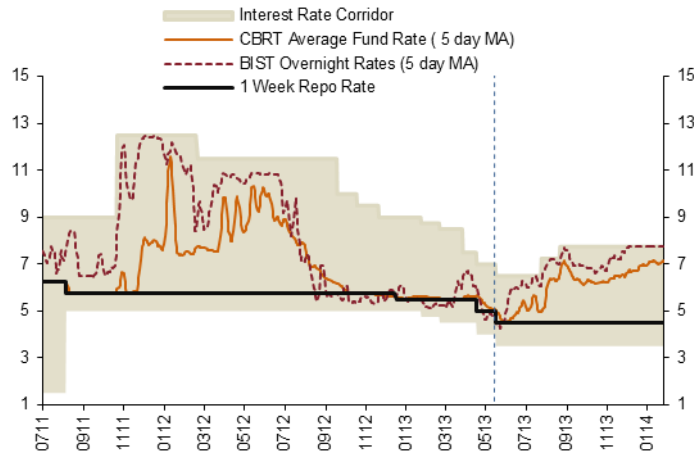
Chart 2.
Real Effective Exchange Rate Index
(CPI-based, 2003=100)



Source: CBRT

Exchange rate developments coupled with the high course of food prices in the second half of 2013 led the year-end inflation to considerably exceed the target. These developments deteriorated inflation expectations as well. To contain the risks to inflation and achieve convergence of the medium-term inflation outlook and the target, the Central Bank enhanced the cautious monetary stance and ensured the interbank market rates to increase more than 300 basis points following May (Chart 3). Moreover, the composition of the provided liquidity was adjusted to have a shorter maturity and mostly as overnight funding, which resulted in a tighter liquidity policy.

Chart 3.
CBRT Rates and BIST O/N Repo Rates (percent)



Source: CBRT, BIST

To contain the upside risks to inflation and enhance financial stability, slowing especially the growth rate of consumer loans is critical as well. This will contribute to the balanced maintenance of the domestic-foreign demand composition in the mild growth process, thereby limiting the demand-driven inflationist pressures. Tightening in the liquidity policy implemented by the Central Bank in the second half of the year will enhance this process. Moreover, it is also expected that net foreign exchange sales will support the effectiveness of the liquidity policy by increasing the liquidity need of the financial system, resulting in an additional slowing effect on consumer loans (Table 1).

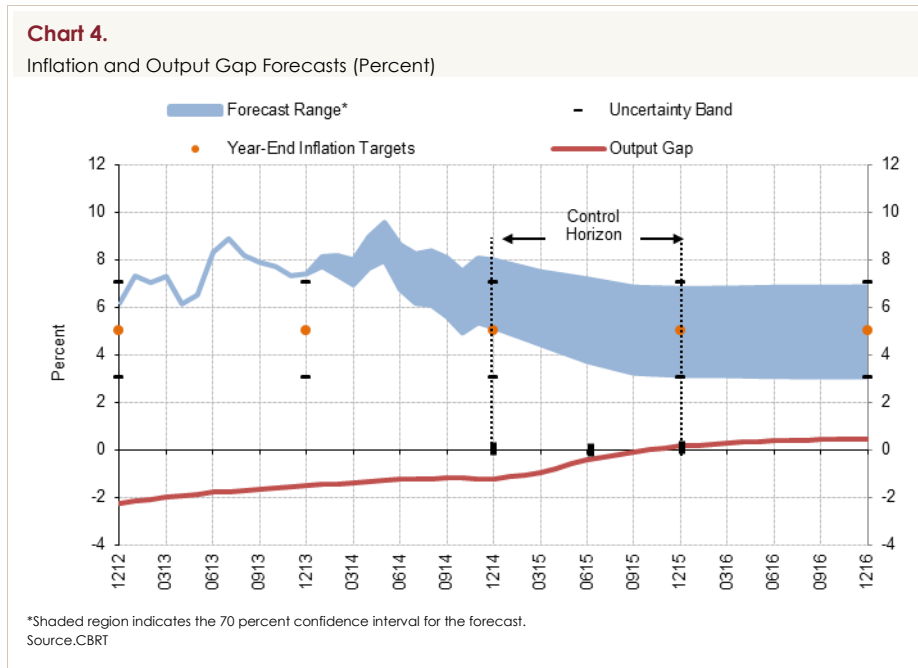
June 2013	1.70
July 2013	5.15
August 2013	1.95
September 2013	1.86
October 2013	0.84
November 2013	1.44
December 2013	4.67

The macroprudential measures taken recently by the Banking Regulation and Supervision Agency (BRSA) are expected to curb consumer loans. The effects of macroprudential measures, such as increasing general provision ratios for consumer loans, raising minimum payments on credit cards, restricting credit card limits based on income levels, reducing the number of instalments on credit cards and applying loan-to-value restrictions for auto loans, on consumer loans will become more evident by February. These developments will allow for a more balanced domestic demand growth, which will both constrain demand-side inflationary pressures and support the correction in the current account deficit.

The Central Bank will maintain its cautious monetary stance until the inflation outlook is consistent with medium-term targets. As the liquidity policy becomes tighter, capital flows remain weak and macroprudential measures become effective, the contribution of domestic demand will be more balanced and the pressures on inflation will be contained. The recent depreciation of the Turkish lira may cause inflation to remain elevated during the first few months. Yet, under the outlook that the recent increase in domestic uncertainty is temporary,

the delayed effects of the exchange rate on inflation are expected to weaken by mid-2014 and inflation is projected to return to a gradual downward path by the second half of the year. Although the monetary policy does not respond to primary effects, it monitors the effects of temporary inflation movements on the pricing behavior. Moreover, it is highly important that the monetary policy in effect does not lead to unwanted fluctuations in economic activity and have adverse effects on financial stability. Therefore, the decline in inflation is expected to be a gradual one and reach the target over a one-and-a-half-year horizon.

Against this background, inflation is expected to reach the 5-percent target in mid-2015 (Chart 4). Inflation may remain volatile in the first half of the year due to tax adjustments, the effects of increased exchange rates and energy prices, but decline rapidly by mid-2014 to stay within the uncertainty band at year-end once the temporary factors fade. The risks to the inflation outlook are analyzed in the January 2014 Inflation Report.



Conclusion

Inflation exceeded the target significantly at the end of 2013, which was caused by the depreciation of the Turkish lira besides food prices. The Central Bank has responded to the increase in inflation by an enhanced cautious stance and tightening in liquidity policy. Accordingly, inflation is expected to move towards the target gradually by the second half of the year. The Central Bank will continue to monitor developments influencing the inflation outlook and take the necessary measures to retain the achievements on price stability. The Inflation Report, published today on our website, which presents the developments regarding inflation and monetary policy as well as our medium-term forecasts, is enclosed for your information.

Yours Sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY Head Office

Erdem Başçı
Governor

Mehmet Yörükođlu
Deputy Governor

Enc: January 2014 Inflation Report