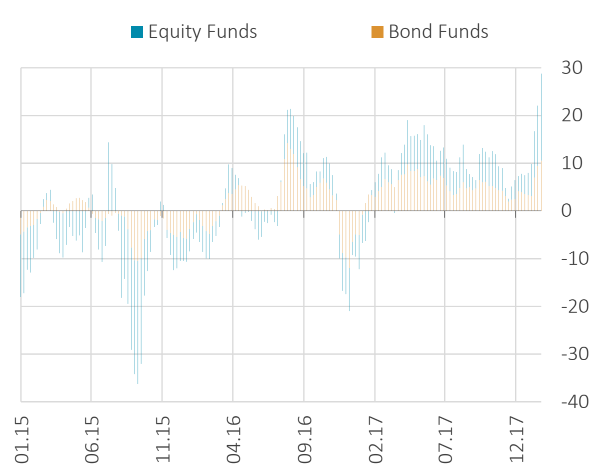
1. Overview

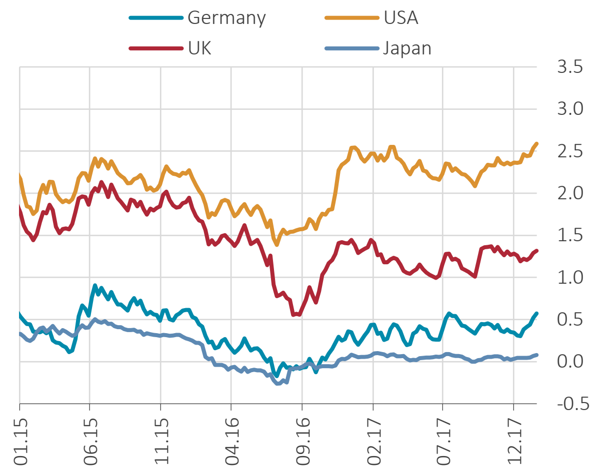
Due to the rebound in global economic activity as well as in trade volume and the alleviated volatility in financial markets, global risk appetite remains brisk, and emerging economies continue to attract portfolio inflows at a steady pace (Chart 1.1). Although global inflation fluctuates in line with changing commodity and oil prices, core inflation follows a flat course at low levels. In this regard, major central banks, particularly the Fed and the ECB, continue to normalize monetary policy at a mild pace. As the steps toward normalization remained largely consistent with expectations, long-term interest rates in advanced economies did not increase noticeably (Chart 1.2).

Chart 1.1: Portfolio Flows to Emerging Economies (Billion USD, 4-Week Cumulative)



Source: EPFR.

Chart 1.2: 10-Year Bond Yields (%)



Source: Bloomberg.

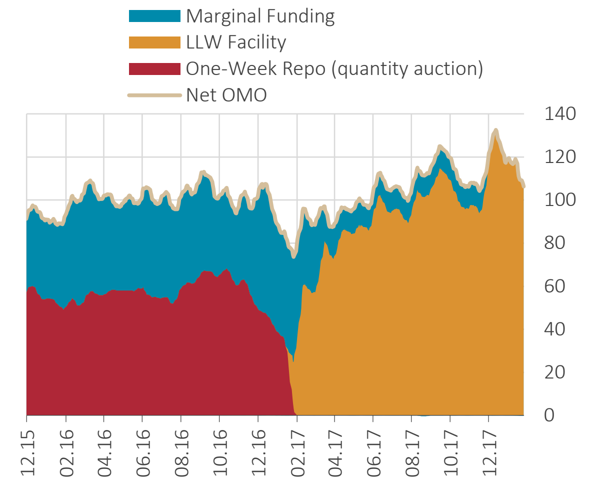
At the September FOMC meeting, the Fed reiterated its commitment to normalization, which led to tentative increases in risk premiums of emerging economies. Owing also to geopolitical developments, Turkey's sovereign risk diverged somewhat negatively from that of other emerging economies from mid-September to the second half of November. However, thanks to the policy measures taken by the CBRT since the end of November as well as the stronger global risk appetite and waning geopolitical risks, financial indicators such as exchange rate volatility, market rates and the risk premium have improved. In the current reporting period, portfolio inflows to Turkey fluctuated slightly due to these developments; yet, bolstered by the strong inflows in the second and third quarters of the year, cumulative portfolio inflows remained above historical averages in 2017. CGF-backed loans have neared their pre-determined limits since mid-2017, causing some deceleration in commercial loans. However, banks' lending appetite remained buoyant in the last quarter on the back of the positive outlook in economic activity.

Pushed up by the depreciation of the Turkish lira against the currency basket as well as rising import prices, especially oil, consumer inflation posted a quarter-on-quarter increase of 0.72 points and ended 2017 at 11.92 percent. Aggregate demand conditions supported the uptrend in inflation, while mounting cost effects accelerated producer prices considerably compared to the previous two quarters and exerted pressure on consumer prices. Economic activity proved robust in the third quarter, as projected in the October Inflation Report. Leading indicators show that economic activity remained firm in the last quarter. Following the withdrawal of tax incentives for durable goods, it is estimated that private consumption weakened slightly in the fourth quarter, while machinery and equipment investments recovered further on a quarterly basis. Exports remained on an uptrend in this period, while imports lost some pace following the sharp increases in the second and third quarters. The outlook for imports is attributed to the slight deceleration in economic activity and exchange rate developments as well as the slowing gold imports. In 2018, exports are projected to bolster growth amid the cumulative depreciation of the real exchange rate and stronger global growth, while the CGF-backed loans will continue, albeit at a more limited pace than 2017, providing further support to domestic demand.

1.1 Monetary Policy and Financial Markets

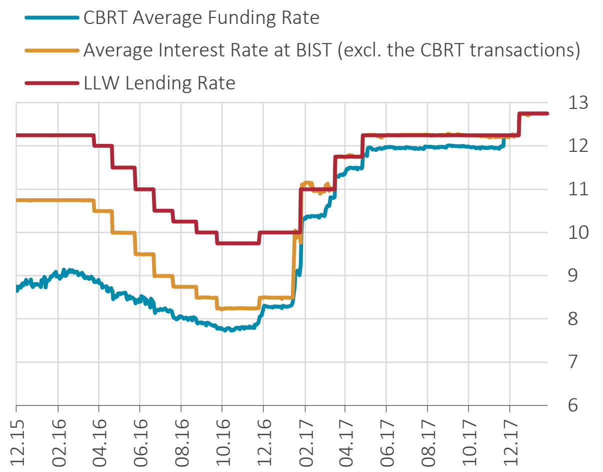
The CBRT strengthened monetary tightening gradually in 2017 to contain the worsening of the inflation outlook. Predictability of the monetary policy improved remarkably throughout the year. Coordinated policy decisions taken in the first half of 2017 targeted to alleviate exchange-rate-driven cost-side pressures on inflation without causing any additional tightening in financial conditions. Backed by accommodative incentives and measures, economic activity grew stronger in 2017. Aggregate demand and credit conditions delayed the improvement in inflation. Noting the presence of persistent risks to pricing behavior, the CBRT opted for a gradual monetary tightening in the last quarter of 2017.

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



Source: CBRT.

Chart 1.1.2: Short-Term Interest Rates (5-Day Moving Average, %)

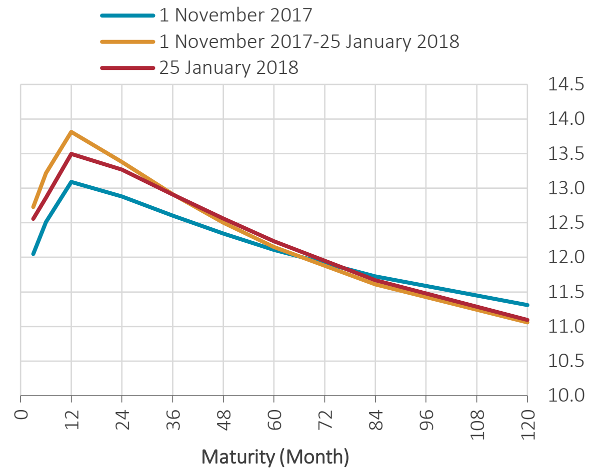


Source: BIST, CBRT.

In November 2017, the CBRT took some liquidity measures to safeguard price stability and financial stability against the negative repercussions of excessively volatile exchange rate and price formations detached from economic fundamentals. Accordingly, the overnight borrowing limits within the Interbank Money Market were reduced to zero effective from 22 November 2017, causing the CBRT funding to be completely provided through the LLW facility (Chart 1.1.1). Thus, the CBRT average funding rate settled at 12.25 percent, which is the LLW lending rate (Chart 1.1.2). Moreover, the CBRT took various measures to bolster the FX liquidity and launched Turkish Lira-Settled Forward Foreign Exchange Sale Auctions on 20 November 2017 for the effective management of the real sector's exchange rate risk. Highlighting that high levels of inflation coupled with cost developments pose risks to expectations and the pricing behavior, the CBRT raised the LLW lending rate to 12.75 percent at the December 2017 MPC meeting. At the January 2018 MPC meeting, the CBRT emphasized that the tight monetary policy stance will be maintained decisively until inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets.

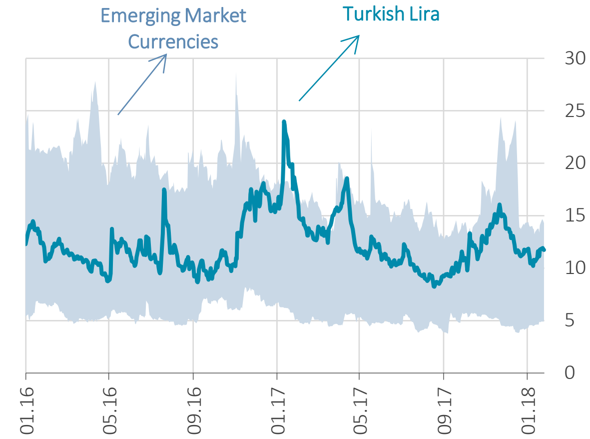
The recent downtrend in geopolitical risks pulled the long-term currency swap rates down in the inter-reporting period, while the short and medium-term currency swap rates increased in tandem with the monetary tightening, and the slope of the yield curve turned more negative (Chart 1.1.3). In 2017, emerging market currencies appreciated against the US dollar amid the brisk global risk appetite. The implied volatility of the Turkish lira has recorded a decline similar to the currencies of other emerging economies since the end of November (Chart 1.1.4).

Chart 1.1.3: Swap Yield Curve (%)



Source: Bloomberg.

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

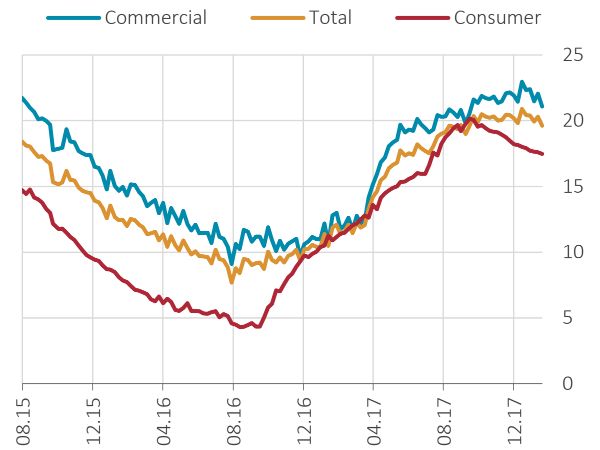


Source: Bloomberg.

* Emerging market currencies include those of Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Romania and South Africa.

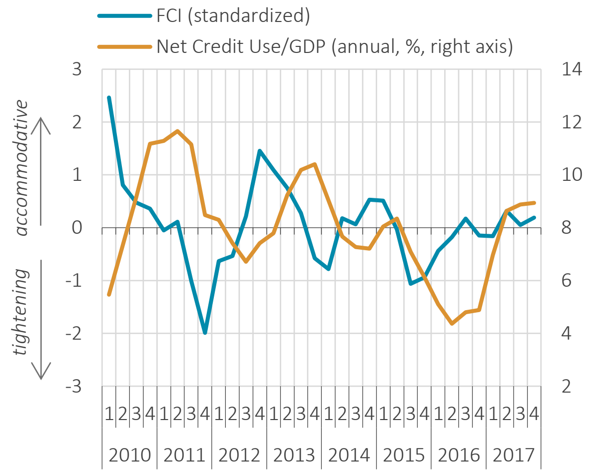
Consumer loan growth decelerated in the last quarter of 2017 amid the withdrawal of tax incentives and the contribution of base effects. In this period, commercial loans continued to stabilize on the back of the Treasury-backed CGF incentive, which neared its pre-determined limits, and the total loan growth remained flat (Chart 1.1.5). The FCI, which serves as a composite indicator of all these developments, implies that aggregate financial conditions have been accommodative across 2017 (Chart 1.1.6).

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



Source: CBRT.

Chart 1.1.6: Financial Conditions and Net Credit Use*



Source: CBRT.

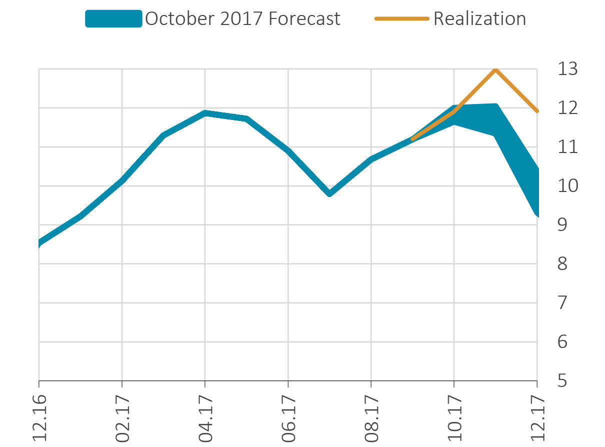
* For further details on measuring FCI, see the CRBT Working Paper No. 15/13. Net Credit Use/GDP is defined as the annual change in the credit stock as a ratio of GDP in current prices.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation stood at 11.92 percent at the end of 2017, above the October Inflation Report projections (Chart 1.2.1). Similarly, consumer inflation excluding unprocessed food, alcoholic beverages and tobacco products also exceeded the forecasts (Chart 1.2.2). Hitting 13.79 percent in this period, food inflation remained considerably above projections, while the rapid depreciation of the Turkish lira coupled with the upsurge in international oil and other input prices were also influential in the course of inflation. The robust course of economic activity emerged as another factor to underpin the ongoing uptrend in inflation in this period.

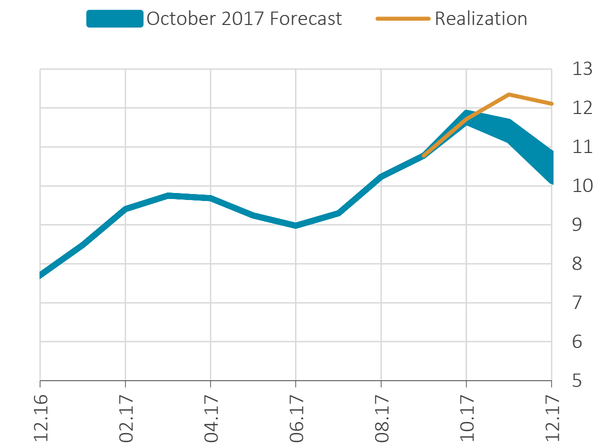
Chart 1.2.1: Inflation Forecast and Realization* (%)



Source: CBRT, TURKSTAT.

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

Chart 1.2.2: Inflation Forecast and Realization Excluding Food, Alcoholic Beverages and Tobacco Products* (%)



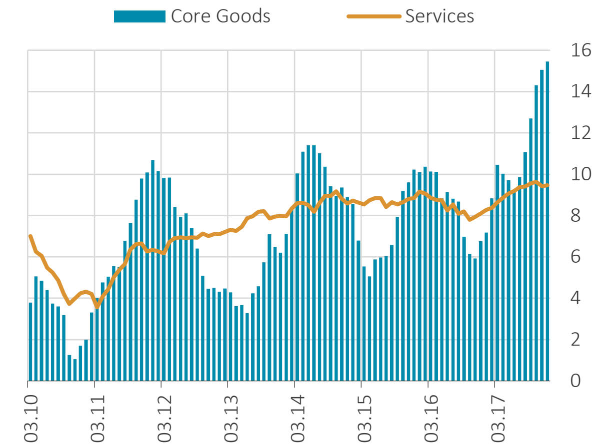
Source: CBRT, TURKSTAT.

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

In the fourth quarter of the year, despite the slight fall in annual services inflation, core goods, food and energy prices saw rising inflation rates, driving consumer inflation upwards compared to the previous quarter (Chart 1.2.1). The depreciation of the Turkish lira caused core goods inflation, particularly durable goods, to register an upsurge in this period (Chart 1.2.3). Moreover, the withdrawal of temporary tax incentives for white goods and furniture, the strong course of demand in certain sectors and the effect of the methodological change in the weighting system of clothing supported the uptrend in core goods inflation. The rise in food inflation during the quarter was mostly driven by processed food prices led by dairy products, while unprocessed food prices followed a volatile course. In the meantime, energy prices remained on the rise in tandem with the developments in international oil prices and other input costs.

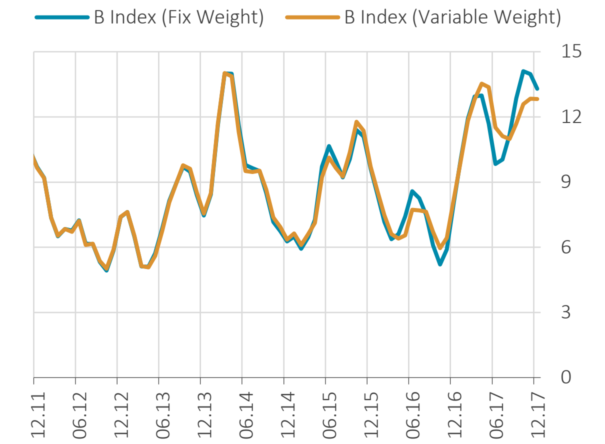
Pressures driven by producer prices grew stronger in this quarter amid the exchange rate developments accompanied by soaring prices of oil and other commodities. The upbeat economic activity caused heightened cost pressures on inflation. The high level of inflation weighed on subcategories with strong backward indexation mechanisms. With a steady uptrend, medium-term inflation expectations hit an all-time high. Against this background, annual inflation in core inflation indicators recorded a quarter-on-quarter rise and reached 12.3 percent. Meanwhile, the underlying trend of core indicators remained elevated (Chart 1.2.4).

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



Source: TURKSTAT.

Chart 1.2.4: The Underlying Trend of B Index* (Seasonally Adjusted, Annualized, 3-Month Average % Change)



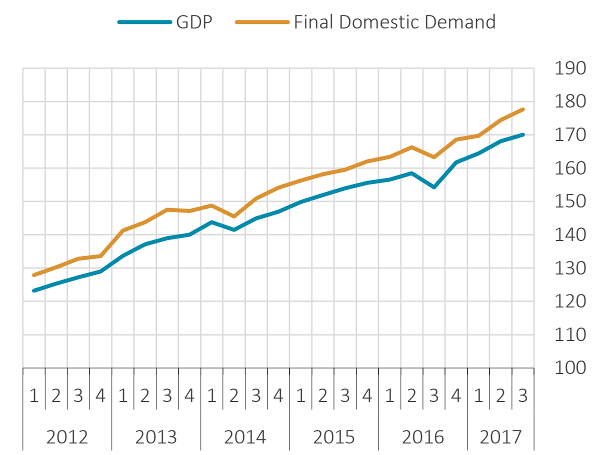
Source: CBRT, TURKSTAT.

* In January 2017, the methodology for the inclusion of clothing and footwear products in CPI was changed from variable-weight to fixed-weight. For a detailed discussion about the effects of this change on core inflation indicators, see the CBRT blog post, dated 6 June 2017.

Supply and Demand

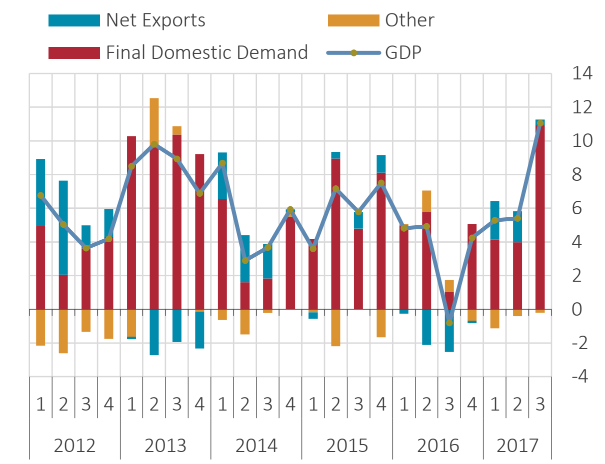
Driven by domestic demand, economic activity remained strong in the third quarter, as projected in the October Inflation Report (Chart 1.2.5). GDP posted a quarterly increase by 1.2 percent in the third quarter, while the annual growth rate remained elevated at 11.1 percent due to the base effect, the increased number of working days and the robust course of the underlying trend of economic activity. Annual growth in this period was fueled mainly by domestic demand (Chart 1.2.6). In terms of demand components, the highest contribution to annual growth was provided by private consumption expenditures due to the increase in subcategories subject to tax incentives, and machinery and equipment investments contributed positively to annual growth for the first time in five quarters. On the other hand, the recovery in domestic demand and the rise in gold trade led imports to pick up notably in the third quarter. Thus, in spite of the favorable prospects for exports, the contribution of net exports to annual growth remained quite limited in the third quarter.

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



Source: CBRT, TURKSTAT.

Chart 1.2.6: Contributions to Annual GDP Growth from the Expenditures Side* (% Point)



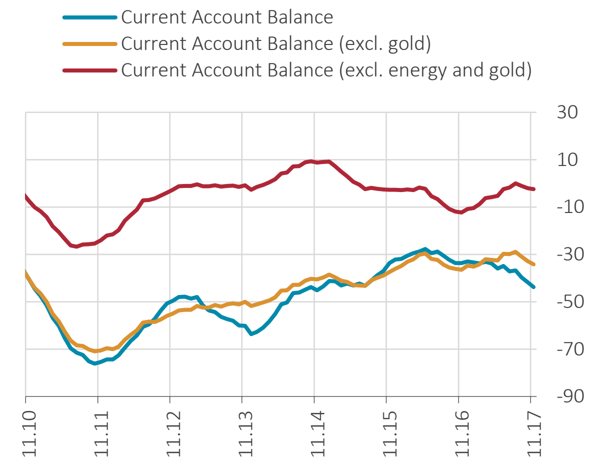
Source: TURKSTAT.

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

Recently released data signal that economic activity remained robust in the last quarter of 2017. Private consumption lost some pace due to the slowing demand that had been brought forward in response to tax incentives, while investments continued to improve. On the external trade front, exports of goods and services continued to increase, bolstered also by the ongoing improvement in the tourism sector. Milder growth in domestic demand, the real depreciation of the Turkish lira and the slowdown in gold imports caused a deceleration in imports. Thus, domestic demand is expected to provide a lower contribution to quarterly growth, while the support from net exports is expected to be higher in the last quarter. Despite the rise in exports in real terms and the deceleration in imports, the surge in import prices, particularly oil, caused the current account balance to deteriorate slightly in the last quarter of the year.

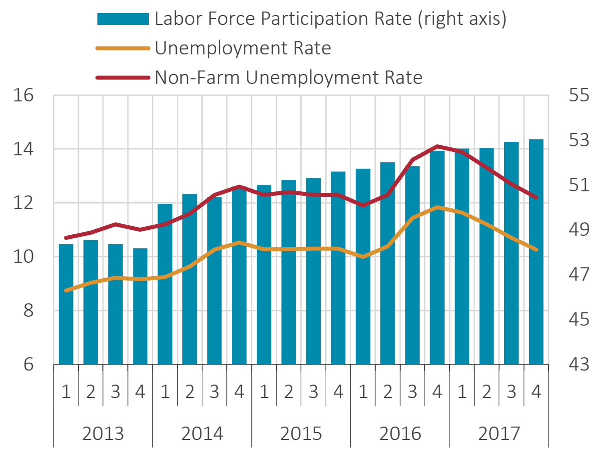
Amid the waning support from the base effect and demand-stimulating policies in 2017, economic activity is projected to move towards its underlying trend and gradually near its potential level in 2018. The cumulative depreciation of the real exchange rate and stabilized global growth are likely to bolster the contribution of exports to growth in 2018 and continue to underpin the current account balance (Chart 1.2.7). The CGF-backed loan support, which will continue in 2018 with a more limited pace than in 2017, will stand as a factor to bolster domestic demand. As the economic growth spreads wider across sectors, its reflections on the labor market become more visible. On the other hand, labor force participation also increased along with the rise in employment, thereby limiting the decline in unemployment rates (Chart 1.2.8). Amid a continued steady course in growth, unemployment rates are expected to decline further gradually while investment will increase, expanding the employment opportunities.

Chart 1.2.7: Current Account Balance (12-Month Cumulative, Billion USD)



Source: CBRT.

Chart 1.2.8: Unemployment and Labor Force Participation Rates* (Seasonally Adjusted, %)



Source: TURKSTAT.

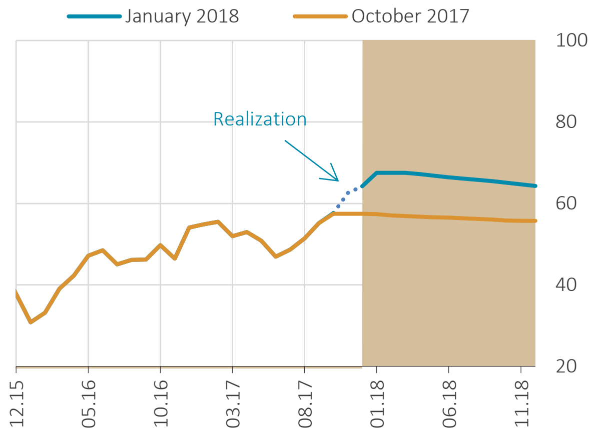
* As of October period.

Oil, Import and Food Prices

In light of recent developments, assumptions for crude oil prices have been revised markedly higher since the October Inflation Report. The crude oil price assumption for 2018 is raised to a yearly average of 66 USD from 56 USD. Along with crude oil and other energy items, prices of input commodities such as industrial metal have also escalated recently. Thus, the assumption for USD-denominated import prices is also revised upwards for 2018 (Charts 1.2.9 and 1.2.10).

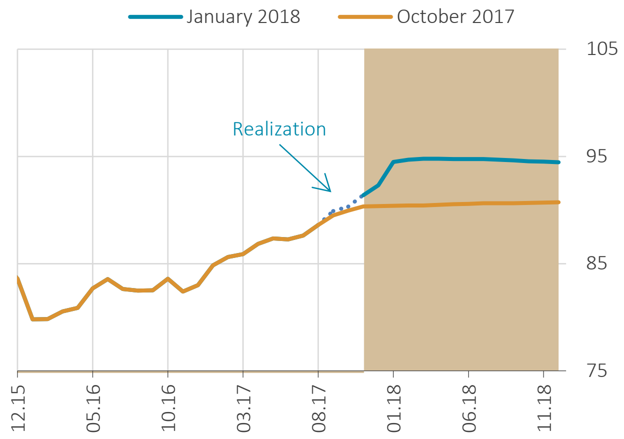
After the third-quarter slowdown, food inflation increased by 1.28 points to 13.79 percent in the final quarter of 2017, exceeding the October Inflation Report forecast mainly because of higher processed food inflation. In view of the measures in the agenda of the Food and Agricultural Products Markets Monitoring and Evaluation Committee (Food Committee), the assumption for food inflation is kept unchanged at 7 percent for both end-2018 and end-2019.

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



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

Chart 1.2.10: Revisions in Import Price Assumptions* (2010=100)



Source: CBRT, TURKSTAT.
* Shaded area denotes the forecast period.

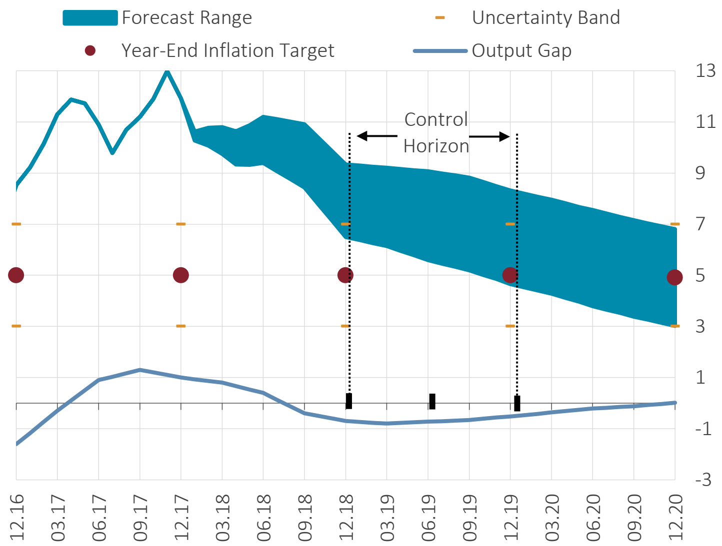
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that fiscal discipline will be maintained, and administered prices and taxes will not be subject to any unanticipated increase. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with MTP projections and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2018-2020 period.

1.3 Inflation and the Monetary Policy Outlook

Given a tight policy stance that focuses on bringing inflation down, inflation is expected to converge gradually to the 5-percent target, reach 7.9 percent at the end of 2018 and stabilize around 5 percent over the medium term after falling to 6.5 percent by the end of 2019. Thus, with a 70 percent probability, inflation is expected to be between 6.5 percent and 9.3 percent (with a mid-point of 7.9 percent) at end-2018 and between 4.7 percent and 8.3 percent (with a mid-point of 6.5 percent) at end-2019 (Chart 1.3.1).

Chart 1.3.1: Inflation and Output Gap Forecasts* (%)



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

Accordingly, the year-end inflation forecast is revised upwards by 0.9 points from the October Inflation Report. The upward revision in the TL-denominated import prices will drive the inflation forecast for end-2018 up by 0.7 points. The output gap that has been revised up for both 2017 and 2018 in the inter-reporting period amid an improved economic outlook is expected to push the end-2018 forecast up by 0.1 point. Moreover, actual inflation proved to be higher than projected in the October Inflation Report, and the underlying inflation increased in the fourth quarter, which added 0.1 point to the end-2018 inflation forecast. Therefore, the year-end consumer inflation forecast for 2018, which was announced as 7 percent in the October Inflation Report, is raised to 7.9 percent.

On the other hand, due to the revised assumption for TL-denominated import prices, the consumer inflation forecast for end-2019 is revised up by 0.5 points from the October Inflation Report. The output gap forecasts for the period spanning the second half of 2018 and the year 2019 have been subject to a minor revision, having virtually no effect on the inflation forecast for 2019. Thus, the year-end consumer inflation forecast for 2019 is raised to 6.5 percent from the October Inflation Report forecast of 6.0 percent.

The key drivers of disinflation in 2018 will be the fading cumulative effects from both the exchange rate depreciation and the inflationary impact arising from rapid rises in import prices in 2017. Furthermore, economic activity and credit growth are expected to follow a milder course in 2018. In addition, a macro policy framework in which taxes and administered prices are set consistently with the MTP as part of the continued strong coordination between monetary and fiscal policies will support the disinflation process.

1.4. Risks and Monetary Policy

Data on global growth hint at continued recovery in both advanced and emerging economies. PMI indicators pointing to growth for both country groups and the upward revisions in growth forecasts, particularly for the Euro Area, confirm the steady economic outlook across the globe. Global inflation has been volatile but low amid changing commodity and oil prices, whereas global core inflation remains stable.

The primary downside risks to the global economic outlook over the upcoming period are the geopolitical tensions in the Middle East and the Korean peninsula and the heightened protectionist rhetoric. Moreover, the US tax reform stands as a positive risk factor for the global economic outlook.

With the Fed and the ECB in the lead, central banks of advanced economies continue to normalize monetary policy. As the steps towards normalization have been in line with expectations, the market reaction is currently mild. However, risks to monetary policy tightening are more on the upside. With the ongoing economic recovery in the US, the Fed reiterated its commitment to policy normalization. The strengthening growth in the Euro area increases the possibility of an earlier-than-anticipated tightening of the ECB monetary policy. The fact that wage growth in advanced economies has not been accelerating despite strong economic activity limits price increases. Still, the steady recovery in the labor market poses an upward risk with regards to global inflation. Another key factor that might deteriorate the stable course of the global inflation is the recent movements in oil prices.

The favorable global economic outlook and trade volume as well as the ongoing global risk appetite drive strong portfolio flows into emerging economies. Portfolio inflows are estimated to continue through 2018 provided that economic recovery is sustained, and the normalization of monetary policy in advanced economies remains moderate. Meanwhile, portfolio investments to Turkey may at times be volatile amid geopolitical risks.

Both global and domestic financial conditions have generally been supportive of economic activity. Since the December MPC meeting, financial indicators such as exchange rate volatility, market interest rates and risk premium have improved. Due to the CBRT’s tighter monetary policy stance, the slope of the yield curve has become more negative. Loan growth, which hovers around historical averages as the CGF-backed loans neared their pre-determined upper limits by mid-2017, is being monitored closely with regard to its impact on aggregate demand and economic activity.

Domestic demand has slowed slightly due to the reduced support of the additional credit boost to growth and the withdrawal of tax incentives for durable goods, and the economy started to move towards its underlying trend as of the fourth quarter of 2017. The accommodative policies of 2017 will have less of an effect in 2018. In addition, the fiscal measures to be introduced within the context of the MTP and the tight monetary policy stance are expected to be the main drivers of the normalization in loan growth and economic activity. Moreover, the continued yet smaller support from CGF will underpin domestic demand in 2018. The steady recovery in tourism, the improving global growth outlook and the favorable course of the real exchange rate are expected to contribute further to growth and the current account balance in the coming months through the export channel. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments remain key to economic activity. Exchange rate volatility that may arise from such factors poses a downside risk to the timing and strength of the support that financial conditions could provide to economic activity.

The inflation outlook deteriorated in the fourth quarter of 2017 due to rising food prices as well as mounting cost pressures driven by exchange rates and commodity prices. The elevated levels of inflation and inflation expectations continue to pose risks to pricing behavior. The currently high inflation has an adverse impact on subcategories where the presence of backward indexation is stronger. Meanwhile, medium-term inflation expectations have not displayed any improvement, yet indicating that upside risks to inflation posed both by wage adjustments and pricing behavior persist. These risks may hinder the expected improvement of the inflation outlook in early 2018.

The risks to food inflation, another major determinant of forecasts, are on the upside. Having pulled annual consumer inflation down in December largely on the back of base effects and weather conditions, food prices might shape consumer prices over the first quarter of 2018, particularly due to the volatility in unprocessed food prices. The projections for food inflation are based on the assumption that measures taken by the Food Committee will considerably balance the upside risks to food prices.

In addition, changes in oil prices put upward pressure on domestic energy prices. Meanwhile, core goods inflation remains on the rise amid cumulative exchange rate effects, and aggregate demand conditions also support this uptrend. Given the elevated services inflation, there seems to be no significant improvement in the core inflation outlook yet.

Against this background, the CBRT has tightened its monetary policy stance. First of all, as of 22 November 2017, the weighted average funding rate was raised by about 25 basis points. Moreover, the CBRT opted for a lending rate hike of 50 basis points at the December MPC meeting and decided to maintain the tight stance in monetary policy in January.

The tight stance in monetary policy will be maintained decisively until the inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets. In light of current data, this requires that the tight monetary policy stance be preserved until a convincing fall is obtained in terms of disinflation. The CBRT formulates its monetary policy by taking the medium-term inflation into account, thus focusing on the developments in the underlying inflation rather than the anticipated fluctuations driven by base effects during the course of the year. Inflation expectations, the pricing behavior and other factors affecting inflation will be closely monitored, and further monetary tightening will be delivered if needed.

Public finance has been providing more support to disinflation, which confirms the stronger coordination between monetary and fiscal policies. Inflationary pressures driven by tax hikes were considerably lower in 2017 than in previous years. The joint efforts to maintain a systematic policy coordination may contribute further to disinflation in 2018.

Developments in 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 and taxes. A revision of the monetary policy stance may be considered should the fiscal policy deviate significantly from this framework and have an adverse effect on the medium-term inflation outlook.

In recent years, sustaining fiscal discipline has been one of the key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of an expansionary fiscal policy. Structural measures to provide room for counter-cyclical fiscal policies will enhance the coordination between monetary and fiscal policies and improve macroeconomic stability. Moreover, taking further structural steps to reduce inertia and volatility in inflation will contribute positively to price stability and social welfare.