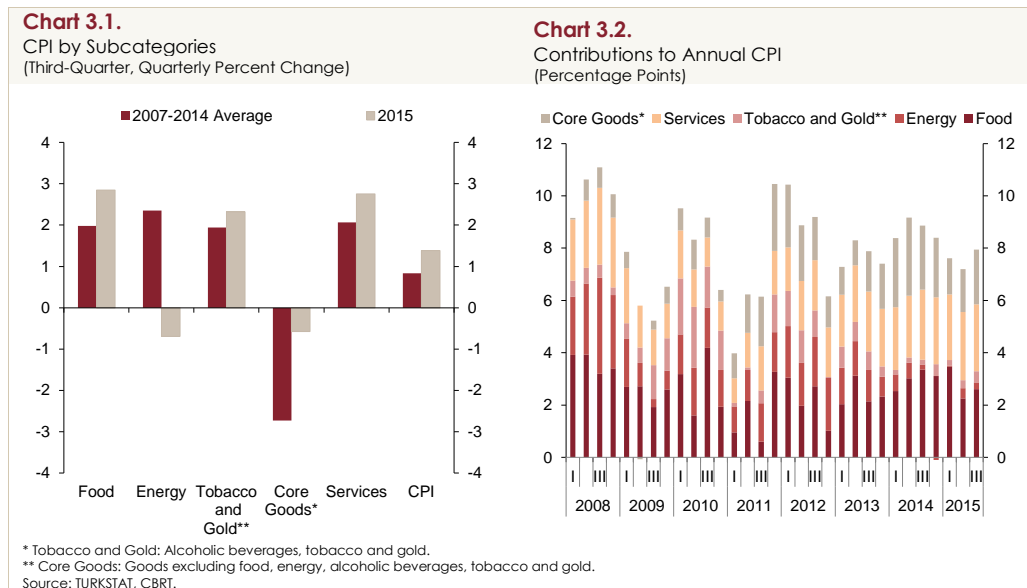


3. Inflation Developments

In the third quarter of 2015, consumer inflation increased by approximately 0.75 points compared to the previous quarter and reached 7.95 percent due to the rise in food and core goods prices. Following the correction in unprocessed food prices in the second quarter, the contribution of food prices to inflation increased again in this quarter. Moreover, annual core goods inflation rose by 2 points as the Turkish lira continued to depreciate in the third quarter from the first half of the year. Despite the depreciation in the Turkish lira, the plunge in oil prices lowered the annual energy inflation in the third quarter. Services inflation fell in this period due mostly to the base effect in transport and communication services, whereas inflation in food prices and services categories sensitive to exchange rates saw rising figures. Thus, the underlying trend of core inflation indicators recorded a slight quarter-on-quarter decline, yet still remained elevated.

In the third quarter of 2015, prices increased faster than historical averages in all subcategories excluding energy (Chart 3.1). The course of food prices was mainly determined by unprocessed food prices, particularly fresh fruits and red meat. The contribution of core goods and food prices to inflation crept up by 0.4 and 0.3 points, respectively, whereas that of the energy prices fell by 0.1 points on a quarterly basis (Chart 3.2). In accordance with the prices of core goods and services, core inflation indicators also increased higher than past averages in this period.



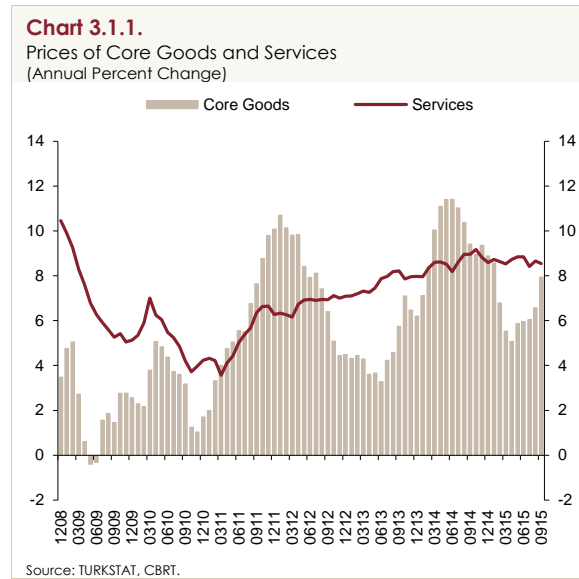
In sum, annual inflation increased in the third quarter due to ongoing increases in food prices as well as the depreciation of the Turkish lira. In spite of the fall in USD-denominated import prices, especially oil, exchange rate movements pushed the core inflation upwards. However, the pass-through of the depreciation in the Turkish lira to non-energy prices is assumed to be limited thanks to the mild outlook in aggregate demand conditions. In the upcoming period, the effects of domestic and global uncertainties on exchange rate movements as well as the course of food prices are the

leading risks to the inflation outlook. Moreover, the deterioration in medium-term inflation expectations constitutes a significant risk factor to categories like services, which present inflationary inertia.

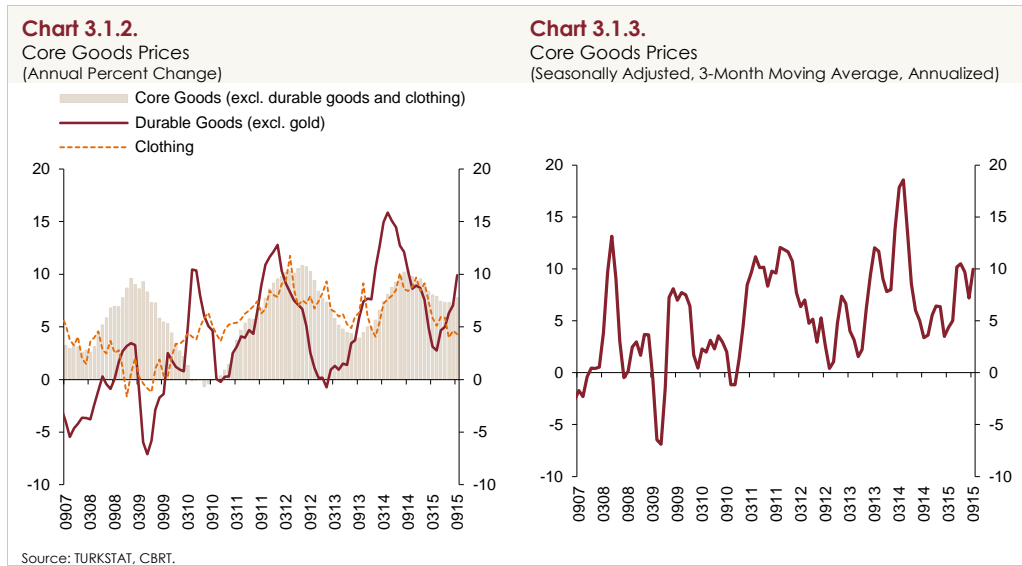
3.1. Core Inflation Outlook

Annual core goods inflation rose by 1.98 points to 7.94 percent in the third quarter (Table 3.1.1 and Chart 3.1.1). This was owed to annual inflation in durable goods, which increased by around 5 points to 9.89 percent due to the exchange rate effects. As for other categories in core goods, annual inflation in clothing declined in this period, while inflation in core goods excluding clothing and durable goods saw a slight rise (Chart 3.1.2).

In the third quarter, the Turkish lira depreciated against the USD and the euro by around 11 percent, and the effect of exchange rate movements on core goods prices grew more apparent. The modest course of demand conditions limited the exchange rate pass-through in this period, yet the cumulative depreciation of the Turkish lira weighed on inflation pressures on durable goods. In fact, monthly price increases in durable goods were high in July and even higher in September, especially in home appliances and automobiles.



In core goods excluding clothing and durable goods, where exchange rate depreciation is observed to have a lagged effect, prices exhibited a surge in September as opposed to the mild course in July and August. Contrary to strong exchange-rate-driven effects in these categories, clothing prices remained modest in the third quarter. In line with the mild course of the aggregate demand, clothing prices saw higher-than-average decline in seasonal sales, which partially limited the deterioration in the core inflation outlook.



Against this background, the contribution of core goods to consumer inflation grew by 0.45 points to 2.09 points in the third quarter (Chart 3.2). The underlying trend of core goods inflation continued to be high in this period (Chart 3.1.3). In September, seasonally adjusted data signaled a notable increase especially in prices of core goods excluding clothing. Also, the depreciation of the Turkish lira is projected to have further adverse effects on core goods inflation in the last quarter.

Table 3.1.1.
Prices of Goods and Services*
(Quarterly and Annual Percent Change)

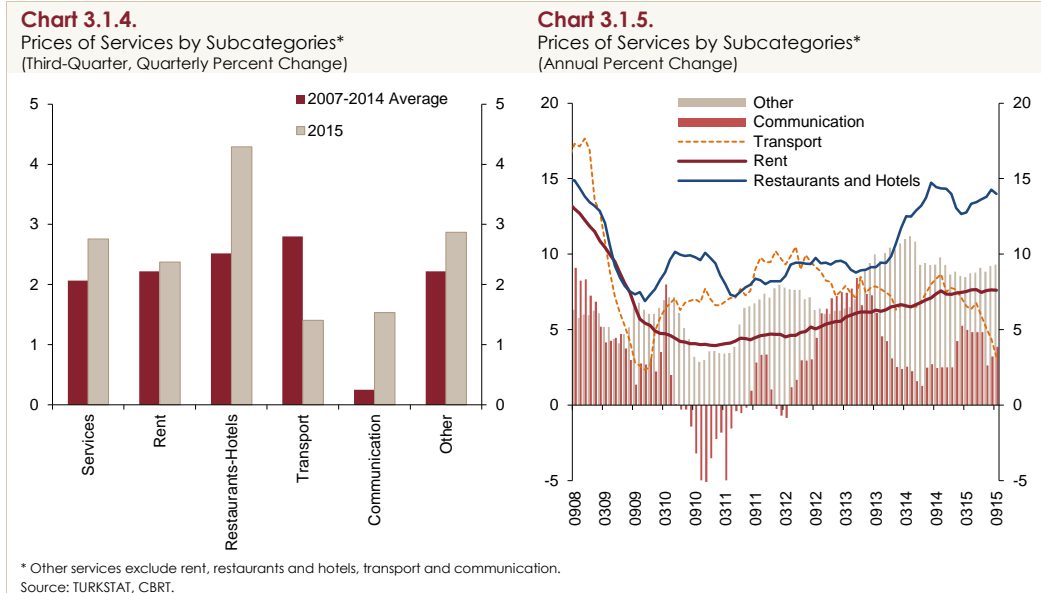
	2014			2015		
	III	IV	Annual	I	II	III
CPI	0.69	1.63	8.17	3.03	1.68	1.39
1. Goods	-0.30	1.99	7.99	3.34	1.37	0.81
Energy	0.11	-0.74	-1.54	1.96	1.44	-0.70
Food and Non-Alcoholic Beverages	1.50	2.90	12.73	8.82	-3.85	2.85
Unprocessed Food	0.02	3.53	12.24	16.40	-9.27	3.56
Processed Food	2.82	2.36	13.16	2.30	1.45	2.22
Core Goods	-2.39	2.98	8.89	-1.10	6.60	-0.57
Clothing and Footwear	-10.50	10.38	8.40	-12.43	22.37	-11.81
Durable Goods (excl. gold)	-0.08	-0.29	8.70	3.91	1.43	4.57
Furniture	-1.11	1.56	7.73	3.55	1.24	3.20
Electrical and Non-Electrical Appliances	0.69	-0.31	1.64	2.44	0.98	4.00
Automobile	-0.10	-1.19	13.72	5.14	1.62	5.60
Other Durable Goods	0.26	1.07	7.02	1.38	3.19	2.69
Core Goods (excl. clothing and durable goods)	1.82	1.38	9.57	1.78	2.16	2.25
Alcoholic Beverages, Tobacco and Gold	0.45	0.00	7.73	4.49	0.61	2.32
2. Services	3.05	0.81	8.59	2.32	2.40	2.76
Rent	2.25	1.78	7.34	1.47	1.77	2.38
Restaurants and Hotels	3.95	2.02	13.98	3.42	3.59	4.29
Transport	4.05	-0.38	7.76	0.10	2.06	1.41
Communication	2.48	0.14	2.50	2.26	-0.11	1.53
Other	2.67	0.21	8.64	2.95	3.00	2.87

* Other services exclude rent, restaurants and hotels, transport and communication.

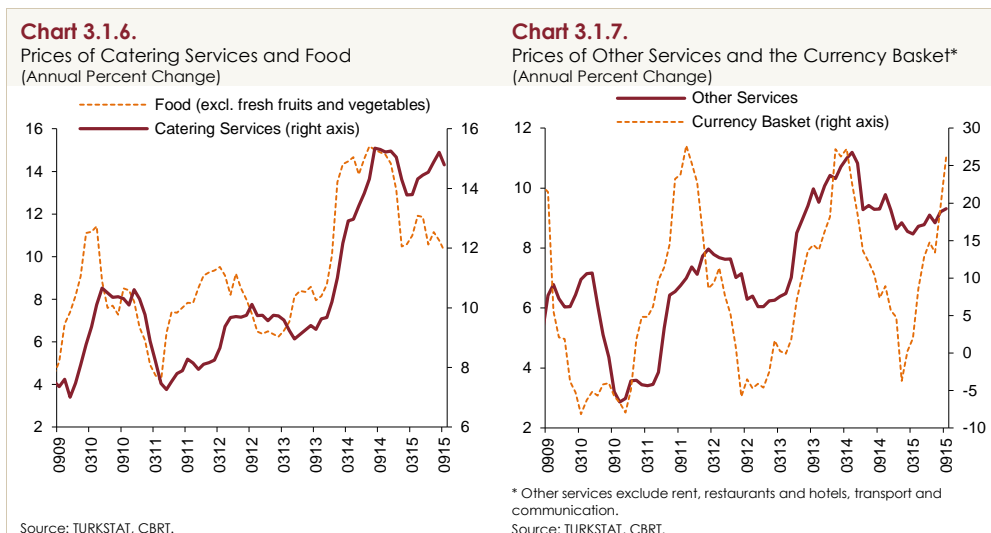
Source: TURKSTAT, CBRT.

Annual services inflation declined by 0.31 points quarter-on-quarter to 8.54 percent in the third quarter (Chart 3.1.1). This was led by communication services and transport services, the annual inflation of which lost pace due to the falling international oil prices. Meanwhile, annual inflation in restaurants and hotels as well as rent and other services increased as the prices of these subcategories

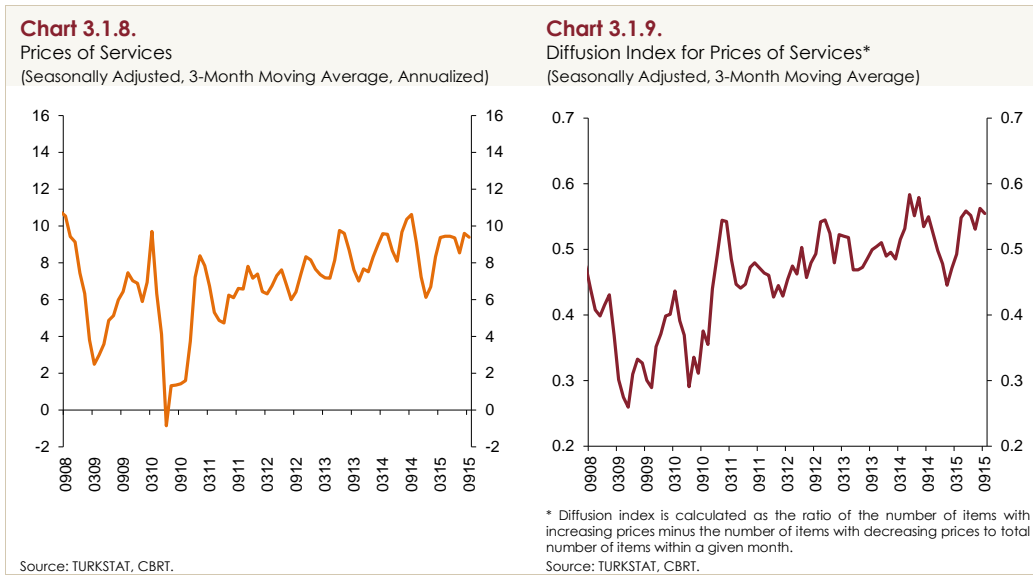
recorded historical highs (Charts 3.1.4 and 3.1.5). Cumulative increases in food prices remained influential in restaurants and hotels, which mainly determine the high course in the services inflation.



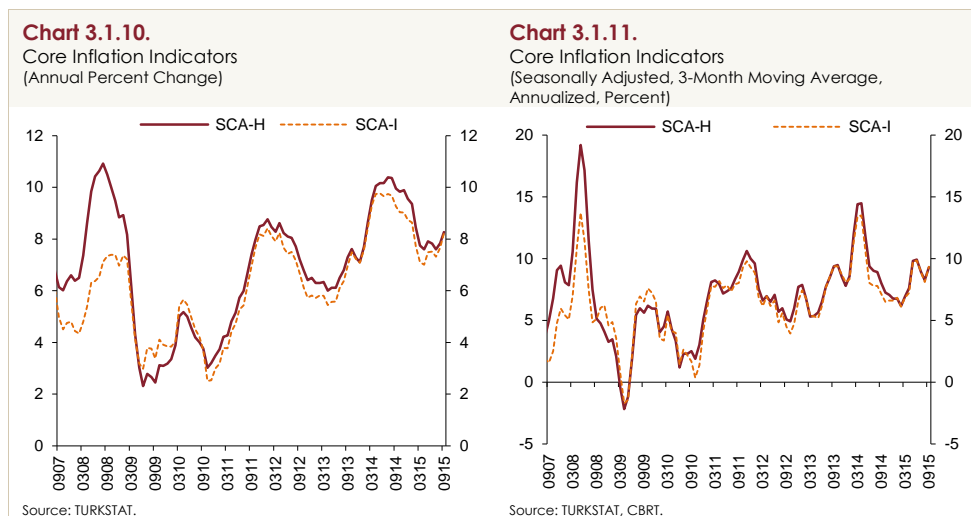
Cost pressures continue to dominate prices of services. The elevated annual food inflation excluding fresh fruits and vegetables caused sustained hikes in catering services and annual inflation hit 14.8 percent (Chart 3.1.6). The cumulative impact of the depreciation in the Turkish lira remained influential in prices of other services (Chart 3.1.7). In addition to cost factors, the prolonged rise in consumer inflation and the deteriorated medium-term expectations have an adverse effect on the services inflation.



In the third quarter, the underlying trend and the diffusion index for services prices remained high amid the persisting cost pressures (Charts 3.1.8 and 3.1.9).

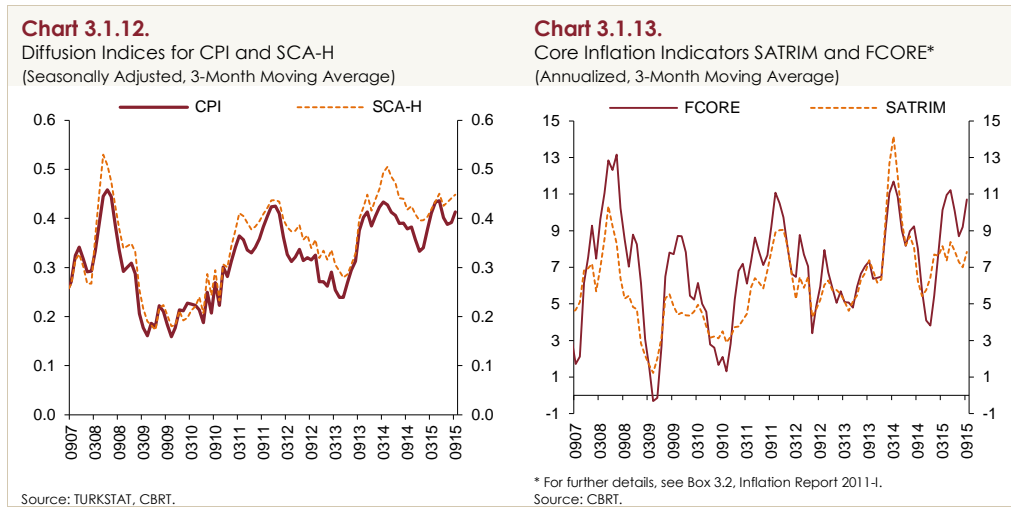


In line with the outlook for prices of core goods and services, annual inflation in SCA-H and SCA-I climbed to 8.26 and 8.23 percent, respectively, in the third quarter (Chart 3.1.10). Despite the slight quarter-on-quarter improvement, the underlying trend of core inflation indicators remained high in the third quarter (Chart 3.1.11).



As of the end of the quarter, the likelihood for prices to rise remained virtually unchanged quarter-on-quarter as implied by the diffusion indices (Chart 3.1.12). Yet, the diffusion indices recorded a limited rise in September, unlike the preceding two months. SATRIM, one of the alternative core inflation indices monitored by the CBRT, remained relatively flat; whereas FCORE, which is a better indicator of the effects of food prices on inflation, posted a quarter-on-quarter increase (Chart 3.1.13).

In sum, exchange rates and other cost factors had further adverse effects in the third quarter, while favorable import prices and the mild course of aggregate demand continued to curb cost pressures, albeit partially. Despite posting a quarter-on-quarter recovery, the underlying indicators are still well above the target-consistent levels.

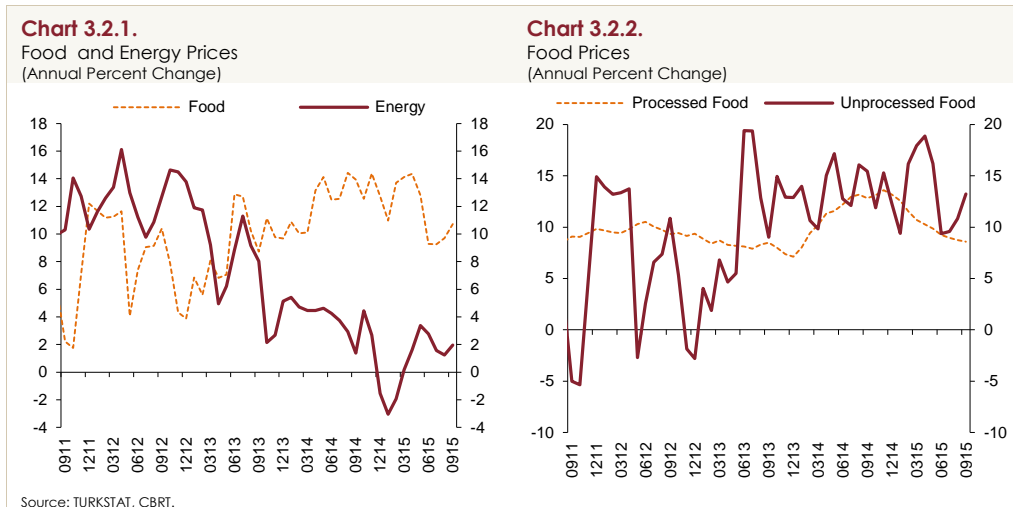


3.2. Food, Energy and Alcohol-Tobacco Prices

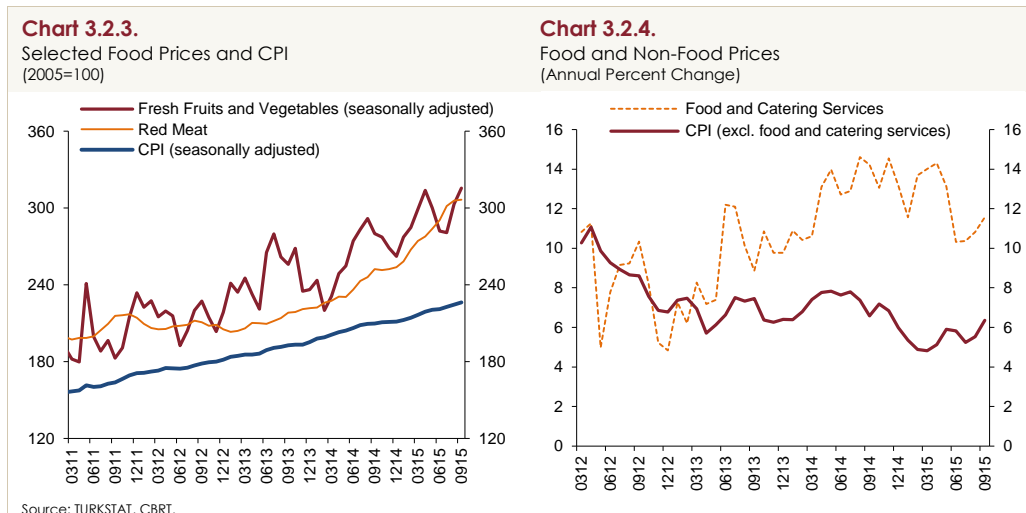
Food inflation headed upwards in the third quarter after a significant downward correction in the second quarter. Annual food inflation, which receded to 9.28 percent in June, climbed to 10.73 percent at the end of the third quarter, remaining above the previous Report's assumptions (Chart 3.2.1).

The rise in annual food inflation was attributed to unprocessed food prices (Chart 3.2.2). On account of the increased supply of fruits and vegetables, seasonally adjusted unprocessed food prices witnessed a correction in May and June. Nevertheless, this was reversed in the third quarter mainly due to soaring fruit prices. Moreover, red meat prices continued to trend upwards in this period due to the subdued supply in livestock. In fact, red meat prices surged by 5.53 percent in this quarter, while registering a 21.58 percent increase in year-on-year terms (Chart 3.2.3). Soaring red meat prices affected both food and catering services inflation negatively. On the other hand, amid the authorization to import carcass meat granted to the Meat and Milk Board, domestic meat prices remained relatively flat in September. As for food categories other than fresh fruits and vegetables as well as red meat, prices displayed a moderate outlook in this quarter. Accordingly, annual inflation in unprocessed food crept up by 3.87 points quarter-on-quarter to 13.23 percent in September.

The annual inflation in processed food continued to slow down in the third quarter (Chart 3.2.2). Amid favorable developments in wheat production, inflation in bread and cereals decelerated further and dropped to 6 percent in annualized terms. Meanwhile, prices of processed food excluding bread and cereals followed a relatively mild course. On the other hand, significant surges registered by vegetable oil prices throughout 2015 curbed the fall in processed food inflation.

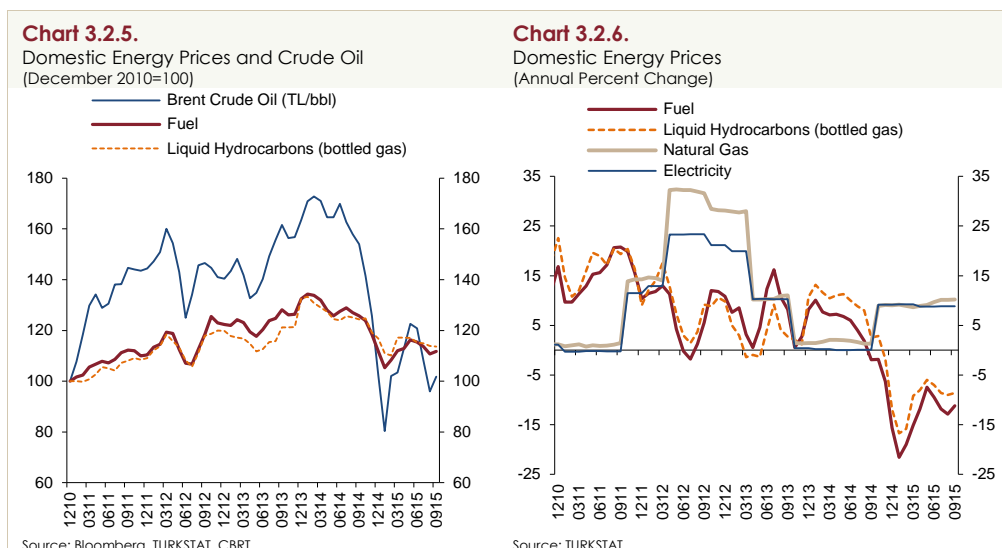


Due mostly to exchange rate effects, annual inflation in food and catering services rose to 11.56 percent, and consumer inflation excluding food and catering services reached 6.36 percent in the third quarter (Chart 3.2.4). Given the high share of food within the consumption basket, the course of food and related services can adversely affect inflation perception and expectation, especially among consumers. Thus, bringing inflation in food-related categories down to levels consistent with the consumer inflation target is of great importance. The measures to be proposed by the Committee on Monitoring and Evaluation of Food and Agricultural Product Markets are expected to provide significant contribution in this regard.



Energy prices fell by 0.70 percent in the third quarter. Given the downtrend in international oil prices during the third quarter, Brent crude oil prices receded to 47 USD at the end of the quarter. However, domestic energy prices were affected less favorably by the fall in international oil prices due to the depreciation of the Turkish lira. Accordingly, fuel and bottled gas prices declined by 3.23 and 1.41 percent, respectively, in this quarter (Chart 3.2.5). As for administered prices, electricity prices were virtually unchanged, while natural gas prices rose by 0.53 points. After the first-quarter jump, municipal

tap water tariffs remained almost flat in this quarter (Chart 3.2.6). As a result, annual energy inflation stood at 1.95 percent in the third quarter and continued to curb consumer inflation (Chart 3.2.1).



Prices of alcoholic beverages and tobacco products posted a slight rise in the third quarter due to adjustments in lump sum tax in July.

3.3. Domestic Producer Prices

Domestic producer prices increased by 2.20 percent in the third quarter amid rising manufacturing prices and annual inflation rose to 6.92 percent (Table 3.3.1 and Chart 3.3.1). The depreciation of the Turkish lira continued to have inflationary effects across subcategories in this quarter.

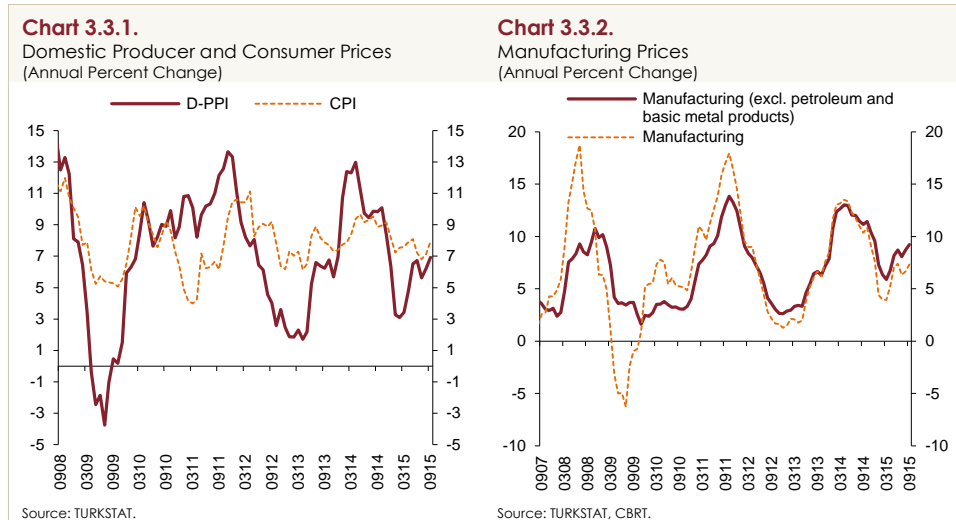
Table 3.3.1.
D-PPI and Subcategories
(Quarterly and Annual Percent Change)

	2014			2015		
	III	IV	Annual	I	II	III
D-PPI	2.02	-0.82	6.36	2.60	2.81	2.20
Mining	0.92	-2.86	1.02	0.33	3.59	-3.41
Manufacturing	2.18	-1.01	7.63	2.64	3.45	2.12
Manufacturing (excl. petroleum products)	2.35	-0.06	8.98	2.65	3.12	2.70
Manufacturing (excl. petroleum and basic metal products)	2.37	0.16	9.56	2.70	3.22	2.88
Electricity and Gas	1.01	1.53	-3.56	1.80	-3.33	5.38
Water	0.95	4.54	11.90	13.75	2.21	0.27
D-PPI by Main Industry Groups						
Intermediate Goods	1.45	-0.36	6.53	1.97	2.96	3.05
Durable Goods	-0.50	0.84	7.55	5.15	3.20	4.07
Durable Goods (excl. gold)	-0.39	1.29	7.38	2.91	2.98	2.87
Non-Durable Goods	4.79	0.49	13.82	3.24	3.31	0.60
Capital Goods	1.18	-0.88	5.97	2.23	2.87	5.15
Energy	-0.07	-5.54	-7.64	2.29	1.33	-0.49

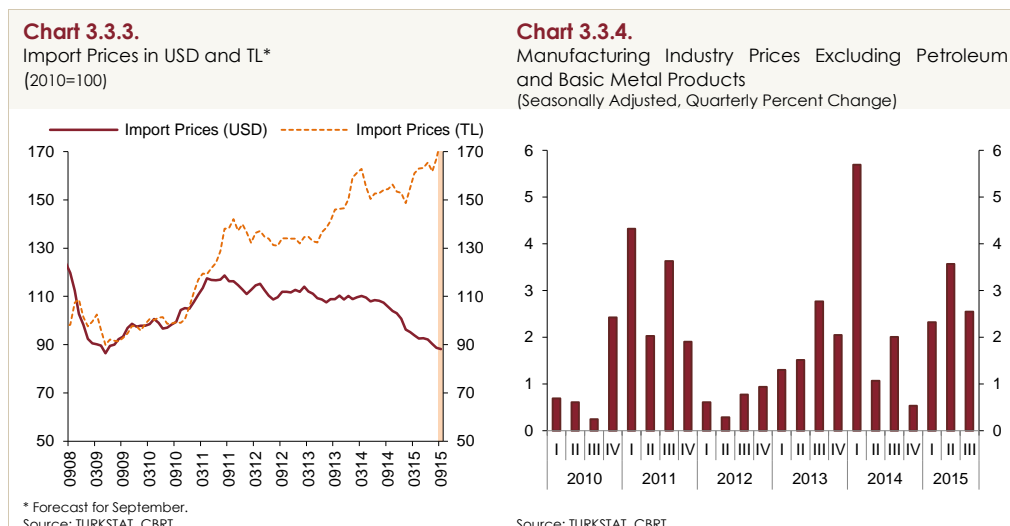
Source: TURKSTAT, CBRT.

Manufacturing industry prices rose by 2.12 percent in this quarter, while annual inflation was recorded as 7.34 percent, remaining unchanged from the previous quarter (Table 3.3.1 and Chart 3.3.2). The depreciation of the Turkish lira had an adverse effect on manufacturing prices, which

was partially balanced by the favorable course of food manufacturing and international oil prices. In fact, import prices receded in USD terms, but soared in TL terms in the third quarter (Chart 3.3.3).

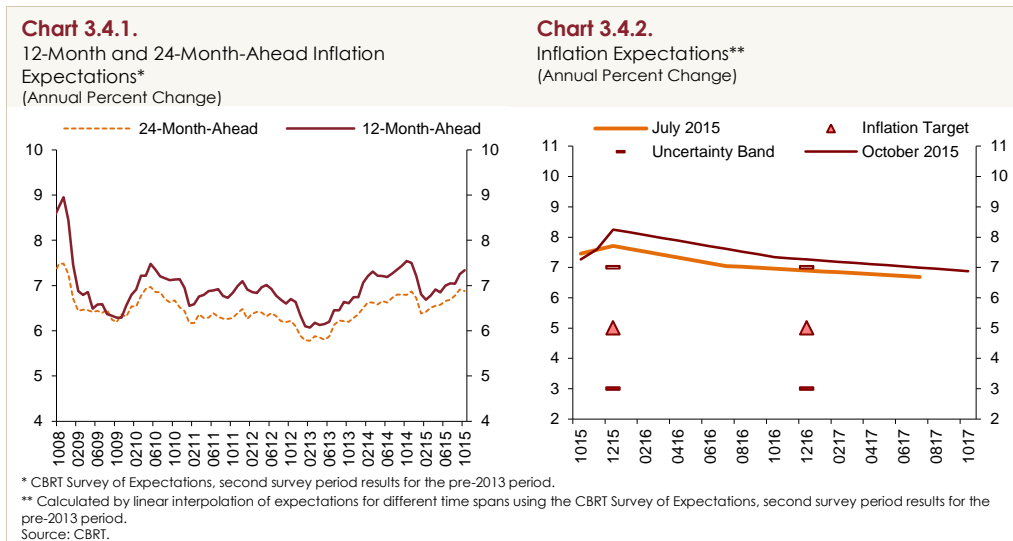


The depreciation of the Turkish lira had an extensive effect across all manufacturing industry subcategories in this period (Table 3.3.1). Prices of durable goods soared by 4.07 percent mainly on account of the increases in prices of gold, furniture and home appliances. The extensive increases were also felt across capital and intermediate goods, the prices of which surged by 5.15 and 3.05 percent, respectively. The mild uptick in prices of non-durable goods, on the other hand, was driven by food manufacturing prices. Price increases in the manufacturing industry excluding petroleum and basic metal products, which entail information on the underlying trend of producer prices, recorded a quarterly decline, yet remained high (Chart 3.3.4). As a result, cost pressures on consumer prices remained brisk in the third quarter amid the cumulative depreciation of the Turkish lira.



3.4. Expectations

Having deteriorated in the first half of the year, medium-term inflation expectations continued to increase in the third quarter given the cumulative depreciation of the Turkish lira and its repercussions on the core inflation indicators. 12-month-ahead inflation expectations remained on an unfavorable track in October, while 24-month-ahead inflation expectations remained virtually unchanged (Chart 3.4.1). Across maturities, 12-month-ahead inflation expectations were revised upwards on a quarterly basis, while 24-month-ahead expectations recorded a more limited rise (Chart 3.4.2). Accordingly, inflation expectations currently hover above the 5-percent year-end target set for 2015 and 2016.



The dispersion of medium-term inflation expectations indicates deterioration in inflation expectations in the inter-reporting period (Charts 3.4.3 and 3.4.4). The percentage of respondents expecting 12-month-ahead inflation to be within the range of 4.5-7.49 percent decreased in this period, while those expecting 7.5 percent or above recorded a notable increase. The deterioration in the dispersion of 24-month-ahead inflation expectations proved more limited.

