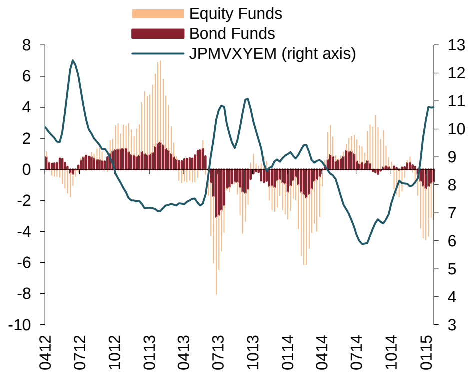
1. Overview

In the fourth quarter of 2014, the persisting divergence among global monetary policies besides uncertainties regarding the normalization process aggravated the volatility in financial markets. This led the portfolio flows towards emerging economies to fluctuate and the volatilities of exchange rates in these countries to heighten (Chart 1.1). Recently, the persisting deterioration in global economic activity accompanied by mainly supply-side factors pulled down oil prices sharply. These developments caused considerable fluctuations especially in energy-exporting emerging countries. Overall, the risk premiums of emerging economies followed a volatile course due to the monetary policy uncertainties, the slowdown in economic activity and the course of oil prices (Chart 1.2).

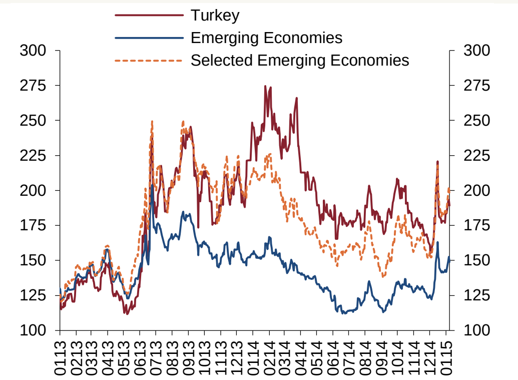
Effects of the increased volatility in global markets were also seen in the Turkish economy, where risk premium indicators and exchange rates have fluctuated. The fall in commodity prices, mainly in oil, is expected to improve the economy especially in terms of inflation and external balance. Along with this, the tight monetary policy stance stood out as a factor that limits the negative effects of global volatilities on Turkey in this period.

Chart 1.1.
Emerging Market Fund Flows and JPMVXYEM Volatility Index
(4 Week Moving Average, Billion USD, Percent)



Source: EPFR.

Chart 1.2.
CDS for Emerging Economies and Turkey*
(Basis Points)



* Emerging economies include Brazil, Chile, Colombia, Czech Republic, Hungary, Indonesia, Mexico, Poland, Romania and South Africa. Selected emerging economies are Brazil, Indonesia and South Africa.
Source: Bloomberg

Annual growth saw some deceleration after the first quarter of 2014 mainly due to the receding agricultural product upon unfavorable climatic conditions as well as the slowdown of export growth due to geopolitical risks. Indicators regarding the last quarter show that annual growth remained moderate due to weak external demand. In 2015, the growth rate is expected to surge gradually with the increased contribution of domestic demand. The positive effects of the tight monetary policy stance and macroprudential measures continued in the last quarter of 2014, causing the core underlying trend to near the target. Moreover, plummeting oil prices supported the disinflation process and inflation expectations have recently seen a noticeable improvement. Due to the fading cumulative effects of the exchange rate, the reverting of food inflation to past years' averages as well as the falling oil prices, a notable decline in inflation is projected in 2015. Accordingly, inflation is estimated to approach target-consistent levels in mid-2015.

1.1. Monetary Policy and Financial Conditions

In the last quarter of 2014, the CBRT maintained its tight policy stance by also implementing tight liquidity policy in consideration of global volatilities. Thus, the BIST overnight repo rates have remained close to the upper band of the interest rate corridor since October in line with the liquidity policy (Chart 1.1.1). Since early 2014, the CBRT funding has been provided mainly through 1-week repo auctions. This continued in the last quarter of the year and the CBRT average funding rate hovered around the 1-week repo rate (Chart 1.1.2).

Chart 1.1.1.
CBRT Rates and BIST O/N Repo Rates
(Percent)

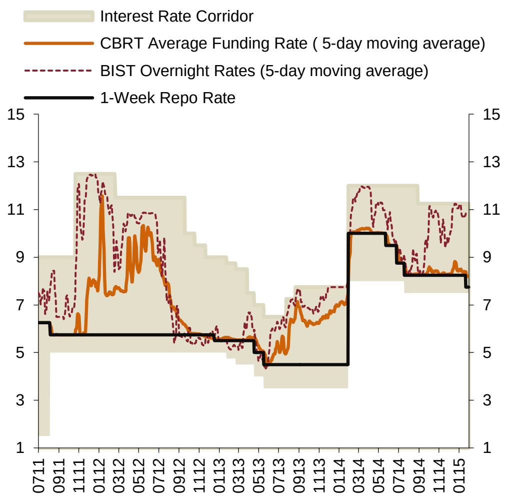
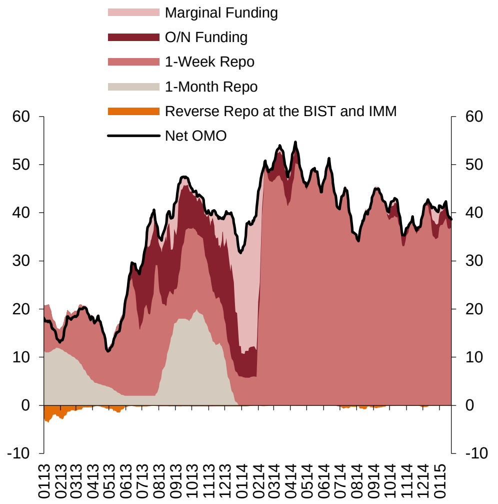


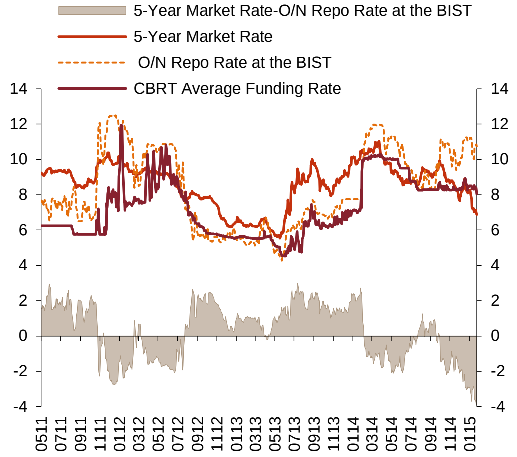
Chart 1.1.2.
CBRT Funding
(2-Week Moving Average, Billion TL)



Source: BIST, CBRT.

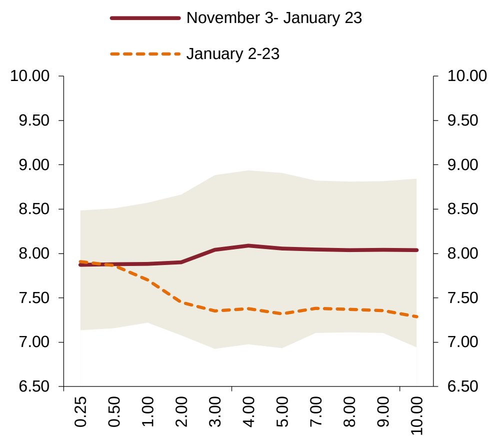
Considering the favorable developments in the inflation outlook amid the continuing fall in core inflation trends, receding oil prices and improved expectations, the CBRT decided on a measured cut in the 1-week repo rate from 8.25 percent to 7.75 percent in January. On the other hand, given the heightened volatility in global markets, overnight rates were kept unchanged with an emphasis on the need for a cautious stance to render the decline in inflation permanent. In this context, it was stated that inflation expectations, the pricing behavior and other factors affecting inflation would be closely monitored and the tight monetary policy stance would be maintained by keeping the yield curve flat until there is a significant improvement in the inflation outlook. Owing to the tight monetary policy stance, the spread between 5-year market rates and the overnight repo rates at the BIST Interbank Money Market continued to take negative values (Chart 1.1.3). Along with these developments, the yield curve has remained nearly flat (Chart 1.1.4).

Chart 1.1.3.
Market Rates and the CBRT Funding Rate
(Percent)



Source: BIST, Bloomberg, CBRT.

Chart 1.1.4.
Yield Curve
(Percent)



Source: Bloomberg.

The CBRT announced the outline of the monetary and exchange rate policy for 2015 on 10 December 2014, and adopted new macroprudential policies to limit macrofinancial risks and to support prudential borrowing. In this scope, to extend the maturities of external borrowing, the required reserve ratios applied to non-core FX short-term liabilities of banks and financing companies were raised. Additionally, the arrangement of the CBRT's remuneration of TL required reserves to stimulate core liabilities was put into effect in January 2015. Moreover, technical adjustments were implemented in reserve option tranches and coefficients to meet the FX liquidity to be required due to the changes in required reserves ratios. These adjustments are expected to strengthen the automatic stabilizing feature of the ROM. The disclosed policy measures are aimed at limiting macrofinancial risks and contributing to balanced growth by supporting prudential borrowing.

Owing to the CBRT's tight monetary policy stance and the macroprudential measures, the rate of increase in the loans extended to the non-financial sector continued on a reasonable course in the last quarter of the year. Supported also by the actions of the BRSA, consumer loans grew slower than past years, while commercial loans displayed a higher rate of increase (Charts 1.1.5 and 1.1.6). According to the current financial conditions and the results of the Loan Tendency Survey, there has not been any noticeable change in demand and supply conditions in commercial and consumer loans in the first quarter of 2015, which indicates that credit growth will maintain its current trend. This outlook in credits is expected to continue to limit medium-term inflation pressures on the one hand, and support the improvement in the current account balance, on the other.

Chart 1.1.5.
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)

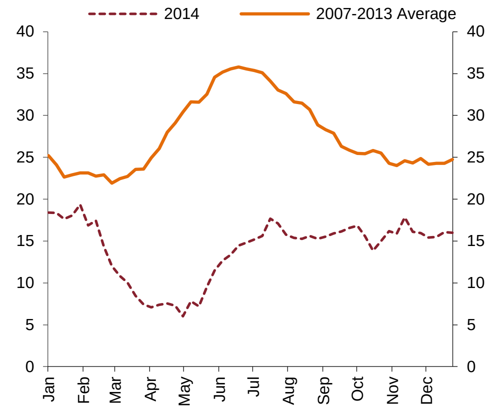
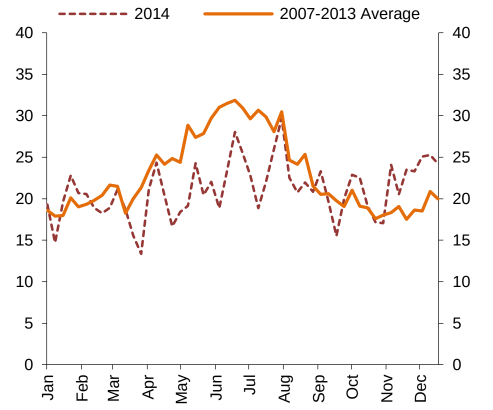


Chart 1.1.6.
Commercial Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the fourth quarter of 2014, annual consumer inflation posted a quarter-on-quarter decline by 0.7 points and stood at 8.17 percent remaining below the forecasts of the October Inflation Report (Charts 1.2.1 and 1.2.2). Annual inflation decreased across subcategories in this period with energy prices registering the most remarkable slowdown, which was led by the plunge in international oil prices. Food prices remained as the largest contributor to inflation. Core goods registered a slight fall in annual inflation, while the improvement in the underlying trend, which has been experienced since the second quarter, halted. Meanwhile, the fall in oil prices affected fuel-related services considerably and the underlying trend of services recorded a notable improvement.

Chart 1.2.1.
October 2014 Inflation Forecasts and Realizations*
(Percent)

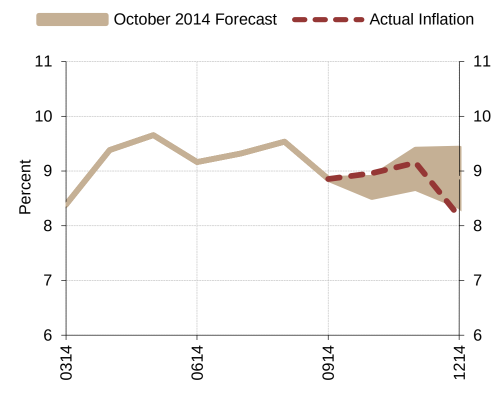
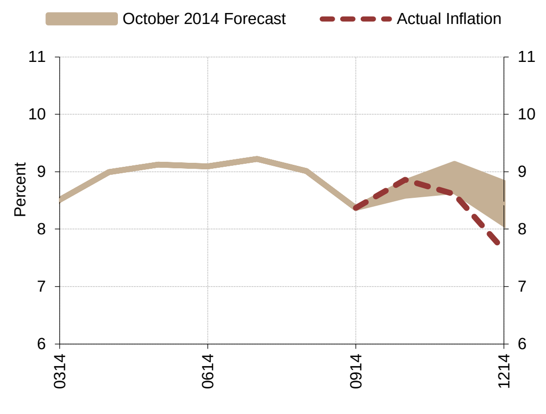


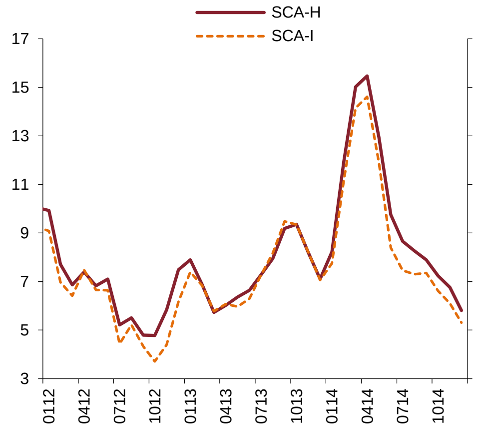
Chart 1.2.2.
October 2014 Inflation Forecasts and Realizations Excluding Unprocessed Food, Tobacco and Alcoholic Beverages*
(Percent)



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

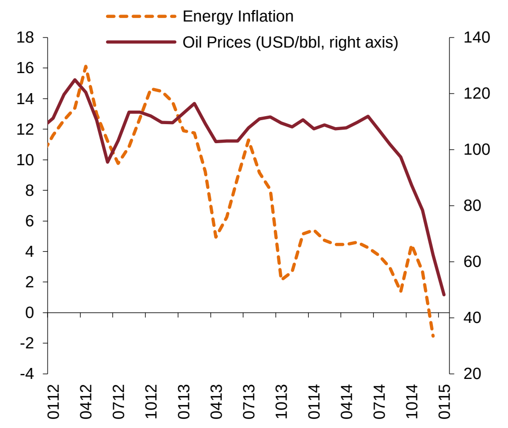
The tight monetary policy stance besides the macroprudential measures continue to improve the core inflation trend (Chart 1.2.3). At the end of 2014, the core underlying inflation trend receded to the levels prior to mid-2013, the period when the effects of the exchange rate depreciation and negative weather conditions appeared. The leading recent development, which had the highest effect on inflation dynamics, has been the plunge in oil prices (Chart 1.2.4). Amid this decline, annual inflation in the energy prices fell remarkably and stood below zero at the year-end. Favorable cost developments driven by plummeting oil prices also contribute to the improvement in the core inflation trend.

Chart 1.2.3.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized Percent Change)



Source: TurkStat, CBRT.

Chart 1.2.4.
Oil Prices and Energy Price Inflation
(Annual Percent Change)



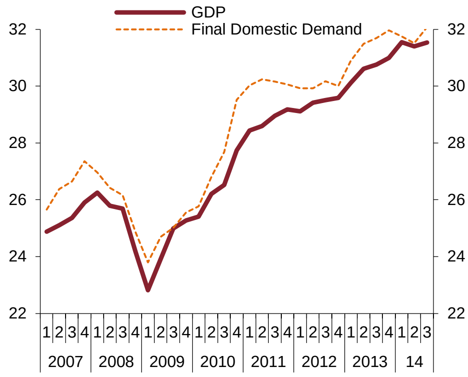
Source: TurkStat, Bloomberg.

To summarize, the last quarter of the year was marked by evident effects of the falling oil prices on inflation. A remarkable improvement was witnessed in inflation expectations after a long period and the positive effect of oil prices on the headline inflation spilled over into many subcategories, especially the services prices. Besides the international price developments that contribute to falling inflation, the gradual elimination of cumulative exchange rate effects, the decline in food inflation to past years' averages and the tight monetary policy stance are envisaged to support the disinflation process in the upcoming period. Against this background, it is projected that consumer inflation will register a notable improvement particularly in the first quarter, and inflation will recede to target-consistent levels in mid-2015.

Supply and Demand

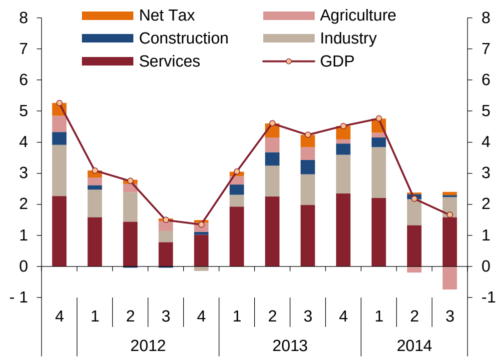
According to the GDP data of the third quarter of 2014, economic activity was relatively weaker compared to the outlook presented in the October Inflation Report. In the third quarter, the GDP rose by 1.7 percent on an annual basis, while growth remained limited compared to the previous quarter with 0.4 percent (Chart 1.2.5). Analysis of national income components on the production side indicate that the contraction in agricultural value-added led by adverse weather conditions is an important factor in the low growth of the national income (Chart 1.2.6). Data on the expenditures side reveal that in the third quarter, final domestic demand compensated for the fall in the first half and stood slightly above its level in the last quarter of 2013 (Chart 1.2.5). Private consumption expenditures recorded a robust recovery after two consecutive quarters. In addition, the persistently sluggish trend in private investments was reversed amid the increase in machinery and equipment investments. These two factors supported quarterly growth. However, the relatively weak course of exports limited the growth in this period.

Chart 1.2.5.
GDP and the Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)



Source: TurkStat.

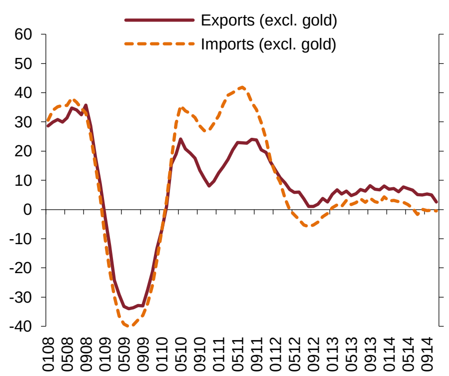
Chart 1.2.6.
Annual GDP Growth and Contributions from the Production Side (Percentage Points)



Falling below its previous quarter average during October-November 2014, industrial production is expected to decrease on a quarterly basis in the fourth quarter in line with the decline in December's PMI and BTS survey indicators. Yet, data for the fourth quarter of 2014 point to a quarter-on-quarter pickup in consumer demand, a moderate course in machinery and equipment investments and some recovery in construction investments. Hence, domestic demand may remain on a modest upward track in the final quarter. External demand, on the other hand, remains weak due to slowing activity in the European economies and geopolitical tensions in neighboring countries. The weak external demand puts pressure on export growth, but the fact that export growth exceeds import growth supports the re-balancing of the economy (Chart 1.2.7). Moreover, falling oil prices contribute positively to the current account balance by reducing import expenditures (Chart 1.2.8).

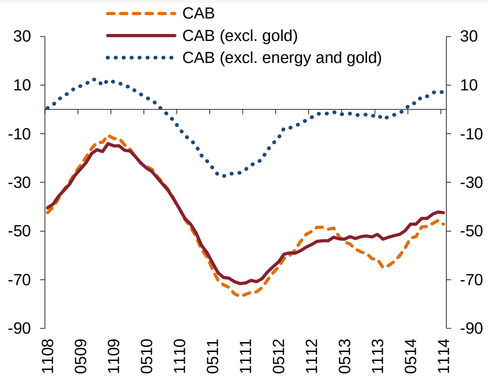
In 2015, domestic demand is expected to recover moderately while external demand is likely to remain weak. Depending on weather and precipitation conditions, the projected correction in the agricultural value-added will be a factor to support growth. However, there are external demand-driven downside risks to growth. Thus, in 2015, demand conditions will contribute to the disinflation process and also support the improvement of the current account balance on the back of the macroprudential measures and the more favorable terms of trade.

Chart 1.2.7.
Exports and Imports
(Nominal, Annual Percent Change, 6-Month Moving Average)



Source: TurkStat, CBRT.

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

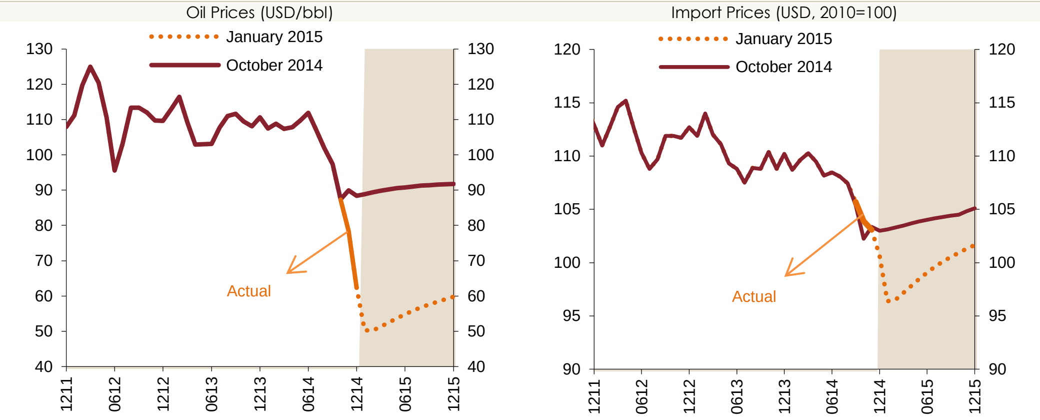


Source: CBRT.

Oil, Import and Food Prices

In the fourth quarter of 2014, oil and import prices remained well below the projections of the October Inflation Report (Chart 1.2.9). Accordingly, oil and import price assumptions for the medium term were revised significantly downwards (Table 7.1.1). In view of the direct and indirect effects of these developments, the end-2015 inflation forecast was revised down by 0.6 percentage points compared to the previous reporting period. In food prices, the end-2015 inflation forecast was left unchanged at 9 percent.

Chart 1.2.9. Revisions to Oil and Import Price Assumptions*



* Shaded region denotes the forecast.
Source: Bloomberg, TurkStat, CBRT.

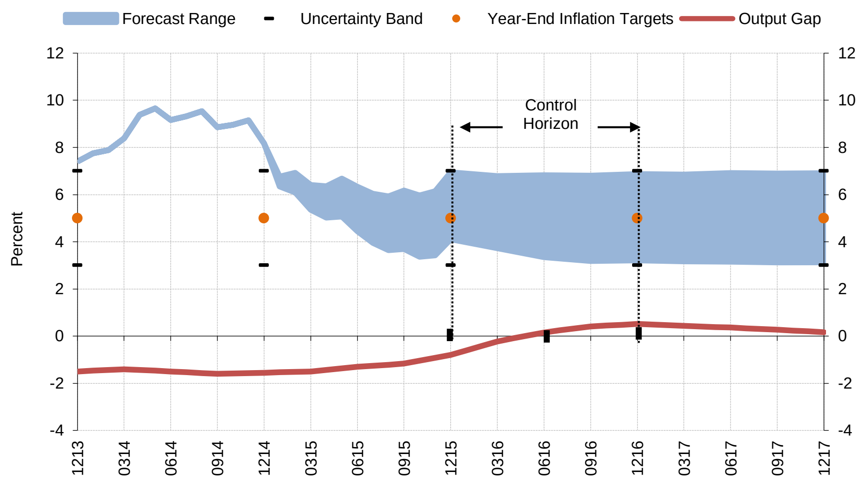
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with inflation targets and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a tight fiscal stance will be implemented and the primary expenditures to the GDP ratio will decrease gradually.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on a framework where a cautious approach will be adopted to achieve a permanent improvement in inflation outlook and the tight monetary policy stance will be maintained by keeping the yield curve flat. It is assessed that the annual loan growth rate will continue to hover around the recent reasonable levels in 2015, also thanks to the macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 4.1 percent and 6.9 percent (with a mid-point of 5.5 percent) at end-2015 and between 3.2 percent and 6.8 percent (with a mid-point of 5 percent) at end-2016. Inflation is projected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts*



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

In sum, the end-2015 inflation forecast is revised down by 0.6 points to 5.5 percent from 6.1 percent in the October Inflation Report. This revision is driven by falling oil prices. The projected noticeable decline in inflation compared to 2014 is largely due to falling oil prices as well as projections that cumulative exchange rate effects will continue to taper off and food price inflation will recede to past years' averages. The course of inflation in 2015 will be determined by base effects. Base effects will pull annual inflation down until August and push it up in the rest of the year (Box 3.3). Thus, annual inflation is expected to remain on a downward track until the third quarter and increase slightly to 5.5 percent due to base effects in the fourth quarter (Chart 1.3.1).

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

Loans continue to grow at reasonable levels amid the tight monetary policy stance and the macroprudential measures. The composition of loans also moves in the desired direction. While the annual growth rate of consumer loans hovers around low levels, commercial loans remain relatively more robust. This loan outlook not only limits medium-term inflationary pressures but also contributes to the improvement in the current account balance.

The CBRT expects the growth composition to change in favor of domestic demand in the upcoming period. Languishing external demand due to weak growth in European countries, the largest export market of Turkey, and geopolitical developments in neighboring countries limit the growth of exports. Yet, with improved financial conditions and the income effect of falling oil prices, domestic demand may see some recovery. In sum, external demand remains weak whereas domestic demand contributes moderately to growth. This change in the growth composition might increase the nonenergy current account deficit to some extent but the current account deficit is expected to narrow further down thanks to the improvement in the energy trade balance.

There are downside risks to economic activity in the upcoming period. The lingering volatility across global financial markets and the sluggish course of confidence indices may cause private final demand to provide limited support to growth. In the case of an additional slowdown in external demand and a sizeable decline in global growth rates, the decrease in commodity prices will pull inflation down. Nevertheless, domestic economic activity may witness notable adverse effects at the same time. Under such circumstances, the CBRT will employ policy tools to support the economy.

There are many factors that might have a favorable effect on the inflation outlook in 2015. The recovery of economic activity is likely to be a gradual one and aggregate demand developments are expected to support disinflation. The tight monetary policy stance and the macroprudential measures continue to have a favorable impact on inflation, especially on core inflation indicators, which exclude energy and food. The adverse impact of cumulative exchange rate developments on annual inflation is also tapering off. Moreover, falling commodity prices, in particular oil prices, contribute to disinflation. In fact, there has recently been a notable decline in medium-term inflation expectations.

Global financial markets have followed a volatile course lately. Capital flows to emerging markets may continue to fluctuate in 2015. The ongoing uncertainty about the normalization of global monetary policies cause the global risk appetite and capital flows to be data-sensitive. The CBRT's current policy framework is flexible enough to provide a prompt response to any impending volatility. In this regard, inflation expectations, the pricing behavior and other factors that affect inflation will be closely monitored and the tight monetary policy stance will be maintained by keeping the yield curve flat until there is a significant improvement in the inflation outlook.

Under the current monetary policy stance, the CBRT anticipates that inflation will decline to levels close to the target by mid-2015. Yet, a more persistent reduction in inflation necessitates a cautious approach in monetary policy. Cost and demand factors are currently supportive of disinflation, which creates a major opportunity to bring inflation down permanently. Sustaining low levels of inflation might contribute to investments and potential growth. In this context, the CBRT will continue to act decisively to control inflation and future monetary policy decisions will be conditional on improvements in the inflation outlook.

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 on 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.

The incorporation of disinflation in the MTP as one of the main objectives was welcomed by the CBRT. Moreover, it is assessed that the implementation of the announced structural reforms would contribute to the potential growth significantly. Any measure to 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.