TÜRKİYE CUMHURİYET
MERKEZ BANKASI

HEAD OFFICE ANKARA, ………………….

Please refer to:
B.02.2.TCM.0.00.00.00-

Mehmet ŞİMŞEK
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 accountable for reporting to the Government and announcing 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 2015", which was published on December 10, 2014; the inflation target for 2015 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 8.81 percent at end-2015, notably exceeding the target. This text elaborates on the reasons why the target was missed and explains the measures already taken—and to be taken—to bring inflation back to the target.

Factors Affecting Inflation in 2015

In the first Inflation Report of 2015 (IR 2015/I), the mid-point of the year-end inflation forecast was given as 5.5 percent. However, deviations from the underlying assumptions and developments affecting the dynamics of inflation over the year caused inflation to end the year above the uncertainty band.

The main factors causing inflation to breach the target in 2015 are the cumulative increases in the exchange rate and the elevated course of food prices. The food and exchange rate-driven prolonged pressures not only had direct impacts on inflation but also strengthened the underlying inflation trend through the expectations channel. The elevated CPI inflation causes inflation to remain high in categories where the backward-looking behavior is strong, particularly in services.

TÜRKİYE CUMHURİYET MERKEZ BANKASI A.Ş.
TİCARET SİCİL NUMARASI: 269
SERMAYESİ: 25.000 TL
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Emerging market currencies have depreciated dramatically since mid-2013 amid heightened uncertainty over global monetary policies. Both this outlook and domestic uncertainties of 2015 caused the Turkish lira to depreciate by about 20 percent against the foreign currency basket in 2015. The direct (first-round) effects of the depreciation were clearly observed in core inflation through the core goods channel. Accordingly, core goods made the largest contribution to CPI inflation as of the end of 2015.

The large cumulative increases in the exchange rate passed through to prices of food and services as well. Inflation in these categories also reflected the second-round effects of the Turkish lira depreciation due to the deterioration in pricing behavior and expectations. Despite the marked decline in import prices, particularly in international oil prices, exchange rate changes brought inflation up by about 3 points as of end-2015.

Another factor causing inflation to remain above the projected level was the annual food price inflation that climbed as high as 10.9 percent, well above target-consistent levels. Food prices also affected services inflation adversely across 2015 through catering services. In 2015, the net effect of administered prices for items such as electricity, natural gas, alcoholic beverages and tobacco on inflation was consistent with the forecasts presented in the January 2015 Inflation Report.

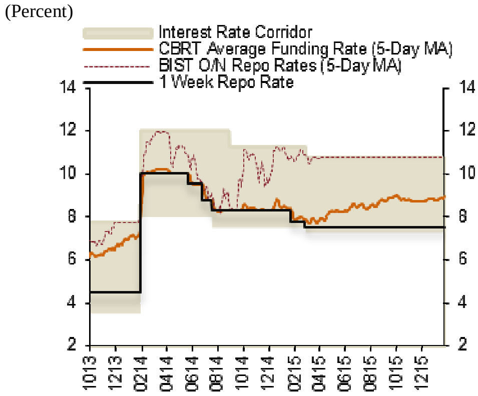
In sum, although 2015, a year the tight monetary stance and macroprudential measures held domestic demand and loan growth in check, was marked by plummeting import prices, inflation exceeded the target due to the strengthened inflation trend caused by both exchange rate and food price developments and deteriorating expectations. However, the ongoing decline in oil prices and the recent relatively stable exchange rate outlook are expected to drive inflation down over 2016. Yet, the large adjustment made to net minimum wages for 2016 will have an impact on inflation in coming months.

Measures Taken to Attain the Inflation Target

In order to contain the negative effects of the cumulative Turkish lira depreciation on inflation and inflation expectations, the Central Bank maintained a tight monetary policy stance throughout 2015. To this end, the one-week repo rate, the overnight lending rate and the overnight borrowing rate have been kept unchanged at 7.5, 10.75 and 7.25 percent, respectively, since March 2015. Meanwhile, liquidity policy was tightened and the average funding rate was gradually raised through an increase in the share of marginal funding in total Central Bank funding (Chart 1). The average funding rate, which was set at around 7.8 percent by March 2015, reached nearly 8.9 percent as of January 2016. Moreover, owing to the tight liquidity policy the BIST overnight repo rates hovered near the upper band of the corridor through the entire year. Considering the effects of wage developments and global market uncertainties on inflation expectations and the pricing behavior as well as the volatilities in energy and unprocessed food prices in the upcoming period, the Central Bank will maintain the tight liquidity policy stance as long as deemed necessary.

Chart 1

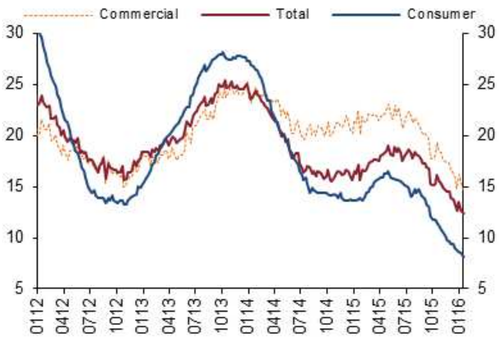
CBRT Rates and BIST Interbank O/N Repo Rates (Percent)



Source: BIST, CBRT.

Chart 2

Annualized Credit Growth Rates (Adjusted for Exchange Rate, 13-Week Moving Average, Percent)



Source: CBRT.

The annual growth rate of loans extended to the non-financial sector, which decelerated partly due to the Central Bank's tight monetary policy stance and the macroprudential measures introduced by the BRSA regarding consumer loans excluding mortgage, fell to 13.6 percent, adjusted for the effects of the exchange rate, in 2015. Commercial loans have been growing at a faster pace than consumer loans since the first quarter of 2014 (Chart 2). These developments in loan growth and loan composition are expected to contribute to the rebalancing process and financial stability as well as to limit the effects of the recent cost pressures on inflation.

Besides interest rate and Turkish lira liquidity policies, the Central Bank continues to use other policy instruments that stabilize foreign exchange liquidity and support financial stability. On the foreign exchange front; in 2015, the amount of FX selling auctions were set more flexibly, reserve option coefficients (ROCs) and remuneration on Turkish lira required reserves were adjusted to inject foreign exchange liquidity into the financial system and the interest rates on FX deposits that the banks can borrow from the Central Bank within their borrowing limits at the FX deposit market were gradually lowered. Moreover, as stated in the road map announced in August, transaction limits for banks at the Central Bank Foreign

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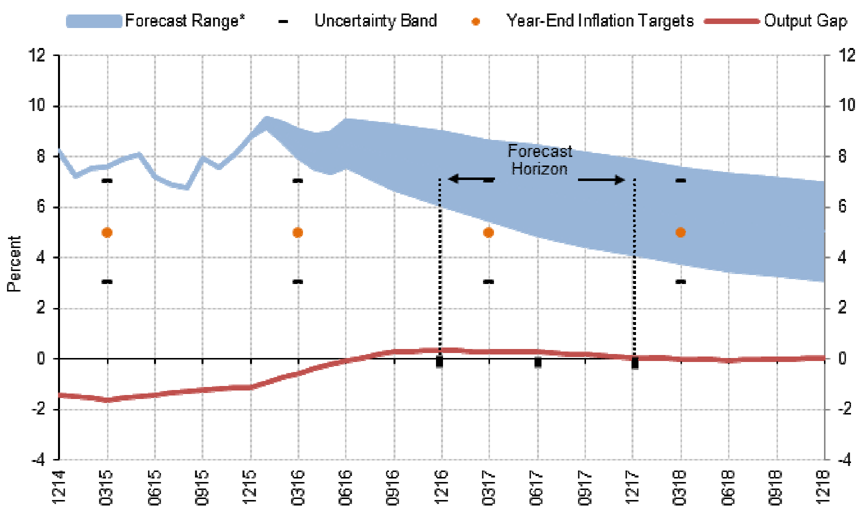
Exchange and Banknotes Markets were raised. Accordingly, the sum of deposit limits allocated to banks and gold and foreign exchange assets held at the Central Bank under the ROM reached a level that is considerably above the external debt payments of banks in one year's time.

With a series of measures since end-2014 with regard to FX required reserves and remuneration rates on Turkish lira required reserves, the Central Bank aimed to support core Turkish lira liabilities and prompt the extension of the maturity of non-core FX liabilities. These measures proved effective in extending the maturity of FX liabilities and suspending the upward trend in the loan to deposit ratio. The road map announced in August features additional measures to be taken in this context. In addition to interest rate and Turkish lira liquidity policies, such policies, which help to stabilize the FX liquidity and support financial stability, will cushion the Turkish economy against possible external shocks, and thus, limit repercussions from any upcoming global uncertainties on inflation and macroeconomic stability to a large extent.

Given a decisive policy stance that focuses on bringing inflation down, the 5-percent target is expected to be achieved gradually; inflation is likely to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017 (Chart 3). The risks to the inflation outlook are analyzed in the January 2016 Inflation Report.

Chart 3
Inflation and Output Gap Forecasts



*Shaded region indicates the 70 percent confidence interval for the forecast.

Conclusion

Notwithstanding the significant external shocks in recent years, the current policy framework limited the worsening in inflation and inflation expectations. Price stability is yet to be achieved. Ten years of experience with inflation targeting has shown that the fight against inflation requires collaboration from all relevant parties. Government income and wage policies as well as structural issues related to food prices are important components in this endeavor. Moreover, macroprudential policies towards prudential borrowing also facilitate the fight against inflation by supporting a balanced growth. Thus, bringing inflation permanently down to the 5-percent target requires all institutions to continue resolutely with the efforts made in recent years.

The Central Bank will continue to do its part to fight against inflation in 2016. Inflation expectations have deteriorated notably in recent months due to minimum wage developments and the high core inflation driven by cumulative exchange rate pass-through effects. The Central Bank monitors the pricing behavior closely and adjusts the degree of tightening within the wide interest rate corridor to contain inflationary pressures. A flexible policy framework, coupled with a variety of instruments enabling a multi-dimensional approach, enhances the effectiveness of monetary policy in an environment of heightened global volatility. Against this backdrop, upside inflationary risks will be monitored carefully in the upcoming period and all policy instruments will be used to bring inflation down in 2016.

The January 2016 Inflation Report, published today on our website, which comprehensively 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 Yörükoğlu
Deputy Governor

Enc: January 2016 Inflation Report