

HEAD OFFICE

ANKARA, 30 January 2020

Please refer to:

TCMB.98422658-

Dr. Berat ALBAYRAK
MINISTER OF TREASURY AND FINANCE
ANKARA

As stipulated in Article 42 of the Central Bank Law No. 1211, if the inflation target is not attained, the Central Bank of the Republic of Turkey (CBRT) is accountable for reporting to the Government and announcing to the public the reasons for the deviation from the inflation target and the necessary measures to be taken. As stated in the main policy document “Monetary and Exchange Rate Policy for 2019”, which was published on 5 December 2018, the inflation target for 2019 was kept at 5% as per the agreement reached with the Government. On the other hand, it was specified that in cases of significant deviations from the inflation target, updated forecasts in Inflation Reports would serve as reference for the path that the inflation would follow while converging to the target over the medium term. Along this path, the first objective is to bring inflation down to single digits, and then gradually reduce inflation further to stabilize it around 5%. In the same document, it was also indicated that the CBRT would write an open letter to the Government should the year-end inflation falls outside the uncertainty band of two percentage points around the target in either direction. The year-end inflation stood above the uncertainty band in 2019. This document elaborates on the reasons for the deviation of inflation from the target and explains the measures already taken, and to be taken, to bring inflation back on track with the target.

Factors Affecting Inflation in 2019

At end-2019, consumer inflation decreased year-on-year by 8.5 points to 11.8%, below the forecast of 14.6% announced at the beginning of the year, but it remained outside the uncertainty band. This was mainly driven by the weakened but persisting lagged effects of the Turkish lira depreciation in 2018 on consumer prices, and by the impact of the elevated level of inflation on wages and prices reflected through the backward-indexation channel. In addition, , administered

price adjustments in the energy group due to cost factors and the withdrawal of tax cuts on durable goods also had an upward effect on inflation. As a matter of fact, despite the curbing effects of the sliding-scale tariff, energy prices increased by 11.0% in 2019 due to price adjustments in electricity and natural gas in the second half of the year.

Food prices constituted another factor causing inflation to remain above the medium-term target. Although unprocessed food inflation decelerated in the second half of the year on the back of favorable supply conditions, annual food inflation was realized as 10.9% by the end of the year due to costs accumulated particularly in the processed food group.

Annual inflation in services, where backward indexation and thus inflation inertia are much stronger, remained elevated due to real unit labor costs, buoyant tourism demand and the course of food prices, ending 2019 at 12.3%. Another upward pressure on consumer inflation was the 43.1% hike in prices of alcoholic beverages and tobacco products. This upsurge contributed 1.8 points to annual inflation.

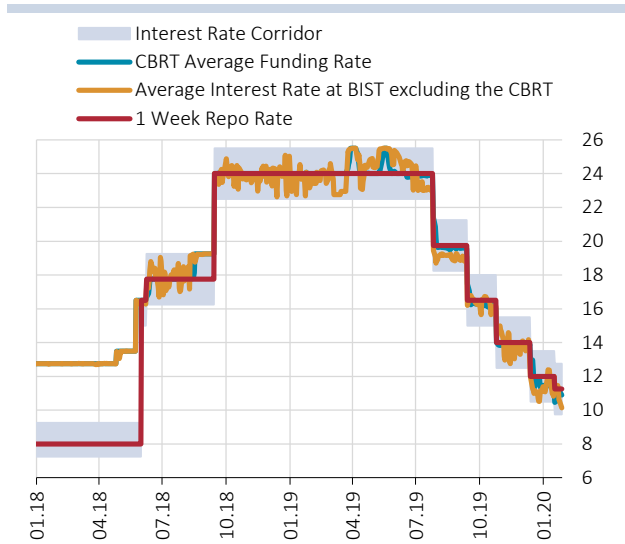
In sum, with stability in Turkish lira, the mild course of domestic demand conditions and import prices, as well as the improvement in inflation expectations, consumer inflation fell sharply in 2019 but was still above the medium-term target.

Measures Taken to Reach the Inflation Target

In 2019, the CBRT determined its monetary stance by taking into account the underlying inflation trend indicators, and set the extent of monetary tightness to ensure that disinflation is sustainable and the actual path of inflation is consistent with the targeted path. Thus, the CBRT's inflation forecasts and the underlying trends implied by these forecasts played an important role in the Bank's decision-making process. In the first half of 2019, the Bank kept the one-week repo rate at 24% and took a number of steps regarding liquidity management. A tight monetary policy stance focused on bringing inflation down and a strong policy coordination brought stability to the Turkish lira. Therefore, the accumulated effects of exchange rates decreased and domestic demand displayed a moderate course, all leading to a significant improvement in inflation dynamics. In view of an improved inflation outlook, the Bank started cutting rates in July, bringing the policy rate gradually down to 11.25% with the 75 basis-point-cut in January 2020 (Chart 1).

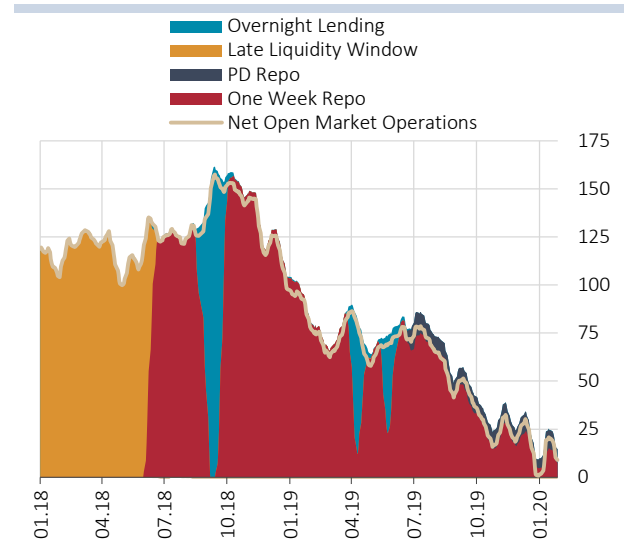
The CBRT continued to broaden its set of tools other than the policy rate, to ensure the effective functioning of markets and the transmission mechanism in the face of financial market volatility and unhealthy price formations. Accordingly, to alleviate the adverse effects of supply and demand imbalances in offshore swap markets in the last week of March, the Bank gradually raised the total limit of outstanding swap transactions (where the CBRT buys FX on spot market and sells FX at maturity) at the Turkish Lira Currency Swap Market. The Bank's swap facilities have been used extensively by banks. In this regard, since the majority of the system's funding need has been met by the CBRT's swap facilities, funding through open market transactions (OMO) has gradually decreased (Chart 2).

Chart 1: Short-Term Interest Rates (%)



Sources: BIST, CBRT.

Chart 2: CBRT Open Market Transactions (2-Week Moving Average, TRY Billion)



Source: CBRT.

In 2019, funding via OMO was mostly done by one-week repo auctions, however these repo auctions were suspended twice over the year due to the developments in the financial markets. The entire CBRT funding was carried out over the CBRT overnight lending rate during these periods, and overnight repo rates at the BIST converged to the upper bound of the CBRT interest rate corridor. To support the Primary Dealership System in view of its contributions to the deepening of financial markets and the effectiveness of monetary policy transmission mechanism, the Primary Dealer (PD) facility that allows banks to obtain liquidity within the framework of the Open Market operations (OMO) was re-introduced on 17 June 2019.

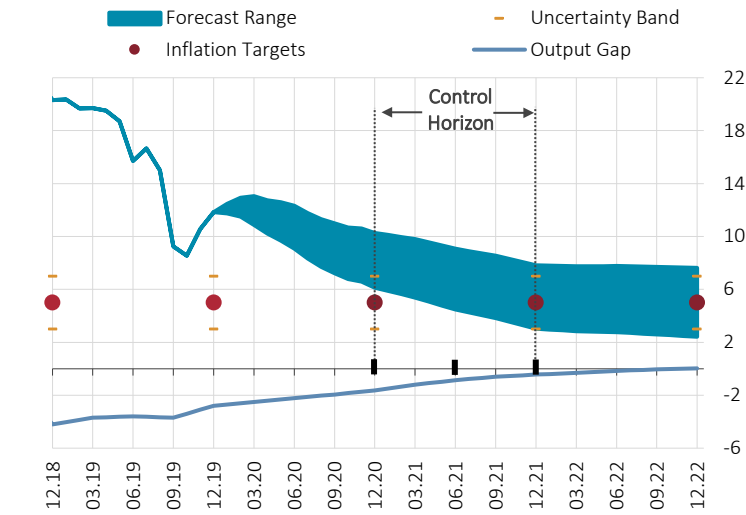
In 2019, occasional fluctuations in financial markets stemming from geopolitical developments waned considerably thanks to the effective use of the CBRT's comprehensive tool set as well as coordinated steps. The country risk premium that receded due to the widespread improvement in inflation expectations, recovering economic activity and global developments brought down long term interest rates. Easing in domestic funding conditions, on the back of improved inflation outlook and policy rate cuts, have been largely transmitted to loan rates.

Inflation outlook continues to improve and inflation expectations sustain their wide-spread decline. The improvement in macroeconomic indicators, inflation in particular, supports the fall in country risk premium and helps contain cost pressures. Developments in the exchange rate, domestic demand conditions and producer prices contribute to a mild trend in core inflation indicators. The course of inflation is considered to be broadly in line with the year-end inflation projection for 2020.

Under a tight monetary policy stance and strong policy coordination focused on bringing inflation down, inflation is projected to converge gradually to the targets. Accordingly, inflation is projected to be 8.2% at the end of 2020 and then fall to 5.4% at the end of 2021, before stabilizing around 5% in the medium-term. Thus, with a 70% probability, inflation is expected to be between 6.2% and 10.2% (with a mid-point of 8.2%) at end-2020 and between 3.0% and 7.8% (with a mid-point of 5.4%) at end-2021 (Chart 3).

In an outlook where global financial conditions will remain mild in 2020 and the recent improvement seen in the country risk premium will continue in the upcoming period, it is expected that financial conditions would support domestic demand and economic activity, but aggregate demand conditions would not be inflationary. Maintaining a sustained disinflation process is a key factor for achieving lower country risk, lower long-term interest rates, and a stronger economic recovery. Strong policy coordination that will help reduce the backward indexation behavior and lower medium-term inflation expectations consistent with the forecasts and targets are key for success in disinflation.

Chart 3: Inflation and Output Gap Forecasts* (%)



Sources: TURKSTAT, CBRT.

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

Conclusion

Consumer inflation, which materialized at 20.3% at end-2018 due to exchange rate developments and the deterioration in pricing behavior, declined by 8.5 points to 11.8% in 2019. In addition to the monetary policy actions, the economic program focusing on macroeconomic rebalancing contributed to the significant improvement in the underlying trend of inflation, expectations and pricing behavior.

The downtrend in the medium-term inflation expectations continues to be widespread and the distribution of expectations implies an increased consensus among survey participants, which indicates that uncertainties regarding the medium-term inflation outlook have significantly decreased. Nevertheless, medium-term inflation expectations still hover above the medium-term target and keep risks to price stability alive.

Keeping the disinflation process on track with the targeted path requires the continuation of a cautious monetary stance. In this respect, monetary stance will be determined by considering the indicators of the underlying inflation trend to ensure the continuation of the disinflation process. The CBRT will continue to use all available instruments in pursuit of the price stability and financial stability objectives.

To support the effectiveness of the monetary policy and minimize the inflation-growth trade-off, it is crucial that macro-financial policies focus on reducing the risk premiums and further improving the predictability of the macro policy outlook. A resolute continuation of the coordination between monetary and fiscal policies will contribute to achieving price stability and financial stability objectives. Accordingly, it is anticipated that the confidence channel and the credit channel will support the economic recovery, while inflation will remain on track with the targeted path in the upcoming period.

Continued structural steps focusing on reducing rigidity and volatility in inflation will contribute to price stability and therefore social welfare. In this context, the CBRT will maintain its efforts to analyze structural factors, develop policy recommendations and raise awareness of the importance of disinflation among related stakeholders and the public.

The January 2020 Inflation Report, published today on our website, is enclosed for your information to provide a comprehensive account of the developments regarding inflation and monetary policy as well as our medium-term forecasts.

Yours sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Murat Uysal
Governor

Dr. Uğur Namık Küçük
Deputy Governor

Enc: January 2020 Inflation Report