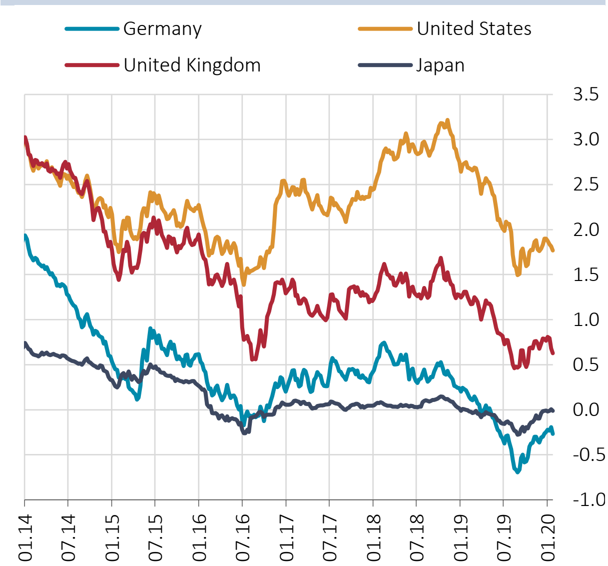
1. Overview

Global growth remained sluggish across both advanced and emerging economies in the fourth quarter of 2019 while uncertainties over global economic policies still remain elevated despite easing to some extent recently. Progress toward resolving the US-China trade dispute, reduced Brexit uncertainty and global monetary policies supporting growth improved the expectations for global economic activity. However, aggravated geopolitical tensions in the Middle East and North Africa as of January, the outbreak of social disturbances in some emerging economies (EMEs), the severe drought in the southern hemisphere and the recent outbreak of an epidemic in China pose downside risk to global economic activity. Thus, while advanced economies are expected to see a modest pickup in growth over the upcoming period, country-specific fragilities will remain a downside risk to the growth outlook for EMEs.

Risks to global inflation are balanced. Fading global economic uncertainty might put upward pressure on global headline inflation through commodity prices and on core inflation through growth. Tightening labor markets in the US and the euro area also pose an upside risk to core inflation. On the other hand, still-high global uncertainty and renewed geopolitical tensions feed into downside risks to global economic activity. Although geopolitical developments pushed oil price volatility higher, oil production forecasts signal that there are both upside and downside risks to prices.

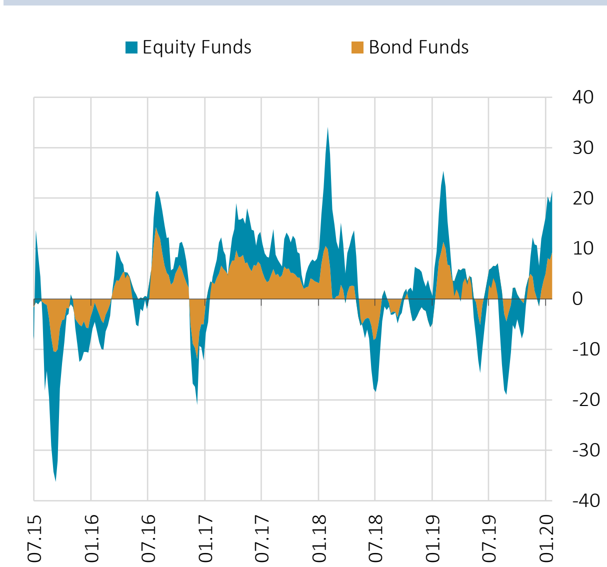
Current global financial conditions and the recent partial improvement in expectations regarding global trade support the demand for emerging market assets and the risk appetite. Long-term bond yields were slightly higher for advanced economies in the fourth quarter of 2019 (Chart 1.1). However, muted global inflation reinforces expectations for monetary policies to support growth. Accordingly, portfolio flows to EMEs have seen some recovery, in particular to equity markets (Chart 1.2). Prolonged high global uncertainty suggests that uncertainty will remain the major downside risk to global growth. Therefore, country-specific factors still play a significant role for portfolio flows to EMEs.

Chart 1.1: 10-Year Bond Yields (%)



Source: Bloomberg.

Chart 1.2: Weekly Portfolio Flows to Emerging Economies (USD Billion, 4-Week Cumulative)



Source: EPFR.

Turkey’s risk premium continues to decline while the support of the credit channel to growth has strengthened. Domestic funding conditions eased amid an improving inflation outlook and policy rate cuts, which led to a significant fall in commercial and consumer loan rates. With loan rates decreasing and domestic demand recovering, loan growth has remained buoyant since the third quarter.

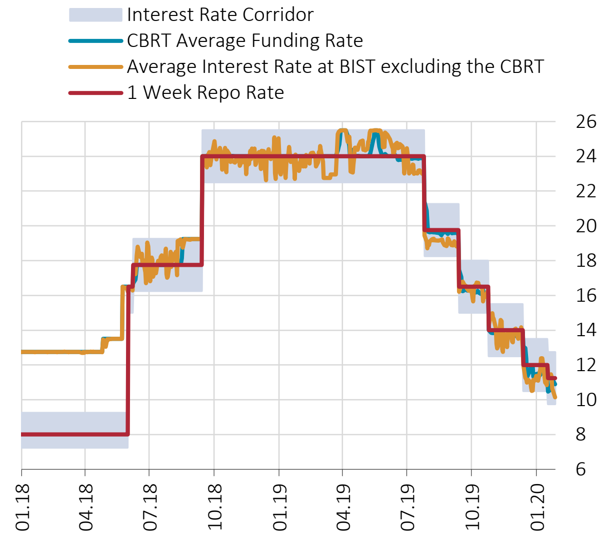
Having fallen to single digits in September and October, consumer inflation went up in the last two months due to the low base effect from the previous year. Accordingly, consumer inflation was up 2.58 points relative to the end of the previous quarter to 11.84% at the end of 2019, undershooting the October Inflation Report forecast. Indicators regarding the trend and pricing behavior suggest that the underlying trend of inflation remained moderate in the fourth quarter. The widespread improvement in inflation expectations and the increased consensus among survey participants indicate that uncertainties regarding the medium-term inflation outlook have significantly decreased.

Economic activity continues to recover. Domestic demand was the main driver of growth partly due to the improvement in financial conditions in the third quarter. Fourth-quarter data indicate that economic activity strengthened on the back of domestic demand, and the sectoral diffusion of economic recovery continues to improve. Against this background, nonfarm employment rose and unemployment rates went down from recent high levels. While investment remained weak in the third quarter, recent data signal improvement in investment tendency. Economic activity is expected to strengthen further in 2020 while global economic uncertainty remains a downside risk to growth through capital flows, international trade and commodity prices.

1.1 Monetary Policy and Financial Markets

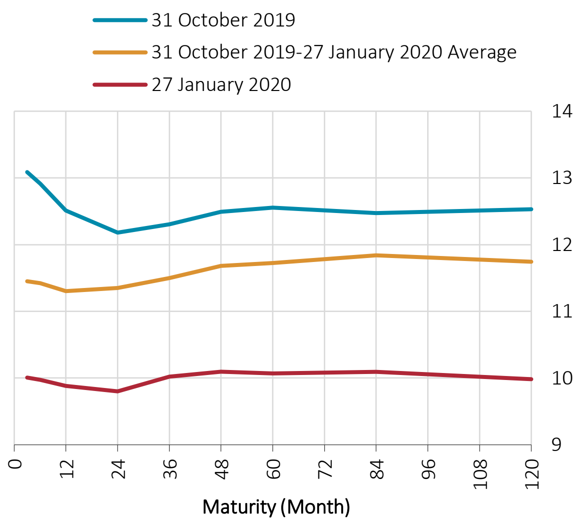
The rate cuts that started in mid-2019 continued into January. Throughout 2019, the CBRT based its monetary stance on the underlying trend of inflation to ensure the continuation of the disinflation process. The Bank kept its policy rate constant in the first half of 2019. The tight monetary stance and the strong policy coordination translated into a better inflation outlook and improved inflation expectations in the second half. This improvement paved the way for strong rate cuts, a total of 1,200 basis points, between July and December. In January, the Bank set its policy rate to 11.25% by a measured 75 basis points cut (Chart 1.1.1). These rate cuts, along with lower inflation expectations and the reduced risk premium, shifted the Turkish lira yield curve down (Chart 1.1.2).

Chart 1.1.1: CBRT Rates and Short-Term Interest Rates (%)



Sources: BIST, CBRT.

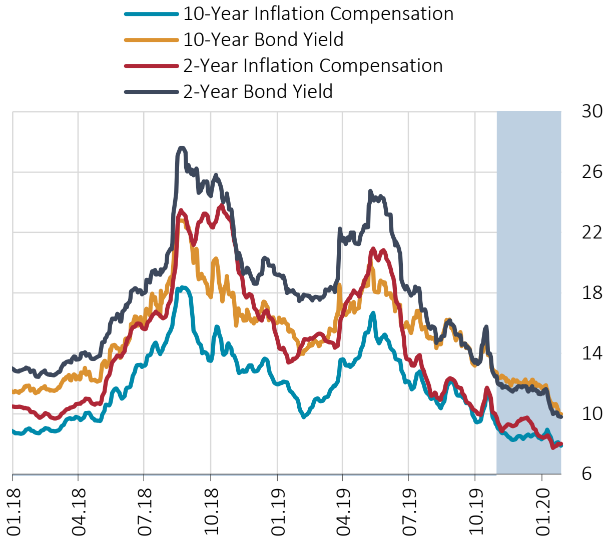
Chart 1.1.2: GDDS Yield Curve (%)



Source: Bloomberg.

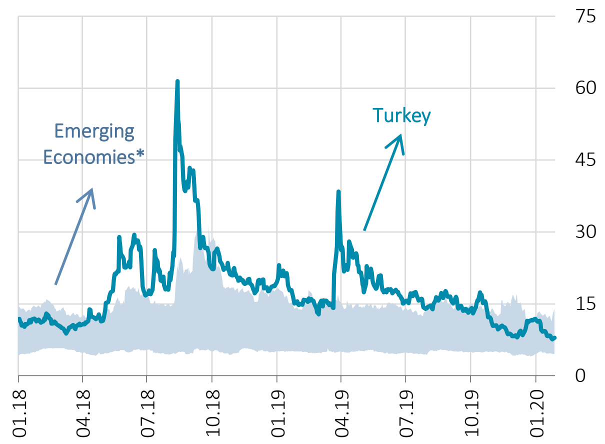
As long-term interest rates continue to decline, short-term exchange rate volatility has fallen to a relatively lower level. Having declined due to widespread improvement in inflation expectations as well as global developments and the recovery in economic activity, Turkey's risk premium helped bring long-term interest rates down. (Chart 1.1.3).[1] The one-month implied volatility of the Turkish lira moved down to rank in the middle among emerging economies (Chart 1.1.4).

Chart 1.1.3: Bond Yields (%) **and Inflation Compensation** (5-Day Moving Average, %)



Source: Bloomberg.

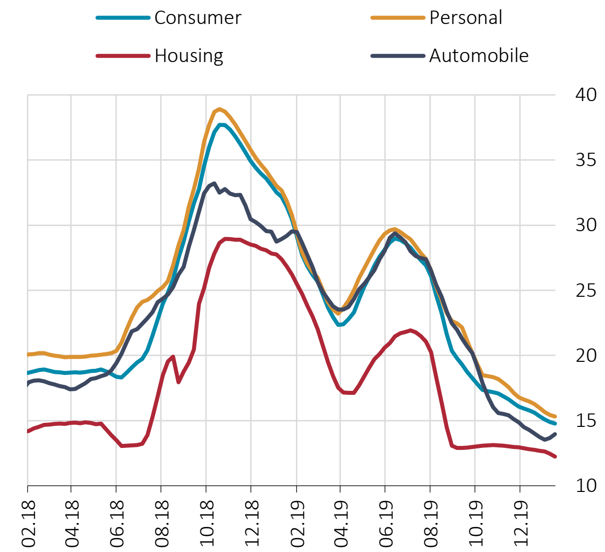
Chart 1.1.4: Implied FX Volatility (1-Month)



Source: Bloomberg.
* Emerging economies include Brazil, Indonesia, the Philippines, South Africa, Colombia, Hungary, Malaysia, Mexico, Poland, Romania and Chile.

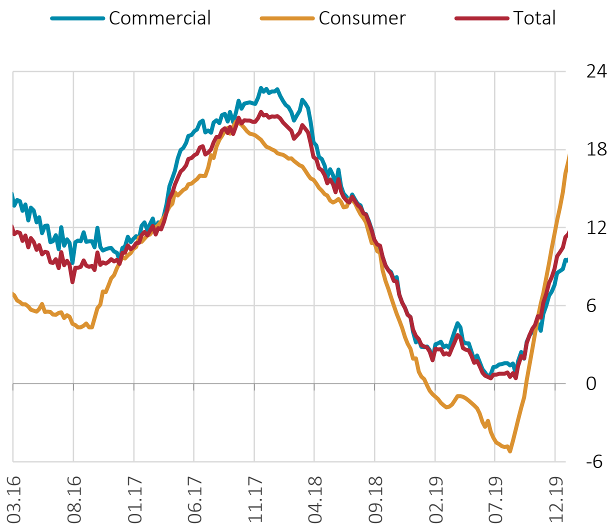
The credit channel supports the recovery in economic activity. Loan rates declined significantly on the back of easing domestic funding conditions, and annual loan growth strengthened (Chart 1.1.5 and Chart 1.1.6). The CBRT's actions regarding the required reserves, and low-rate housing and personal loan campaigns led by state banks also contributed to the rebound in loans.

Chart 1.1.5: Consumer Loan Rates (Flow Data, Annual Interest Rate, 4-Week Moving Average, %)



Source: CBRT.

Chart 1.1.6: Annual Loan Growth (Adjusted for Exchange Rates, Annual % Change)



Source: CBRT.

[1] Box 5.1 presents a more detailed analysis of the sources of the decline in the country risk premium.

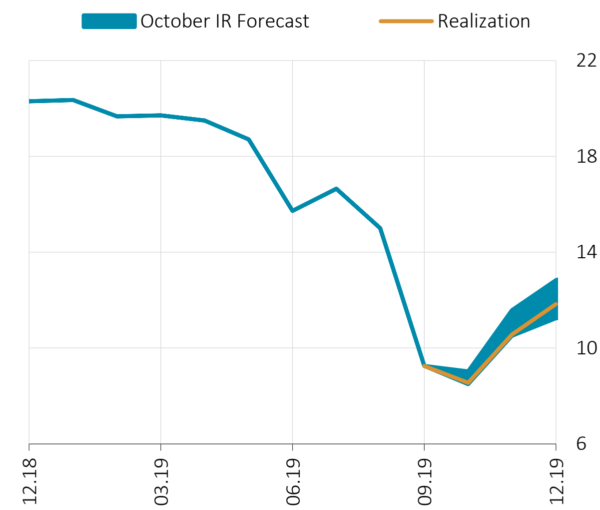
1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation increased by 2.58 points relative to the end of the previous quarter to 11.84% in the final quarter of 2019, closing the year below the level projected in the October Inflation Report (Chart 1.2.1). Thus, compared to end-2018, inflation decelerated by 8.5 points in 2019 mainly due to the waning cumulative exchange rate effects. Demand conditions, unprocessed food prices, and import prices stood as the other factors that underpinned the disinflation process. In this period, the annual inflation of the core indicator B index was also slightly lower than projected (Chart 1.2.2).

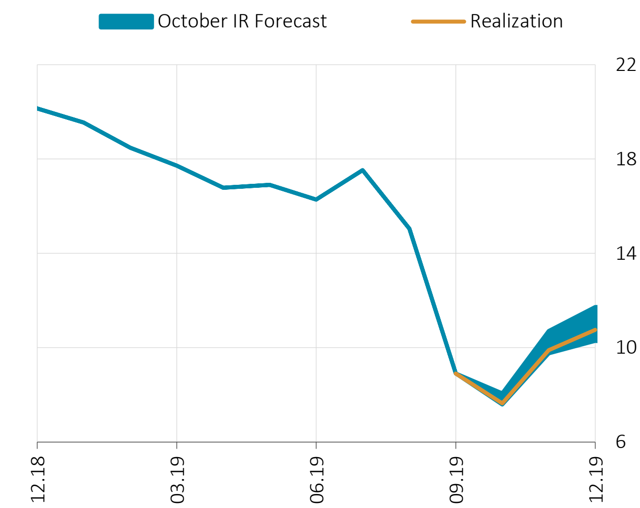
In the final quarter of the year, while the Turkish lira followed a relatively moderate course, import prices in USD declined, and domestic demand conditions were mild, both consumer inflation and the annual inflation of core indicators increased due to the increase in international oil prices and the low base effect in the same period of the previous year. The rise in inflation was more evident in core goods and energy groups in which the base effect was stronger. While food inflation was driven up by the unprocessed food group, services inflation remained almost flat (Chart 1.2.3).

Chart 1.2.1: October Inflation Forecast and Actual Inflation* (%)



Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

Chart 1.2.2: October Forecast and Actual Rates for Inflation Excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold (B Index)* (%)

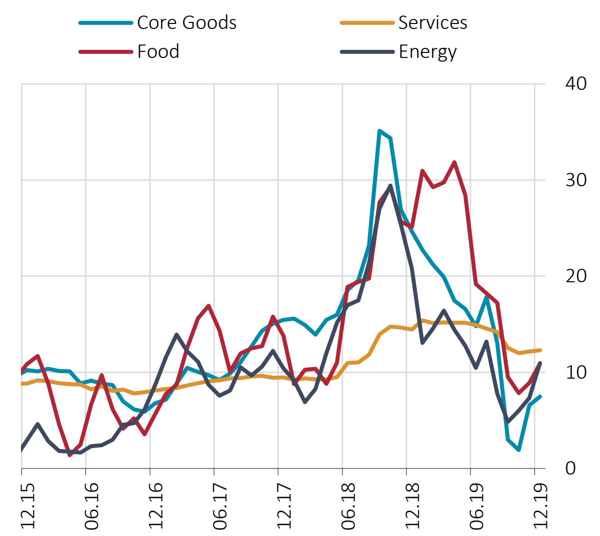


Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

The improvement in inflation expectations continues to be widespread while the distribution of expectations implies an increased consensus around the mean expectation, which indicates that the uncertainty regarding medium-term inflation has significantly decreased. Developments in the exchange rate, domestic demand conditions and producer prices contributed to a mild trend in core inflation indicators in the final quarter of the year. Other indicators of inflation trend and pricing behavior also supported this mild trend (Chart 1.2.4).

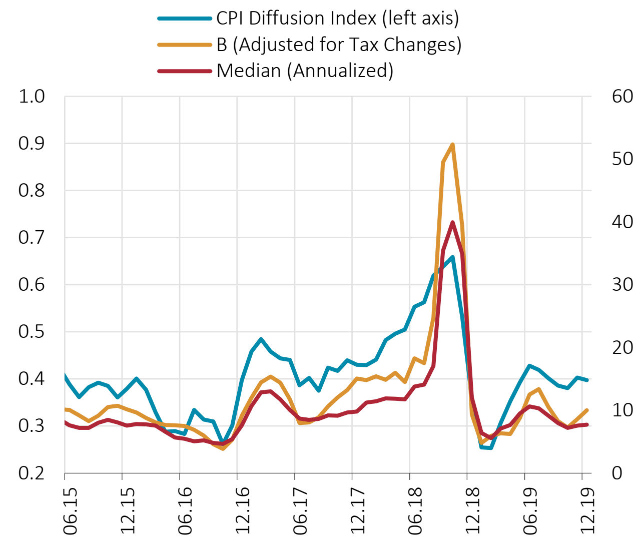
The trend of inflation is projected to increase somewhat in the first months of the year depending on cost factor developments. Inflation is expected to be contained by VAT rate cuts in certain products and by specific taxes on alcohol-tobacco products being kept constant for the first six months of 2020. On the other hand, the effects of the minimum wage hike on inflation via the real unit labor cost channel are closely monitored.

Chart 1.2.3: CPI Sub-Groups (Annual % Change)



Sources: TURKSTAT.

Chart 1.2.4: CPI Diffusion Index, B Index and Median Inflation * (Seasonally-Adjusted, 3-Month Average)



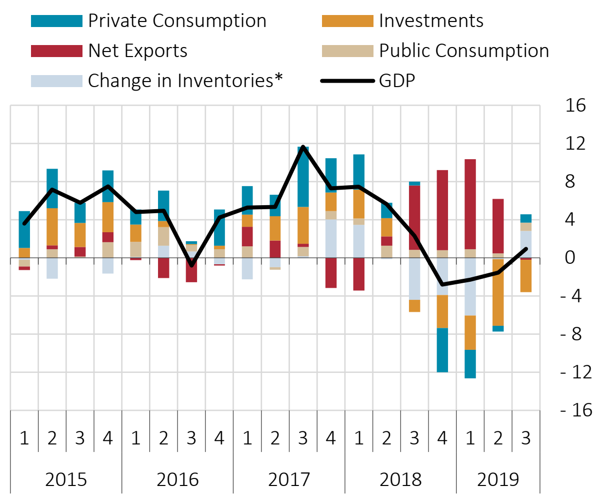
Sources: CBRT, TURKSTAT.

* Diffusion Index: Ratio of the number of items with increasing prices minus the number of items with decreasing prices to total number of items within a given month.
Median inflation: Median monthly inflation of seasonally-adjusted 5-digit sub-price indices.
B Index: Seasonally adjusted, annualized, 3-month average % change

Supply and Demand

Economic activity continued to post a recovery in the third quarter of 2019 as projected in the October Inflation Report. In this period, gross domestic product (GDP) increased by 0.4% quarter-on-quarter in seasonally and calendar-adjusted terms and by 0.9% year-on-year. Underpinned by the improvement in financial conditions, domestic demand stood as the main driver of growth in the third quarter (Chart 1.2.5). While consumption expenditures continued to increase, the downtrend in total investments halted but the weak level was maintained. Notwithstanding the continued rise in exports, net exports negatively contributed to annual and quarterly growth for the first time in a long while, due to the rise in imports induced by the recovery in domestic demand.

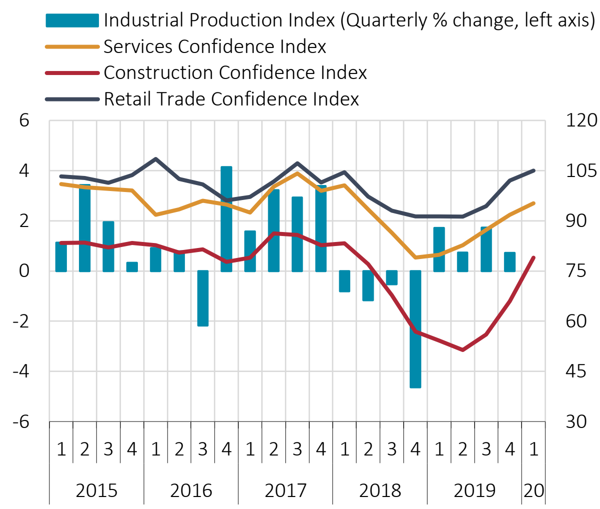
Chart 1.2.5: Contributions to Annual GDP Growth by Expenditures (% Points)



Sources: CBRT, TURKSTAT.

* Includes inventories and statistical discrepancy caused by chain-linking.

Chart 1.2.6: Industrial Production Index and Sectoral Confidence Indices* (Seasonally-Adjusted)



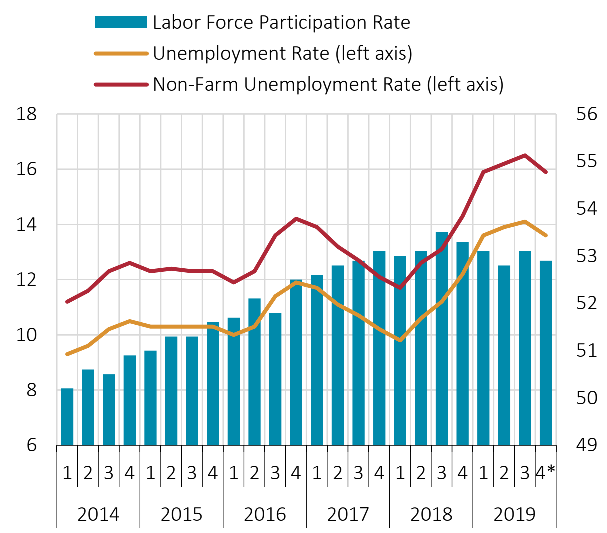
Source: TURKSTAT.

* Last observation is November 2019 for the Industrial production, and January 2020 for confidence indices.

In the final quarter of the year, economic activity strengthened and the improvement in the sectoral diffusion of recovery continued (Chart 1.2.6). The decline in risk premium, exchange rate volatility and uncertainties as well as the improvement in financial conditions supported domestic demand considerably in this period. In addition, public expenditures continued to support growth through the consumption channel. With the strengthened recovery, nonfarm employment increased, including the construction sector as well, and unemployment rates declined (Chart 1.2.7). Despite the weakening global growth outlook, improved competitiveness, flexibility in market diversification and the strong course in tourism supported the growth in exports of goods and services. However, as imports continue to increase on the back of the recovery in domestic demand, net exports are expected to contribute negatively to growth also in the final quarter. Based on this outlook, the annualized current account balance is also decreasing (Chart 1.2.8).

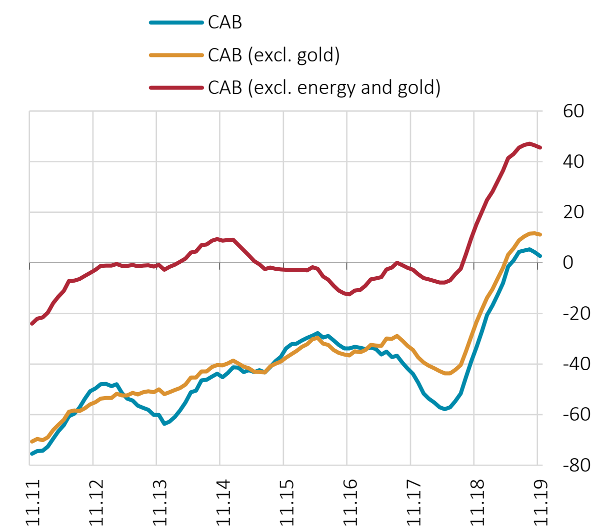
With the improvement in financial conditions, economic activity is projected to continue converging to its potential level in 2020. Considering the current levels of output gap, it is estimated that aggregate demand conditions will not be inflationary under the projected recovery trend. It is also projected that domestic demand will gradually strengthen on the back of the improvement in investment and employment tendency, and net exports will negatively contribute to annual growth in 2020 due to the recovery in import demand that will be brought about by the change in the composition of growth. Against this background, in the last quarter of the year, it is expected that the current account balance, which has recently recorded a significant improvement, will maintain a moderate course with the contribution of supportive policy measures. Geopolitical developments and persisting uncertainties regarding the global economic activity outlook keep the downside risks to growth alive via both the capital flows and foreign trade channels.

Chart 1.2.7: Unemployment Rates (Seasonally-Adjusted, %)



Source: TURKSTAT.
* October period.

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



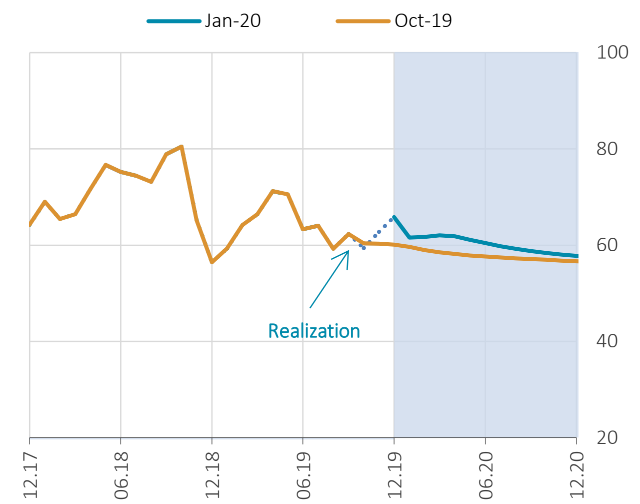
Source: CBRT.

Oil, Import and Food Prices

While the international crude oil prices remained above the assumptions of the October Inflation Report, USD-denominated import prices were consistent with projections. Although the weak course of global growth coupled with the projections that oil production will remain robust has driven down oil prices, geopolitical developments increase volatility and keep the upside risks alive. Accordingly, the average crude oil price assumption, which was 57.7 USD/bbl for 2020 in the October Inflation Report, was increased to 60 USD/bbl (Chart 1.2.9). Similarly, the assumption for the average annual rate of increase in USD-denominated import prices for 2020 was revised upwards to a limited extent (Chart 1.2.10).

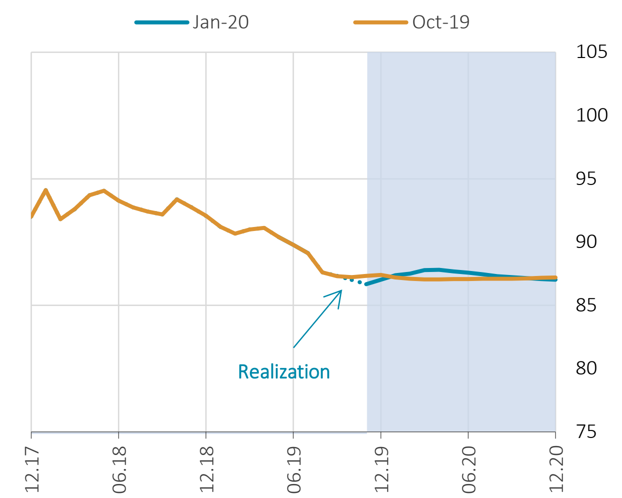
Another exogenous variable on which the medium-term projections are based is unprocessed food prices. Annual inflation in the food and non-alcoholic beverages group increased in the last quarter and hit 10.89% at the year-end, slightly higher than the projections of the October Inflation Report. The year-end food inflation forecast, which was 11% in that Report, was left unchanged for 2020.

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



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

Chart 1.2.10: Revisions to Import Price Assumptions* (Index, 2010=100)



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

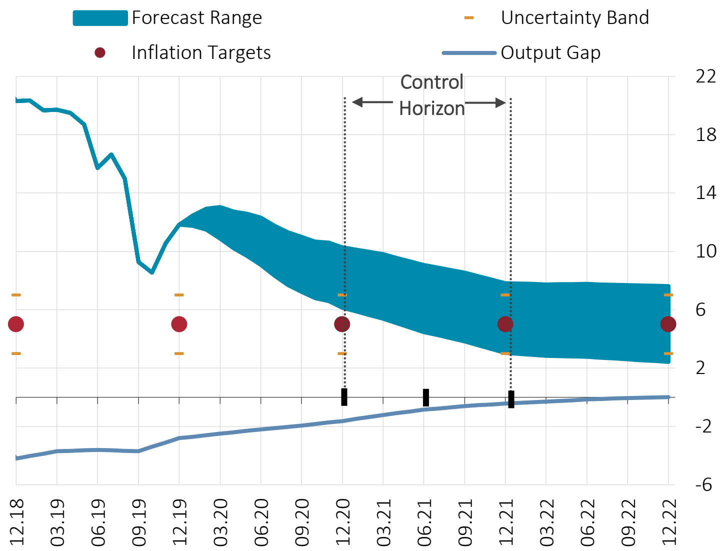
Fiscal Policy, Administered Prices and Tax Adjustments

Medium-term projections are based on an outlook where macroeconomic policies are determined with a medium-term perspective and in a coordinated manner, with a focus on bringing inflation down. In this context, the current projections are based on the assumption that fiscal policy will continue to contribute to macroeconomic rebalancing and that administered prices and wages will be largely set to support disinflation, as laid out in the New Economy Program (NEP). The strong policy coordination that prioritizes sustained disinflation is critical to continued improvement in the risk premium and perceptions of uncertainty.

1.3 Inflation and the Monetary Policy Outlook

Under a tight monetary policy stance and a 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 fall to 5.4% at the end of 2021, before stabilizing around 5% over the medium term. 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 1.3.1).

Chart 1.3.1: Inflation and Output Gap Forecasts*



Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

Inflation developments after the October Inflation Report were consistent with projections. Within the framework that monetary policy stance and macro policy coordination focuses on maintaining the sustained disinflation process, inflation projections for 2020 and 2021 were kept unchanged.

The inflation forecast for end-2020 was held constant at 8.2 percent. The effect of the increase in the oil price assumption on inflation is limited, due to the support from the sliding-scale tariff in fuel products, and calculated to be 0.1 point. The output gap, which is expected to be slightly higher than the forecasts of the previous Report, and the increase in real unit labor costs add 0.1 and 0.2 points, respectively, to the consumer inflation forecast. On the other hand, the realization at the end of the last quarter of 2019 and the expected improvement in the underlying trend of inflation are estimated to bring inflation down by 0.2 points in the upcoming period. Moreover, tax adjustments in furniture, alcoholic beverages and tobacco along with some food products are estimated to bring down inflation by 0.2 points.

The inflation forecast for 2021 was kept unchanged at 5.4%. The disinflation process is expected to continue on the back of sustained caution in monetary stance as well as the improvement in expectations.

The above-mentioned forecasts are based on a framework in which global financial conditions will follow a moderate course and the recent gradual improvement in the country risk premium will continue into the upcoming period. The sluggish global economic activity and the low global inflation rate strengthen the expectations that the recent accommodative stance of major central banks will be preserved in the medium term under current circumstances. Projections rely on an outlook in which the monetary stance will be determined in a way to ensure that the ongoing disinflation is consistent with the targeted path. Additionally, it is assumed that the fiscal policy stance will be determined in coordination with monetary policy with a focus on price stability and balanced growth.

Despite the geopolitical developments since the previous Report, further improvement in the country risk premium and the outlook for global financial conditions have curbed the volatility in financial markets. Against this backdrop, adjustments in reserve requirements, the improvement in the banking sector liquidity and other supportive measures provided a boost to loan supply. Meanwhile, notable rate cuts since July have also helped to buoy the loan demand, which have led to further loan growth. The current improvement in financial conditions supports the gradual recovery in domestic demand. Accordingly, aggregate demand conditions are expected to be non-inflationary.

Maintaining a sustained disinflation process is critical to achieving lower country risk premium, lower long-term interest rates, and a stronger economic recovery. Stronger policy coordination towards disinflation that will help reduce the backward indexation behavior and lower medium-term inflation expectations consistent with forecasts and targets is key for success in disinflation.

1.4 Key Risks to Inflation Forecasts and the Likely Monetary Policy Response

The outlook underlying the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions. The major upward and downward macroeconomic risks that may lead to a change in the baseline projections and the associated monetary policy stance are as follows:[2]

- Possible fluctuations in the country risk premium due to global and geopolitical developments,
- Medium-term inflation expectations that still hover above the target despite the improvement,
- Risks to the coordination between monetary and fiscal policies (fiscal stance, administered prices, wage and tax adjustments),
- Risks to the credit market,
- Uncertainty over the global trade and growth outlook,
- Uncertainty over the evolution of capital flows to emerging market economies,
- Volatility in crude oil and import prices.

Turkey's risk premium continued to decline owing to the cautious monetary policy stance, improved macroeconomic indicators and the accommodative monetary policies in advanced economies. However, upside risks regarding global and geopolitical uncertainties on the medium-term inflation outlook through country risk premium and exchange rate volatility channels will continue to be monitored closely. If financial volatilities elevate to a level that may pose risks to price and financial stability, an appropriate policy response will be given using the comprehensive tool set for the TL and FX liquidity management. Determining the monetary policy stance to keep the disinflation process on track with the targeted path is of great importance for a sustained improvement in the sovereign risk premium and the exchange rate volatility. In order to enhance the effectiveness of the monetary policy and to minimize a likely inflation-growth trade-off, it is crucial that macro-financial policies are determined with a focus on reducing financial volatility and the risk premium, and that predictability of the fiscal policy continues to be reinforced.

The downtrend in medium-term inflation expectations continues to be widespread, the distribution of expectations implies an increased consensus among survey participants, which indicates that uncertainties regarding the medium-term inflation outlook have considerably declined. However, medium-term inflation expectations still hover above the inflation target, continuing to pose an upside risk to the medium-term inflation outlook. In order to anchor expectations, it is critical to determine the monetary policy stance to keep the disinflation process on track with the targeted path.

Medium-term projections rely on an outlook where the fiscal policy is formulated in coordination with the monetary policy focusing on the price stability and macroeconomic balancing. Accordingly, it is assumed that the administered price, wage and tax adjustments are formulated in a way that will help to reduce the backward indexation behavior. In case the fiscal policy significantly deviates from the explained framework leading to an adverse impact on the medium-term inflation outlook, the monetary policy stance may be revised.

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[2] Evaluations of how and through which channel these risks may affect the inflation forecasts cited in the previous section are summarized in Table 7.3.1. in Chapter 7.

Loan and deposit rates continued to decline due to the CBRT's notable policy rate cuts since July as well as the improvement in inflation expectations and financial sector's liquidity. The TL-denominated loan growth, consumer loans in particular, remained on the rise thanks to improved financing conditions and recovering domestic demand. The more flexible and effective use of required reserves as a countercyclical financial policy tool in this period supports credit growth. Moreover, the aim of the reserve requirement practices is to encourage the use of long-term commercial loans that have a stronger relation with investment and of long-term mortgage loans that have a weaker relation with imports, thereby achieving a credit growth composition that would pose smaller risk to inflation and the current account balance. In case banks' risk perceptions lead them to a credit composition more significantly tilted towards consumer loans than envisaged in the baseline scenario, current regulations may need to be revised according to their impact on the composition of growth, inflation, current account balance and risk premium.

Although the current monetary stance is likely to further underpin the normalization in credit demand and credit supply conditions, there are some downside risks to the credit market in the upcoming period. While there is an apparent preference for the Turkish lira in loans, a slower shift of preference towards Turkish lira deposits against FX deposits may tighten credit supply conditions and curb loan growth in case of increased financial fluctuations driven by the global risk appetite or geopolitical developments. Moreover, despite the improvement in the outlook of non-performing and Stage 2 loans, the relevant developments in these type of loans will continue to be monitored for any impact they might have on credit supply. The pace, scope and sustainability of normalization in credit supply and demand remain important for the economic activity outlook.

Global economic activity remains sluggish in both advanced and emerging economies. Expectations regarding the global trade improved partially following the first phase trade deal between the US and China. However, several issues, along with uncertainties over whether mutual commitments would be delivered, remain to be solved, which keeps the downside risks of trade conflicts to global economic activity alive. Likely effects of other uncertainties regarding global economic policies, geopolitical developments, and increased concerns surrounding the recent epidemic in China on domestic economic growth and inflation through the foreign trade, capital flows and commodity prices channels are monitored closely.

Current global financial conditions and the recent partial improvement in expectations regarding global trade support capital flows towards emerging economies. Nevertheless, downside risks to global growth, uncertainties over global economic policies, geopolitical developments and vulnerabilities peculiar to emerging economies may curb the recent acceleration in capital flows.

Crude oil prices followed a volatile course due to recent geopolitical developments and news flow about the recent epidemic. The sliding-scale tariff in fuel prices has alleviated the effect of the recent oil price hike on inflation. Additionally, the weak global economic activity contains a further rise in commodity prices. The course of crude oil and other commodity prices in the upcoming period will continue to depend on the global growth outlook, news flow about the recent epidemic and geopolitical developments. Therefore, volatilities in commodity prices keep both downside and upside risks to inflation alive. Against this background, the monetary policy response will be determined in a way to keep the likely impacts of energy and commodity prices-driven risks on inflation expectations and pricing behavior under control.