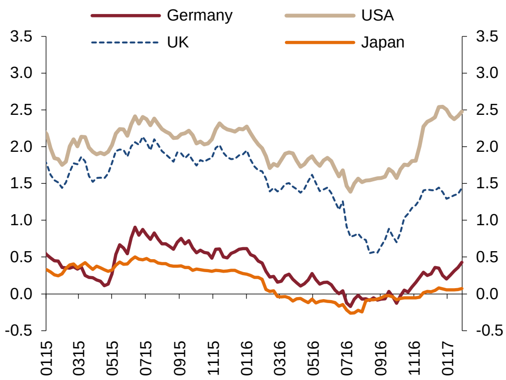
1. Overview

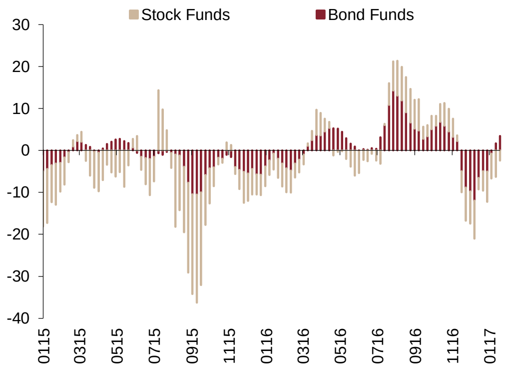
Global economic uncertainty intensified following the US presidential election in November 2016, fostering prospects for accelerated growth in the US amid accommodative fiscal policies and increasing the possibility of a more aggressive Fed monetary tightening. Accordingly, interest rates in advanced economies surged in the fourth quarter and the US dollar appreciated (Chart 1.1). These developments directed capital away from emerging markets into advanced economies as of November (Chart 1.2).

Chart 1.1.
10-Year Treasury Bond Yields
(Percent)



Source: Bloomberg.

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



Source: EPFR.

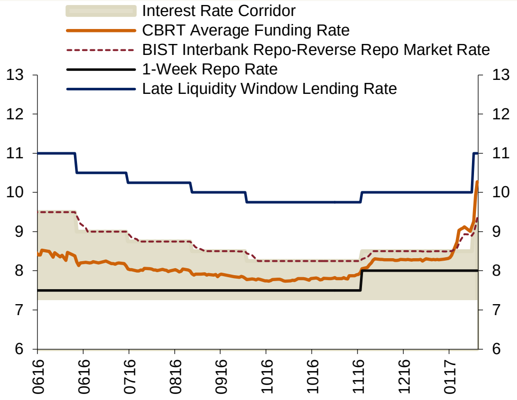
In addition to the volatility in global markets, both geopolitical tensions and domestic uncertainties sent domestic financial markets into a spin over the fourth quarter of 2016, causing exchange rate and market rates in Turkey to be affected more adversely compared to other emerging economies. In this period, all emerging markets, including Turkey, experienced portfolio outflows, which were more pronounced for bond markets than for stock markets. Credit use has shown some improvement thanks to macroprudential policies that support the financial system, the lagged effects of the CBRT's liquidity measures and public incentives. In the fourth quarter of 2016, loan growth remained on a moderate uptrend on the back of the recovery in consumer loans and TL commercial loans. Moreover, due to the government's loan program for businesses, interest rates on commercial loans to SMEs are on the decline.

Consumer inflation picked up from the previous quarter and ended the year at 8.53 percent amid the depreciation in the Turkish lira, tax adjustments and the partial increase in food prices. Economic activity posted a quarterly decline in the third quarter, as predicted in the October Inflation Report, while current indicators signal a modest recovery in the underlying trend for the fourth quarter. Domestic demand remained relatively subdued but the growing EU demand continues to stimulate exports. Thanks to accommodative measures and incentives, economic activity is likely to remain on a moderate upward track. Lastly, commodity prices are expected to have a gradually lessening positive effect on the current account in the upcoming period. However, the current account balance will continue to improve with the recovery in the net exports of goods.

1.1. Monetary Policy and Financial Conditions

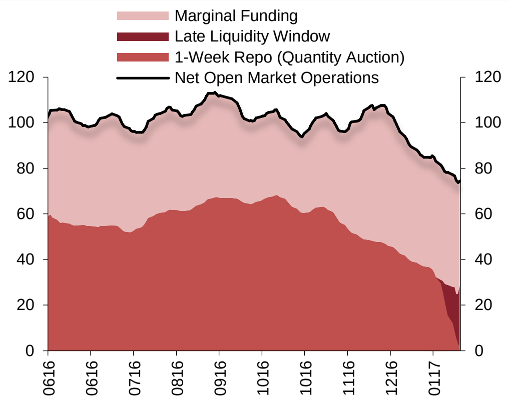
To contain the negative effects of global and domestic financial market volatilities on exchange rates and lending standards, the CBRT maintained a stabilizing stance for FX liquidity and a supportive stance for financial stability in the final quarter of 2016. Moreover, in order to restrict the adverse impact of exchange rate developments spurred by heightened global uncertainty and volatility on inflation expectations and the pricing behavior, the CBRT opted for some monetary tightening in November and raised the marginal funding rate and the 1-week repo rate by 25 and 50 basis points, respectively (Chart 1.1.1). In December, interest rates were kept unchanged to monitor the stabilizing effects of aggregate demand on upside risks to inflation due to exchange rate developments and rising oil prices.

Chart 1.1.1.
CBRT Policy Rates and BIST Interbank Repo-Reverse Repo Market Rate (Percent)



Source: BIST, CBRT.

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



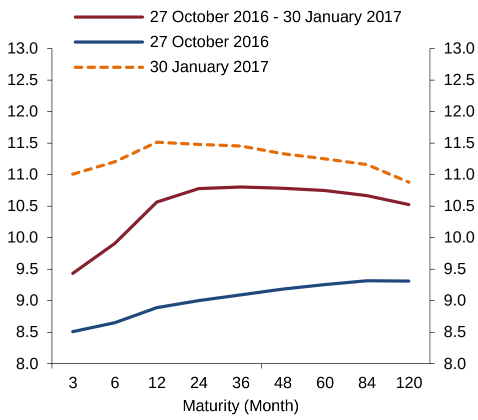
* Marginal funding is overnight funding quoted at the upper band of the interest rate corridor.
Source: CBRT.

The CBRT adopted a series of liquidity measures in January, particularly against the excessive volatility in the foreign exchange market. Accordingly, 1-week repo auctions have been suspended as of 12 January 2017. Given restrictions on marginal funding, a part of the net funding need of the system has been provided through the late liquidity window as of 16 January on any day deemed necessary (Chart 1.1.2). This in turn led to a rise in the CBRT average funding rate and the BIST Repo-Reverse Repo Market rate (Chart 1.1.1). Furthermore, with the aim of enhancing flexibility and instrument diversity of the TL and FX liquidity management, Foreign Exchange Deposits against Turkish Lira Deposits Market has been put in place. At the MPC meeting on 24 January, the CBRT decided to tighten the monetary policy further in order to contain the deterioration in the inflation outlook driven by the excessive fluctuations in exchange rates. Thus, the marginal funding rate and the late liquidity window lending rate were hiked by 75 and 100 basis points to 9.25 and 11 percent, respectively.

The CBRT will continue to use all available instruments in pursuit of the price stability objective. Future monetary policy decisions will be conditional on the inflation outlook. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered, if needed. Moreover, necessary liquidity measures will be taken in case of speculative pricing in the foreign exchange market that cannot be justified by economic fundamentals.

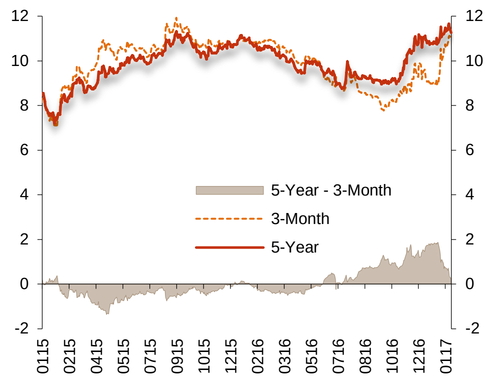
Although the yield curve shifted upwards in all maturities from the previous reporting period amid mounting global, geopolitical and domestic uncertainties and higher inflation expectations, it has also became flatter due to the recent monetary tightening (Charts 1.1.3 and 1.1.4).

Chart 1.1.3.
Yield Curve on Currency Swaps
(Percent)



Source: Bloomberg.

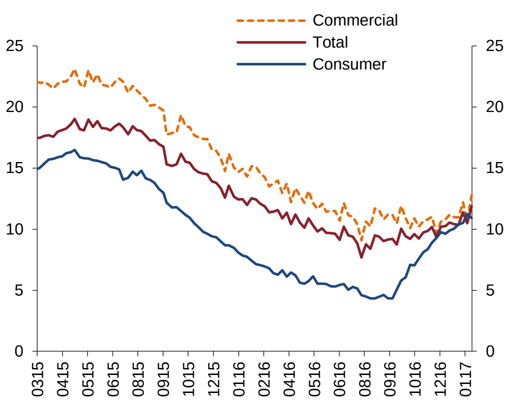
Chart 1.1.4.
Currency Swap Rates
(5-Day Moving Average, Percent)



Source: Bloomberg, BIST.

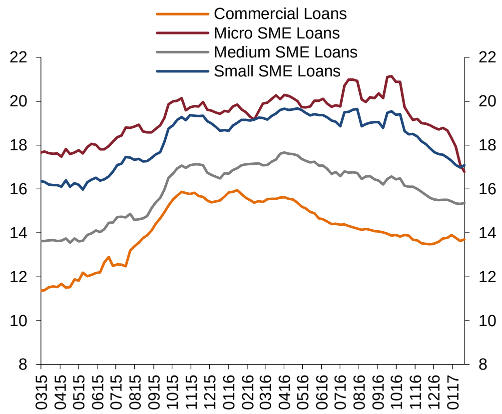
The annual growth rate of loans extended to the non-financial sector picked up in the fourth quarter of 2016 owing to accommodative macroprudential measures, the lagged effects of the CBRT's liquidity measures and government incentives (Chart 1.1.5). Across subcategories, commercial loans inched up on the back of TL loans, while consumer loans grew at a faster pace amid recovering consumer confidence and lagged effects of new measures. This upsurge was spread across all types of consumer loans. Lending standards remained rigid due to tighter domestic and external funding conditions in the fourth quarter of 2016. Meanwhile, interest rates on TL commercial loans to SMEs saw a decline in the final quarter thanks to accommodative government policies (Chart 1.1.6).

Chart 1.1.5.
Annual Loan Growth
(Adjusted for Exchange Rate, Percent)



Source: CBRT.

Chart 1.1.6.
TL Commercial Loan Rates*
(Flow, Annualized, 4-Week Moving Average, Percent)



* Excluding overdraft accounts, credit cards and non-zero interest rate loans.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

Having gradually slowed down after July, consumer inflation reached 7 percent in November, remaining close to the lower band of the October Inflation Report forecast. However, largely due to the volatility in unprocessed food prices and adjustments in the prices of tobacco products, consumer inflation ended the year at 8.53 percent, exceeding the upper band of the forecast (Chart 1.2.1). Exchange rate depreciation and tax adjustments were also influential on inflation excluding unprocessed food and tobacco products, which posted a smaller upturn (Chart 1.2.2).

Chart 1.2.1.
Inflation Forecast and Realization*
(Percent)

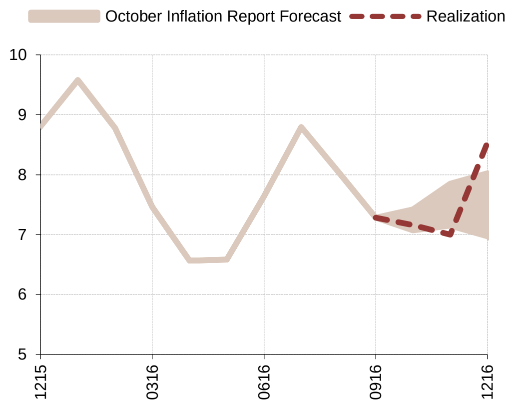
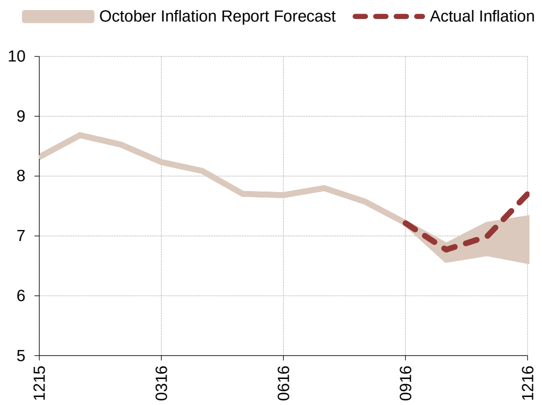


Chart 1.2.2.
Inflation Forecast and Realization Excluding Unprocessed Food and Tobacco Products*
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

The effects of the large depreciation in the Turkish lira were firstly reflected in energy prices, which are subject to a faster exchange rate pass-through. Moreover, with the additional upward pressure from rising crude oil prices, energy inflation increased sharply (Chart 1.2.3). Higher exchange rates put further upward pressure on core goods inflation, which, having followed a downward trend until November, surged in December owing also to tax increases.

Recent tax adjustments, especially in tobacco products, had a significant upward effect on inflation. The SCT on automobiles was adjusted in November while the SCT on alcoholic beverages and tobacco products was raised for the second time in December after the January 2016 hike (Chart 1.2.3). Thus, tax adjustments and administered prices made a historically high contribution to inflation in 2016.

Food inflation followed a modest path until November, making a relatively smaller contribution to inflation than in previous years. In December, however, the plunging Turkish lira and adverse weather conditions pushed food inflation higher (Chart 1.2.3). Despite this increase, owing both to the slump in tourism and the measures in effect, annual food inflation ended the year at 5.65 percent, which is a historically low rate. Annual food inflation remained mostly in line with the projections of the October Inflation Report.

Chart 1.2.3.
Prices of Food, Energy, Alcoholic Beverages and Tobacco Products (Annual Percent Change)

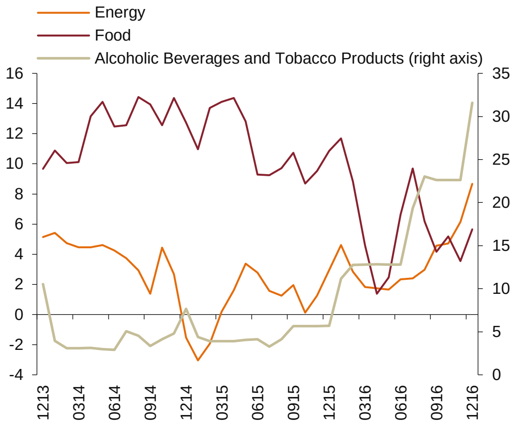
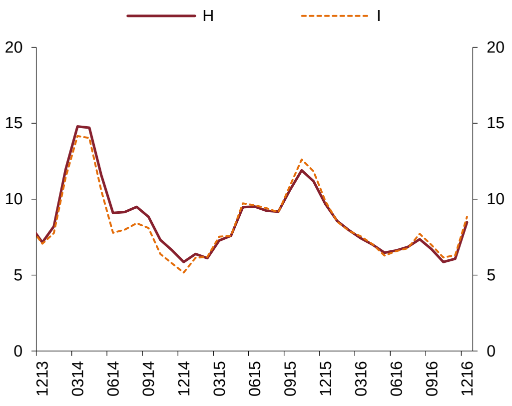


Chart 1.2.4.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



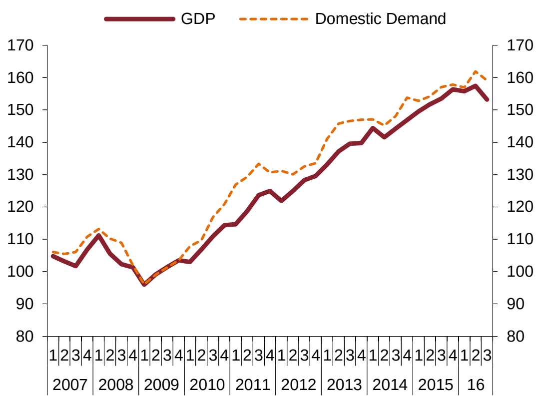
Source: TURKSTAT, CBRT.

In the fourth quarter, prices varied across subcategories of core goods, with inflation slowing in sectors such as clothing and furniture and rising in sectors posting strong domestic sales. Despite the favorable food inflation outlook and weak demand conditions, services inflation remained elevated amid rising real unit labor costs and higher rents, especially in Istanbul. Pressures from producer prices were more severe towards the end of the year, with diffusion indices signaling a growing tendency to hike prices, especially in December. Accordingly, the underlying core inflation indicators turned upward as of December (Chart 1.2.4). A similar upturn was recorded in the alternative core inflation indicators followed by the CBRT. In short, despite the downward pressure from economic activity, inflation outlook recently deteriorated due to tax hikes, strong cost pressures and the partial increase in food prices.

Supply and Demand

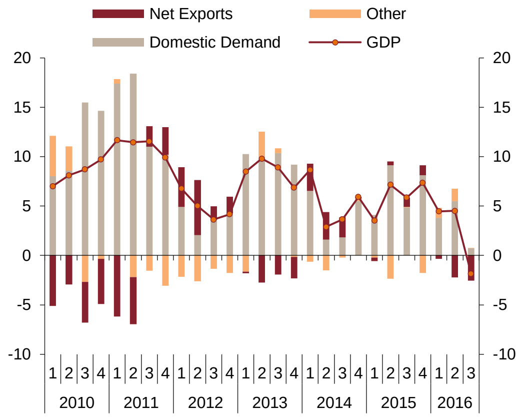
Economic activity slowed down significantly in the third quarter. The GDP declined by 2.7 and 1.8 percent in quarter-on-quarter and year-on-year terms, respectively (Chart 1.2.5). Having already slowed due to dropping tourism revenues, the economy decelerated further as a result of the negative repercussions of the July incidents on domestic demand (Chart 1.2.6). The marked increase in public consumption spending by 23.8 percent in annual terms and the favorable outlook of the construction industry contained the negative effects of the fall in other domestic demand components on growth. In addition, the loss of working days driven by extended religious holidays and the mid-July turmoil weighed on economic activity. Therefore, despite slowing down, the underlying trend in economic activity is assessed to be stronger than implied by the currently available data. Adjusted for working day losses as well as normal calendar effects, economic activity is estimated to have registered a limited growth rate rather than a contraction in the third quarter on an annual basis.

Chart 1.2.5.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, 2009=100)



Source: TURKSTAT, CBRT.

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

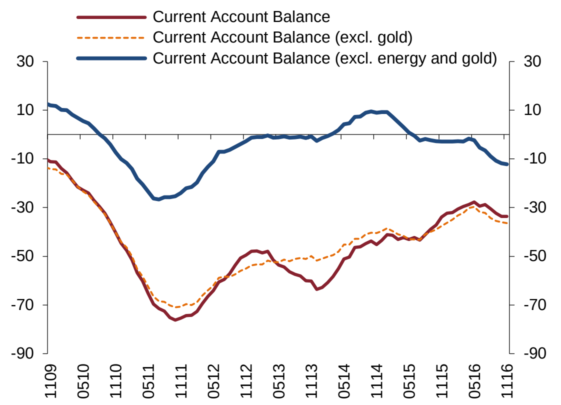


* Other includes statistical error due to inventories and chain index.
Source: TURKSTAT, CBRT.

Indicators for the fourth quarter of 2016 point to a mild growth in economic activity, apart from the technical recovery due to the compensation of the third quarter's working day losses. In addition to increased lending spurred by new measures and incentives, the demand brought forward for durable goods stimulated the private consumption in the third quarter. However, the demand for goods excluding durables remained weak, preventing the recovery in private consumption demand from spreading across sectors in the fourth quarter. Meanwhile, investment is recovering at a slower pace than consumption spending. Against this background, domestic demand is expected to pick up slightly in annual terms in the final quarter. Although terms of trade are likely to become less favorable for the current account deficit in the coming months, net exports will contribute to a recovery in quarterly growth rate thanks to restored relations with Russia and the depreciation of the Turkish lira (Chart 1.2.7).

In the forthcoming period, despite the lack of a signal for improvement in the prospects for tourism, the mild recovery trend in economic activity is expected to continue owing to the recent accommodative incentives and measures. However, the heightened sense of uncertainty may restrict domestic demand both from consumption and investment channels. The global growth outlook, uncertainties regarding monetary policies of advanced economies, the weak course of capital flows and geopolitical developments pose a downside risk to growth in 2017 as well. Meanwhile, the improvement in the current account balance is expected to continue. Despite the rise in commodity prices, the mild growth outlook is estimated to limit the increase in imports in the upcoming period. Notwithstanding the restrictive impact of geopolitical developments, the current account balance is projected to improve in 2017 due to the normalization of the relations with neighboring countries, the sustained increase in the EU demand and the flexibility in diversifying exports.

Chart 1.2.7.
Current Account Balance
(12-Month Cumulative, Billion USD)



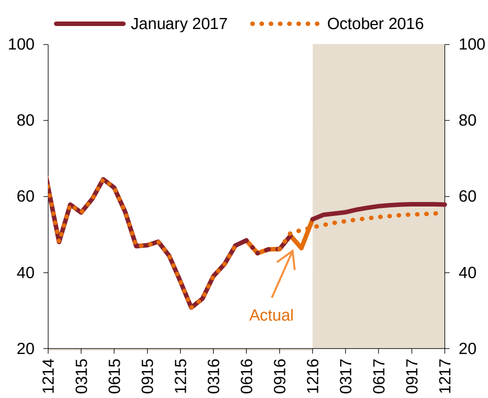
Source: CBRT.

Oil, Import and Food Prices

Assumptions for crude oil prices, which were 54 USD in the October Inflation Report, were revised upwards to 57 USD for 2017 in light of the recent developments. Meanwhile, assumptions for USD-denominated import prices saw a limited downward revision for 2017 due to the relatively low course of commodity prices excluding crude oil (Chart 1.2.8). However, in TL terms, import prices also witnessed a notable upward revision compared to the previous reporting period.

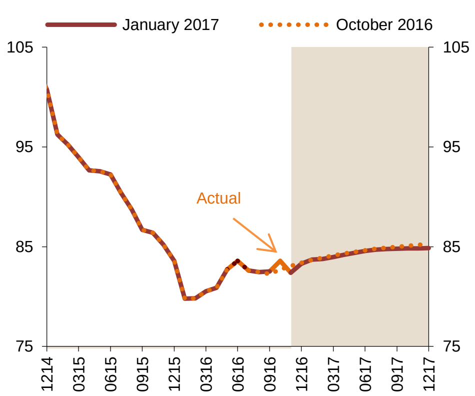
Food inflation, which was estimated to be 6 percent at the end of 2016 in the October Inflation Report, remained broadly consistent with the projections standing at 5.65 percent. However, given the probable effects of the recent adverse weather conditions on the food supply coupled with the effects of the depreciation in the Turkish lira, food inflation is likely to increase in 2017. On the other hand, the ongoing subsided food demand due to the sluggish tourism sector accompanied by the measures taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee (the Food Committee) are expected to limit this rise to some extent. Accordingly, the assumption for food price inflation has been revised upwards from 7 percent to 9 percent for end-2017 since the October Inflation Report, while that for 2018 has remained intact as 7 percent.

Chart 1.2.8.
Revisions in Oil Prices
(USD/bbl)



Source: Bloomberg, CBRT.

Chart 1.2.9.
Revisions in Import Prices
(2010=100)



Source: CBRT, TURKSTAT.

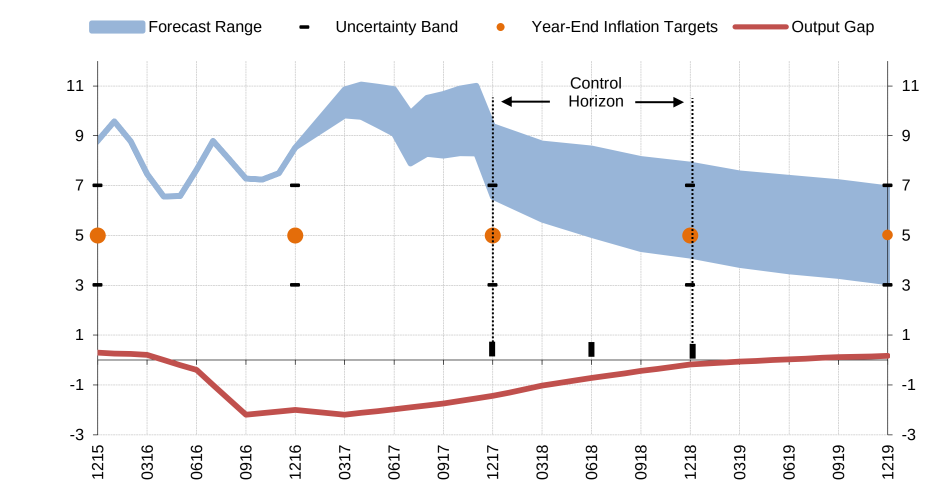
Fiscal Policy and Tax Adjustments

The contribution of adjustments in administered prices to consumer inflation was well above the historical averages in 2016. Forecasts for 2017 and onwards are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2017-2019 period.

1.3. Inflation and Monetary Policy Outlook

Given a tight policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to be 8 percent in 2017, and stabilize around 5 percent in 2019 after falling to 6 percent in 2018. Hence, inflation is expected to be, with 70 percent probability, between 6.6 percent and 9.4 percent (with a mid-point of 8 percent) at end-2017 and between 4.2 percent and 7.8 percent (with a mid-point of 6 percent) at end-2018 (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts*
(Percent)



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

Year-end inflation forecasts for 2017 and 2018 were revised upwards by 1.5 and 1 points, respectively compared to the 2016 October Inflation Report. Assumptions for TL-denominated import prices for the upcoming period were subject to a sizeable upward revision compared to the previous reporting period. This revision is estimated to drive the year-end inflation forecast for end-2017 upwards by 1.3 points compared to the previous Report. On the other hand, recent indicators suggest that the recovery in domestic demand may prove slower in 2017 than envisioned in the October Inflation Report. Accordingly, output gap forecasts were revised downwards, which is estimated to pull the end-2017 inflation forecast down by 0.4 points.

Another factor affecting forecasts was the revision of food inflation forecasts for 2017 from 7 percent to 9 percent. This revision added 0.4 points to the inflation forecast for 2017 compared to the previous reporting period. Lastly, the higher actual inflation at end-2016 than projected in the October

Inflation Report and the rise in core inflation indicators are estimated to drive inflation at end-2017 upwards by 0.2 points. Accordingly, the consumer inflation forecast for end-2017, which was 6.5 percent in the October Inflation Report, was raised to 8 percent. On the other hand, the consumer inflation forecast for end-2018 was revised from 5 percent to 6 percent. The additional 1-point to end-2018 forecast from the October Inflation Report was caused by the upward revision in TL-denominated import prices and the rise in the underlying trend of inflation by 1 point and 0.2 points respectively, while the downward revision in output gap is projected to offset these effects by 0.2 points. The projection of a decline in inflation from 8 percent by end-2017 to 6 percent by end-2018 is based on an outlook where cumulative exchange rate effects will diminish and economic activity will remain moderate.

1.4. Risks and Monetary Policy

Global economic uncertainties intensified following the US elections in November 2016. In this period, long-term interest rates surged in advanced economies, while capital flows towards emerging economies subsided. The increased prospects for the adoption of protective policies in the US pose a downside risk to the pace of growth and employment in emerging economies. In addition, the growing possibility of US to adopt accommodative fiscal policies may lead to accelerated rate hikes by the Fed, which may result in further tightening of financial conditions in emerging economies.

In addition to the ongoing uncertainties in global markets, the geopolitical and domestic developments also caused fluctuations in domestic financial markets in the fourth quarter of 2016. The adverse impact of these on financial conditions is partly compensated by liquidity measures, macroprudential arrangements and other incentives. In fact, consumer loans and TL-denominated commercial loans have recently shown signs of recovery. On the other hand, consumer loans may lose some pace in the first quarter of 2017 as the demand for automobiles and durable goods was brought forward amid tax arrangements and exchange rate developments in the last quarter.

Recently released data hint at a noticeable economic slowdown in the third quarter of the year. Thanks to the accommodative incentives and measures, domestic demand recorded an improvement in the last quarter. Nevertheless, the improvement has been rather restricted on a sectoral basis and the underlying trend of economic activity registered a mild growth. Recent indicators suggest that the depreciation in the Turkish lira and the aggravating uncertainty may lead to a slowdown in domestic demand in the first quarter of the year. However, as uncertainties and volatility in financial markets wane, the economy is expected to normalize and grow moderately in 2017. On the other hand, the pace of recovery in tourism revenues, the global economic outlook, uncertainties regarding the monetary policies of advanced economies and geopolitical developments pose downside risks to the economic activity, while possible lagged effects of recent incentives and measures are considered as the upside risk factor. Maintaining price stability as the main objective, the CBRT closely monitors the downside risks to economic activity with respect to its reverberations on financial stability as well.

In the last quarter, inflation increased due to energy, alcoholic beverages, tobacco products and unprocessed food prices. The effects of the rapid depreciation in the Turkish lira were evident mainly in items such as energy and durable goods in which exchange rate pass-through to inflation is relatively fast. Recent tax adjustments, particularly those in tobacco products, also had a significant upside effect on inflation. Although aggregate demand conditions continued to be disinflationary, the depreciation of the Turkish lira and higher commodity prices increased the underlying trend of core inflation. In the short term, the base effect from unprocessed food prices and developments in the TL-denominated import prices are expected to drive inflation upwards significantly. Hence, even though mild aggregate demand conditions are expected to support disinflation, inflation is projected to remain high for a while due to cost pressures and decline gradually as of the second half of the year. Despite the tourism-induced slowdown in food demand and the support from the actions taken by the Food Committee, the base effect from unprocessed food prices, probable consequences of adverse weather conditions on the food supply and the exchange rate developments are expected to push the end-2017 food inflation up compared to the previous Report.

Inflation forecasts accommodate both downside and upside risks, yet upside risks to end-2017 inflation forecast seem more evident. Recently, the marked rise in FX market volatility has posed an upside risk to inflation through expectations and the pricing behavior as well as from the cost channel. On the other hand, demand conditions may prove more disinflationary should economic activity recover more slowly than expected in the period ahead. Risks to food inflation – another major determinant of forecasts – are considered to be balanced. Despite the possibility of a higher-than-expected food inflation amid adverse weather conditions and the reverberations of the exchange rate, measures taken by the Food Committee are believed to counterbalance these risks. The CBRT will closely monitor the developments regarding inflation outlook and continue to take necessary policy measures to achieve price stability.

Against this background, starting from January 2017, the CBRT has taken a series of liquidity measures in response to the excessive exchange rate volatility and deterioration in the inflation outlook and decided to impose stronger tightening in the monetary policy in the January MPC meeting. The CBRT will continue to use all available instruments in pursuit of the price stability objective. Future monetary policy decisions will be conditional on the inflation outlook. Inflation expectations, pricing behavior and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered, if needed. Moreover, necessary liquidity measures will be taken in case of speculative pricing in the foreign exchange market that cannot be justified by economic fundamentals.

Foreign exchange markets experienced heightened volatility in January 2017 despite the absence of a change in the macroeconomic framework or economic fundamentals. This required the adoption of a dynamic framework, which includes various liquidity instruments. While a simple policy framework enhances the effectiveness of the transmission mechanism, it does not rule out such dynamic reactions.

Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The contribution of adjustments in administered prices to consumer inflation was above historical averages in 2016. This was one of the main reasons for the actual inflation to surpass the CBRT's forecasts announced at the beginning of the year. The baseline monetary policy stance for the upcoming period is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in 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.

In recent years, sustaining fiscal discipline has been one of key factors in lowering the sensitivity of the Turkish economy against external shocks. Moreover, the room provided by the fiscal discipline facilitated the implementation of an expansionary fiscal policy without causing a permanent deterioration in budget balances. However, in the conduct of fiscal policy, other macroeconomic variables such as growth, domestic savings and inflation should also be taken into account besides the budget balance. This enhances the coordination of monetary and fiscal policy, and improves macroeconomic stability.