TÜRKİYE CUMHURİYET
MERKEZ BANKASI

HEAD OFFICE ANKARA, 30 January 2018

Please refer to:

**Mehmet ŞİMŞEK**
**DEPUTY PRIME MINISTER**
**ANKARA**

As stipulated in the 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 behind the exceeding of the inflation target and the necessary measures to be taken. As stated in the main policy document titled "Monetary and Exchange Rate Policy in 2017", which was published on 6 December 2016, the inflation target for 2017 was set jointly with the Government as 5 percent. In the same document, it was also indicated that the CBRT would write an open letter to the Government should the year-end inflation deviate from the target range (by more than 2 percentage points in either direction from the target). At end-2017, inflation stood above the target range. This document elaborates on the reasons for the deviation of the inflation from the target and explains the measures already taken—and to be taken—to bring inflation back to the target.

**Factors Affecting Inflation in 2017**

The main factor causing inflation to overshoot the target in 2017 was the notable depreciation of the Turkish lira. In addition, USD-denominated import prices remained above projections in this period. Despite posing a downward pressure on inflation in the 2012-2016 period, import prices recorded an increase in 2017 and posed a cost-side pressure on inflation in tandem with the tumbling Turkish lira. In fact, producer prices soared by 15.47 percent in 2017 and producer prices-based pressures on consumer prices remained strong throughout the year. Moreover, annual inflation in food and non-alcoholic beverages was realized as 13.79 percent, and played a significant role in the deviation of inflation from the target. In 2017, the brisk course of economic activity stood as another factor to fuel the increase in inflation. The deterioration in inflation expectations, together with the worsening in overall pricing behavior also proved influential in the surge in inflation. On the other hand, owing to the stronger coordination between monetary and fiscal policies, the contributions of public prices and taxes to inflation was limited in 2017 compared to previous years.

The Turkish lira depreciated by 22 percent on average against the currency basket in 2017. Adverse impacts of this depreciation were manifested across the subcategories of consumer inflation, and particularly the core goods group, which is characterized by high exchange rate pass-through. Cumulative effects of the depreciation were evident across the group, and especially products with high import content such as automobiles registered sharp price increases. Moreover, the brisk external demand for certain sectors coupled with the increased domestic demand in sectors subject

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to temporary tax reduction incentives allowed cumulative cost pressures to be reflected in prices more easily.

International commodity prices trended upwards across 2017. Increasing by around 25 percent compared to 2016, international metal and oil prices became one of the major determinants of the rise in inflation through the cost channel. The uptick in oil and other input prices as well as the depreciation of the Turkish lira caused a year-on-year increase in the annual energy inflation.

Another factor that drove consumer inflation upwards in 2017 was food prices. Contrary to the favorable outlook in the previous year, annual inflation both in processed and unprocessed food group remained elevated across the year. Producer inflation in agricultural products stood at 17.30 percent at the year-end. Although the measures taken by the Food and Agricultural Product Markets Monitoring and Evaluation Committee contained inflationary pressures in certain subcategories, cost developments, sectoral price shocks and the rebound in tourism caused food prices to have a higher contribution to annual inflation than historical averages.

Services inflation recorded gradual increments across the year. The high level of inflation had an adverse impact on the rate of price increases in items with vigorous indexation behavior, particularly education services and rent. The outlook for food inflation pushed inflation up in the restaurants-hotels group through the catering services channel. Meanwhile, fuel prices, which soared amid the depreciation of the Turkish lira accompanied by the increases in oil prices, emerged as the main driver of the rise in inflation in transport services. The depreciation of the Turkish lira also caused price hikes in other items of services affected by the exchange rate. Services inflation was also shaped by the strong course of domestic demand.

Alcoholic beverages and tobacco products proved to be the only subcategory that had a lower contribution to inflation in 2017 compared to the previous year. This was owed to the fact that the lump-sum special consumption tax on cigarettes and other tobacco products was not hiked as projected under the automatic pricing mechanism as per the decision of the Council of Ministers.

All in all, aside from cost-side factors which had a major impact on inflation, demand developments also pushed up inflation in 2017. The depreciating Turkish lira, rising import prices, developments in food prices and the brisk course of aggregate demand conditions were the leading factors to drive inflation above the target. Moreover, rising medium-term inflation expectations and the deterioration of the pricing behavior put an upward pressure on the inflation outlook as well.

**Measures Taken to Reach the Inflation Target**

Throughout 2017, the CBRT strengthened monetary tightening gradually to contain the worsening in the inflation outlook (Chart 1). Following the significant global and geopolitical shocks in the second half of 2016, the volatility in exchange rates became notable in early 2017. This had an impact on inflation outlook and became the major determinant of the monetary policy decisions at the start of the year. Accordingly, in the January 2017 meeting of the Monetary Policy Committee (MPC), lending rates were raised. Moreover, the CBRT adopted a monetary policy framework entailing dynamic and different liquidity tools in order to safeguard price stability and financial


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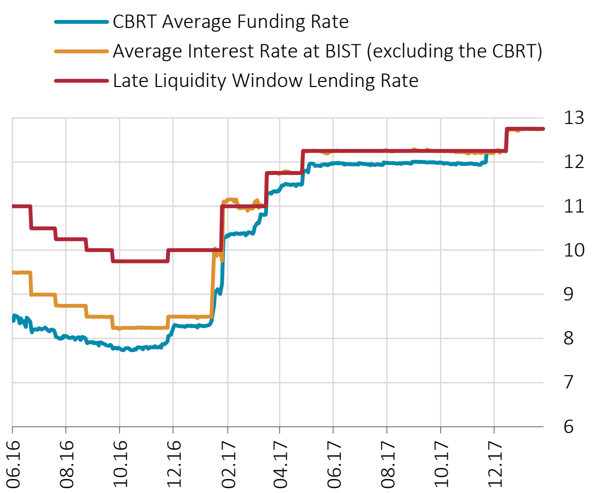
stability against the possible negative repercussions of excessive volatility observed in the foreign exchange market in early 2017. In this regard, one-week repo auctions were suspended starting from 12 January 2017. Moreover, various measures were adopted in January to provide flexibility for the foreign exchange (FX) liquidity management. To this end, foreign exchange reserve requirement ratios were lowered by 50 basis points for all maturity brackets and the Foreign Exchange Deposits against Turkish Lira Deposits Market was opened on 17 January 2017 to enhance the flexibility and instrument diversity of the Turkish lira and FX liquidity management. The CBRT raised the Late Liquidity Window (LLW) lending rate to 11.75 percent in March, underlining the lagged exchange rate pass-through, and to 12.25 percent in April in view of the risk that the inflation outlook posed to the pricing behavior.

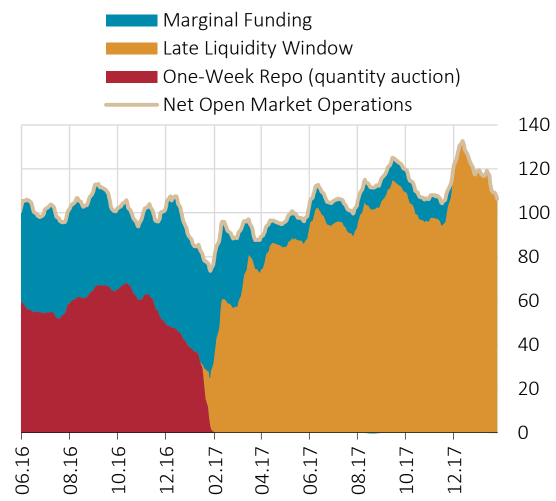
Policy decisions taken in the first half of 2017 aimed at alleviating the inflationary pressures. On the other hand, aggregate demand and credit conditions delayed the improvement in inflation. Considering the ongoing risks to the pricing behavior due to the elevated levels of inflation and inflation expectations as well as the core inflation outlook, the CBRT adopted a more cautious tone in communicating the monetary policy in September and October 2017.

**Chart 1: Short-Term Interest Rates** (5-Day Moving Average, %)




Source: BIST, CBRT.

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




Source: CBRT.

In November 2017, the CBRT adopted a series of liquidity measures in order to safeguard price stability and financial stability against possible negative effects arising due to the geopolitically driven exchange rate volatility and the pricing dynamics detached from economic fundamentals. Thus, starting from 22 November 2017, the funding cost was realized as 12.25 percent. Additionally, on 6 November 2017, the upper limit of the FX maintenance facility within the Reserve Options Mechanism was lowered from 60 percent to 55 percent and all tranches were reduced by 5 points, which offered additional FX liquidity to the banking system. Moreover, the CBRT's decision to allow repayments of certain export rediscount credits in Turkish lira at a pre-determined exchange rate provided extra FX liquidity for the market. The CBRT launched Turkish

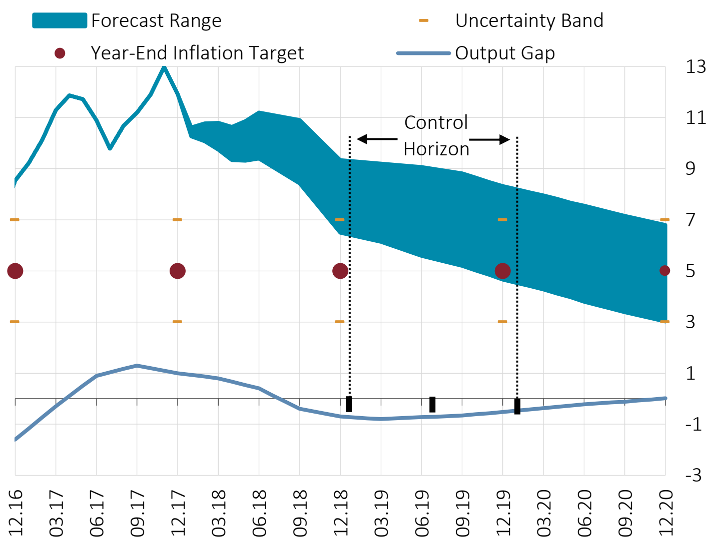
Lira-Settled Forward Foreign Exchange Sale auctions on 20 November 2017 to manage the FX risk of the real sector effectively.

Noting that the current elevated levels of inflation and the recent cost developments continued to pose risks to expectations and the pricing behavior, the CBRT decided to tighten the monetary policy stance further at the December meeting by raising the funding cost to 12.75 percent. Monetary policy has become considerably more predictable as most of the CBRT funding was provided through facility single channel in 2017 (Chart 2). In the upcoming period, the CBRT will continue to use liquidity tools with an appropriate composition and in a manner to support predictability in line with its objective of achieving price stability. As stated in the MPC statement of January 2018, the tight stance of the monetary policy will be maintained decisively until the inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets.

Given a tight policy stance that focuses on bringing inflation down, inflation is expected to gradually near the 5-percent target, reach 7.9 percent at the end of 2018 and stabilize around 5 percent over the medium term after falling to 6.5 percent by the end of 2019. Thus, with a 70 percent probability, inflation is expected to be between 6.5 percent and 9.3 percent (with a mid-point of 7.9 percent) at end-2018 and between 4.7 percent and 8.3 percent (with a mid-point of 6.5 percent) at end-2019 (Chart 3).

In 2018, the waning inflationary impact of cumulative exchange rate effects and higher import prices observed in 2017, is expected to contribute to the downward trend in inflation. Furthermore, in addition to a more moderate economic activity and a milder loan growth in 2018, a macro policy framework in which taxes and administered prices are consistent with the Medium-Term Program through strong coordination of monetary and fiscal policies will support the disinflation process as well.

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




Source: TURKSTAT, CBRT.

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



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## Conclusion

In the upcoming period, the CBRT will continue to use all available instruments in pursuit of the price stability objective and base all monetary policy decisions on the inflation outlook. Inflation expectations, the pricing behavior and other factors affecting inflation will be closely monitored by the CBRT, and, further monetary tightening will be delivered if needed.

Our experience with inflation targeting and developments in 2017 showed that success in combatting inflation lies in a holistic approach for macro policy design. Therefore, in order to achieve permanent price stability, which is a key ingredient for improving social welfare, it is essential to enhance cooperation among institutions and to constitute coordination between fiscal and monetary policies on a sustainable basis.

In recent years, various shocks and structural factors have kept inflation volatile and above the target. In this regard, the CBRT will carry on making efforts in many dimensions, in coordination with other institutions in order to solve the root cause of the problem. The CBRT will continue to contribute to studies on structural factors that cause additional inertia and volatility in inflation. Moreover, studies aiming to increase the domestic value added by reducing the imported inputs in production and managing the FX risk from a financial stability perspective will also provide a significant contribution to the effectiveness of monetary policy and the fight against inflation. Lastly, structural reforms that improve competitiveness and productivity are essential for achieving permanent price stability over the medium term.

The January 2018 Inflation Report is enclosed for your information, which is published on our website today, giving a comprehensive account of the developments regarding inflation and monetary policy as well as our medium-term forecasts.

Yours sincerely,

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