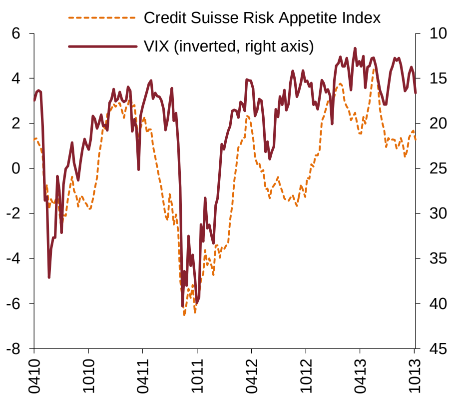
1. Overview

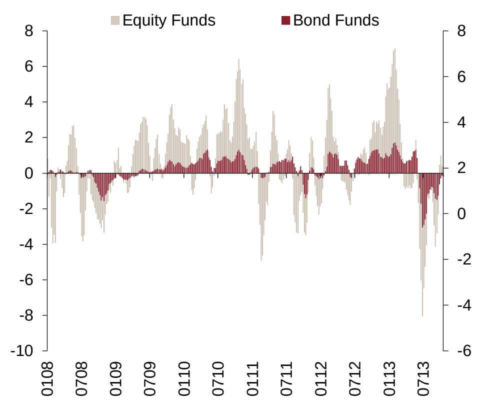
Global monetary policy developments continued to influence financial markets in the third quarter of the year. Ongoing concerns over global growth led to expectations that the US Federal Reserve might soon start trimming its bond purchases, while the pullback on bond purchases was postponed, thereby causing the global risk appetite to remain volatile (Chart 1.1). Emerging economies have witnessed capital outflows since the Fed's first signal on tapering off bond purchases in May (Chart 1.2). In this period, all financial assets were re-priced on a global scale.

Chart 1.1.
Global Risk Appetite



Source: Bloomberg, Credit Suisse.

Chart 1.2.
Portfolio Flows to Emerging Economies
(12-Week Moving Average, Billion USD)



Source: EPFR.

As global economic activity remains weak, uncertainties over global monetary policies are expected to linger for some time. While the US economic recovery is yet to stabilize, financial volatilities and the budget battle pose risks to the recovery by tightening financial conditions. Notwithstanding some positive signs from the Euro Area economies, the high unemployment rate and problems in the credit transmission mechanism cause the economic outlook to remain weak. The fact that the global monetary policies depend on high frequency data releases and the course of economic recovery, and that these data and recovery indicators are volatile causes the uncertainties about global monetary policies to persist.

1.1. Monetary Policy and Financial Conditions

Elevated uncertainties regarding global monetary policies since May have led the CBRT to adopt a cautious monetary policy that observes both inflation indicators and macro financial risks fueled by global uncertainties. Accordingly, additional monetary tightening was implemented further with a view to containing the negative effects of rising inflation on the pricing behavior. To enhance the effectiveness of the additional monetary tightening, the interest rate corridor was widened in August via an O/N lending rate hike from 7.25 percent to 7.75 percent. In addition, short-term rates were brought close to the upper band of the corridor through effective liquidity management. Thus, a front-loaded monetary tightening was implemented in the same period, which compensated for the distortion in inflation expectations. As of August, the CBRT decided to enhance the predictability of the Turkish lira liquidity policy in order to limit the impacts of global monetary policy uncertainties on the domestic economy. To this end, the CBRT decided to pursue a strategy to reduce interest rate uncertainty by creating a framework where the relationship between global interest rates and domestic interest rates weakens largely and market rates become more sensitive to domestic macroeconomic developments as they should be.

In the third quarter of the year, the CBRT continued to provide FX liquidity to the market via FX selling auctions, which fed into the growing Turkish lira liquidity deficit in the market (Chart 1.1.1). The CBRT's reduction of the share of 1-week repo in total funding in this quarter led to an increase in the share of funds provided by the overnight and monthly lending facilities. Correspondingly, the CBRT's average funding rate and the BIST Interbank O/N repo rate increased (Chart 1.1.2). Moreover, in line with its strategy to enhance the predictability of liquidity management, the CBRT has been sharing more information about the frequency and timing of the additional monetary tightening since August. Recently, due to the CBRT's cautious monetary stance, both the Interbank Repo Market rates and the Repo-Reverse Repo Market rates (when the costs of required reserves are added) have been mostly hovering between 6.75 and 7.75 (for money market rates, see Box 1.1).

Chart 1.1.1.
CBRT Funding* (2-Week Moving Average, Billion TL)

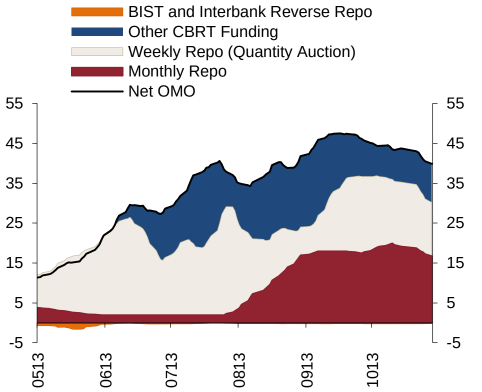
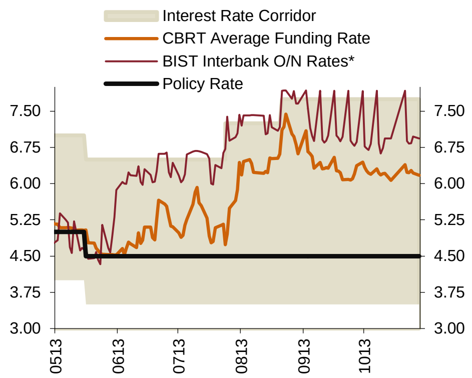


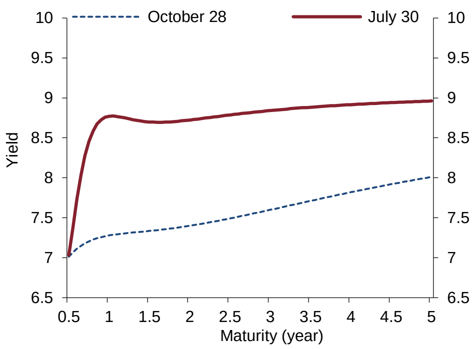
Chart 1.1.2.
CBRT Rates and BIST O/N Repo Rates** (Percent)



* Other CBRT funding includes primary dealer repo transactions, repo transactions at the BIST Repo and the Reverse Repo Market and lending depot facility at the Interbank Money Market.
** Includes the additional 18 basis points BIST transaction cost. For O/N BIST Interbank Repo and Reverse Repo Market rates, see http://borsaistanbul.com/veriler/verileralt/tahvil-ve-bono-piyasasi-verileri/piyasa-verileri.
Source: BIST, CBRT.

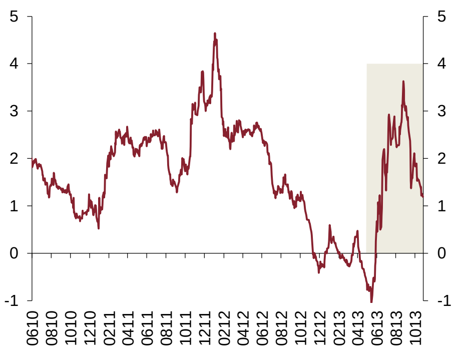
In the third quarter of the year, interest rates were down from the previous reporting period across all maturities, with a larger decrease in the shorter end, while the yield curve trended upward (Chart 1.1.3). This is due to the slightly improved global risk sentiment and Turkey's falling sovereign risk premium as well as the CBRT's monetary policy strategy for reducing interest rate uncertainty to have a greater impact on short-term rates. Meanwhile, 2-year real rates declined on falling nominal rates and rising inflation expectations (Chart 1.1.4).

Chart 1.1.3
Yield Curve*
(Percent)



* Calculated from the compounded returns on bonds quoted in BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

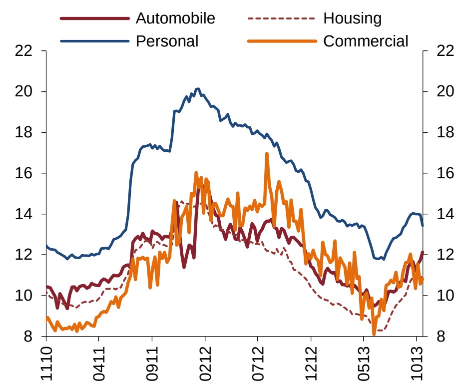
Chart 1.1.4.
2-Year Real Interest Rates for Turkey*
(Percent)



* Calculated as the difference between 2-year discounted bond returns derived from the yield curve and the 24-month ahead inflation expectations derived from the CBRT Survey of Expectations.
Source: BIST, CBRT.

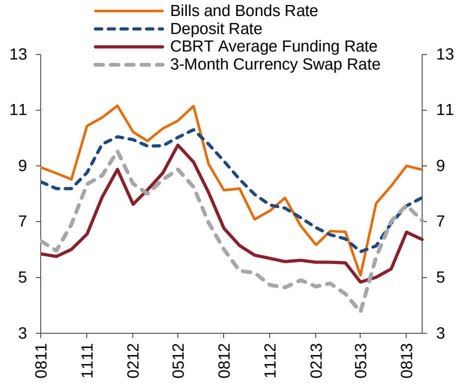
Loan rates that were trending down in the first half of 2013 started to go up by the third quarter (Chart 1.1.5). This quarter-long uptrend reflects global financial developments and the CBRT's July and August tightening of O/N lending rates via the interest rate corridor. Moreover, deposit rates, currency swap rates, the CBRT's average funding rate as well as bill and bond rates issued by banks, which all represent the Turkish lira funding costs of banks, also increased in the same period (Chart 1.1.6).

Chart 1.1.5.
TL Loan Rates
(Percent)



Source: CBRT.

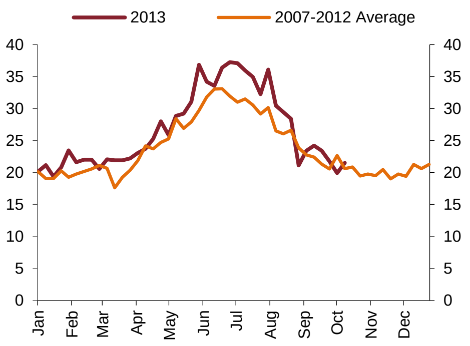
Chart 1.1.6.
Funding Costs of Banks
(Percent)



Source: PDP, CBRT.

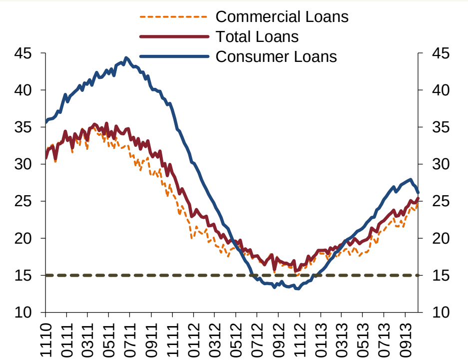
After a more robust first half compared to historical averages, loan growth has returned to the average of the past years as of August (Chart 1.1.7). The recent financial fluctuations and the rising loan rates driven by the cautious monetary stance have contributed to this slowdown. Yet, the annual rate of loan growth still recorded a striking 25 percent in the third quarter (Chart 1.1.8). The cautious monetary stance, the adopted macroprudential measures and the weak capital inflows are expected to bring loan growth rates gradually to more plausible levels in the forthcoming period.

Chart 1.1.7.
Growth Rate of Loans
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

Chart 1.1.8.
Annual Growth Rate of Loans
(Percent)

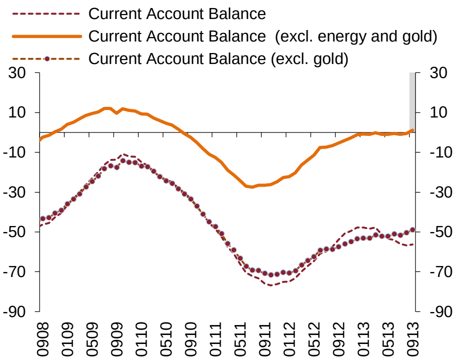


Source: CBRT.

The current policy framework has a favorable impact on the current account balance. After hitting an all-time high at the end of 2011, the current account deficit saw a major correction in 2012. This has largely been driven by the temporary gold trade dynamics, notwithstanding some deterioration in the 12-month cumulative current account deficit since early 2013. As for the current account balance excluding gold, the correction that started in 2012 has continued into 2013, albeit more slowly (Chart 1.1.9).

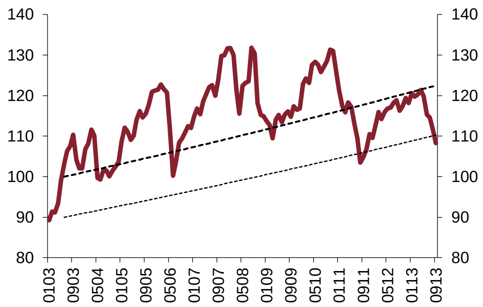
The real exchange rate and credit developments are expected to support balancing of the economy over the upcoming period. As a result of the recent developments in the nominal exchange rate, the real effective exchange rate depreciated and largely retreated from the levels that can be called excessively overvalued (Chart 1.1.10). The current account balance is expected to correct further in the forthcoming period amid expectations for a more acceptable rate of loan growth, a moderate final domestic demand growth and developments in the real exchange rate. This will cushion the Turkish economy against the potentially high levels of global uncertainty in the upcoming period by strengthening its financial stability and supporting the re-balancing process.

Chart 1.1.9.
Current Account Balance*
(12-Month Cumulative, Billion USD)



* Estimate for September.
Source: TurkStat, CBRT.

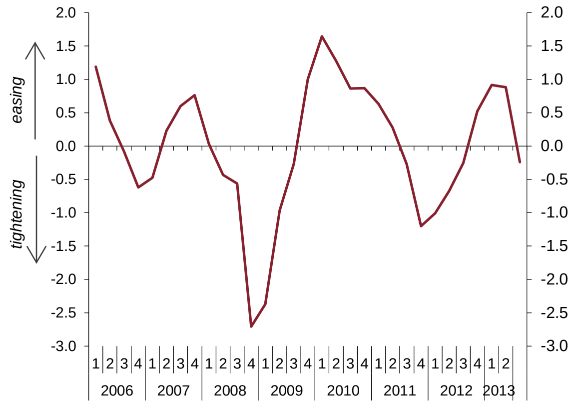
Chart 1.1.10.
Real Effective Exchange Rate*
(2003=100)



* The dotted lines show the 2-percent annual growth starting from June 2003=100 and June 2003=90. Deflated by CPI.
Source: CBRT.

In sum, uncertainty continued to reign over financial markets in the third quarter of 2013 and financial conditions tightened (Chart 1.1.11). The tightening of the financial conditions index is mostly due to weak capital inflows, rising loan rates and higher market rates.

Chart 1.1.11
Financial Conditions Index *



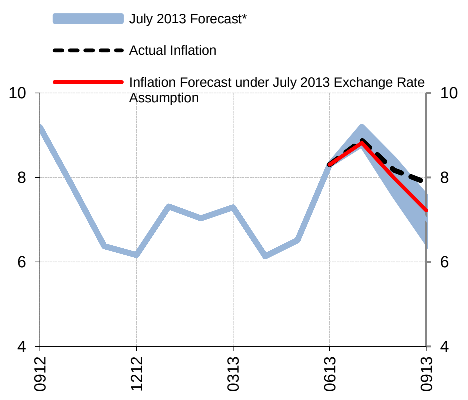
* For further details on financial conditions index, see the CBT Research Notes in Economics No. 12/31.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

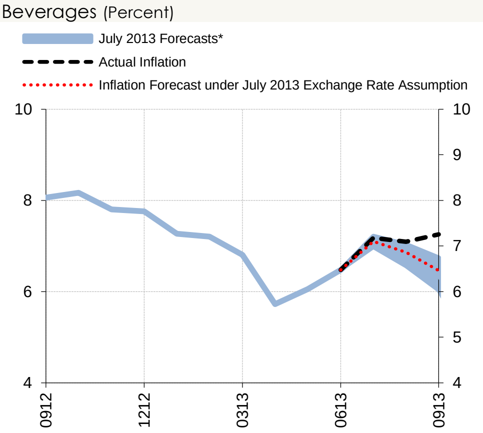
Annual consumer inflation fell by 7.9 percent in the third quarter of 2013, slightly overshooting the July Inflation Report forecasts (Chart 1.2.1). This was mainly attributed to a weaker Turkish lira and higher unprocessed food prices. As a result, the main inflation indicators increased as well (Chart 1.2.2).

Chart 1.2.1.
July 2013 Inflation Forecasts and Realizations (Percent)



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food, Tobacco and Alcoholic Beverages (Percent)



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

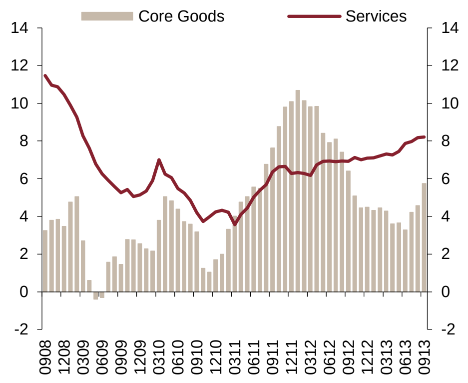
The higher-than-projected inflation realization in the previous quarter was largely induced by the additional depreciation of the Turkish lira (Charts 1.2.1

and 1.2.2). In general, the Inflation Report takes the exchange rate realizations during the reporting month as given for the current quarter, and adopts a framework where exchange rates respond endogenously to the monetary stance and other economic developments afterwards. The Turkish lira witnessed additional depreciation following the July Inflation Report, causing inflation to be higher than projected in the third quarter. This additional depreciation put an upward pressure of about 0.4 points on the end-2013 inflation forecast.

Exchange rate developments affect core inflation via prices of core goods (Chart 1.2.3). Services inflation also went up in the third quarter, but remained relatively more stable. Accordingly, core inflation indicators displayed an upward trend (Chart 1.2.4).

Chart 1.2.3.

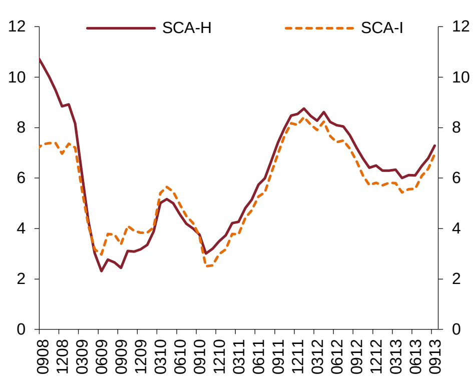
Prices of Core Goods and Services
(Annual Percent Change)



Source: TurkStat.

Chart 1.2.4.

Core Inflation Indicators
(Annual Percent Change)



Source: TurkStat.

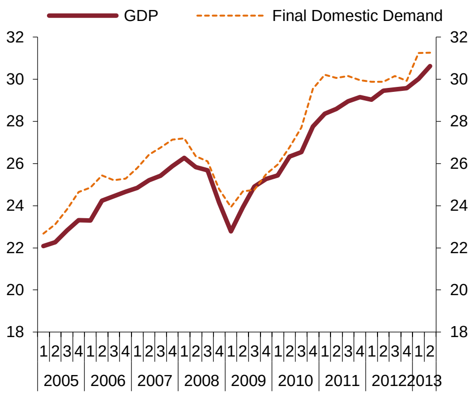
Supply and Demand

Economic activity was more favorable in the second quarter of 2013 compared to the outlook set in the July Inflation Report. Private consumption demand saw a dramatic recovery, while final domestic demand remained almost flat due to slowing public demand (Chart 1.2.5). Meanwhile, imports grew strongly, while exports increased only modestly due to weak global demand. The stronger-than-expected economic activity was mostly induced by changes in inventories.

Indicators for the third quarter of 2013 suggest that the economic activity will grow more moderately than in the second quarter. During July-August period, production of consumption goods was down from the previous quarter, while imports of consumption goods continued to rise. On the investment side, indicators show a weaker outlook compared to consumption demand. During this period, exports were flat, while imports saw a remarkable decline. Therefore, the negative contribution of net exports to growth is expected to decrease in the third quarter. Meanwhile, the export-weighted global growth index remains virtually unchanged from the previous reporting period (Chart 1.2.6).

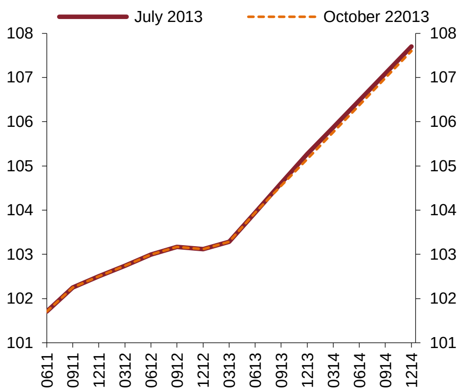
Final domestic demand is likely to continue to recover modestly in the second half of the year. Thus, output gap forecasts are revised slightly upwards for 2013. However, downside risks to recovery have been aggravated following the latest financial developments. Accordingly, output gap forecasts are revised downwards for 2014. Domestic demand developments are expected to support the downtrend in inflation and the improvement in the current account deficit in coming months.

Chart 1.2.5.
GDP and the Final Domestic Demand
(Seasonally Adjusted, 1998 Prices, Billion TL)



Source: TurkStat, CBRT.

Chart 1.2.6.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)



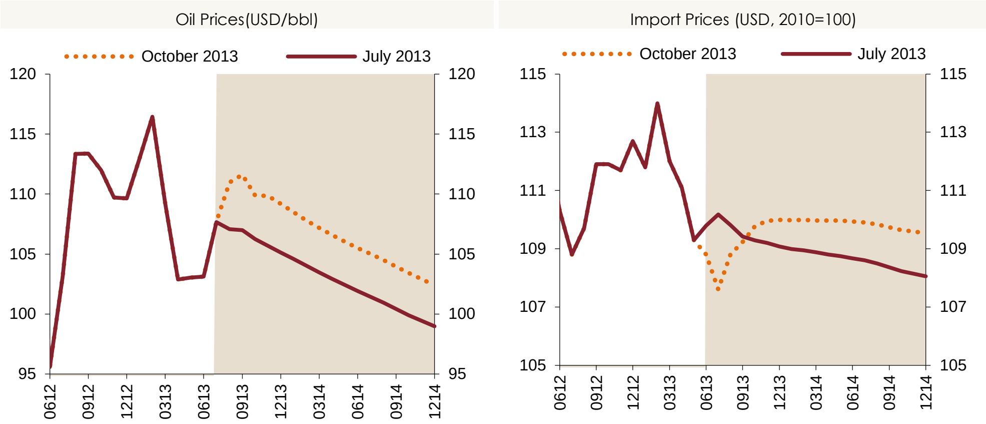
* For methodology, see Box 2.1, Inflation Report 2010-II.
Source: Bloomberg, Consensus Forecasts, CBRT.

In view of both domestic and external demand developments, forecasts are based on an outlook in which the contribution of aggregate demand conditions to the end-2013 inflation has slightly increased compared to the previous reporting period. This revision pulled the end-2013 inflation forecast up by 0.1 points.

Energy, Import and Food Prices

In the third quarter of the year, import prices remained below the assumptions of the July Inflation Report, while oil prices were slightly above the projections (Chart 1.2.7). In line with the average futures prices in the first three weeks of October, the average assumption for 2013, which was set as 107 USD in July, was revised upwards to 109 USD. This revision added 0.1 percentage points to the end-2013 inflation forecast.

Chart 1.2.7.
Revisions to Oil and Import Price Assumptions



Source: TurkStat, CBRT.

Source: TurkStat, CBRT.

The assumption for the annual rate of increase in food prices remained unchanged at 7 percent. In other words, it is assumed that the recent unfavorable course of unprocessed food prices will be temporary, and prices will gradually be normalized by the year end.

Fiscal Policy and Tax Adjustments

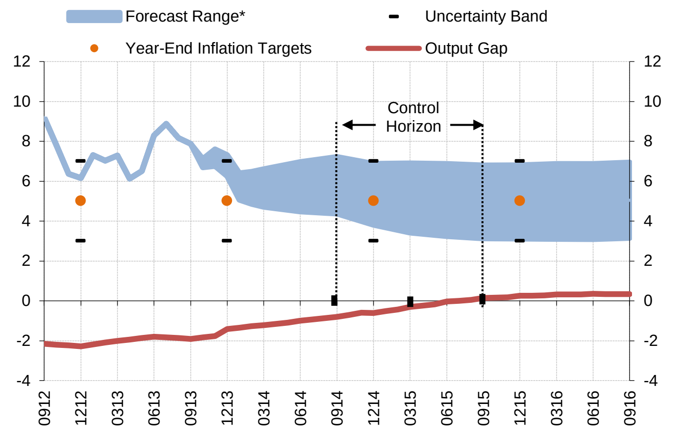
Medium-term projections are based on the assumption that no additional tax adjustments will be introduced to tobacco and energy products in the rest of the year. Meanwhile, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms. Thus, there has been no revision to the end-2013 inflation forecast stemming from the fiscal policy.

The medium-term stance of the fiscal policy is based on the recently revised MTP projections. Accordingly, it is assumed that the fiscal discipline will be maintained in the forthcoming period and the ratio of primary expenditures to GDP will decline gradually starting from the next year.

1.3. Inflation and Monetary Policy Outlook

Medium-term forecasts are based on an outlook where the predictability of the monetary policy continues to be raised gradually. Furthermore, it is assumed that the liquidity policy will mostly be tight owing to the sustained cautious stance, and the annual growth rate of credit will fall to 15 percent by mid-2014 on the back of the adopted macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.3 percent and 7.3 percent (with a mid-point of 6.8 percent) at end-2013 and between 3.8 percent and 6.8 percent (with a mid-point of 5.3 percent) at end-2014. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts
(Percent)



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

In sum, inflation forecasts for end-2013 and end-2014 were revised upwards by 0.6 and 0.3 percentage points, respectively, in the inter-reporting period (Chart 7.2.2). 0.4 percentage points of the revision to end-2013 inflation forecast was caused by exchange rate developments, while 0.1 percentage points stemmed from the rise in the average oil price assumption. Moreover, the output gap forecast, which was revised upwards on the better-than-expected growth outlook for 2013 than presented in the July Inflation Report, is expected to add 0.1 percentage points to the year-end inflation forecast, while developments in the exchange rate and oil prices were influential in the revision to the end-2014 inflation forecast. Taking into account the output gap forecasts, these cost-side factors are expected to push the end-2014 inflation forecast by 0.3 percentage points.

Although inflation is estimated to fluctuate in the short term due to the base effect on energy prices, it is expected to remain on a downward track. As the effects of the tobacco price hike in January 2013 on annual inflation taper off, inflation is expected to plunge in early 2014, and come down to target-consistent levels by the last quarter of 2014.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

Financial markets have recently experienced heightened uncertainty mainly due to global monetary policies. This heightened uncertainty prompted re-pricing of all financial assets, including exchange rates, and the weight of emerging economies in global portfolio investments posted a decline. During this period, despite an absence of problems in external borrowing of the financial and non-financial sectors, portfolio items saw capital outflows and financial assets were re-priced in Turkey. Against this background, the monetary policy adopted a cautious stance with a view to balancing macro financial risks and restraining the deterioration of the inflation outlook. In addition, the predictability of the monetary policy was enhanced to contain the effects of global volatilities on the Turkish economy.

Both advanced and emerging economies might be favorably affected should uncertainties regarding global monetary policies diminish in the upcoming months. In that case, capital flows towards emerging economies are likely to re-accelerate. Materialization of such a scenario may prompt the CBRT to take steps towards accumulating foreign exchange reserves.

Probable aggravation of uncertainties regarding global monetary policies may bear consequences on the global liquidity, capital flows and the pricing of financial assets. In that case, capital flows towards emerging economies are likely to remain weak, and this may pose a risk to the inflation outlook. Should such a scenario materialize, the CBRT may start implementing additional monetary tightening for longer periods to enhance price stability.

Other important factors that pose risks to inflation forecasts are food and energy prices. Assumptions regarding food prices were kept unchanged in the Inflation Report. However, the lower-than-anticipated correction in unprocessed food prices in the third quarter caused unprocessed food prices, which remained above historical averages in the first three quarters of the year, to pose an upside risk to the inflation outlook. Should unprocessed food prices remain elevated throughout the fourth quarter, the year-end inflation may materialize above our inflation forecast of 6.8 percent in the baseline scenario. Energy prices are assumed to maintain their relatively favorable course in the rest of the year. However, cumulative effects of the depreciation of the Turkish lira and the international oil price developments pose an upside risk on administered energy prices, albeit limited.

Effects of rising core inflation indicators on the pricing behavior due to the recent volatility in exchange rates appear as an upside risk factor and are monitored closely. On the other hand, the mild course of the international commodity prices excluding oil and the limited recovery in economic activity are the leading downside risk factors on inflation.

In formulating its monetary policy strategy, the CBRT closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. Inflation forecasts presented in the baseline scenario take the framework outlined in the MTP as given. Accordingly, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, has an adverse effect on the medium-term inflation outlook.

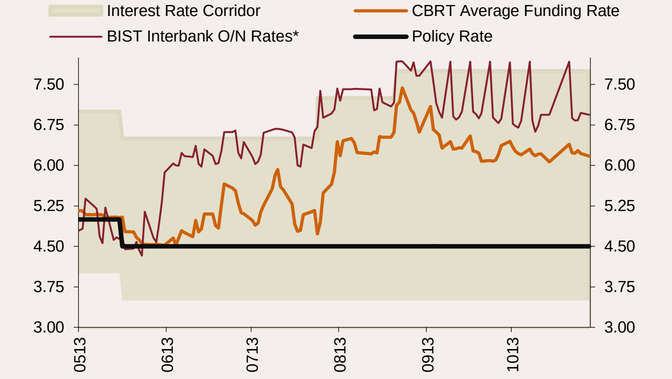
Maintaining the cautious stance in fiscal and financial sector policies is critical to maintaining the resilience of our economy against global imbalances. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improve social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, implementation of the structural reforms outlined by the MTP remains to be of utmost importance.

Box 1.1 Money Markets and the CBRT

Money markets are essentially an aggregation of organized and over-the-counter markets, which ensure the balancing of the placement of surplus funds and short-term liquidity deficits in the short term. The CBRT plays an active role in organized money markets by controlling the quantity of liquidity via its policy tools and determines the money market rates. This box discusses the money market rates influenced by the CBRT.

Under the scope of the liquidity management framework, the CBRT provides banks with collateralized funding throughout the required reserve maintenance period as necessitated by market conditions. Accordingly, under current circumstances, 1-week and 1-month repo funds are provided via the quantity auction and the traditional auction method, respectively. Moreover, under the current facilities, primary dealer banks are able to borrow from the CBRT within their limits at the interest rate provided for primary dealers or all banks are able to borrow from the CBRT at the Interbank O/N lending rate.

Chart 1. CBRT Rates and BIST O/N Repo Rates (Percent)



* Includes the additional 18 basis points BIST transaction cost. For O/N BIST Interbank Repo and Reverse Repo Market rates, see http://borsaistanbul.com/veriler/verileralt/tahvil-ve-bono-piyasasi-verileri/piyasa-verileri.
Source: BIST,CBRT.

Banks can also secure funding through the quantity auction method at the 1-week repo rate, which is the policy rate. In these auctions, each bank makes a bid not to exceed 30 percent of the auction amount and if the auction amount remains below total bids, banks may borrow up to the amount of the ratio of their bids to the total auction amount. As for the funding provided via the traditional auction method, rates are determined by the market.

Under current circumstances, primary dealer banks may benefit from the O/N repo facility at a lower cost than other banks. However, this option is not currently available for primary dealer banks on the days of additional monetary tightening. This enables the CBRT to influence the money market rates more efficiently. As the CBRT provides the market with liquidity through multiple channels, the average funding rate of the CBRT is also closely monitored. This rate reflects the weighted average cost of outstanding funding by the CBRT.

In order to keep market rates within the interest rate corridor, the CBRT conducts transactions at the organized BIST Repo and Reverse Repo Market and the BIST Interbank Repo and Reverse Repo Market. Even though transactions are collateralized in both markets, there is a significant difference: Banks have to maintain required reserves for their funding obtained via BIST Repo and Reverse Repo Market, whereas they are not obliged to do so for the funding provided through the BIST Interbank Repo and Reverse Repo Market. Hence, due to the reserve requirement cost, the BIST Repo and Reverse Repo Market rates hover above the BIST Interbank Repo and Reverse Repo Market rates. Given the cautious monetary policy stance of the CBRT and the higher predictability, the rates at the BIST Interbank Repo and Reverse Market have lately been hovering between 6.75 and 7.75 percent, and on the days of additional monetary tightening, the borrowing cost went above 7.75 percent when the BIST share of 18 basis points transaction cost is included (Chart 1).

In sum, the CBRT controls money market rates by an efficient liquidity management via various policy tools, and influences the size and the direction of the change in money market rates. For a better understanding of the CBRT's monetary policy stance, closer monitoring of the Interbank Repo Market rates is required as well as the average funding rate.