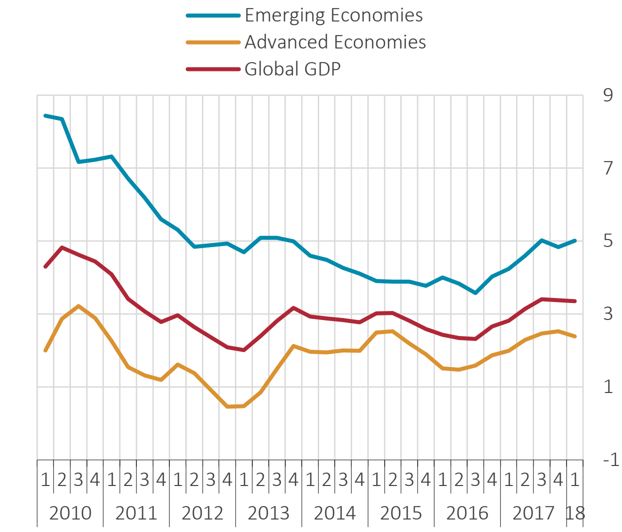
1. Overview

In the first half of the year, global growth stabilized and remained strong (Chart 1.1). The growth in the US economy was more stable, whereas growth in the euro area, Japan and the UK decelerated in the first quarter, prompting downward revisions to their year-end inflation expectations. Growth prospects have varied across emerging economies due to weakening currencies, rising oil prices and increasing protectionist tendencies in international trade. Despite rising commodity and energy prices, consumer and core inflation rates have been moderate globally. Amid positive growth performance and accommodative fiscal policies, the US Federal Reserve (Fed) seems more likely to speed up the monetary policy normalization compared to the previous reporting period, and this has driven US bond yields higher. The appreciation of the US dollar has recently triggered fluctuations in global financial markets. The deteriorating risk sentiment towards emerging markets led to weaker portfolio inflows, depreciation in currencies and higher volatility in the second quarter (Chart 1.2).

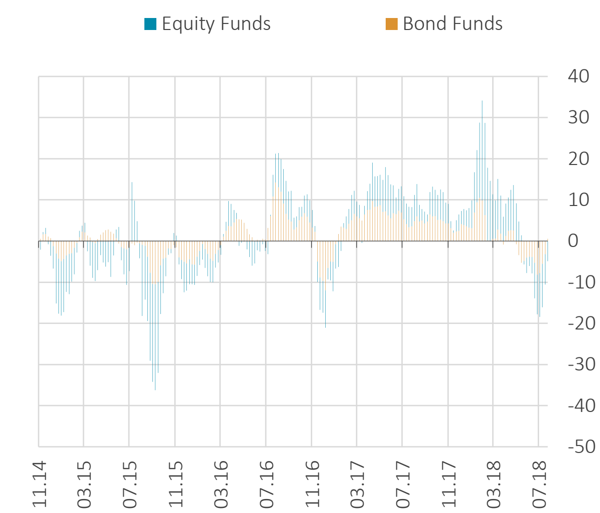
Chart 1.1: Global Growth Rates* (Annual % Change)



Source: Bloomberg, CBRT.

* Weighted by each country's share in global GDP.

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



Source: EPFR.

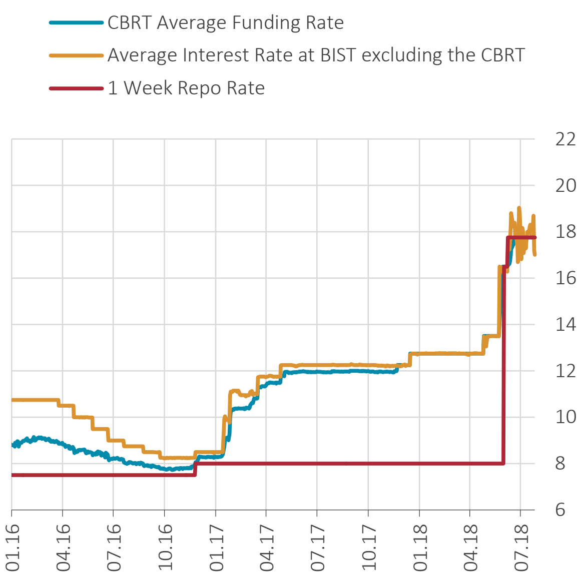
In the second quarter of 2018, Turkey's risk premium and exchange rate indicators diverged negatively from other emerging economies due to turbulent global financial markets and rising emerging market risk premiums aggravated by domestic uncertainties, a widening current account deficit and rising inflation. In response to tighter financial conditions, banks tightened their standards for commercial loans in the second quarter, and commercial loan demand decreased with the additional impact of the slowdown in economic activity. Thus, loan growth continued to decrease in the second quarter.

Consumer inflation accelerated to 15.4 percent in the second quarter. The rise in inflation was widespread across all subcategories, with food, core goods and energy in the lead. Core inflation indicators also deteriorated significantly while the tendency to raise prices increased. Even if the impact of aggregate demand conditions on inflation started to wane gradually as of the second quarter, cost-side pressures and the deteriorated pricing behavior affect the inflation outlook adversely. In the first quarter, economic activity was slightly stronger than envisaged in the April Inflation Report, with private consumer spending being the main driver of growth. Economic activity seems to be rebalancing as of the second quarter owing to decelerating domestic demand, while the recovery in tourism helps net exports provide further contribution to growth.

1.1 Monetary Policy and Financial Markets

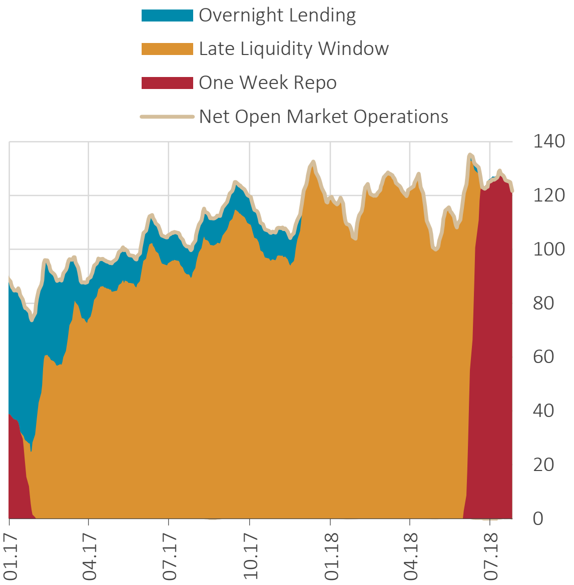
After a 75-basis point rate hike at the MPC meeting in April, the CBRT tightened monetary policy two more times, introducing an additional tightening of 425 basis points in total. In the inter-reporting period, the CBRT first raised the Late Liquidity Window (LLW) lending rate by 300 basis points at the interim meeting on 23 May 2018, emphasizing that the unhealthy price formations in the market and persisting rise in inflation expectations posed risks to the general pricing behavior (Chart 1.1.1). Moreover, to improve the predictability of monetary policy and strengthen the monetary transmission mechanism, the Bank announced in a press release dated 28 May 2018 that it had decided to complete the simplification process regarding the operational framework of the monetary policy to be effective as of 1 June 2018. Accordingly, the Bank set the one-week repo rate as its new policy rate and primary funding channel (Chart 1.1.2) and adopted a framework in which overnight market rates would be determined around the policy rate within a symmetrical corridor of overnight borrowing and lending rates. At the MPC meeting in June, the Bank highlighted that high inflation and inflation expectations continued to pose risks to pricing behavior, and decided to further tighten monetary policy by hiking the policy rate to 17.75 from 16.50 percent (Chart 1.1.1). At the July meeting, however, the Bank kept its monetary policy stance unchanged considering the need to monitor the slowdown in domestic demand and the lagged effects of monetary policy, but nevertheless stated that monetary policy may have to remain tight for an extended period as high inflation and inflation expectations continue to pose risks to pricing.

Chart 1.1.1: Short-Term Interest Rates (%)



Source: BIST, CBRT.

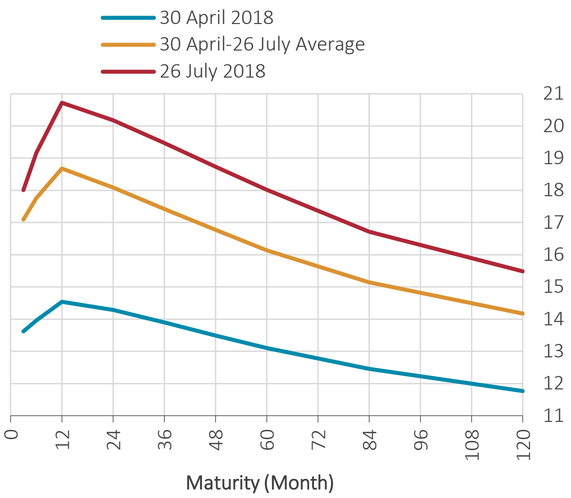
Chart 1.1.2: CBRT Funding (2-Week Moving Average, Billion TL)



Source: CBRT.

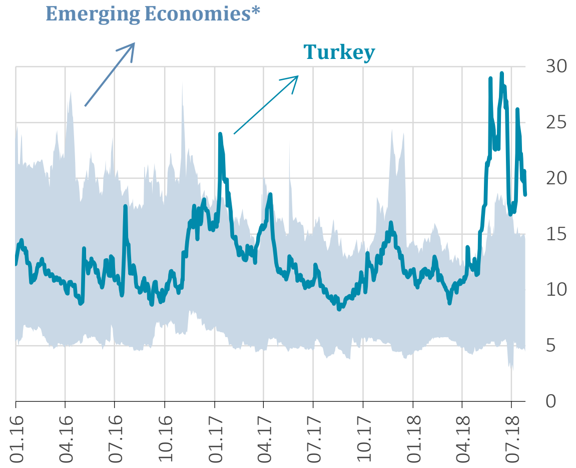
The monetary tightening in May and June and Turkey's rising risk premium pushed currency swap rates up across all maturities in the inter-reporting period (Chart 1.1.3). In addition, the yield curve assumed a more negative slope, suggesting tighter monetary conditions compared to both the previous reporting period and peer economies. Due to the deteriorated risk sentiment towards emerging economies along with geopolitical tensions, and worries over the domestic macroeconomic outlook, the implied volatility of the Turkish lira significantly increased compared to the April Inflation Report period (Chart 1.1.4).

Chart 1.1.3: Swap Yield Curve (%)



Source: Bloomberg.

Chart 1.1.4: Implied FX Volatility (1-Month-Ahead, %)

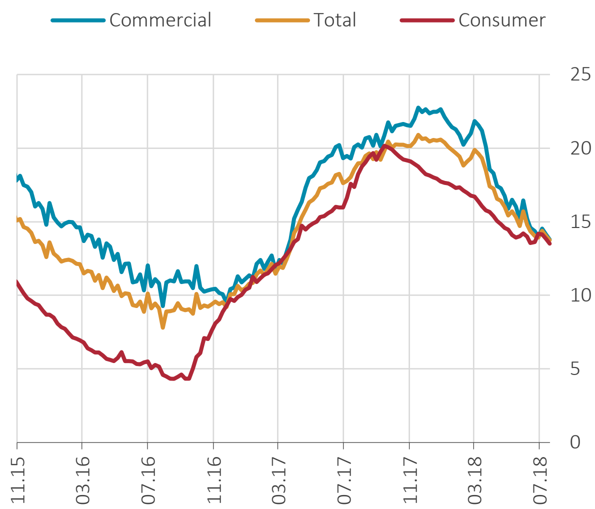


Source: Bloomberg.

* Emerging market currencies include those of Brazil, Indonesia, the Philippines, South Africa, India, Colombia, Hungary, Malaysia, Mexico, Poland, Romania and Chile.

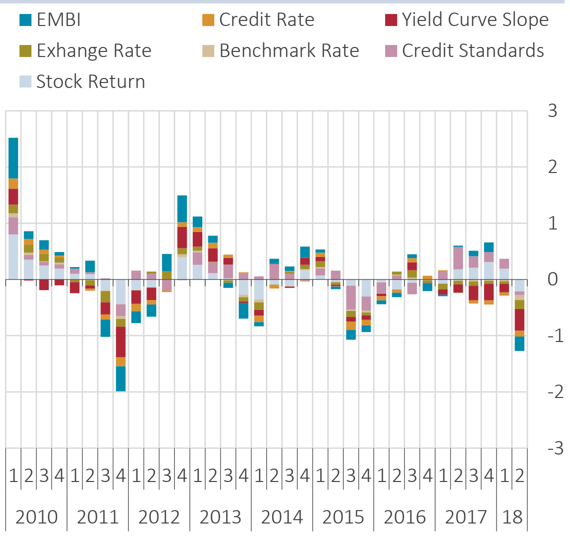
Growth in commercial loans slowed in the second quarter due to tighter loan standards and weaker loan demand whereas growth in consumer loans slightly accelerated thanks to mortgage promotions (Chart 1.1.5). All components, the slope of the yield curve and the risk premium in particular, contributed to the tightening of the Financial Conditions Index (FCI), which suggested a significant tightening in the second quarter (Chart 1.1.6).

Chart 1.1.5: Annual Loan Growth (Adjusted for Exchange Rates, YoY % Change)



Source: CBRT.

Chart 1.1.6: Contributions to FCI*



Source: CBRT.

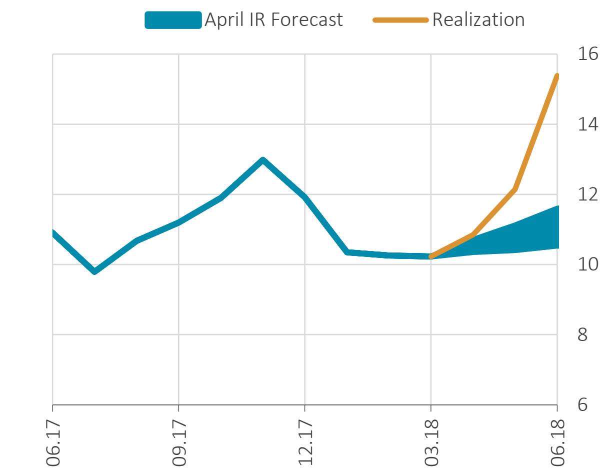
* For further details on measuring the FCI, see the CBRT Working Paper No. 15/13.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation was up 5.2 points from the end of the first quarter to 15.4 percent in the second quarter of 2018, a level significantly higher than the April forecast (Chart 1.2.1). A similar pattern was observed in the forecast for the CPI excluding unprocessed food, alcohol and tobacco (Chart 1.2.2). The recent cost-side developments and fluctuations in food prices have been affecting inflation. Price hikes spread across all subcategories. The depreciating Turkish lira as well as the rise in oil and commodity prices contributed to this result as well. Albeit weakening, demand conditions continued to put pressure on inflation in the second quarter.

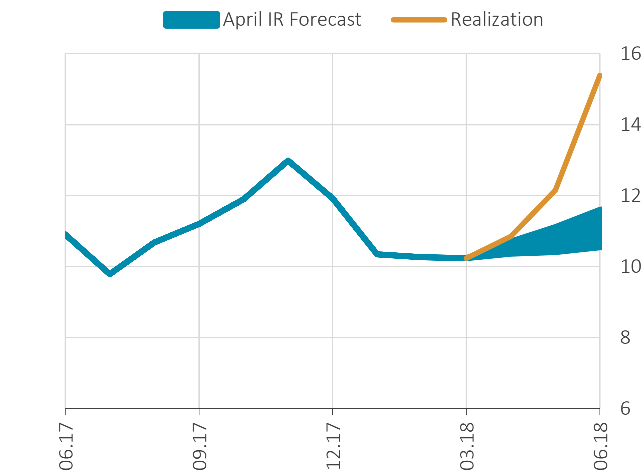
Chart 1.2.1: April Inflation Forecast and Actual Inflation* (%)



Source: CBRT, TurkStat.

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

Chart 1.2.2: Forecast and Actual Inflation Rates for Inflation excl. Unprocessed Food, Alcoholic Beverages and Tobacco Products* (%)



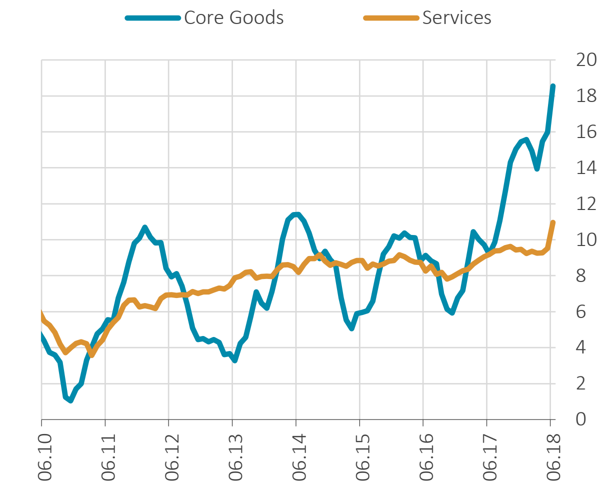
Source: CBRT, TurkStat.

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

In the second quarter, the main factor pushing annual inflation was the core goods group. Cumulative exchange rate effects and strong aggregate demand conditions added to this outlook. Moreover, the rise in the contribution from food, services and energy was significant. The higher-than-expected increase in annual food inflation was mainly driven by unprocessed food prices that rose on the back of exchange rate developments and supply shortages in some agricultural products. Meanwhile, annual services inflation was driven higher by several factors such as the weaker Turkish lira, backward-indexation, worsening food inflation, the buoyant tourism industry and real unit labor costs (Chart 1.2.3). Energy inflation accelerated due to both exchange rate effects and higher international oil prices, nevertheless the new sliding-scale pricing implementation for fuel curbed further increase in energy prices.

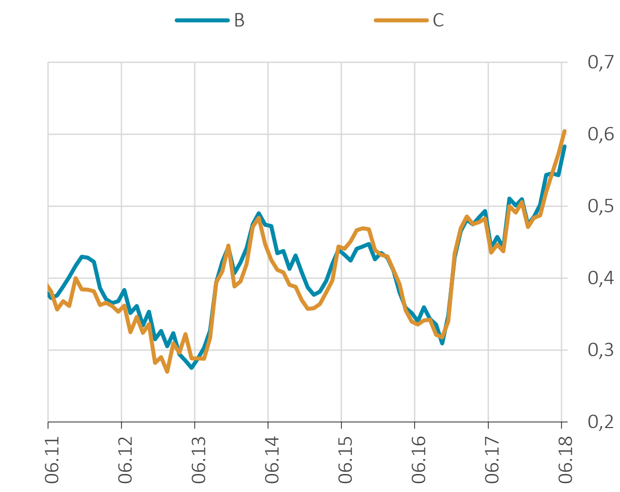
As producer inflation hit 23.7 percent at the end of the second quarter, cost pressures on consumer prices significantly increased. In this period, the impact of demand conditions on inflation still exerted an upward pressure despite the diminished effect compared to the previous quarter. Moreover, the ongoing robust outlook in the tourism sector increases inflation pressures on the sectors tightly affiliated to this sector. In this period, both core inflation indicators and inflation expectations deteriorated significantly. Due to high inflation rates and rising inflation expectations, pricing behavior deteriorates and the tendency for price hikes grows stronger in excess of demand and cost pressures in the economy. Actually, diffusion indices reveal that economic units have a growing tendency to raise prices (Chart 1.2.4). In sum, trend indicators and pricing behavior suggest a notable deterioration in the underlying trend of inflation.

Chart 1.2.3: Prices of Core Goods and Services (Annual % Change)



Source: TURKSTAT.

Chart 1.2.4: Diffusion of B and C Indices (Seasonally Adjusted 3-Month Average)



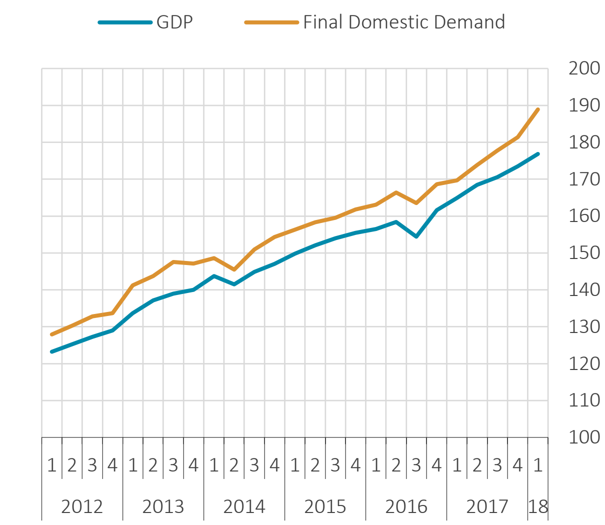
Source: CBRT, TURKSTAT.

Supply and Demand

In the first quarter of 2018, economic activity remained robust, slightly stronger than projected in the April Inflation Report (Chart 1.2.5). Gross Domestic Product (GDP) increased by 2.0 percent on a quarterly basis and 7.4 percent on an annual basis in this quarter.

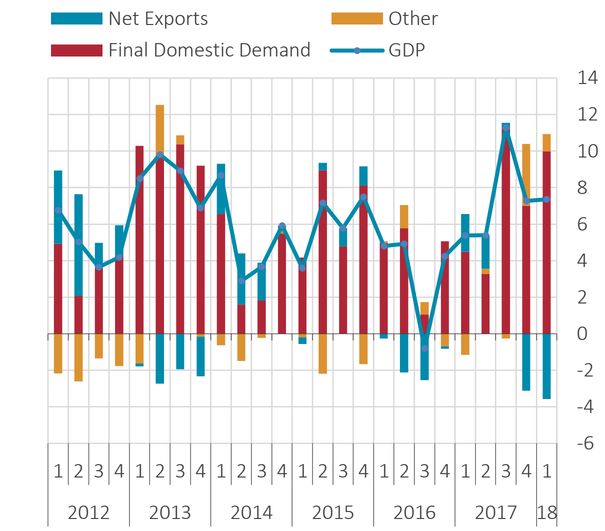
In the first quarter, quarterly and annual growth were both mainly driven by domestic demand (Chart 1.2.6). The improvement in the labor market led to an acceleration in private consumption, while public consumption offered less support to growth. In this quarter, investments contributed to annual growth through machinery-equipment and construction investments; while investments' contribution to quarterly growth came only from the rise in construction investments and the contraction in machinery-equipment investments deepened. The contribution of net exports proved negative to annual growth, but positive to quarterly growth, the latter being driven by the significant fall in imports.

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



Source: CBRT, TURKSTAT.

Chart 1.2.6: Contributions to Annual GDP Growth from the Expenditures Side (% Points)



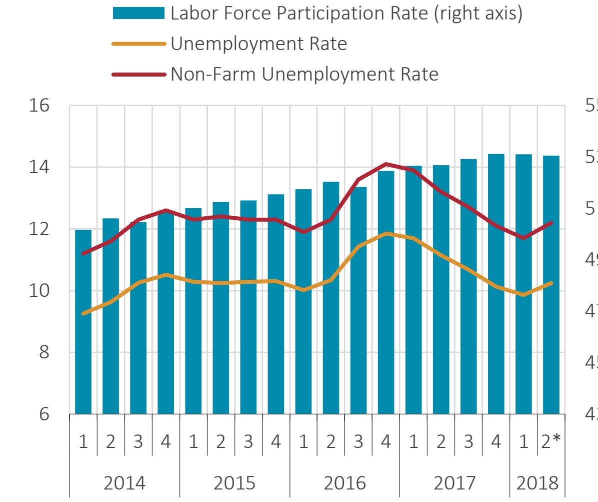
Source: CBRT, TURKSTAT.

* Other includes changes in inventories and statistical discrepancy due to the use of chain-linked index.

Data for the second quarter suggest that economic activity has decelerated and started rebalancing. The possible deceleration particularly in the construction sector as well as services sectors that are not subject to foreign trade is expected to have negative repercussions on the labor market, and indicators suggest an increase in unemployment rates (Chart 1.2.7). In this period, the depreciation in the Turkish lira accompanied by the increased financial volatility, perceptions of uncertainty and financing costs as well as the uptrend in inflation are projected to decelerate domestic demand via the consumption and investment expenditures channels. Meanwhile, the public sector's supportive stance for economic activity through expenditures and other fiscal measures is expected to limit the slowdown in domestic demand to some extent in the second quarter. On the other hand, recovery in tourism continues strongly and net exports continue to underpin growth due to the slowdown in import demand resulting from the subdued domestic demand. Rising import prices, particularly oil, weigh on the current account balance further, while the slowing domestic demand restricts the deterioration in the current account balance excluding gold and energy (Chart 1.2.8).

In the second half of 2018, economic activity is projected to continue rebalancing. Owing to the cumulative depreciation in the real exchange rates, the strong rebound in tourism and the favorable course of global growth, it is likely that exports of goods and services will continue to underpin growth and affect the current account balance positively. Nevertheless, the slowdown in economic activity will have an adverse impact on the labor market and thus, unemployment rates will rise slightly.

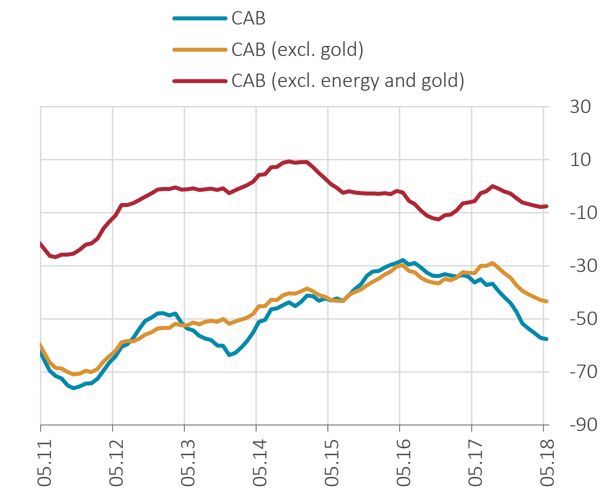
Chart 1.2.7: Unemployment Rates (Seasonally Adjusted, %)



Source: TURKSTAT.

* April period.

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



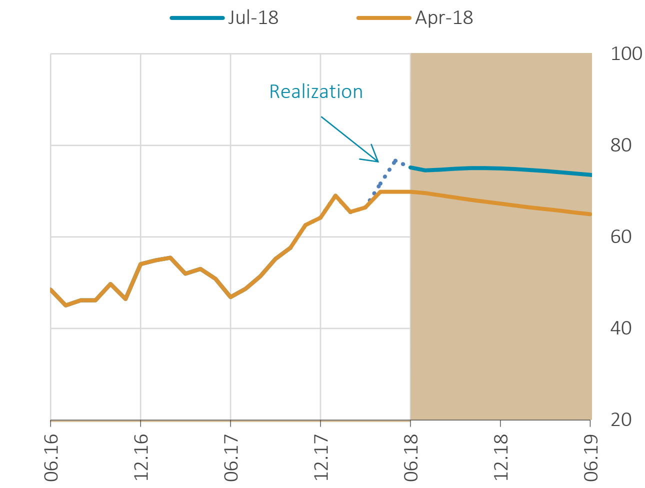
Source: CBRT.

Oil, Import and Food Prices

Led mainly by energy and industrial metal prices, commodity prices on international markets remained on the rise in the second quarter. Due to the rise in crude oil prices in the second quarter, assumptions for crude oil prices in the medium-term forecasts in the April Inflation Report were revised upwards from USD 68 to USD 73 for 2018, and from USD 65 to USD 73 for 2019 (Chart 1.2.9). The assumptions for average annual increase in import prices in USD terms were revised upwards for 2018 and 2019 on account of the recent developments (Chart 1.2.10).

Unprocessed food inflation surged by 16.9 percent quarter-on-quarter and hit 23.2 percent at the end of the second quarter of 2018, significantly exceeding the assumptions cited in the April Inflation Report. Unprocessed food inflation is assumed to converge to its historical averages and decline to 12 percent at the end of the year as prices of some vegetables and fruits are expected to normalize with the supply of new products in the upcoming period. Accordingly, the food inflation forecast was revised upwards to 13 percent from 7 percent for end-2018, and to 10 percent from 7 percent for end-2019.

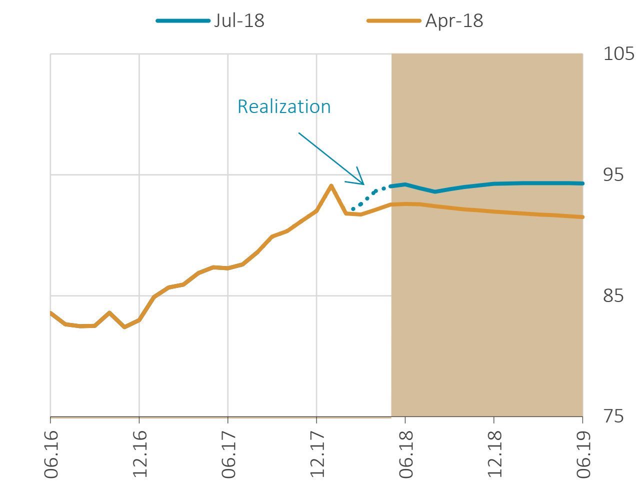
Chart 1.2.9: Revisions in Oil Price Assumptions* (USD/bbl)



Source: Bloomberg, CBRT.

* Shaded area denotes the forecast period.

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



Source: Bloomberg, CBRT.

* Shaded area denotes the forecast period.

Fiscal Policy and Tax Adjustments

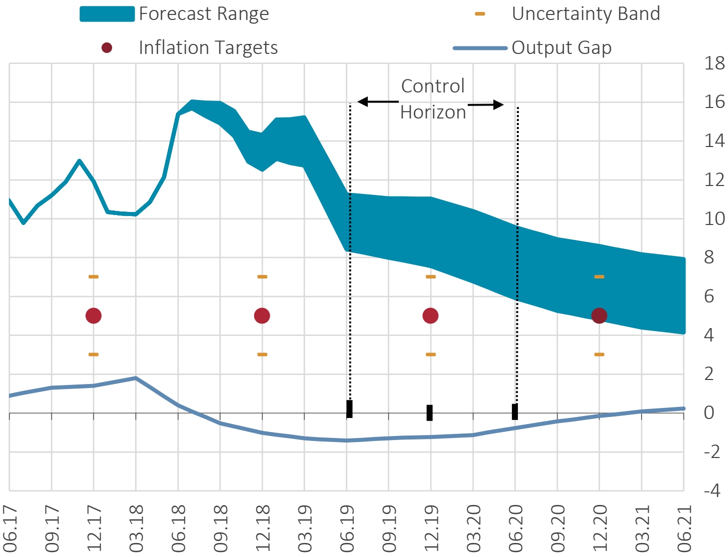
Fiscal policy remained supportive of economic activity in the second quarter, while some arrangements on administered prices and tax adjustments curbed further rise in inflation. Forecasts are based on the scenario that the arrangement introduced to stabilize fuel prices will continue until the end of the year. On the other hand, it is assumed that energy items excluding fuel will witness price adjustments at higher rates in the third quarter than those envisaged in the April Inflation Report.

Medium-term projections are based on a framework entailing a fiscal policy focused on lowering inflation in the medium term and conducted in coordination with the monetary policy. Accordingly, it is assumed that the support of the public sector for economic activity will be replaced by a neutral stance, and the prices and wages controlled by the government will be set broadly consistent with inflation targets to reduce backward-indexation. The strong policy coordination to lower inflation and achieve macroeconomic rebalancing is envisaged to gradually improve the risk premium and uncertainty perceptions.

1.3 Inflation and the Monetary Policy Outlook

With a tight policy stance that focuses on bringing inflation down through enhanced policy coordination, inflation is projected to converge gradually to the target. Accordingly, inflation is projected to be 13.4 percent at the end of 2018 and then fall to 9.3 percent at the end of 2019, 6.7 percent at the end of 2020, stabilizing around 5 percent over the medium term. Thus, with a 70 percent probability, inflation is expected to be between 12.5 percent and 14.3 percent (with a mid-point of 13.4 percent) at end-2018, between 7.6 percent and 11.0 percent (with a mid-point of 9.3 percent) at end-2019 and between 4.8 percent and 8.6 percent at the end of 2020 (with a mid-point of 6.7 percent) (Chart 1.3.1). Forecasts are based on an outlook that the tight monetary policy stance will be maintained for an extended period.

Chart 1.3.1: Inflation and Output Gap Forecasts*



Source: CBRT, TURKSTAT.

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

The annual consumer inflation forecast for end-2018 has been revised upwards to 13.4 percent, indicating a 5-point rise compared to April Inflation Report. Of this rise, 2.3 percentage points came from the revision in import price assumption in TL terms because of the developments stemming from oil prices and exchange rates. In this revision, the impact of oil and exchange rate-induced cost factors on energy prices other than fuel has been included as well. Food inflation, which was revised upwards from 7 percent to 13 percent, contributes to the revision in end-year consumer inflation forecast by 1.4 percentage points. The high inflation forecast discrepancy coupled with the deterioration in pricing behavior is estimated to add 1.3 percentage points to the inflation forecast. The rise in the prices of alcoholic beverages -on the back of the increased special consumption tax- constitutes 0.1 percentage points of the total revision. The output gap estimates, which are revised downwards compared to the previous reporting period, are expected to decrease the end-2018 consumer inflation forecast by 0.1 percentage points.

Meanwhile, the inflation forecast for end-2019 has been revised upwards from 6.5 percent to 9.3 percent. Of the 2.8-point upward revision in end-2019 inflation forecast compared to the April Inflation Report, 1.5 percentage points stemmed from the upward revision in oil and import price assumptions in TL terms, whereas 0.7 percentage points came from the revision in food prices assumption from 7 percent to 10 percent. While adjustment for the higher inflation outturn and deterioration in the underlying trend drove the forecast 1 percentage point higher, the downward revision in the output gap decreased the forecast by 0.4 points.

In the forecast framework described above, annual consumer inflation is projected to display a modest rise in the third quarter and to fall in the final quarter to 13.4 percent at the end of the year. Under the assumption that there will be no additional rise in Turkey's risk premium driven by global or domestic developments, the disinflation process throughout 2019 will be supported by the tight monetary policy stance and the determined implementation of inflation-oriented policy coordination, as well as economic activity and loan growth converging to a milder path.

With a view to reduce the tradeoffs regarding disinflation in the current juncture and to enhance the resilience of the Turkish economy, and also considering the high levels of inflation and elevated global risks, the prospective contribution from fiscal and macroprudential policies to the rebalancing process is of critical importance (Box 7.1). The main outlook is based on a framework in which the negative divergence of risk perceptions regarding Turkey would be largely taken back so that depreciation pressures on the Turkish lira would be alleviated as a result of the macro policy mix formulated in a coordinated way prioritizing the disinflation process. Accordingly, a moderate appreciation trend was assumed in the real exchange rate. Moreover, while formulating forecasts, it was envisaged that this policy coordination would stop the extended deterioration in inflation expectations and contribute in particular to the gradual convergence of medium-term inflation expectations to the target.

The enhanced coordination between macroeconomic policies is judged to alleviate the decelerating impact of increased financial volatility and uncertainty perceptions on domestic demand and limit the tightening of financial conditions. Therefore, the output gap estimates for the second and third quarters, which were revised downwards significantly compared to the April Inflation Report, are projected to trend down moderately in the fourth quarter. The economic activity is expected to start contributing to disinflation in the second half, as domestic demand decelerates. Output gap forecasts for 2019 are lower compared to the April Inflation Report, and imply an outlook where economic activity gradually recovers and converges to the underlying trend.

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

The outlook that the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions. Nevertheless, various risks to these factors may affect the inflation outlook and necessitate changes in the monetary policy stance envisaged in the baseline scenario.

Risks to the medium-term inflation outlook are mostly on the upside. Risks that have the potential to change the outlook that the baseline scenario hinges on are as follows:[1]

- Risks to the effectiveness of the coordination between the monetary and fiscal policies;
- A deterioration in pricing behavior and expectations formation;
- Weaker capital flows towards emerging market economies;
- Persisting volatilities in financial markets stemming from domestic factors;
- Further supply-side tightening in bank loans;
- Likely adverse impacts of global protectionist trade policies on economic activity, trade volume and prices;
- Rise in crude oil import prices;
- Sustained rise in food prices.

A weaker coordination between monetary and fiscal policy than in the baseline scenario is regarded as a risk with respect to disinflation and macroeconomic rebalancing. This coordination has two pillars. Firstly, it is important that the administered prices, tax adjustments and incomes policies are formulated in a way to help diminish the backward-indexation behavior. The second pillar is to implement countercyclical fiscal policy to ensure the rebalancing of the economy. The demand-side pressures on prices may continue if the supportive impact of expansionary fiscal policy measures on domestic demand and economic activity persists. Amid further tightening in global financial conditions and also taking into account the current high levels of inflation and the current account deficit, this would lead to a climb in Turkey's risk premium, an increased pressure on exchange rates, and hence, a tighter monetary policy stance would be required to decrease inflation.

Another important risk to inflation outlook in the upcoming period would be further deterioration in the pricing behavior. Under a conjuncture of high inflation rates and risk premium level and in case of a failure in implementing the macroeconomic rebalancing process rapidly and effectively, inflation and

[1] The channels through which these risks may change inflation outlook are summarized in Table 7.3.1 in Chapter 7.

exchange rate expectations may feed each other and undermine the disinflation process. In such a case, any further deterioration in the pricing behavior may necessitate a tighter monetary policy stance for longer in order to lower inflation.

Moreover, there are also risks stemming from global monetary policies and risk appetite developments that may lead to a decline in capital flows towards emerging economies and feed into exchange rate volatility. If unhealthy price formations and excessive volatility occur in the markets due to fluctuations in global liquidity conditions, the CBRT may continue using liquidity measures intended for providing the FX liquidity needed in the market in a timely, controlled and effective manner, and it may introduce additional tightening in monetary policy to curb the impact of these risks on inflation and inflation expectations.

Although the forecasts in the previous section are based on an outlook of moderately slowing economic activity, in the case of high market volatility and additional depreciation of the Turkish lira, firms' cash flows and balance sheets may be adversely affected and financial conditions may tighten further. Likewise, a significant deceleration in the rate of increase in house and commercial real estate prices may decrease the value of collaterals that the firms put up against loans and firms may be exposed to tighter credit conditions. Should the risks mentioned materialize, they could lead to a more significant slowdown in economic activity than envisaged. The policy mix that would be employed in such a case will be very important for preventing the financial conditions from falling into an unproductive tightening cycle. A strong coordination to be established between the financial sector policies addressing the balance sheet effects in particular and the monetary policy focusing on inflation will enhance the effectiveness of the policies.

On a global scale, the likely adverse impact of protectionist trade policies on economic activity, trade volume and prices may have a downward impact on inflation in Turkey mainly through the external demand channel. On the other hand, if these trade policies cause a rise in global inflation, countries involved in trade protectionism may tighten their monetary policies and the global risk appetite may deteriorate. In this case, the likely depreciation in Turkish lira will necessitate a policy response proportionate to the impact of this depreciation on inflation.

There are also supply-side risks to food and crude oil prices that may affect inflation adversely. The CBRT's monetary policy response will be determined in such a way to curb a possible deterioration in inflation expectations and pricing behavior, taking into account the direct and secondary effects of respective risks on inflation.