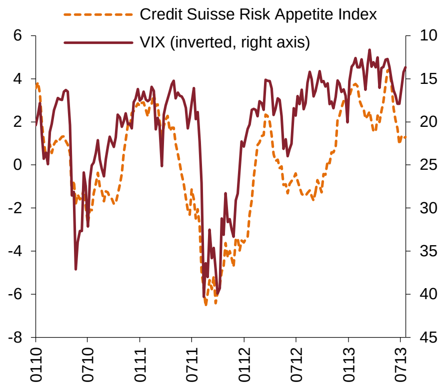
1. Overview

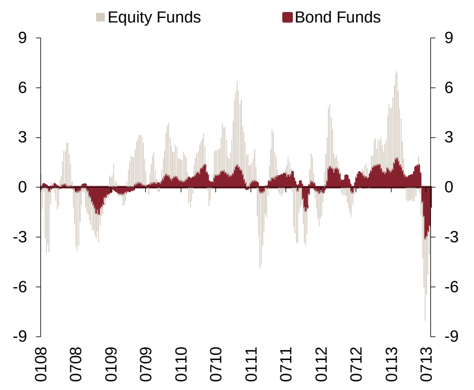
Global monetary policy developments influenced financial markets in the second quarter of the year. Persisting fragilities in the global economy in addition to increased uncertainty over the monetary policies of advanced economies led to higher volatility in the risk appetite (Chart 1.1). In particular, the Fed's signals for a pullback on bond purchases in the near future have resulted in capital outflows from emerging economies as of May (Chart 1.2).

Chart 1.1
Global Risk Appetite



Source: Credit Suisse, Bloomberg.

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



Source: EPFR, Bloomberg.

As global economic activity remains weak, global growth forecasts are revised downwards. Despite the stable growth in the US economy, the weak course of the Euro Area economies and the slowdown in emerging economies still persist. A recent surge in the volatility of capital flows have exacerbated the downside risks on emerging economies through the credit and expectations channel. In such an economic environment, maintaining a flexible monetary policy framework with multiple instruments remains crucial in order to preserve price stability while observing financial stability.

1.1. Monetary Policy and Monetary Conditions

Since end-2010, the CBRT has been implementing a monetary policy framework designed to take macro financial risks into account. Accordingly, special emphasis is placed on containing the distortionary effects of capital flow volatility on price stability and financial stability.

Owing to the improved inflation outlook and strengthened capital inflows as of the third quarter of 2012, the CBRT opted for a gradual monetary easing. Despite occasional fluctuations stemming from the global risk appetite, liquidity policy in this period has been largely accommodative. By providing excess liquidity to the market, the CBRT kept overnight market rates close to the lower band of the interest rate corridor (Charts 1.1.1 and 1.1.2). Short-term interest rates and the CBRT average funding rate were reduced until May 2013. Moreover, reserve options coefficients were gradually raised to alleviate the adverse effects of capital inflows on financial stability.

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

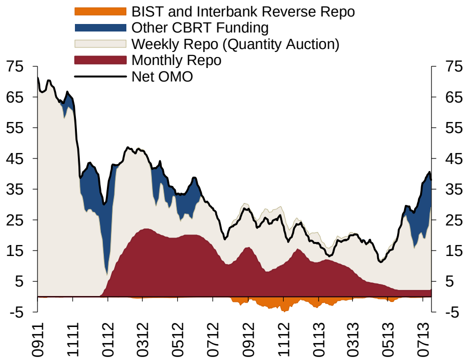
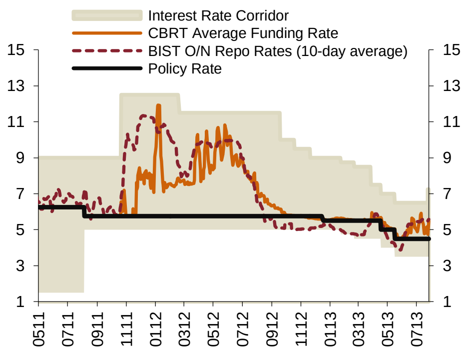


Chart 1.1.2.
Policy Rate and Liquidity Policies
(Percent)



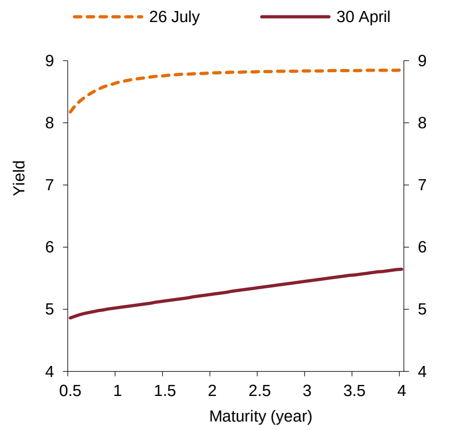
* Other CBRT funding includes primary dealer repo transactions, repo transactions at the BIST Repo and the Reverse Repo Market and lending depot facility at the Interbank Money Market.
Source: BIST, CBRT.

Developments as of late May called for a change in the monetary policy stance. Elevated uncertainties regarding global monetary policies caused rapid capital outflows, excessive depreciation of the Turkish lira and fluctuations in financial markets, which led the CBRT to tighten the liquidity policy by changing the composition of the liquidity injected into the market (Chart 1.1.1). In its July meeting, the MPC decided to raise the upper band of the interest rate corridor by 75 basis points in order to contain the distortionary effects of rising inflation on pricing behavior and to support financial stability. Moreover, some arrangements were introduced to strengthen the effects of the interest rate corridor and the liquidity policy on the days of additional monetary tightening. The MPC stated that the monetary policy would remain cautious until the inflation outlook aligns with the medium-term targets and reiterated that additional monetary tightening would be implemented when deemed necessary.

Meanwhile, the MPC decided to increase the flexibility of the Turkish lira liquidity policy, highlighting the persisting uncertainties regarding the global economy and the volatility in capital flows. The MPC emphasized that developments regarding price stability and financial stability will be closely monitored and necessary adjustments would be made regarding the composition of the Turkish lira liquidity provided by the CBRT.

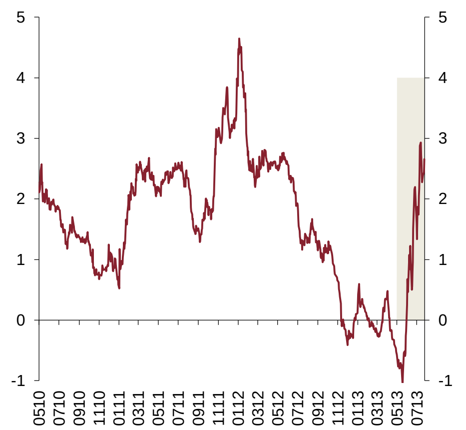
In line with the declining risk appetite, the tightening liquidity policy and the rising global interest rates, nominal market interest rates increased notably across all maturities as of July, while real interest rates also followed a similar trend (Charts 1.1.3 and 1.1.4).

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.

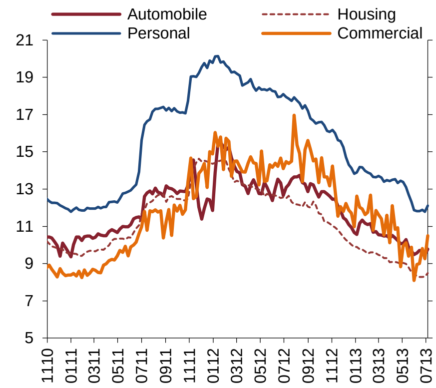
Chart 1.1.4.
2-Year Real Interest Rates for Turkey*
(Percent)



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

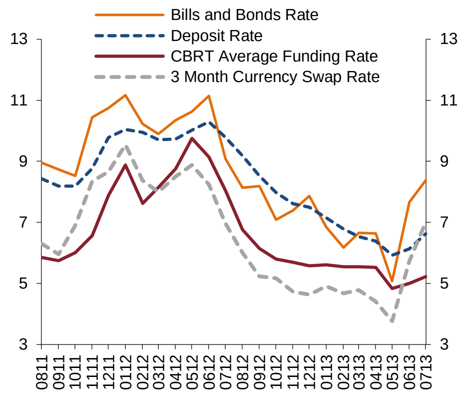
Recently, loan rates have also moved upwards. While commercial loan rates, which respond more quickly to liquidity conditions, posted an evident increase, consumer loan rates recorded a more limited rise (Chart 1.1.5). Deposit rates, currency swap rates, the CBRT's average funding rate as well as bill and bond rates issued by banks, which all represent the Turkish lira funding costs of banks, increased as well (Chart 1.1.6).

Chart 1.1.5.
TL Loan Rates
(Percent)



Source: CBRT.

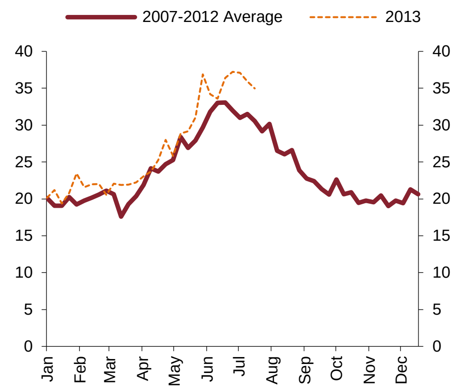
Chart 1.1.6.
Funding Costs of Banks
(Percent)



Source: PDP, CBRT.

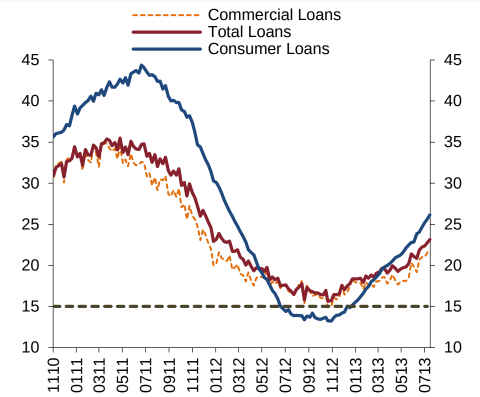
Despite the recent slowdown in capital flows, credit growth remains robust. The course of credits as of July points to a faster growth compared to the average of past years (Chart 1.1.7). Against this backdrop, annual credit growth rates also hover above the reference value (Chart 1.1.8). Due to mounting uncertainties in financial markets, both credit supply and credit demand may slow down in the forthcoming period. Nevertheless, the annual credit growth rate is expected to exceed the reference level at end-2013.

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



Source: CBRT.

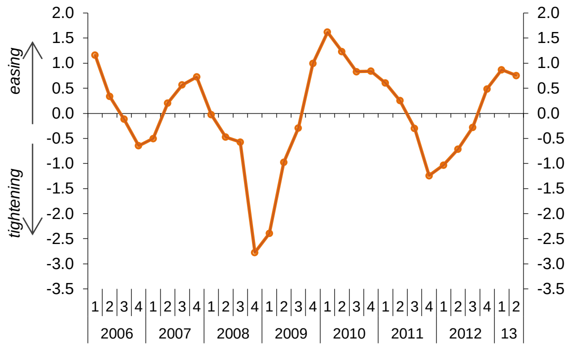
Chart 1.1.8.
Annual Growth Rate of Loans
(Percent)



Source: CBRT.

In the second quarter of the year, financial conditions continued to be accommodative despite a limited quarter-on-quarter tightening (Chart 1.1.9). Financial conditions tightened further in July amid the slowdown in capital flows as of May. In view of the cautious stance of the monetary policy, forecasts are based on an outlook where the accommodative effect of financial conditions on domestic demand and credits will taper off in the second half of the year.

Chart 1.1.9.
Financial Conditions Index



*For further details on financial conditions index, see CBT Research Notes in Economics No.12/31 and Inflation Report 2012-IV, Box 5.2.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

Inflation posted a higher-than-expected increase in the second quarter of 2013 and stood at 8.3 percent at the end of the quarter (Chart 1.2.1). The higher-than-estimated course of inflation was mainly attributed to developments in unprocessed food prices, which posed upside risks on inflation in the April Inflation Report. In fact, inflation excluding unprocessed food and tobacco was largely in line with forecasts (Chart 1.2.2).

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

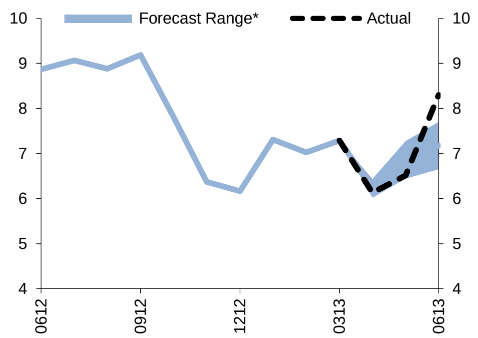
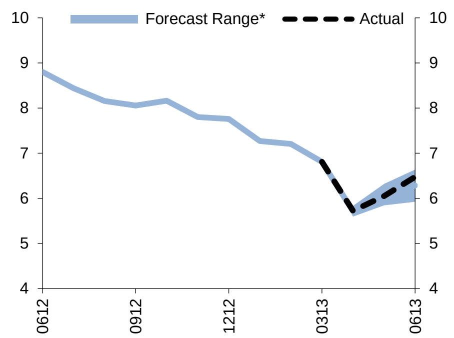


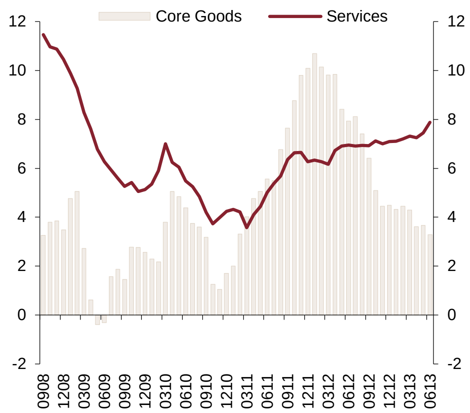
Chart 1.2.2.
Inflation Forecast and Realizations Excluding Unprocessed Food, Tobacco and Alcoholic Beverages
(Percent)



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

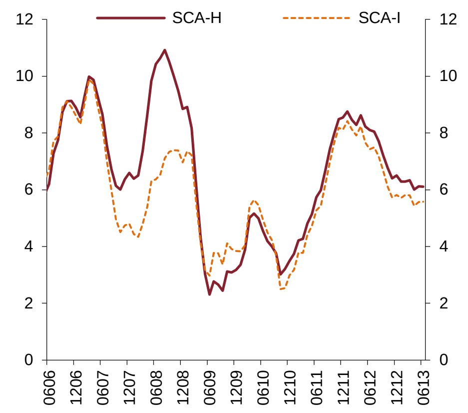
A higher-than-projected rise in inflation in the previous quarter was partly induced by the services inflation, which overshot expectations. This unexpected rise in services inflation added around 0.1 percentage points to the year-end inflation forecast. On the other hand, as the effects of exchange rate developments on core goods prices have not yet materialized, prices of core goods continued with a downward trend, owing also to the base effect (Chart 1.2.3). In light of these developments, core inflation indicators followed a flat course in the second quarter (Chart 1.2.4).

Chart 1.2.3.
Core Goods and Services Prices
(Annual Percent Change)



Source: TurkStat.

Chart 1.2.4.
Core Inflation Indicators
(Annual Percent Change)



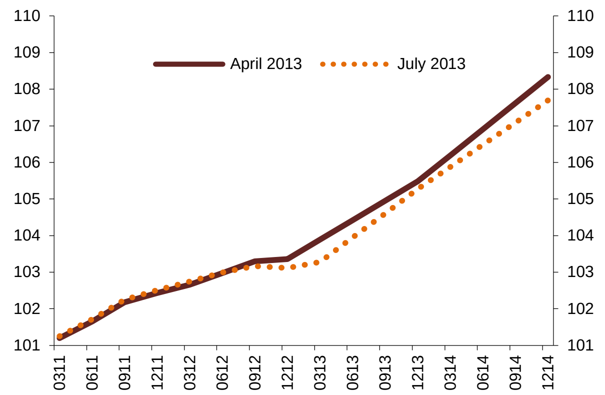
Source: TurkStat.

Supply and Demand

National accounts data pertaining to the first quarter of 2013 pointed to a domestic-demand-driven recovery in economic activity as envisaged in the April Inflation Report. The second quarter data indicated that demand for consumption maintains a moderate growth. However, the recent volatility in financial markets induced by the changes in global liquidity conditions may cause the domestic demand to follow a weaker course in the second half of the year than envisaged in the previous reporting period. In fact, firms' expectations for domestic orders have recently displayed a slight decline.

External demand remained weak in the second quarter of 2013. Euro Area economic activity remained on a downward track, while global growth forecasts were pulled down in this period. Accordingly, export-weighted global growth index was slightly revised downwards (Chart 1.2.5).

Chart 1.2.5.
Export-Weighted Global Economic Activity Index* (2008Q2=100)



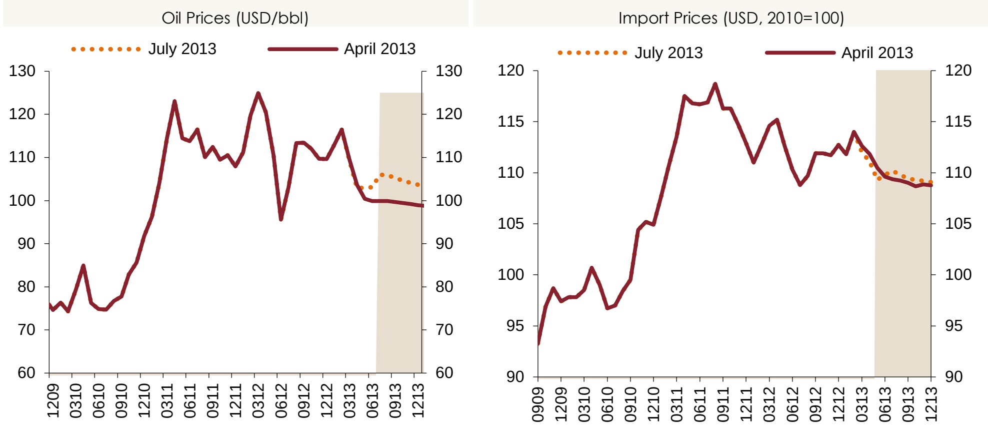
* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

To sum up, forecasts are based on an outlook in which the contribution of aggregate demand conditions to the fall in inflation has slightly increased compared to the previous reporting period. As the effects of economic activity on inflation generally appear with a lag, this revision did not affect end-2013 inflation forecasts; whereas it pulled the end-2014 inflation forecasts down by 0.1 percentage points.

Energy, Import and Food Prices

Import prices remained flat in the last quarter largely consistent with the assumptions of the April Inflation Report (Chart 1.2.6). On the other hand, TL-denominated import prices rose notably due to the recent developments in exchange rates. In addition, in line with the average futures prices in the first three weeks of July, average oil price assumption for 2013, which was set as USD 103 in April, was revised upwards to USD 107 (Chart 1.2.6). These developments added 0.8 percentage points to end-2013 forecast and 0.2 points to end-2014 inflation forecast.

Chart 1.2.6.
Oil and Import Price Assumptions



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

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

The assumption for the annual rate of increase in food prices remained unchanged as 7 percent. In other words, the recent unfavorable course of unprocessed food prices will be temporary, and prices will gradually be normalized by August.

Fiscal Policy and Tax Adjustments

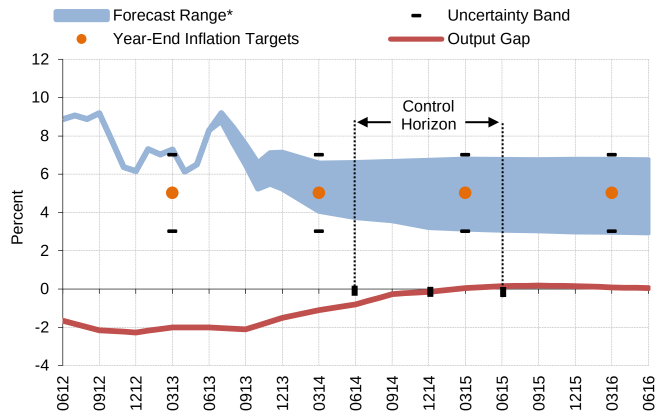
Medium-term projections are based on the assumption that no additional tax adjustments will be introduced to tobacco and energy products in the rest of the year. Meanwhile, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms.

MTP projections on the fiscal policy stance are taken as given. Accordingly, it is assumed that fiscal discipline will be preserved and the ratio of primary expenditures to GDP will not display a notable change compared to the first half of the year. Thus, there has been no change in end-2013 inflation forecast stemming from the fiscal policy.

1.3. Inflation and Monetary Policy Outlook

Medium-term forecasts envisage an outlook where the cautious and flexible stance of the monetary policy is preserved on account of the recently-elevated uncertainties regarding global monetary policies and weakening capital flows. Accordingly, it is assumed that the liquidity policy will be tight, the interest rate corridor will be actively used when necessary, and the annual growth rate of credit will fall to 15 percent by mid-2014. Accordingly, inflation is expected to be, with 70 percent probability, between 5.2 percent and 7.2 percent (with a mid-point of 6.2 percent) at end-2013 and between 3.3 percent and 6.7 percent (with a mid-point of 5.0 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



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

In sum, given the assumptions underlying the inflation forecasts and external conditions, the end-2013 inflation forecast was revised upwards by 0.9 percentage points mainly due to developments in the exchange rate and oil prices. Given the sluggish outlook of the global economy and the mild course of domestic demand, these developments are expected to have a limited effect on end-2014 inflation.

Inflation is estimated to fluctuate in the short term due to the base effect on energy prices. Accordingly, annual inflation is expected to go up in July before trending downwards in August. Although inflation is likely to overshoot the 5 percent target at year-end, it is expected to converge to the target by early 2014 as the effects of the hike in tobacco prices on annual inflation taper off in January 2013 (Chart 1.3.1). Core inflation indicators (SCA-H and SCA-I) are expected to display a limited rise in the third quarter due to the lagged effects of the recent exchange rate developments, and then remain largely flat until the end of the year.

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

Ongoing fragility in the global economy and heightened uncertainty regarding global monetary policies necessitate a flexible monetary policy framework. Accordingly, global liquidity conditions will play an important role in the future course of monetary policy. The current monetary policy and the instruments designed by the CBRT provide a flexible framework to contain adverse effects of global shocks on the domestic economy.

Currently, the data on global economic activity do not exhibit a stable pattern. Risk appetite and capital flows may remain volatile, should uncertainties regarding economic policies of advanced economies persist. This situation may pose risks to the inflation outlook and financial stability. In order to contain the excessive volatility in the exchange rate, the CBRT will effectively use the interest rate corridor and other policy instruments should such a risk materialize.

The possibility of a delay in the global economic recovery, which will require maintaining quantitative easing policies in advanced economies for an extended period, remains as a downside risk. In that case, capital flows to emerging economies are likely to re-accelerate. Materialization of such a scenario may prompt the CBRT to lower short-term money market rates by easing liquidity conditions, while the adverse impact of rapid capital inflows on financial stability can be alleviated through required reserves and reserve options mechanism.

Recently, the medium-term inflation expectations have displayed a slight deterioration as several factors have simultaneously exerted pressure on inflation. Increases in unprocessed food prices, higher oil prices, and exchange rate volatility may continue to have an adverse impact on inflation in the short term. Although these effects are expected to be temporary, it is also possible that unprocessed food prices can be corrected with a delay or financial markets may continue to be volatile. Accordingly, the CBRT will maintain its cautious stance until the inflation outlook is consistent with the medium-term targets and will opt for further monetary tightening by closely monitoring pricing behavior.

In formulating its monetary policy strategy, the CBRT monitors developments on fiscal policy and tax adjustments closely with regard to their effects on the inflation outlook. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. Hence, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes to 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, have an adverse effect on the medium-term inflation outlook.

Sustaining the cautious stance in fiscal and financial sector policies is critical to maintain our economic resilience against global imbalances. Strengthening structural reforms that ensure the sustainability of fiscal discipline on a permanent basis 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, fulfilling the structural reforms envisaged by the MTP remains to be of utmost importance.