CENTRAL BANK OF
THE REPUBLIC OF TURKEY

inflation report
2009-III

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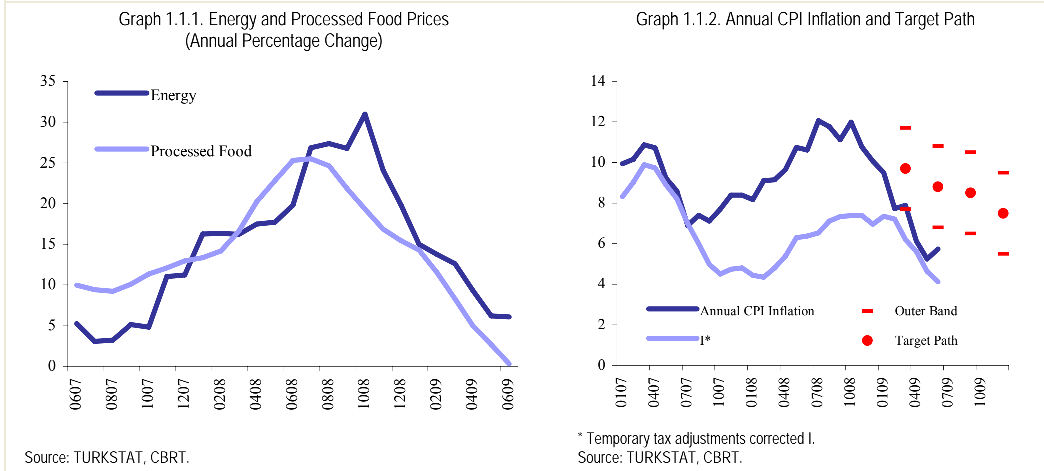
1. Overview

The global crisis which erupted in developed markets and then spread across the world during the last quarter of 2008, has continued to dominate the economic outlook during the second quarter of 2009. While recent data releases indicate that the worse may be over, improvements in leading indicators have been slow, problems in credit markets linger, and employment remains in a precarious state, suggesting that the recovery will be anemic and protracted.

1.1. Inflation Developments

The sharp contraction in economic activity and the collapse of commodity prices have brought down inflation across the world, including Turkey. Despite the relative soundness of the Turkish financial system, a higher share of cyclically sensitive exports, firms' dependence on external financing conditions, and high production capacity just before the global downturn have all been factors that exacerbated the severity of the contraction in output. At the same time, tighter credit conditions, heightened risk perceptions, and rising precautionary savings have contributed to the marked decline in domestic demand.

The fall in commodity prices have led to a sharper-than-expected drop in annual processed food and energy inflation. Specifically, the fall in annual inflation has been 25 percentage points for energy prices and 19 percentage points for processed food prices since October 2008 (Graph 1.1.1). Moreover, the contraction in the aggregate demand and the temporary tax cuts, have led to a more-than-anticipated decline in core goods and services inflation. Consequently, inflation dropped to 5.73 percent in June—below the lower bound of the uncertainty band set at 6.8 percent for the end of second quarter. The inflation measure excluding food, energy, tobacco, alcohol, and gold items (Core Index I) has decreased to 4.13 percent, after being corrected for the temporary tax adjustments (Graph 1.1.2).



1.2. Monetary Policy

Anticipating that inflation would decrease sharply following the last quarter of 2008, the Central Bank of the Republic of Turkey (CBRT) focused on alleviating the harsh impact of the global financial crisis on the domestic economy. In this respect, the CBRT has delivered sizeable cuts in policy rates, while providing liquidity support to facilitate the smooth operation of credit and financial markets. Relative soundness of Turkey's financial system, coupled with the expected decline in inflation, set the ground for rapid and bold rate cuts. Consequently, the CBRT lowered policy rates more than any other emerging market central bank operating within an inflation targeting framework. Data releases on inflation and economic activity since the inception of the rate cutting cycle and the benign course of risk indicators have vindicated these preemptive monetary policy decisions, and strengthened the impact of the policy decisions on expectations, bringing government bond yields to historically low levels.

As of the second quarter, credit markets have started to respond to the easing of policy rates. Especially, the fall in business loan rates has been quite noticeable. Decreasing loan rates have helped to lower the financing costs of firms restructuring their debt, easing balance sheet constraints, and thereby helping offset a persistent deterioration of production capacity. While business loan rates declined considerably, longer-term consumer loans with fixed rates still remained at relatively high levels. Along with elevated term premiums, the decline in interest rates was relatively limited for longer-term consumer loans.

Overall, the CBRT has adopted a countercyclical policy to alleviate the adverse impact of the global crisis on the domestic economy. With the support of the expansionary fiscal measures, the rate cuts totaling 850 basis points since November 2008 have started to show its effects on credit markets and domestic demand, helping reduce macroeconomic risks. Despite these policy initiatives, financial conditions have remained relatively tight owing to persisting uncertainties regarding the global economic outlook.

1.3. Outlook for Inflation and Monetary Policy

The first quarter Gross Domestic Product (GDP) release was broadly in line with the outlook presented in the April Inflation Report. During this period, external demand remained weak, the adverse impact of the global crisis on the labor market intensified, and domestic demand displayed a sharp slowdown. Accordingly, the contraction in the economic activity has deepened and output gap has further widened.

Although recent releases point to a partial improvement in domestic consumption demand, the ongoing tightness in credit markets and the weakness in employment conditions pose uncertainties regarding the strength and durability of the recovery. Moreover, external demand remains weak. Leading indicators suggest that the recovery process in the Euro area—our main trade partner—will be anemic and protracted. Therefore, demand uncertainty and the low level of resource utilization are expected to continue to weight down on investment and employment, while high unemployment rates would suppress domestic demand going forward.

In sum, taking domestic and external demand developments into account, the revised inflation forecasts are based on an outlook which envisages that the aggregate demand conditions would support disinflation for an extended period of time.

Although the recovery in global economic activity is expected to be gradual, the recent bottoming out of leading indicators has led to a rebound in commodity prices. Accordingly, the oil price assumptions stated in the past Report are revised in line with futures prices registered in the first half of July. In this context, the previous assumption of average oil prices at USD 55 per barrel in the previous Report is revised to USD 60 for 2009, and to USD 70 in

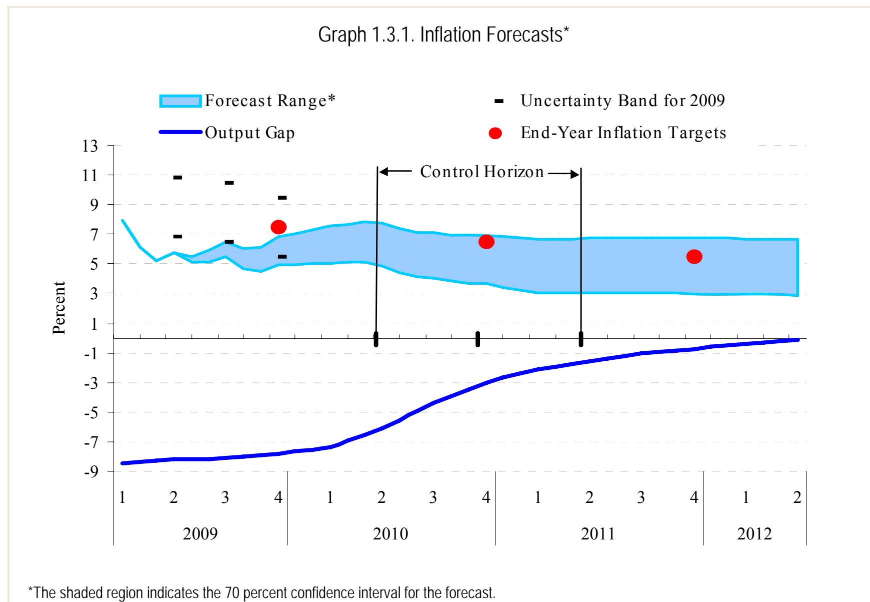
2010 and thereafter. On the other hand, projections for food inflation of 7.5 percent for end-2009 and 6 percent for the following years are maintained.

The impact of exchange rate movements since the last quarter of 2008 on input costs were offset by declining import prices. Therefore, import prices denominated in domestic currency did not display significant changes. Throughout the forecast horizon, imported input costs are assumed to increase gradually, in line with the anticipated slow recovery in global economic activity.

Furthermore, the revised forecasts envisage world interest rates to remain low for an extended period of time. Regarding fiscal policy, it is assumed that fiscal discipline will be established within a medium-term program. Moreover, adjustments in taxes/administered prices in the second half of 2009, are assumed to add around 1.5 percentage points to 2009 inflation.

Against this background, assuming some further easing in the near term, and constant policy rates until the end of 2010, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 4.9 and 6.9 percent with a mid-point of 5.9 percent at the end of 2009, and between 3.7 and 6.9 percent with a mid-point of 5.3 percent at the end of 2010. Furthermore, inflation is expected to come down to 4.9 percent by the end of 2011 and to 4.8 percent by mid-2012 (Graph 1.3.1).

Graph 1.3.1. Inflation Forecasts*



*The shaded region indicates the 70 percent confidence interval for the forecast.

The revised forecasts indicate that the output gap will not close over the next two years, even when policy rates are kept at low levels for an extended period. However, significant base effects may lead to some inflation volatility in the short term (up to one-year ahead). Specifically, cumulative inflation during the first half of 2009 has been historically low at 1.83 percent, indicating that inflation, *ceteris paribus*, would rise in the first half of 2010 due to base effects (Graph 1.3.1). Afterwards, as the impacts of the tax hikes would disappear gradually, inflation is expected to trend downwards starting from the second half of 2010, stabilizing slightly below the 2011 target of 5.5 percent. It is critical to note that, inflation would be less persistent and thus the economic recovery would be smoother should economic agents take these forecasts as benchmark in their pricing decisions.

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 on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risk Factors and Monetary Policy

Despite having partially receded, the risks regarding the global economy are still important for the inflation and monetary policy outlook. In particular, ongoing problems in credit and labor markets pose downside risks on global activity. Should the global conditions and consequently domestic economic activity further deteriorate, the CBRT would consider another cycle of rate cuts, and then maintain policy rates at low single digits for an extended period.

Another possible scenario is a surge in capital inflows to emerging markets owing to the relative improvement in creditworthiness of these countries. In this context, receding risk premiums and appreciating currencies would present downside risks regarding inflation prospects. These circumstances could also trigger an acceleration in rate cuts, or another easing cycle, which could then bring policy rates hovering around low single digits for a prolonged period of time.

Increasing budget deficits on a worldwide scale continue to pose risks on inflation expectations and thus on global interest rates in the long term. The medium-term forecasts presented above envisage that the slow recovery in the global economic activity and rising saving rates will keep global interest rates

at low levels for an extended period. However, the lack of a clear exit strategy from the global fiscal stimulus packages creates upside risks regarding global inflation rates and therefore longer-term global interest rates.

The outlook for fiscal policy in Turkey, would therefore be a key input for monetary policy strategy to be followed in the medium term and especially after 2011. The relatively strong performance of the risk indicators of the Turkish economy during the global crisis, owing to the soundness of its financial system, have created a conducive environment for rapid monetary policy easing. As a consequence, policy rates are now at historically low levels. Medium- and long-term government bond yields, on the other hand, still hover at high levels. Current global conditions provide an important opportunity to bring longer-term government bond yields to single digits and keep them at single digits over the three-year forecast horizon. Bringing medium- and long-term yields to single digits would be largely conditional on the establishment of a solid fiscal framework. A credible fiscal framework will not only bring down risk premiums, but also allow monetary policy to keep interest rates at low levels for an extended period. Therefore, the establishment of a credible medium-term program ensuring fiscal discipline and debt sustainability should make it possible to keep longer-term rates at single digit levels.

In sum, increased perceptions that low growth and low interest rates in the global economy will persist for an extended period allows monetary policy to provide more solid information regarding the future policy path. Accordingly, inflation and output gap forecasts have been presented under the assumption of some further easing in the near term and constant policy rates until the end of 2010. The course of monetary policy during 2011 and thereafter would depend on the factors affecting inflation. Assuming that fiscal discipline will be restored progressively and decisively once the crisis is over, policy rates could remain at single digit levels over the whole three-year forecast horizon.

The CBRT will continue to take the necessary measures to contain the adverse effects of the global financial turmoil on the domestic economy, provided that they do not conflict with the price stability objective. Prudent monetary policy is necessary but not sufficient to maintain the resilience of the economy against the global crisis. Therefore, strengthening the commitment to fiscal discipline and the structural reform agenda is also critical for facilitating

expectations management and for supporting the effectiveness of the monetary policy decisions. In this respect, timely implementation of the structural reforms in the context of the European Union accession process remains to be of utmost importance.

2. International Economic Developments

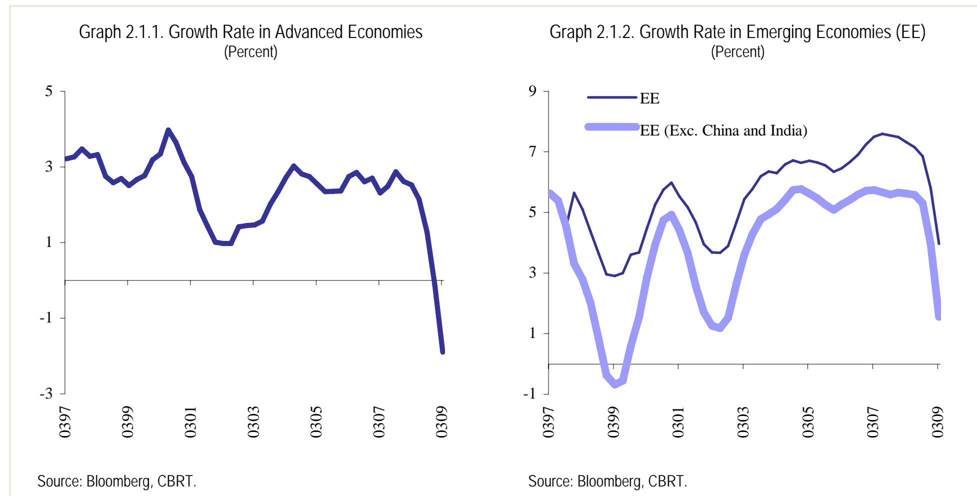
The first quarter of 2009 was marked by the growing impact of the global crisis on real economy. In addition, spillovers from the global financial turmoil have become increasingly prevalent in developing and emerging market economies by the first quarter. Although advanced economies had launched the largest fiscal stimulus packages in history, they failed to ease the severe crunch in credit markets, and growth rates tumbled amid the rapid economic slowdown in the world. The decline in economic activity and higher unemployment continue to weigh on the financial sector.

Markets have stabilized somewhat following the G-20 London summit in March, which envisaged the inaction of a fiscal stimulus package of about 5 trillion US dollars. Meanwhile, ongoing policy rate cuts, massive liquidity injections into markets, increased government guarantees and measures to recapitalize troubled banks have helped promote intermediation and allay concerns over financial markets. However, despite the slowing contraction in world trade volume and confidence indices, financial fragility still abounds, while house prices continue to decline and credit conditions remain tight.

Moreover, as the effects of the advanced economies' expansionary and coordinated fiscal and monetary policies began to unfold, expectations have partially improved, leading many to believe that the worst of the global recession is over. In fact, after quarters of steady downward revisions, international institutions revised their growth estimates for 2010 slightly upwards in the second quarter (Table 2.1.1). Expectations and leading indicators are likely to improve partially in the near term, while the timing of global recovery remains highly uncertain. The financial fragility in advanced economies places further constraint on credit expansion and economic recovery. Economic recessions associated with financial crises prove to be deeper and longer (Box 2.1). Besides, mounting worries about public debt sustainability in some advanced economies drive bond yields higher and, therefore, have a potentially detrimental influence on consumption and investment decisions, particularly in housing markets, which might delay the recovery of the world economy.

2.1. Global Growth

The annual composite GDP growth[1] in advanced economies fell from –0.1 percent in the fourth quarter of 2008 to –1.9 percent in the first quarter of 2009. Japan's GDP expanded by –3.1 percent in the first quarter, while the US and euro area economies grew by –2.5 and –1.1 percent, respectively (Graph 2.1.1).

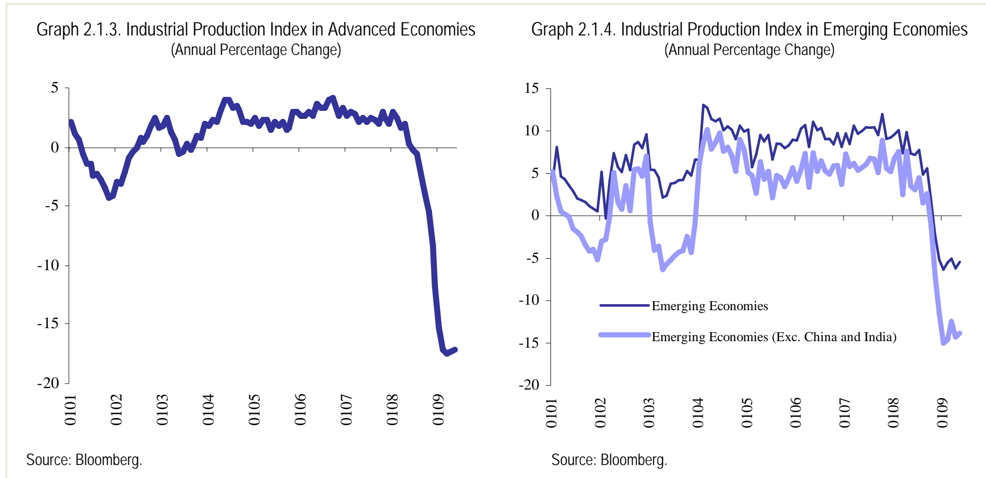


Although leading indicators suggest that the contraction in US economy has slowed somewhat, falling asset prices and tight credit conditions are very likely to weigh on growth. Meanwhile, the turmoil in the European banking system, the ongoing decline in house prices and the credit crunch offer a clouded outlook for economic growth in the euro area for the remainder of the year.

The growth rates in emerging economies fell markedly in the first quarter. The annual composite GDP growth in emerging economies dropped from 5.8 percent in the fourth quarter of 2008 to 4 percent in the first quarter of 2009. Excluding China and India, growth rates were again down from 3.9 to 1.6 percent over the same comparative period (Graph 2.1.2).

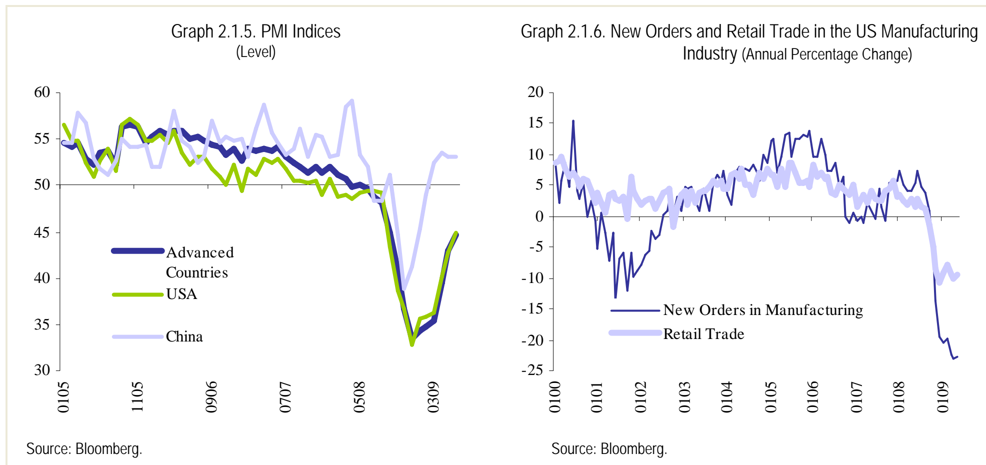
[1] Growth rates are derived from four quarterly cumulative national income figures. Calculated by the same method, Turkey's GDP has grown by –3.9 percent year-on-year as of end-Q1 2009.

The acceleration of the year-on-year decline in the industrial production index for advanced economies has stopped by February (Graph 2.1.3). Similarly, the downturn in the industrial production index for emerging economies has also lost pace (Graph 2.1.4). Both developments indicate that industrial production has bottomed out in advanced and emerging economies.



After a sharp downtrend since May 2008, the composite Purchasing Managers Index (PMI) for advanced economies started to gain pace in January 2009, climbing up to 44.7 points by June. Yet, despite the recent rebound, the index is still below the neutral mark of 50 points. Similarly, the US PMI is also on the rise. The index rose from 32.0 points in December 2008 to 44.8 points in June 2009. Meanwhile, having surpassed the neutral mark by climbing to 52.4 points in March, the Chinese PMI remains quite unchanged as of June (Graph 2.1.5).

The year-on-year decline in the US retail trade volume since September 2008 continued into the first five months of 2009. Having shrunk by an average of 9 percent in the first quarter of 2009, the retail trade volume declined by around 10 percent on average in April and May, which indicates that consumer demand is likely to remain weak in the second quarter of 2009. Moreover, the year-on-year decline in new orders across the manufacturing sector that started in the fourth quarter of 2008 continued into the first quarter of 2009, but has lost momentum by March (Graph 2.1.6).



The global crisis has a growing adverse impact on job markets. In the United States, unemployment climbed to 9.4 percent in May 2009 from 5.5 percent a year ago in seasonally adjusted terms. In the euro area, unemployment soared to 9.5 percent in May 2009 from 7.4 percent a year earlier. US and euro area unemployment is likely to rise further through 2010 and peak above 10 percent.

In view of the above global developments, it is particularly noteworthy that, after having steadily lowered their forecasts of global growth, many financial institutions have made an upward revision for the first time since the second half of 2007. The International Monetary Fund (IMF) raised its 2010 global growth forecast from 1.9 to 2.5 percent, while the Organization for Economic Cooperation and Development (OECD) revised its 2010 growth forecast for all OECD countries upwards from –0.1 to 0.7 percent (Table 2.1.1).

Table 2.1.1. Annual Growth Forecasts

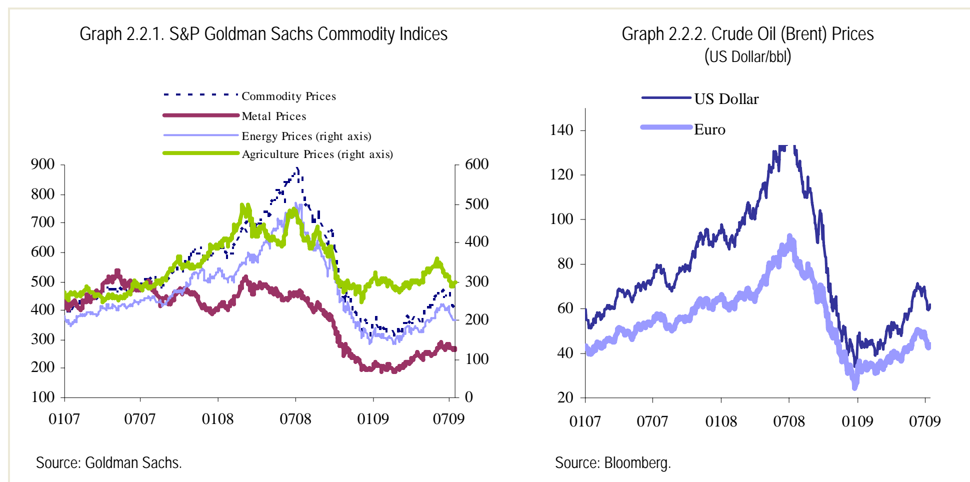
	2009		2010	
	Previous	**Revised**	**Previous**	**Revised**
IMF				
World	-1.3	-1.4	1.9	2.5
Advanced Economies	-3.8	-3.8	0.0	0.6
United States	-2.8	-2.6	0.0	0.8
Euro Area	-4.2	-4.8	-0.4	-0.3
Emerging Economies	1.6	1.5	4.0	4.7
OECD				
All OECD	-4.3	-4.1	-0.1	0.7
United States	-4.0	-2.8	0.0	0.9
Euro Area	-4.1	-4.8	-0.3	0.0
Consensus Forecasts *				
World	-2.1	-2.6	1.9	2.1
United States	-2.7	-2.6	1.8	2.1
Euro Area	-3.4	-4.4	0.3	0.4

Source: IMF World Economic Outlook, April and IMF World Economic Outlook July Update.
OECD Economic Outlook, interim report, March and OECD Economic Outlook, 2009/I, June.
*Consensus Forecasts, April and Consensus Forecasts, July.

The revised forecasts of international institutions raises expectations that the US will recover faster and sooner than the euro area. The Japanese economy, on the other hand, is expected to remain on hold for quite some time due to its export-driven economic structure. In view of these considerations, we maintained the baseline scenario offered in the April Inflation Report and built our medium-term forecasts in the final chapter of this Report on the assumption that the world economy contracts sharply through 2009 and will only start to recover by mid-2010.

2.2. Commodity Prices

The ongoing uncertainty about the timing and scale of the global economic recovery caused commodity prices to fluctuate in the second quarter of 2009 (Graph 2.2.1). Commodity prices picked up during April and May amid mounting hopes of an earlier-than-expected recovery, higher demand boosted by China's stimulus package and weaker US dollar. In the following period, however, latest US and euro area labor market data dashed hopes of a quicker recovery, while the stimulus-induced acceleration in demand was largely for inventories and proved to be short-lived, causing commodity prices to fall. Accordingly, The S&P Goldman Sachs (GS) Commodity Index went down by 46.8 percent year-on-year and up by 20.7 percent quarter-on-quarter in the second quarter of 2009. The GS energy, metals and agriculture indices followed the same trend as the overall index and dropped by 52.6, 44.9 and 25.1 percent year-on-year, respectively, in the second quarter of 2009.



Graph 2.2.1. S&P Goldman Sachs Commodity Indices

Source: Goldman Sachs.

Graph 2.2.2. Crude Oil (Brent) Prices
(US Dollar/bbl)

Source: Bloomberg.

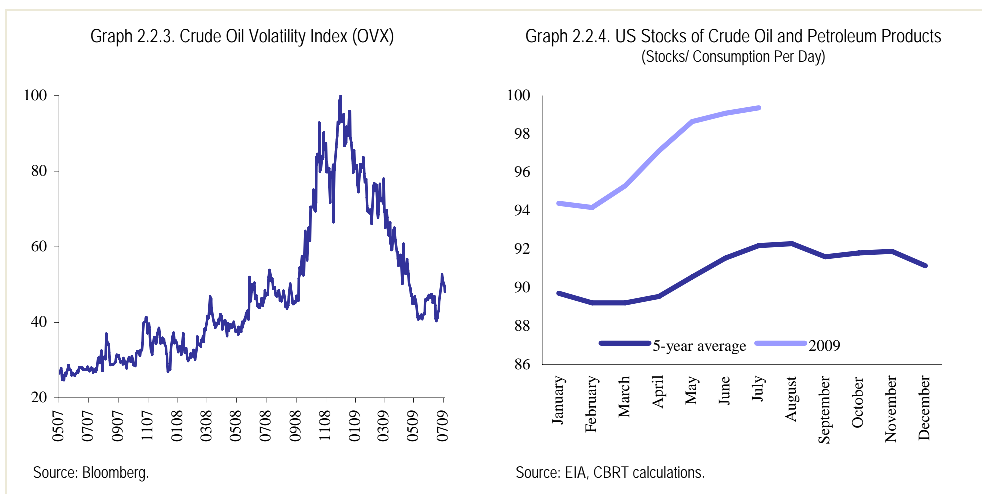
Developments in the Chinese economy had a major influence on metal prices. The economic stimulus plan spurred fixed capital investments, particularly in the automotive industry. Moreover, lower international prices caused a substantial rise in China's copper and aluminum inventories. As a result, prices for industrial metals rose in the second quarter. Yet, the weakening global demand and the sizable global inventory build-up caused prices to fall by mid-June.

In recent years, the increased grain-based biofuel production and the crop loss-driven drops in stockpiles sent prices for agricultural products to record highs. However, expectations of a sluggish global demand and a better wheat harvest helped prices fall by the second quarter of 2009.

After having averaged around 44 US dollars per barrel from early 2009 to mid-March, Brent crude oil prices began to rise amid growing perceptions of a bottoming out of the global recession, weaker US dollar and OPEC's (Organization of the Petroleum Exporting Countries) output cut, and jumped as high as 71.4 US dollars per barrel on June 11 (Graph 2.2.2). However, with mounting worries about the global economic recession in the subsequent period, crude oil prices decelerated again, and Brent crude oil prices dropped by 9.2 percent from its June average to 61.8 US dollars per barrel on July 15. During the first half of July, crude oil prices fell by 55.9 percent year-on-year in US dollars and 50.3 percent year-on-year.

Graph 2.2.3. Crude Oil Volatility Index (OVX)

Graph 2.2.4. US Stocks of Crude Oil and Petroleum Products (Stocks/ Consumption Per Day)



Source: Bloomberg.

Source: EIA, CBRT calculations.

In sum, the first-quarter rise in commodity prices appears to have resulted from the expectation of an earlier global economic recovery. Yet, both the

mounting evidence of a protracted recovery and the substantial buildup in commodity stocks have reduced the upward pressure on commodity prices.

As a measure of uncertainty, the volatility and the levels of stocks are very important for future crude oil prices (Graph 2.2.3 and Graph 2.2.4). The oil volatility index has been plunging recently. In addition, the fact that US stocks of crude oil and petroleum products were well above the five-year average in the first quarter of 2009 indicates sluggish demand. These developments lower the likelihood of sharp increases in crude oil prices over the second half of 2009. Moreover, OPEC's output cut strategy in the face of prices dipping below a certain level keeps prices from falling further. Thus, our medium-term forecasts in the final chapter of this Report are based on the assumption that crude oil prices will average 60 US dollars per barrel in 2009 and 70 US dollars per barrel in 2010 and thereafter.

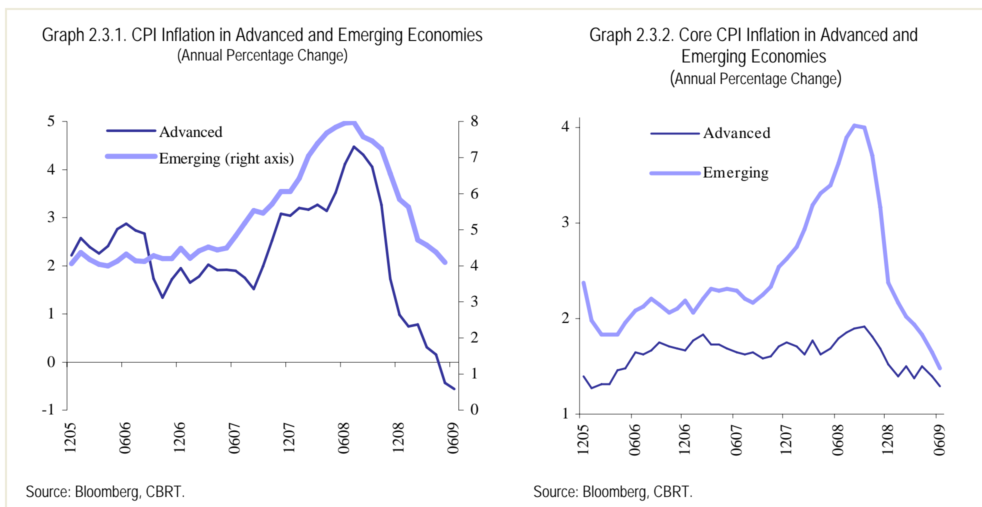
2.3. Global Inflation

Having slumped on demand and cost pressures since the second half of 2008, global inflation continued to trend downward in the second quarter of 2009 (Graph 2.3.1).

The most striking change in the second quarter of 2009 was the negative shift in the yearly rate of the CPI inflation in advanced economies during May and June, sliding down to –0.56 percent in June. Meanwhile, the CPI inflation in emerging economies continued to fall, down to 4 percent in June from 4.6 percent at the end of the first quarter.

Graph 2.3.1. CPI Inflation in Advanced and Emerging Economies (Annual Percentage Change)

Graph 2.3.2. Core CPI Inflation in Advanced and Emerging Economies (Annual Percentage Change)



Source: Bloomberg, CBRT.

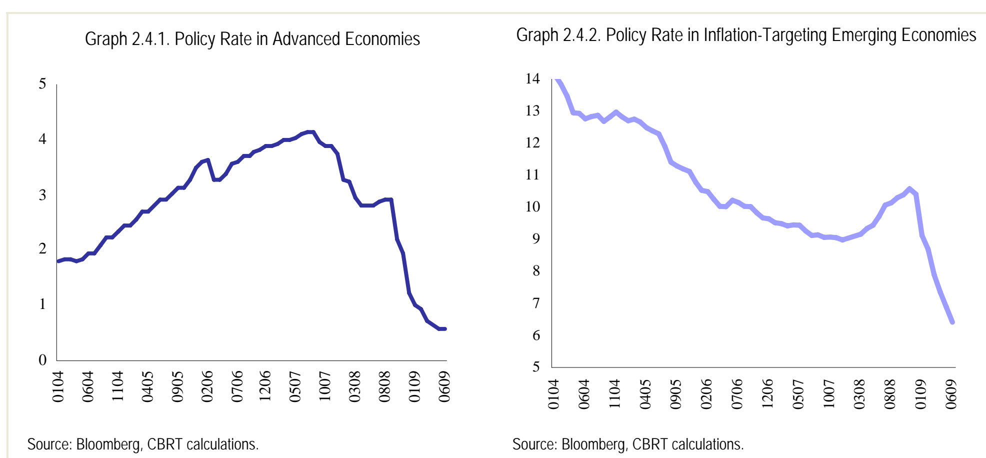
Source: Bloomberg, CBRT.

Adjusted for transient and seasonal variations, core inflation figures indicate significant downturn in the underlying inflation in both advanced and emerging economies (Graph 2.3.2). Accordingly, the downward movement in core inflation indices continued into the second quarter. Besides, the core inflation in emerging economies converges to those in advanced economies.

Broken down by countries, in June 2009, inflation fell from 5 to –1.4 percent year-on-year in the United States, from 2 to –1.1 percent year-on-year in Japan, and from 4 to –0.15 percent year-on-year in the euro area Harmonized Index of Consumer Prices (HICP). Among emerging economies, annual inflation in China dropped to –1.4 percent in May 2009 from 7.7 percent a year earlier.

2.4. Monetary Policy Developments and Financial Conditions in the World

The deepening of the global financial crisis in the final quarter of 2008 has led central banks in both advanced and emerging economies to slash their policy rates. The monetary loosening continued into the second quarter of 2009, albeit at a less rapid pace. Central banks such as the US Federal Reserve (Fed) and the European Central Bank (ECB) have increased the scope and scale of monetary expansion. However, these expansionary policies are yet to stimulate the credit and capital markets.



Graph 2.4.1. Policy Rate in Advanced Economies

Source: Bloomberg, CBRT calculations.

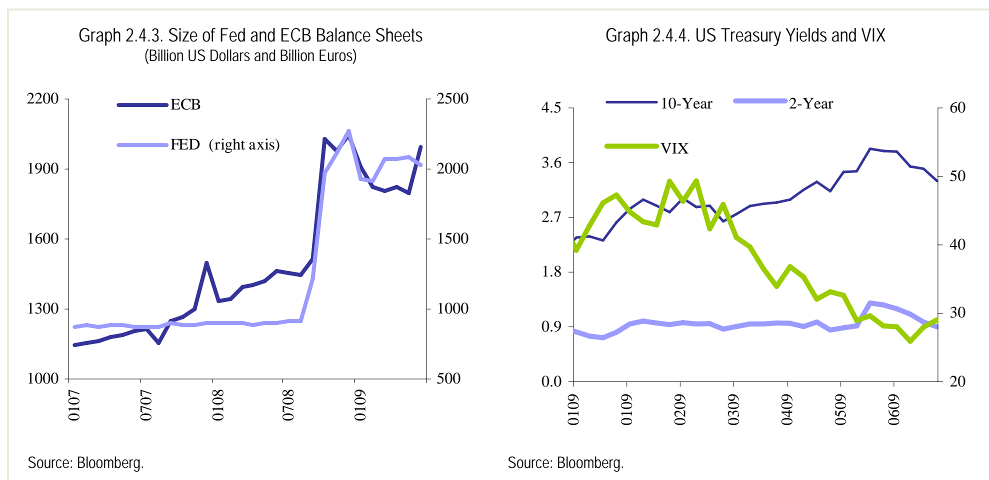
Graph 2.4.2. Policy Rate in Inflation-Targeting Emerging Economies

Source: Bloomberg, CBRT calculations.

The monetary easing in advanced economies has slowed markedly as their policy rates approached the zero bound, causing the composite policy rate to decrease by 17 basis points quarter-on-quarter to 0.56 percent (Graph 2.4.1). Meanwhile, inflation-targeting emerging economies continued to cut policy

rates, though at a less aggressive pace than in the first quarter, bringing the composite rate down by 147 basis points to 6.4 percent (Graph 2.4.2).

Central banks in advanced economies continued to inject liquidity to enhance financial intermediation and stimulate the economy in the second quarter, which has further expanded their balance sheets (Graph 2.4.3). At its meeting on March 18, the Fed vowed again to act as needed, and as a further measure, decided to purchase treasury securities to lower market rates by affecting the long end of the yield curve. Meanwhile, the ECB injected 442 billion euros worth of one-year funds into the banking system in late June. Since the banking sectors of emerging countries have been less affected by the global crisis, the central banks of these countries were less inclined to resort to liquidity injections. In fact, after the policy rate cuts, the most resorted policy measure that emerging economies have adopted to counter the global crisis has been lowering reserve requirements. Nonetheless, some emerging economies, particularly emerging Asian economies, have conducted or declared to conduct liquidity operations when necessary.



Graph 2.4.3. Size of Fed and ECB Balance Sheets
(Billion US Dollars and Billion Euros)

Source: Bloomberg.

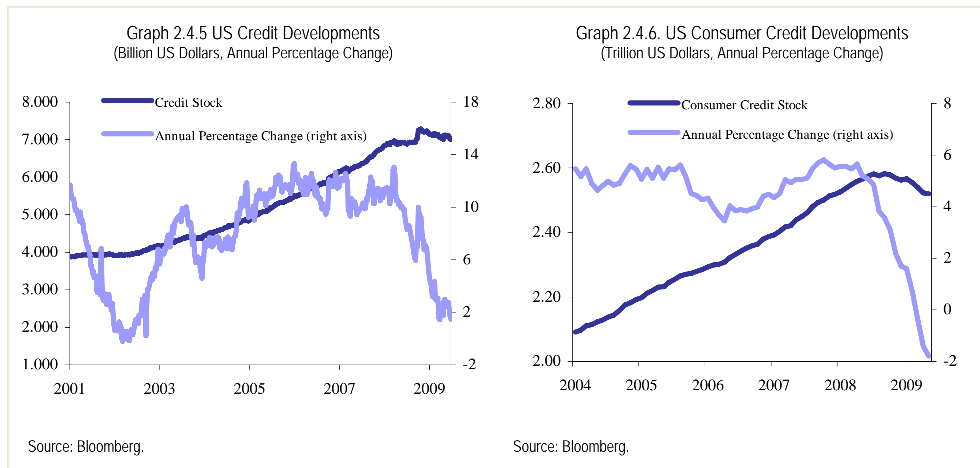
Graph 2.4.4. US Treasury Yields and VIX

Source: Bloomberg.

Despite expansionary monetary measures in the US, higher market rates obstruct the effectiveness of monetary policy. Many believe that the rise in US long-term yields during recent months is largely driven by the rebound in risk appetite and the shift in investor sentiment towards riskier markets and assets (Graph 2.4.4). Another highlight is the widening spread between short- and long-term yields since early 2009. The spread between two-year and ten-year treasury notes has widened from 125 basis points at end-2008 to 240 basis points by July 10, mainly on account of rising long-term bond yields. This

development signals that, if risk appetite continues to grow, yields will rise further and the recovery will arrive later, prompting the Fed to purchase more treasury securities.

Moreover, credit conditions remain tight and the business sector continues to have limited access to funds. Fed's quarterly Senior Loan Officer Opinion Survey released in June shows that despite lower effective rates, maturities have shortened and borrowers have been facing higher collateralization requirements.



Graph 2.4.5 US Credit Developments
(Billion US Dollars, Annual Percentage Change)

Source: Bloomberg.

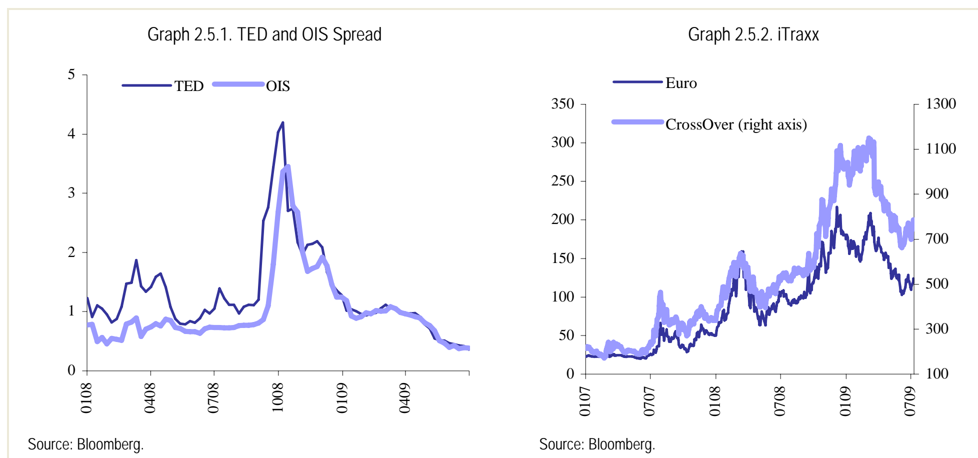
Graph 2.4.6. US Consumer Credit Developments
(Trillion US Dollars, Annual Percentage Change)

Source: Bloomberg.

The US loan stock dipped dramatically from its peak in October 2008, having grown by a mere 1.5 percent year-on-year as of June 24 (Graph 2.4.5). Similarly, the consumer loan stock began to slow down on the same date, posting a yearly change of –1.8 percent. Commercial papers, which are widely used by US businesses to access funds, are also plunging. The commercial paper stock amounted to 1.14 trillion US dollars in the first week of July, which translates into a year-on-year decline of 35.4 percent, while the asset-backed commercial paper stock dropped by 39.2 percent year-on-year to 456.7 billion US dollars.

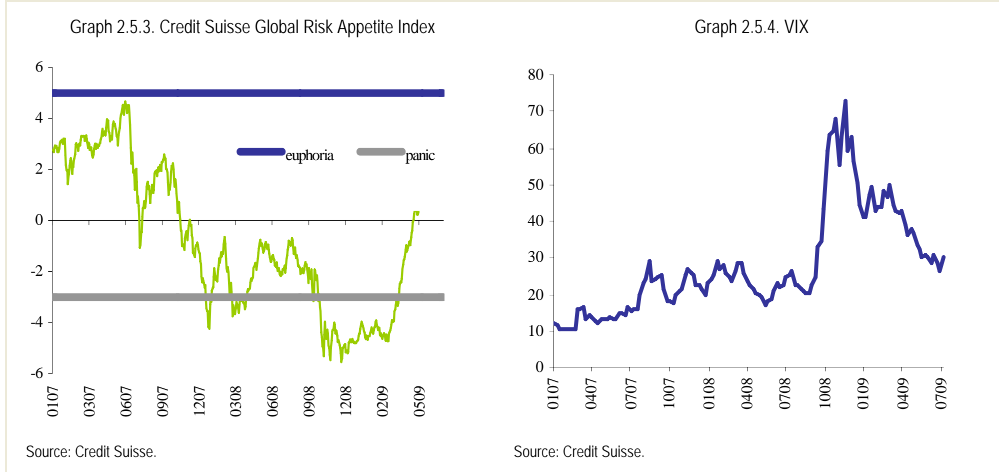
2.5 Global Risk Indicators

The improved investor sentiment that the worst of the financial crisis has passed bolstered risk appetite in the second quarter of 2009 and helped financial markets regain their footing. In addition, the fact that global commercial and investment banks, which have been at the epicenter of the crisis, were able to raise the capital required by stress tests, strengthened their balance sheets in the first quarter, leading many to expect the same for the second quarter, and sought to repay Fed's Troubled Asset Relief Program (TARP) funds earlier contributed to the bounce-back of financial markets.[2] Furthermore, central bank liquidity facilities helped banks improve their balance sheets and reduced uncertainties by raising their cash holdings.



Accordingly, conditions in money markets eased, and credit and liquidity risks remained on the downside, as confirmed by TED and OIS spreads. As of the end of June, the spreads have narrowed 60 basis points from the end of the first quarter (Graph 2.5.1). Similarly, in Credit Default Swap (CDS) markets, the iTraxx Europe and iTraxx Crossover indices fell markedly in the second quarter, but failed to return to pre-crisis level as economies continue to shrink and fears over economic activity abide (Graph 2.5.2). Meanwhile, risk appetite has improved from the first quarter's level. The Credit Suisse Index has moved out of the 'panic' zone, while the VIX index has stabilized around the critical point of 30 (Graph 2.5.3 and Graph 2.5.4).

[2] The improved outlook for investments banks is also evident in stock market indices. The S&P 500 increased by 12.6 percent quarter-on-quarter, while the S&P investment banks and brokers sub-index jumped by 27.4 percent quarter-on-quarter, offsetting some of the earlier losses.



Graph 2.5.3. Credit Suisse Global Risk Appetite Index

Source: Credit Suisse.

Graph 2.5.4. VIX

Source: Credit Suisse.

Despite recent improvements, risks to the global economy still predominate. Although there has been some rebound in financial markets, the housing sector is yet to fully stabilize. The fact that house prices continue to fall, albeit at a slower pace, postpones buying and selling plans and creates uncertainty over the value of mortgage-backed financial assets. Moreover, although new US building permits and housing starts have recently delivered better-than-expected results, it is premature to say that the housing sector has started to improve.

The fact that long-term market rates run above policy rates is another factor that may prevent growth. Higher long-term market rates affect loan rates, driving up the cost of transactions, like mortgage, where interest rates are linked to yields on government bonds.

In sum, the continued fragility in financial markets, particularly in the housing market, and the ongoing uncertainty over global growth not only delay the easing of credit conditions but also tighten global capital flows. On balance, as of the first half of 2009, problems in the global economy still need to be resolved, while uncertainties surrounding financial markets remain.

Box 2.1 GLOBAL RECESSIONS AND ECONOMIC POLICIES

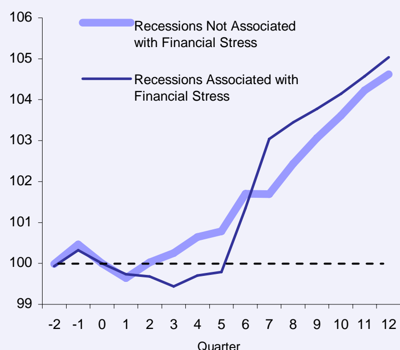
The crisis that began in advanced economies and spread across emerging economies continues to have a dampening effect on economic and financial stability. Presently, the global economy has yet to emerge from the steepest downturn since the World War II. While recent data on the financial system and global economic activity indicate that the worst of the crisis is behind us and the world economy may start to recover, downside risks to the global economic activity still persist. The sluggish performance in global trade and capital flows, the continued weakening of employment conditions and the ongoing, though less severe, tightening in credit markets renew concerns about economic activity.

The current crisis that the world economy is facing today differs from earlier episodes of financial crises in two ways: first, the current crisis emerged in the financial markets of advanced economies and led to the collapse of international capital markets. Secondly, the economic slowdown that accompanied the crisis struck not just certain countries or regions, but the entire global economy. Against this backdrop, to better understand the way out of the current crisis, it is useful to investigate past experiences. The aim of this Box is to analyze previous episodes of synchronized recessions which may have been associated with financial crises, and the role of economic policies addressing these downturns.

Recent research indicates that recessions associated with acute financial stress are deeper and longer than other types of recessions.[3] During these episodes, an impaired financial system is unable to promote efficient financial intermediation, leading to a relatively more protracted recovery that are at least twice as long as recessions not associated with financial stress (Graph 1).

[3] See, Cardarelli, Elekdag and Lall (2009) and IMF (2008), *World Economic Outlook*, "Financial Stress and Economic Downturns."

Recessions Associated With Financial Stress

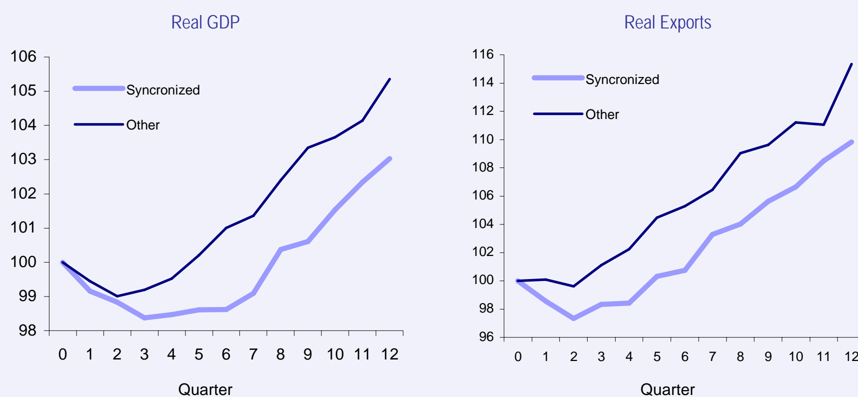


Note: Real GDP = 100 at t=0.
Source: CBRT.

In particular, recessions characterized by banking-related financial stress are especially severe. Advanced economies that suffered the deepest recessions experienced levels of financial stress that crippled the entire banking sector, and include Finland, Sweden, Japan and Norway during the 1990s.

Another feature of the recent crisis was its global nature. In this context, there is little room for foreign demand to support a recovery, and therefore we see that past episodes of globally synchronized recessions were deeper and their recoveries were more prolonged (Graph 2).[4] Historically, the period of recovery from a global recession appears to be about one-and-a-half times longer than that from other recessions. The sluggish rebound of exports highlights one reason why recoveries associated with synchronized recessions are relatively weak and protracted.

Graph 2. Synchronized Recessions and Economic Activity



Note: Peak in GDP at t= 0, index medians = 100 at t=0, quarters.
Source: IMF World Economic Outlook, April 2009.

4 IMF (2009), *World Economic Outlook*, "Recessions and Recoveries—How Soon and How Strong?"

Economic policies are given high priority during episodes of synchronized global recessions. Although countercyclical monetary policies may help shorten recessions, evidence for advanced economies suggests that financial intermediation cannot function properly during financial crises, which may hamper the effectiveness of the interest rate and credit channels of the monetary policy transmission mechanism. In such times, expansionary fiscal policies seem particularly effective in shortening recessions and boosting recoveries. As compared to earlier episodes of crises, the synchronized expansion of monetary and fiscal policies can help move the recovery three months forward. Yet, it should be noted that the effectiveness of countercyclical fiscal policies during recessions is inversely proportional to the level of public debt. Therefore, in order to benefit from monetary and fiscal expansion, a credible fiscal framework is needed to preserve debt sustainability over the medium run.

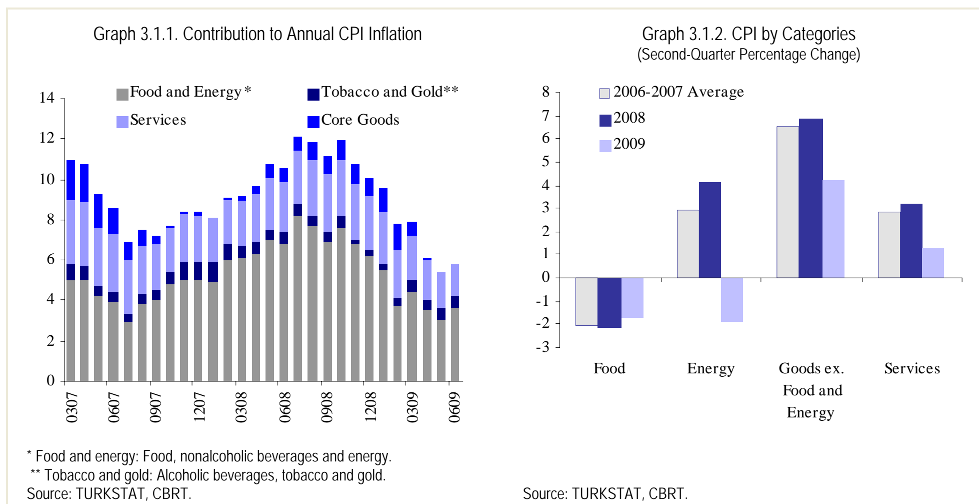
In sum, to put crises episodes in historical perspective, recovery from global recessions associated with severe financial stress seems to be anemic and very gradual, coordinated expansionary monetary and fiscal policies may help foster faster recoveries. Taken together, although the recent data on global economic activity indicate that the worst of the crisis is over, downside risks remain significant.

3. Inflation Developments

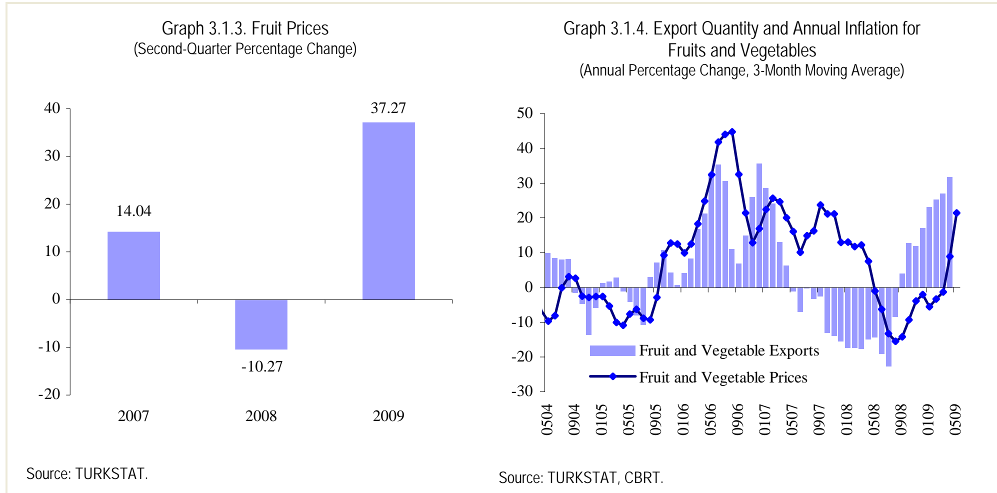
3.1. Inflation

Consumer prices were up 0.77 percent in the second quarter of 2009, while CPI inflation fell by 2.16 percentage points quarter-on-quarter to 5.73 percent year-on-year. The economic slowdown had a more severe impact on inflation in the second quarter, causing underlying inflation to sink to an all-time low in near history.

During the second quarter, annual inflation decelerated across all major categories except food. Despite rising food prices, the contribution of food and energy to annual inflation continued to decline on falling energy prices, while services made the lowest contribution in history (Graph 3.1.1).



Although processed food inflation slowed down significantly during the second quarter, annual food inflation soared as unprocessed food prices decelerated at a slower pace than seasonal averages. The annual rate of increase in energy prices continued to slide due to the cumulative decline in commodity prices. The slowdown in services intensified in the second quarter, bringing annual services inflation down to a historic low. Prices of goods excluding food and energy increased at a less rapid pace than in previous years, mainly on account of temporary tax cuts (Graph 3.1.2).



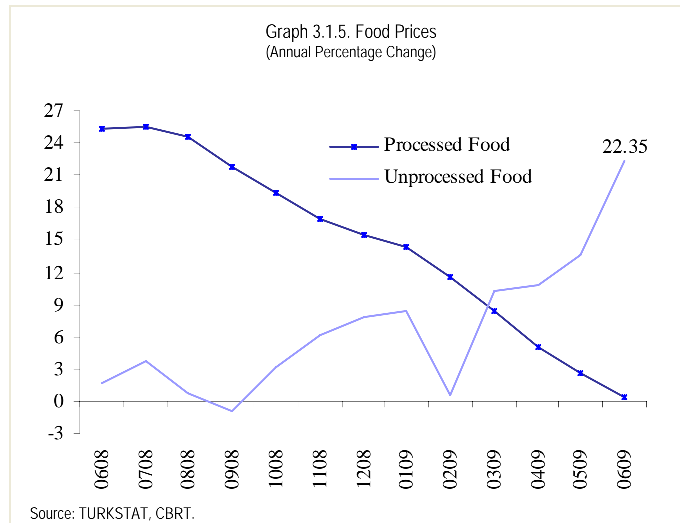
Graph 3.1.3. Fruit Prices
(Second-Quarter Percentage Change)

Source: TURKSTAT.

Graph 3.1.4. Export Quantity and Annual Inflation for Fruits and Vegetables
(Annual Percentage Change, 3-Month Moving Average)

Source: TURKSTAT, CBRT.

As in the first quarter, food inflation soared due to rising unprocessed food prices, hitting 9.68 percent year-on-year. In the second quarter, the annual rate of increase in vegetable prices continued the uptrend that began in the final quarter of 2008, while fruit prices increased rapidly (Graph 3.1.3). Accordingly, inflation in fresh fruits and vegetables reached a record of 41.34 percent year-on-year by the end of the second quarter, driving the annual rate of increase in unprocessed food prices higher. The rise in fruit and vegetable prices appears to have resulted from changes in foreign demand. In fact, the export quantity for fruits and vegetables increased by 36.88 percent in May from a year earlier (Graph 3.1.4). Therefore, production has placed only limited downward pressure on prices. As a result, unprocessed food price inflation surged by 12.15 percentage points quarter-on-quarter to 22.35 percent year-on-year (Graph 3.1.5).



Graph 3.1.5. Food Prices
(Annual Percentage Change)

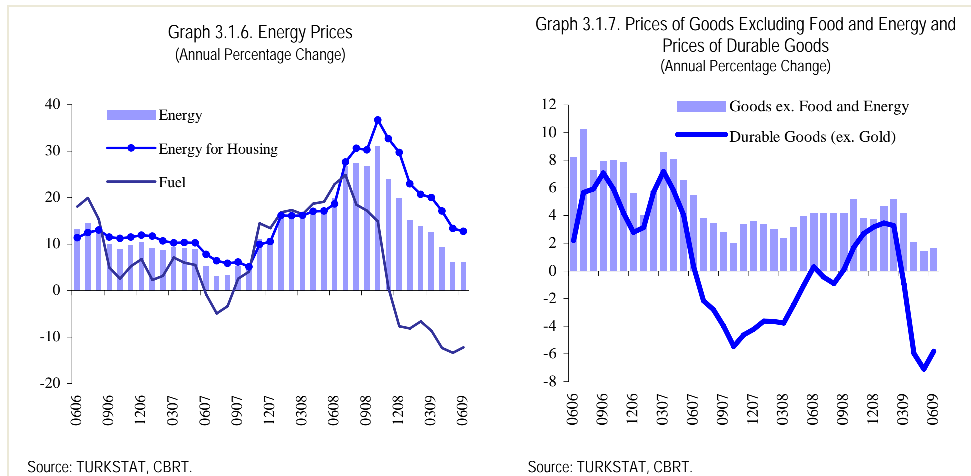
Source: TURKSTAT, CBRT.

After having soared by 8.06 percent in the second quarter of 2008 and 25 percent year-on-year amid supply concerns and rising import prices, processed food prices headed for a marked downturn with the reversal of these unfavorable developments. Moreover, the sharp contraction in total demand added to the deceleration in the rate of increase in processed food prices. Accordingly, annual processed food inflation fell to 0.32 percent in the second quarter (Graph 3.1.5).

The downtrend in energy prices continued into the second quarter of 2009 (Table 3.1.2). The slump in oil prices continued to have lagged effects, while prices of solid fuels and bottled gas declined along with reductions in electricity and natural gas tariffs, bringing energy inflation down to 6.09 percent year-on-year (Graph 3.1.6). Meanwhile, after having fallen as low as 45 US dollars per barrel in the first quarter, average oil prices climbed to 60 US dollars per barrel in the second quarter, which caused domestic fuel prices to rise by 5.20 percent and limited the slowdown in energy prices. If oil prices remain at current levels, annual energy inflation is expected to slide further in the rest of the year, with the removal of the high base effect from the major hikes in electricity and natural gas tariffs in 2008.

Graph 3.1.6. Energy Prices
(Annual Percentage Change)

Graph 3.1.7. Prices of Goods Excluding Food and Energy and Prices of Durable Goods
(Annual Percentage Change)

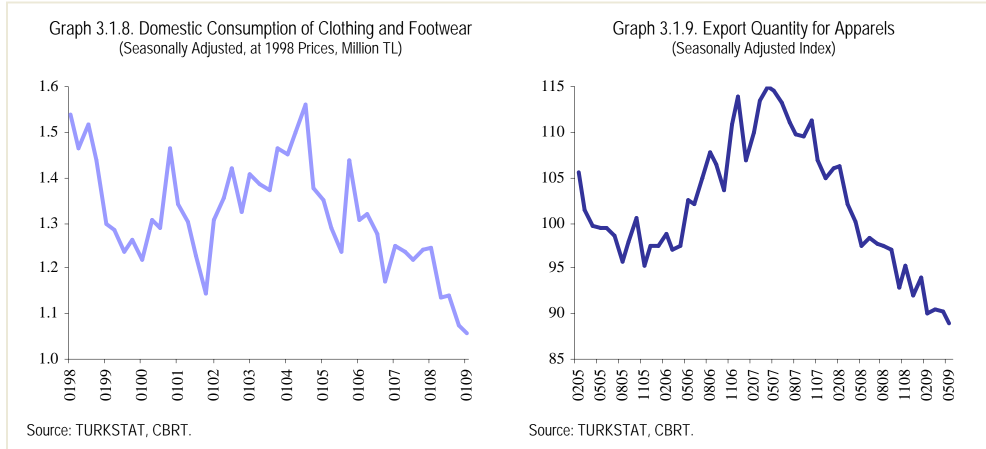


Source: TURKSTAT, CBRT.

Source: TURKSTAT, CBRT.

Annual inflation in goods excluding food and energy was down 2.59 percentage points to a historic low of 1.63 percent in the second quarter (Graph 3.1.7), largely due to the further drop in prices of durable goods driven by Special Consumption Tax (SCT) and Value Added Tax (VAT) cuts. Moreover, with the marked decline in total demand, annual inflation slowed down across all subcategories in the second quarter, particularly in clothing prices, which were down compared to previous year levels. Given the

significant rise in prices for tobacco products during July and the expiration of tax cuts on some durable goods in late September, goods excluding food and energy inflation is expected to soar in the second half of the year.



Graph 3.1.8. Domestic Consumption of Clothing and Footwear (Seasonally Adjusted, at 1998 Prices, Million TL)

Source: TURKSTAT, CBRT.

Graph 3.1.9. Export Quantity for Apparels (Seasonally Adjusted Index)

Source: TURKSTAT, CBRT.

Domestic consumption on clothing and footwear continued to weaken in the first quarter, down by 15.83 percent year-on-year (Graph 3.1.8), bringing domestic clothing consumption down from levels in previous years. Similarly, the export quantity index for apparels indicates that foreign demand continues to shrink dramatically (Graph 3.1.9). Accordingly, total demand conditions for clothing remain weak, which helps clothing prices put further downward pressure on CPI inflation.

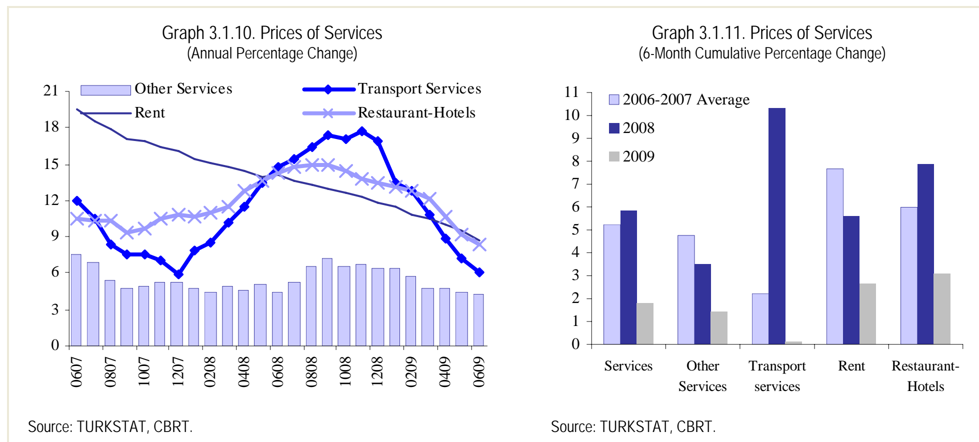
Having decreased by 2.49 percent in the first quarter, prices of durable goods (excluding gold) dropped by 2.23 percent in the second quarter (Table 3.1.1) amid temporary tax cuts on goods such as furniture, white goods, automobiles and IT equipment, which passed through to prices to a great extent (Box 3.1). However, the government decided on June 16 to remove, extend or phase out some of the tax cuts on certain goods (Box 3.1). Therefore, prices of durable goods fluctuated over the second quarter as a result of these tax adjustments. It should be noted that (under current adjustments) prices of durable goods are likely to rise again in July and October with the expiration of tax cuts in the second half.

Table 3.1.1. Prices of Durable Goods
(Quarterly and Annual Percentage Change)

	2008				2009	
	II	III	IV	Annual	I	II
Durable goods (excluding gold)	**2.81**	**-1.80**	**0.61**	**3.19**	**-2.49**	**-2.23**
Furniture	7.60	-1.27	-1.31	9.17	-3.17	-7.61
Electric and non-electric appliances	0.68	0.12	6.04	8.13	-4.26	-2.54
Automobiles	2.44	-3.63	-2.30	-2.56	-1.36	-0.11
Other durable goods	0.89	1.02	2.27	4.29	0.36	0.20

Source: TURKSTAT, CBRT.

The annual rate of increase in prices of services continued to slow notably in the first half of 2009 due to the lagged effects of easing cost pressures and weakening domestic demand. Prices of services rose by 1.81 percent in the first half, at a more subdued pace than in previous years. Accordingly, annual services inflation dropped by 4.19 percentage points from end-2008 to 6.27 percent in June.



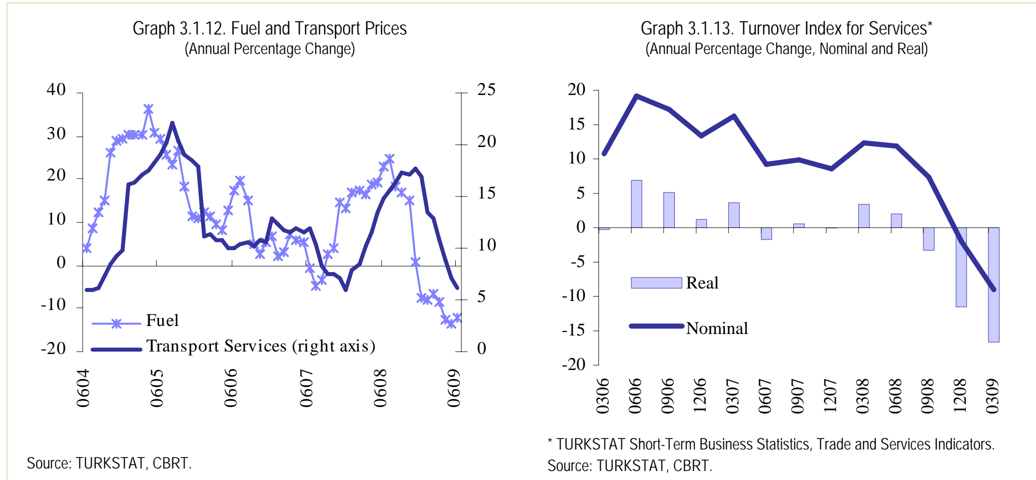
Graph 3.1.10. Prices of Services
(Annual Percentage Change)

Source: TURKSTAT, CBRT.

Graph 3.1.11. Prices of Services
(6-Month Cumulative Percentage Change)

Source: TURKSTAT, CBRT.

Annual services inflation was down across all subcategories (Graph 3.1.10). The first-half rise in prices for all subcategories of services was well below the figures in previous years (Graph 3.1.11). Having increased by 2.67 percent during the first six months of the year, rent inflation continued to edge down year-on-year. Meanwhile, the annual rate of increase in transport services slowed markedly amid significantly lower oil prices than the previous year and the lagged effect of the resulting drop in fuel prices (Graph 3.1.12). According to the turnover index for services, the total services turnover declined year-on-year both in nominal and real terms during the first quarter (Graph 3.1.13). As the slight rebound in domestic demand has failed to gain strength, services inflation is expected to decelerate further in coming months, albeit at a more moderate pace.



Source: TURKSTAT, CBRT.

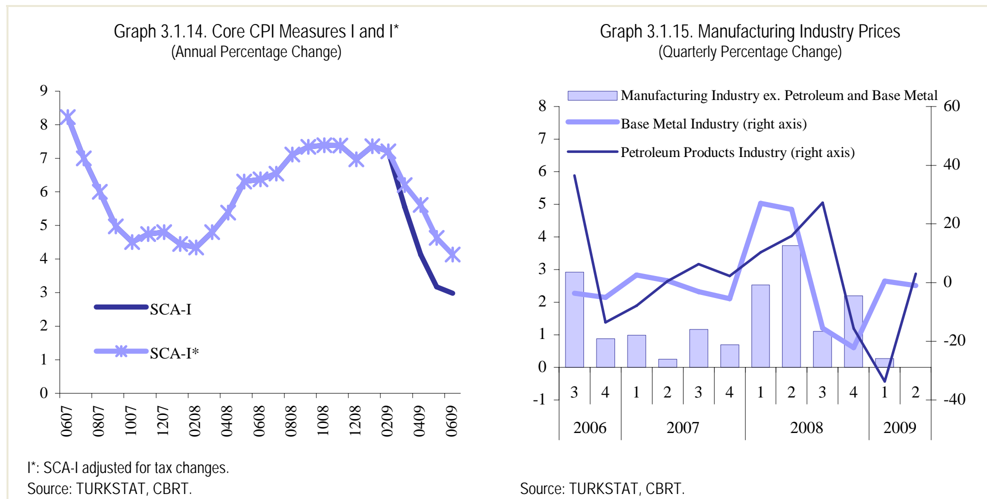
* TURKSTAT Short-Term Business Statistics, Trade and Services Indicators.
Source: TURKSTAT, CBRT.

Table 3.1.2. Prices of Goods and Services
(Quarterly and Annual Percentage Change)

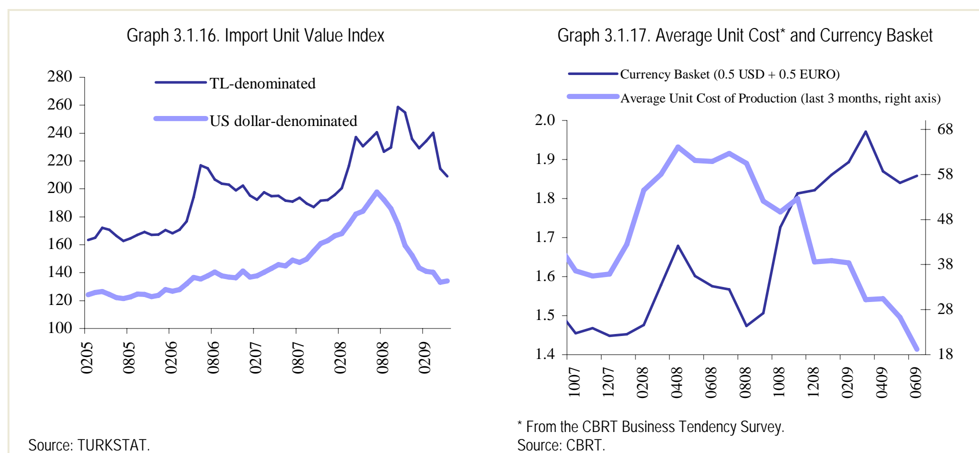
	2008				2009	
	II	III	IV	Annual	I	II
CPI	**2.82**	**0.78**	**3.03**	**10.06**	**1.05**	**0.77**
1. Goods	**2.69**	**0.05**	**3.61**	**9.93**	**1.22**	**0.60**
Energy	4.12	6.41	1.91	19.81	-0.28	-1.90
Unprocessed food	-13.25	-0.29	12.45	7.87	13.29	-3.68
Processed food	8.06	1.37	-0.20	15.46	-0.93	0.09
Goods ex. energy and food	6.87	-3.52	3.04	3.75	-1.89	4.21
Durable goods	1.97	-2.34	2.45	5.54	-0.27	-2.76
Durable goods (ex. gold)	2.81	-1.80	0.61	3.19	-2.49	-2.23
Semi-durable goods	9.20	0.01	3.42	11.54	-3.46	4.55
Non-durable goods	-1.43	0.74	4.07	9.99	5.21	-1.22
2. Services	**3.20**	**2.94**	**1.39**	**10.46**	**0.53**	**1.27**
Rents	2.74	3.58	2.25	11.85	1.51	1.14
Restaurants and hotels	4.58	2.77	2.34	13.44	1.88	1.19
Transport	5.98	4.35	1.54	16.89	-1.29	1.43
Other	1.80	2.29	0.49	6.40	0.13	1.31

Source: TURKSTAT, CBRT.

At the end of the second quarter, the CPI index excluding energy, unprocessed food, alcoholic beverages, tobacco and gold (SCA-H) fell to 2.31 percent year-on-year, while, with a further exclusion of processed food, the index (SCA-I) dropped to 2.98 percent year-on-year. Although tax cuts were the major driver of the decline, both indices continued to fall even without the tax cut factor, suggesting that underlying inflation remains on a downward track (Graph 3.1.14).



Changes in producer prices are of great importance as to their cost pressure on CPI inflation. Even though international oil and commodity prices stopped plunging, producer prices decreased year-on-year during the second quarter of 2009 due to the high base effect from a year earlier. In the second quarter, producer prices increased by 1.55 percent, manufacturing industry prices rallied on rising oil prices, and prices for base metals dropped slightly. Excluding oil and base metals, manufacturing industry prices remained unchanged from their first-quarter level (Graph 3.1.15). Meanwhile, agricultural producer prices increased by 8.91 percent, at a more rapid pace than in previous quarters.

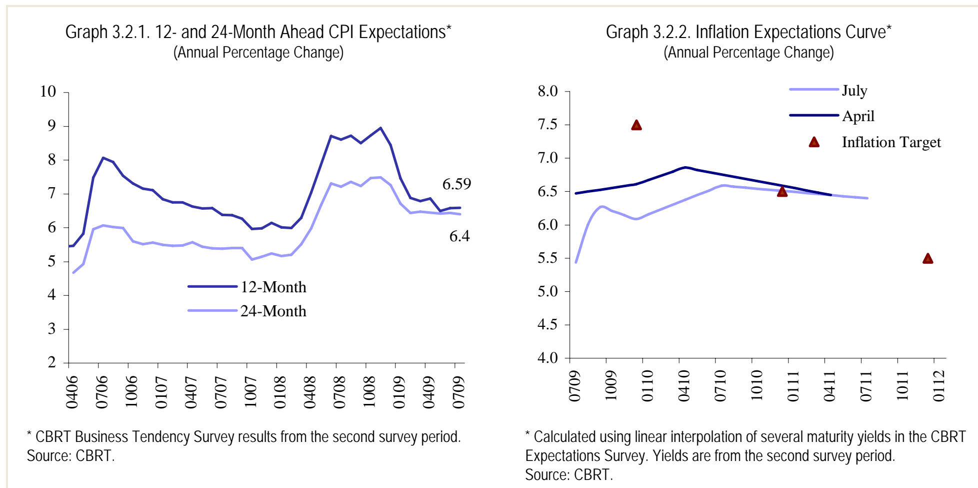


Import prices continued to fall in the second quarter, further offsetting the likely pressure from exchange rate movements on prices (Graph 3.1.16). Accordingly, the average unit cost (CBRT Business Tendency Survey) continued to trend downward (Graph 3.1.17). All in all, there is no

significant cost pressure on inflation, in the second quarter excluding the agricultural industry.

3.2. Expectations

The first-quarter slump in medium-term inflation expectations virtually flattened out in the second quarter. Meanwhile, 12-month ahead inflation expectations declined slightly, while 24-month ahead inflation expectations remained flat at 6.4 percent (Graph 3.2.1).



Graph 3.2.1. 12- and 24-Month Ahead CPI Expectations*
(Annual Percentage Change)

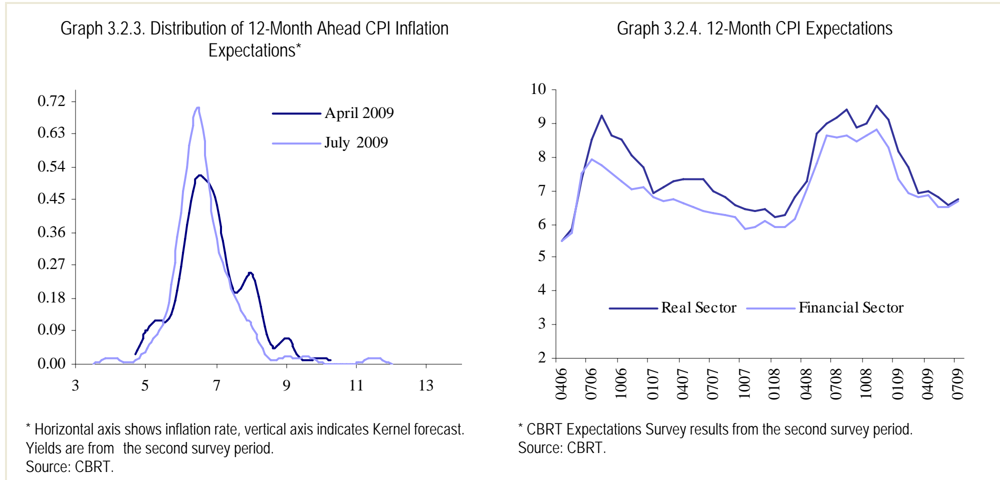
* CBRT Business Tendency Survey results from the second survey period.
Source: CBRT.

Graph 3.2.2. Inflation Expectations Curve*
(Annual Percentage Change)

* Calculated using linear interpolation of several maturity yields in the CBRT Expectations Survey. Yields are from the second survey period.
Source: CBRT.

Near-term inflation expectations fell dramatically over the past three months, whereas medium-term expectations declined modestly and the expectations curve flattened (Graph 3.2.2). Currently, expectations for end-2009 are anchored at 6.09 percent, well below the target. On the other hand, the end-2010 inflation expectation, calculated as the average of 12- and 24-month ahead inflation expectations, appears to be consistent with the target at 6.5 percent.

The distribution of inflation expectations indicates that despite hitting extreme values in July compared to April, participants’ expectations have become increasingly uniform (Graph 3.2.3).



Lastly, on the financial and real sector front, expectations continued to fall in the second quarter, albeit to a lesser extent (Graph 3.2.4). Moreover, real sector expectations remained higher than financial sector expectations, but the difference between expectations narrowed down considerably.

Box 3.1 THE IMPACT OF TEMPORARY TAX ADJUSTMENTS ON CONSUMER PRICES

In order to contain the negative effects of the global crisis on economic activity, the government adopted a package of temporary tax cuts on certain goods in March 2009. In this Box, we analyze the impact of these tax adjustments on the consumer price index.

Tax Adjustments: The first tax adjustment was introduced on March 16, as per the Council of Ministers' Decision no 2009/14802-3. Accordingly, the following rates were lowered for three months: the Resource Utilization Support Fund (RUSF) levied on consumer loans; the Value Added Tax (VAT) on new homes with a size equal to or larger than 150sqm; the Special Consumption Tax (SCT) on household appliances, audio-visual equipments and motor vehicles (varying based on the type of vehicle and engine capacity).

The second tax adjustment came on March 30, as per the Council of Ministers' Decision no 2009/14812-3. Accordingly, the following rates were lowered for a further period of three months: property register fees; the VAT on certain manufacturing-related industrial or construction vehicles, furniture, computers and IT products.

Table 1. SCT Rates (Percent)

	Before March16	From March 15 to June 15	From June 16 to September 30	After October 1
Automobiles*	37	18	27	37
White goods	6.7	0	2	6.7
Other electric household appliances	6.7	0	6.7	6.7
Audio-visual equipment	6.7	0	6.7	6.7

* With engines of less than 1600cc.

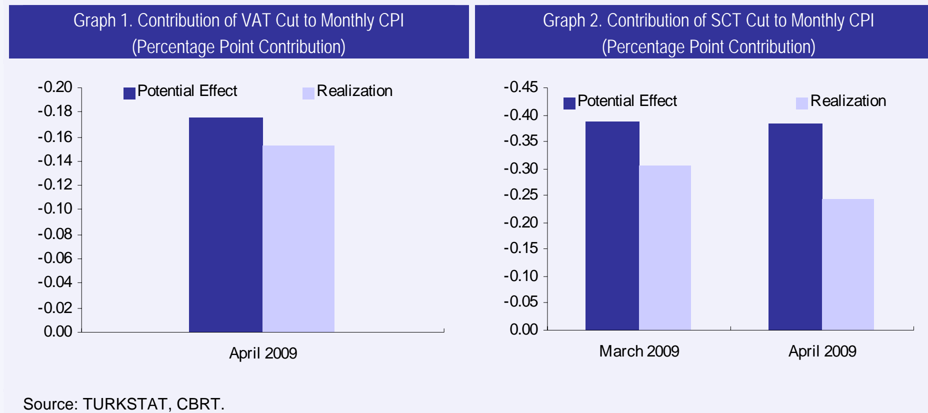
In view of the performance of tax cuts, the government decided, on June 16, to extend some of the tax cuts until September 30, as per the Council of Ministers' Decision no 2009/15081. The renewed and cyclical tax rates on certain CPI items are shown in Table 1 and Table 2.

Table 2. VAT Rates (Percent)

	Before March 30	From March 30 to June 30	From June 30 to September 30	After October 1
Furniture	18	8	8	18
IT products	18	8	8	18

Pass-Through of Tax Adjustments on Prices: Changes in SCT and VAT rates pushed CPI inflation down in March and April and up in June. As both tax cuts became effective on different dates, inflation was particularly affected by SCT cuts in March and June, whereas the April inflation was influenced by both VAT and SCT cuts.

Based on the released data , an item-by-item analysis shows that tax cuts passed through to consumer prices, not completely but to a great extent. Across categories of items, the highest pass-through rates are evident in VAT-reduced subcategories of furniture and IT products. The VAT cut pass-through[1] on these items was 86 and 93 percent, respectively. The SCT cut pass-through was 74 percent in automobiles, 72 percent in household appliances and 33 percent in audio-visual equipment. In general, the VAT cut pass-through has been higher than the SCT cut pass-through, while the pass-through of the SCT cut, the effect of which lasted for two months, was lower in April than in March (Graph 1, Graph 2).

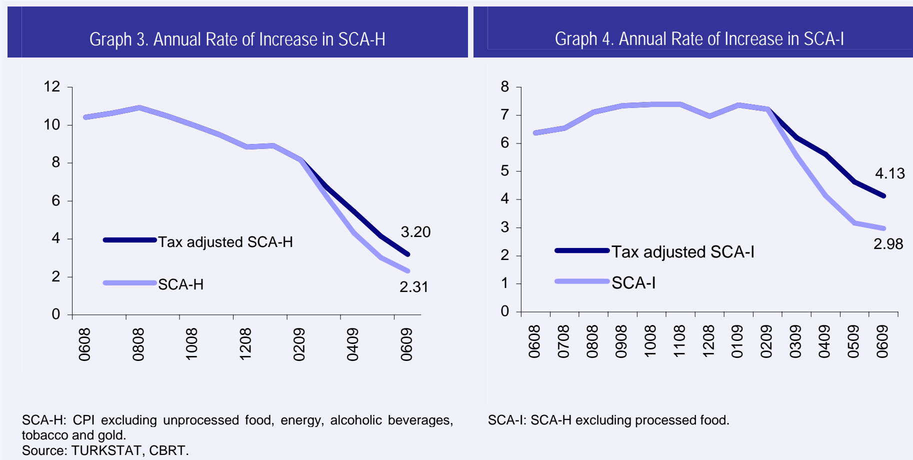


Source: TURKSTAT, CBRT.

The SCT hike on June 16 passed through to prices in June, by 93 percent in automobiles and 20 percent in white goods. There was no SCT hike driven change in audio-visual equipments. However, it should be noted that the mid-June gradual SCT hike would have an impact on July prices as well. Therefore, the total effect of the SCT hike on prices can only be measured when July prices are released.

[1] The pass-through of tax changes on prices is a percentage measure obtained by dividing the price change (realization) in a tax adjusted product by the change driven by a tax adjustment under the assumption of full pass-through (potential effect). If the price change is consistent with or higher than the potential effect, the tax adjustment is considered to have fully passed through to prices. If the price changes in the opposite direction of the potential effect, the tax adjustment is assumed to have a zero pass-through on prices.

Impact of Tax Adjustments on Core Inflation Measures: The annual inflation in special CPI aggregates (SCA) that provide a clear indication of the underlying inflation trend has been on a steady downward track since early 2009, which intensified during the second quarter. As all of the tax-reduced goods are involved in SCA-I and SCA-H, the effects of tax cuts have been completely available in these indices. In order to ensure a more accurate reading of the underlying inflation trend, we need to filter out the effects of temporary tax adjustments on special CPI aggregates.



SCA-H: CPI excluding unprocessed food, energy, alcoholic beverages, tobacco and gold.
Source: TURKSTAT, CBRT.

SCA-I: SCA-H excluding processed food.

Calculations based on the above effects indicate that underlying inflation continues to fall, even when the downward pressure from tax cuts is omitted (Graph 3, Graph 4). Excluding the effects of temporary tax adjustments, annual SCA-H inflation was 3.20 percent in June, while annual SCA-I inflation was 4.13 percent.

The phased-out tax cuts will continue to put upward pressure on prices in coming months. Assuming that pricing dynamics will remain unchanged and tax hikes will entirely pass through to prices, tax hikes are expected to add 0.2 and 0.6 percentage points to monthly inflation in June and October, respectively. This contribution will be much higher in SCA-I and SCA-H. The due reading of the inflation figures to be released in July and October will provide a clearer picture of the underlying inflation trend.

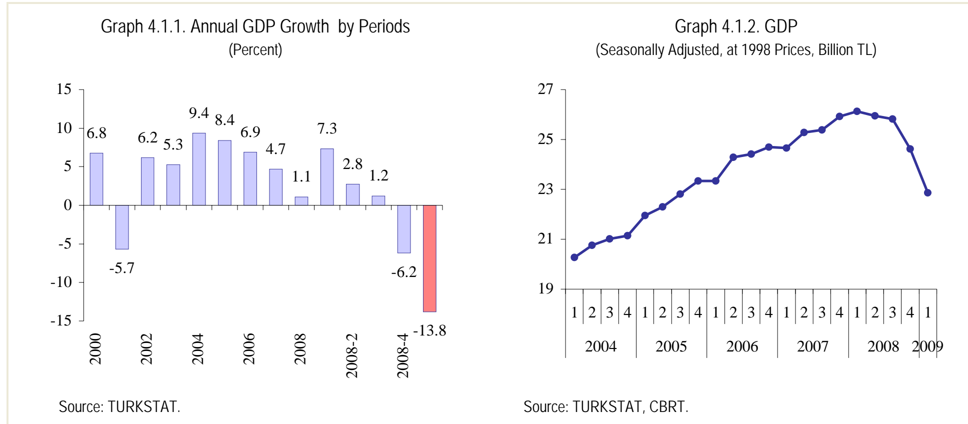
4. Supply and Demand Developments

The first-quarter national accounts data confirmed the outlook presented in the April Inflation Report. Foreign demand conditions continued to worsen, the global crisis put even more pressure on the labor market, and domestic demand declined rapidly. Accordingly, the economic contraction deepened further, and total demand conditions made a stronger contribution to disinflation.

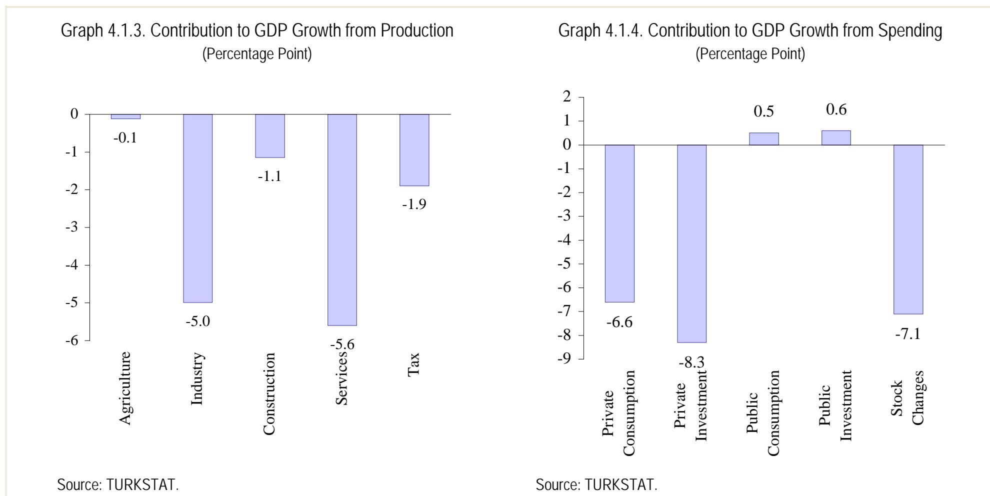
Recent data releases point to some rebound in domestic demand and economic activity, driven by monetary easing and fiscal measures. However, the additional tightening in financial conditions and the ongoing distress in the labor market becloud the medium-term outlook for domestic demand. In addition, given the fact that fiscal stimulus packages may gradually lose momentum by the third quarter, domestic demand is not expected to recover rapidly. In fact, demand uncertainty is expected to suppress investment demand and employment prospects, while higher unemployment will continue to weigh on total wages and domestic demand for a long time. The continued global turmoil and the absence of solid signs of recovery in advanced economies strengthen the likelihood of a protracted recovery in foreign demand. Therefore, total demand conditions may continue to support disinflation in the medium term.

4.1. Gross Domestic Product Developments and Domestic Demand

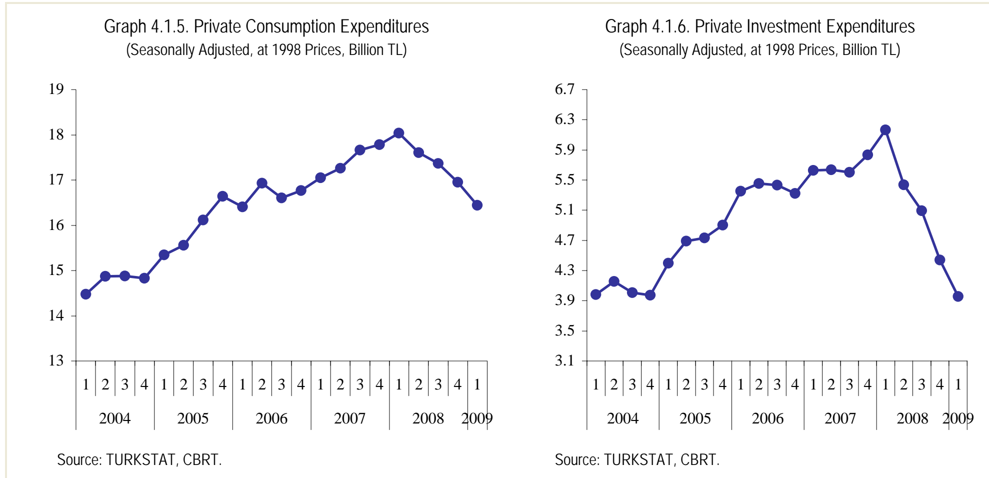
According to the national accounts data released by the Turkish Statistical Institute (TURKSTAT), GDP shrunk by 13.8 percent in the first quarter of 2009 from a year earlier (Graph 4.1.1). Having declined since the second quarter of 2008, GDP contracted even more deeply during the first quarter in seasonally adjusted terms (Graph 4.1.2).



On the production side, value added fell year-on-year across all industries. With the sharp reduction in industrial activity, the value added in services provided the most negative contribution to GDP growth, particularly from wholesale-retail trade and transport-communication industries (Graph 4.1.3). In contrast, the financial institutions sector, a sub-category of services, continued to register a positive contribution to growth. On the spending side, both the drastically weaker private demand and the inventory change brought GDP growth down. Yet, despite sluggish exports, net foreign demand made further contribution to GDP, quarter-on-quarter, owing to the marked decline in imports. Meanwhile, public spending added 1.2 percentage points to GDP and curbed the slowdown in domestic demand (Graph 4.1.4).



In seasonally adjusted terms, the contraction in both private consumption and private investment demand intensified in the first quarter (Graph 4.1.5 and Graph 4.1.6).



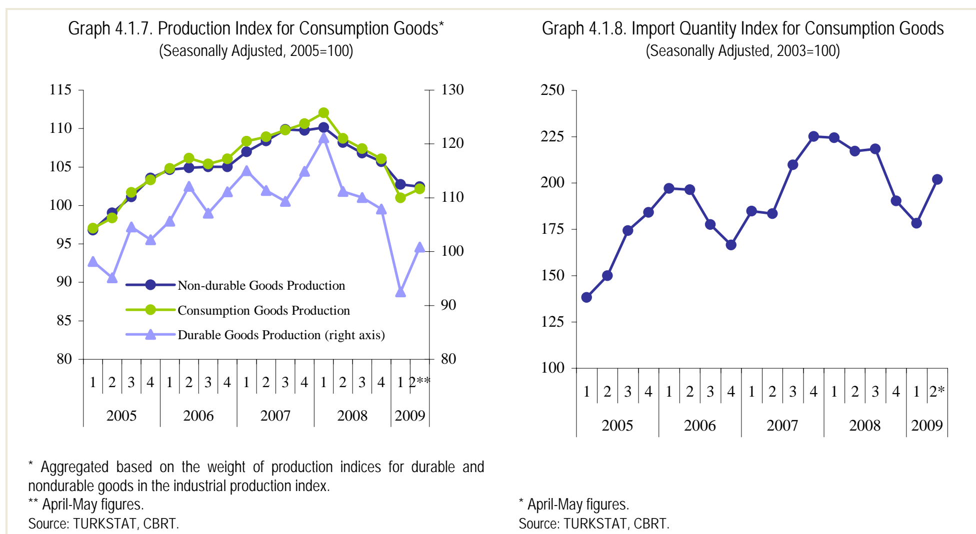
Graph 4.1.5. Private Consumption Expenditures (Seasonally Adjusted, at 1998 Prices, Billion TL)

Source: TURKSTAT, CBRT.

Graph 4.1.6. Private Investment Expenditures (Seasonally Adjusted, at 1998 Prices, Billion TL)

Source: TURKSTAT, CBRT.

The near-term outlook for the second quarter of 2009 reveals that the fiscal package of tax cuts on certain goods has helped to stimulate domestic sales. Accordingly, private consumption demand has slightly increased, while the recovery in production and imports has been rather limited for goods other than durables, which suggests that the fiscal measures have failed to pass through to all categories of goods and data releases are yet to point to a durable recovery in domestic demand. In the second quarter of 2009, the production of consumer goods rose quarter-on-quarter, particularly in durable goods, while imports increased on the back of the robust demand for passenger cars (Graph 4.1.7 and 4.1.8). On balance, despite running above its first-quarter level, private consumption demand is expected to fall further year-on-year (Graph 4.1.9).

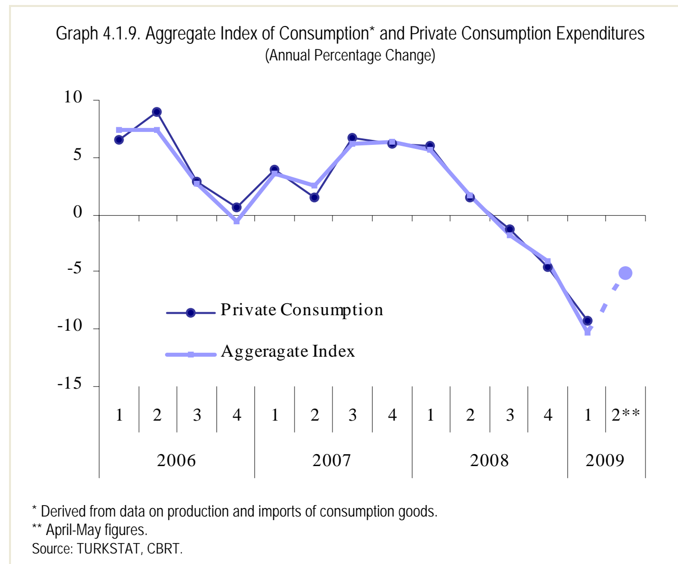


Graph 4.1.7. Production Index for Consumption Goods* (Seasonally Adjusted, 2005=100)

* Aggregated based on the weight of production indices for durable and nondurable goods in the industrial production index.
** April-May figures.
Source: TURKSTAT, CBRT.

Graph 4.1.8. Import Quantity Index for Consumption Goods (Seasonally Adjusted, 2003=100)

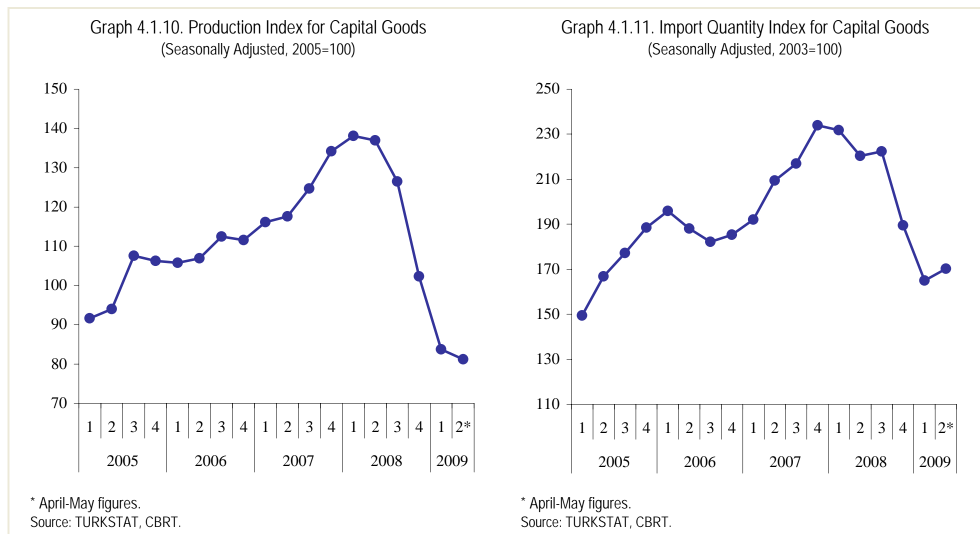
* April-May figures.
Source: TURKSTAT, CBRT.



Graph 4.1.9. Aggregate Index of Consumption* and Private Consumption Expenditures
(Annual Percentage Change)

* Derived from data on production and imports of consumption goods.
** April-May figures.
Source: TURKSTAT, CBRT.

On the other hand, private investment spending continued to weaken in the second quarter. The production of capital goods dropped by 38.7 percent year-on-year during April-May and fell below its quarter-ago average in seasonally adjusted terms (Graph 4.1.10). Meanwhile, although there has been some rebound in the demand for imported capital goods, the weak readings on production suggest that the private investment demand for machinery and equipment will decline further in the second quarter both in quarterly and yearly terms (Graph 4.1.11 and Graph 4.1.12).

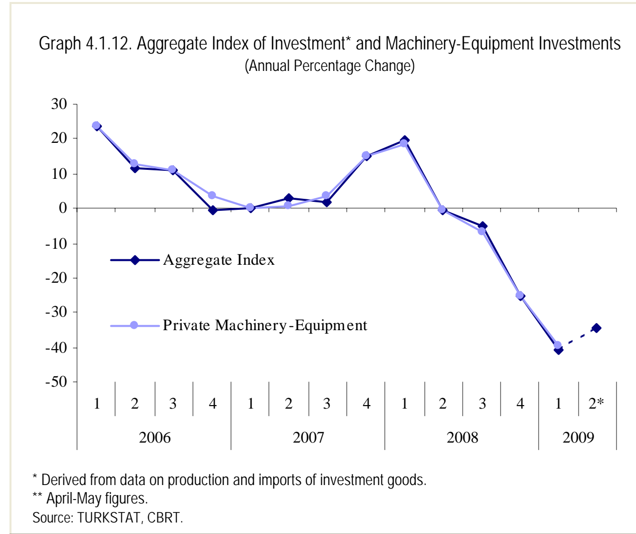


Graph 4.1.10. Production Index for Capital Goods
(Seasonally Adjusted, 2005=100)

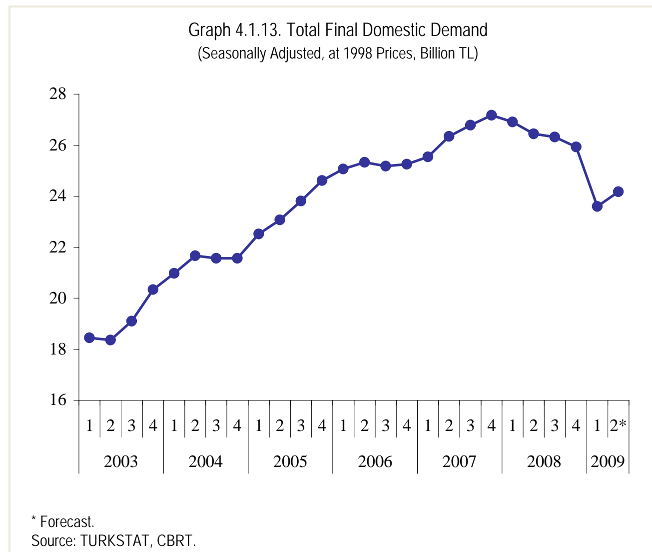
* April-May figures.
Source: TURKSTAT, CBRT.

Graph 4.1.11. Import Quantity Index for Capital Goods
(Seasonally Adjusted, 2003=100)

* April-May figures.
Source: TURKSTAT, CBRT.

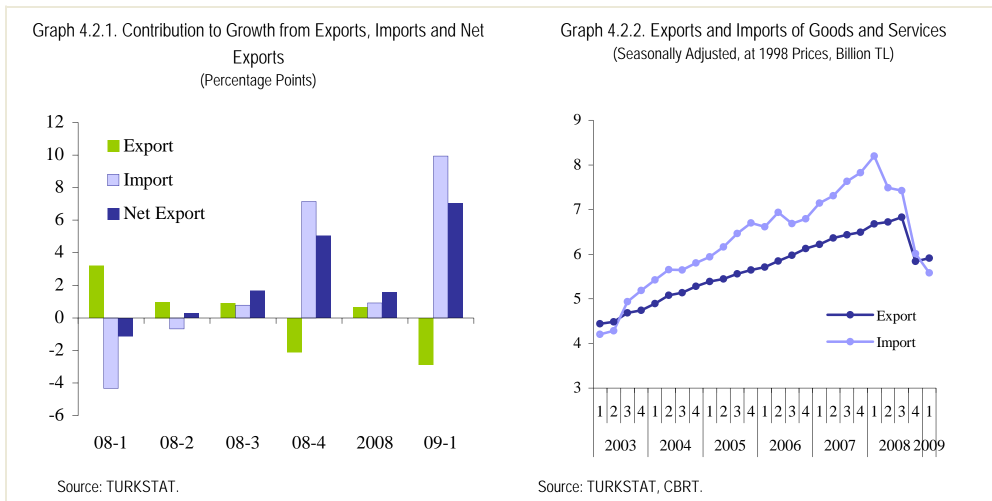


In sum, according to recent data releases, the fiscal stimulus package that creates a tax advantage for certain goods failed to pass through to major spending items. The ongoing uncertainty surrounding total demand conditions causes investment demand to remain weak. Yet, public spending is expected to make further positive contribution to growth in the second quarter. On balance, after the first-quarter slump, total final domestic demand is expected to grow slightly in the second quarter (Graph 4.1.13).



4.2. Foreign Demand

Exports and imports of goods and services decreased by 11.3 and 31.9 percent year-on-year, respectively, in the first quarter of 2009. Accordingly, net exports added 7 percentage points to GDP growth, up from a quarter earlier, accounting for –2.9 and 9.9 percentage points, respectively, of export and import growth (Graph 4.2.1). Seasonally adjusted data are in line with the outlook presented in the April Inflation Report. Accordingly, exports flattened out during the first quarter, while imports continued to contract due to the growing impact of the global economic downturn on domestic demand and economic activity. The fact that imports fell below exports for the first time in a long while explains the solid contribution of net exports to GDP growth in the face of weaker foreign demand (Graph 4.2.2).



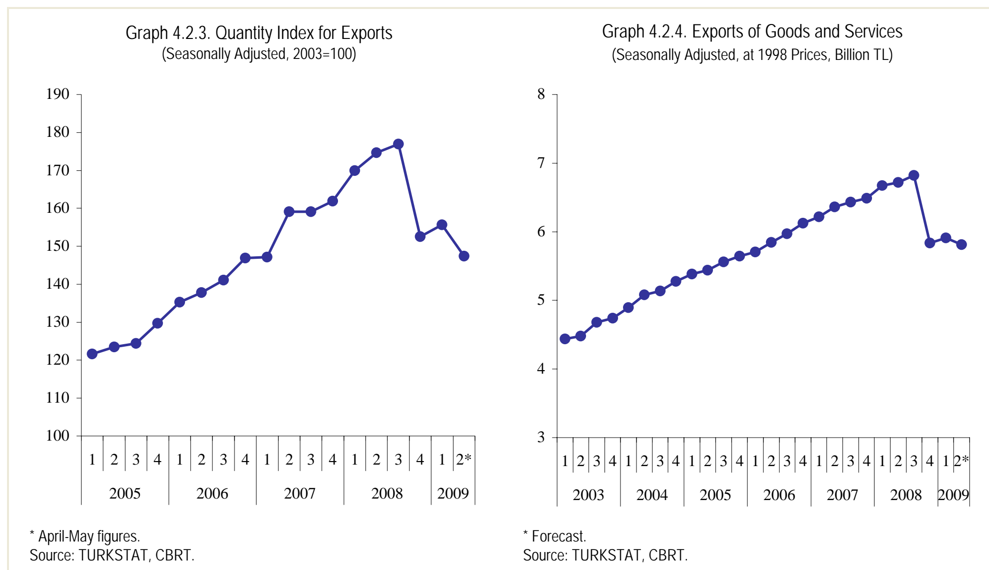
Graph 4.2.1. Contribution to Growth from Exports, Imports and Net Exports
(Percentage Points)

Source: TURKSTAT.

Graph 4.2.2. Exports and Imports of Goods and Services
(Seasonally Adjusted, at 1998 Prices, Billion TL)

Source: TURKSTAT, CBRT.

Recent data indicate that net foreign demand is likely to make further positive contribution, though to a lesser extent, to GDP growth in the second quarter of 2009. The export quantity index fell by 19 percent year-on-year during April-May, and went down from its quarter-ago average in seasonally adjusted terms (Graph 4.2.3). Recent readings on goods exports and tourism revenues indicate that exports of goods and services remained flat in the second quarter and are, therefore, expected to weaken further and continue to fall year-on-year (Graph 4.2.4).



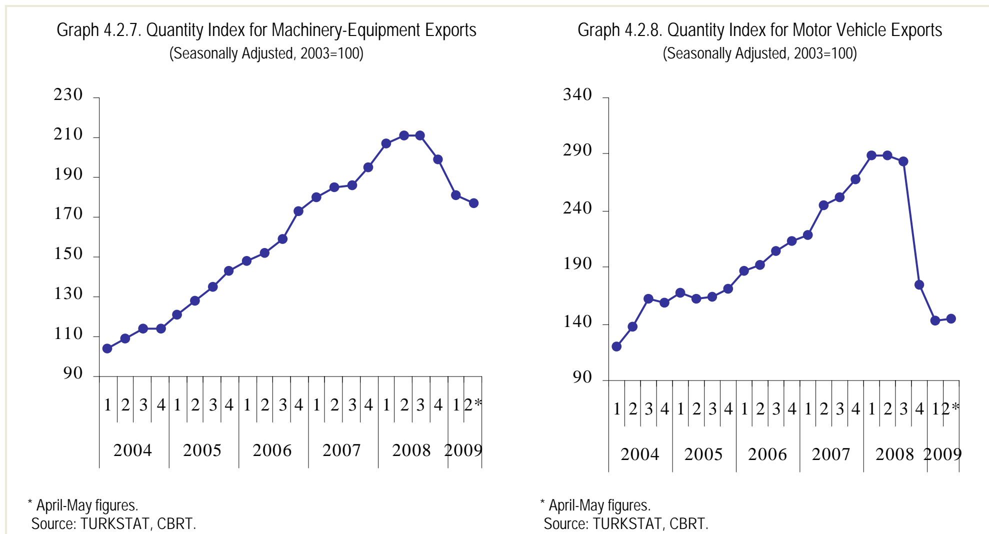
Keeping track on the pace and timing of the global economic recovery provides major insight to the foreign demand outlook. Recently, US growth forecasts for 2009 remained stable, while growth forecasts for the euro area – Turkey's largest export destination, continued to be revised downward in July. Consensus Forecasts revised its euro area contraction forecast for 2009 upwards to 4.4 percent in its July Survey, from 3.4 percent in its April Survey (Table 4.2.1).

Table 4.2.1. Consensus Forecasts
(Survey Date: July 13, 2009)

GDP Growth	Historical Data		Forecasts for 2009 from Survey of										
	2007	2008	Sep 08	Oct 08	Nov 08	Dec 08	Jan 09	Feb 09	Mar 09	Apr 09	May 09	Jun 09	Jul 09
United States	2.0	1.1	1.4	0.0	-0.6	-1.3	-1.8	-2.1	-2.8	-2.7	-2.9	-2.8	-2.6
Euro Zone	2.7	0.7	0.9	0.5	-0.2	-0.9	-1.4	-2.0	-2.6	-3.4	-3.7	-4.2	-4.4
Japan	2.4	-0.7	0.9	0.5	-0.1	-0.9	-1.7	-3.8	-5.8	-6.3	-6.1	-6.6	-6.2
UK	3.0	0.7	0.6	-0.2	-0.9	-1.5	-2.2	-2.6	-3.0	-3.3	-3.8	-3.7	-4.0

Source: Consensus Forecasts, July.

The above outlook for foreign demand is more negative than that presented in the April Inflation Report, which is also evident in the second-quarter figures from export industries. According to seasonally adjusted data from leading export industries, exports have not registered a solid quarterly recovery, except for the textile industry, and have remained at low levels. Compared to a year ago, second-quarter data indicate that exports will continue to contract markedly year-on-year (Graphs from 4.2.5 to 4.2.8).



In sum, latest data releases indicate that goods exports continued to weaken in the second quarter. Recent readings of the quantity index for exports excluding gold point to a very slow and limited growth of underlying exports (Box 4.1), which is consistent with the above global growth outlook.

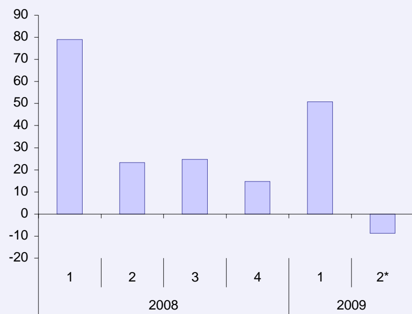
Box 4.1

MEASURING UNDERLYING EXPORTS: ARE CORE INDICATORS NEEDED?

As in deriving core inflation measures to track the trends in inflation and employment, it is necessary to exclude transient factors to better gauge underlying exports. For example, portfolio choices, which are influenced by the global risk sentiment, can cause gold exports to show temporary fluctuations that are inconsistent with the overall economic activity. The exclusion of these movements from underlying exports will facilitate a better understanding of the foreign demand outlook. In fact, the export quantity for the base metals industry rose by a stunning 50.8 percent year-on-year in the first quarter, owing to the jump in gold exports, but fell by 9.5 percent from a year earlier during April-May (Graph 1).

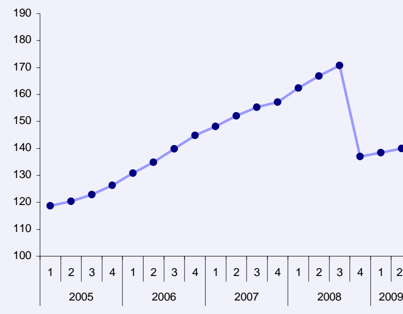
The quantity index for exports excluding gold has slightly improved recently in seasonally adjusted terms, and continued to edge up during the first half of July, as shown by the Turkish Exporters Assembly (TEA) readings. However, considering its pre-Q4 2008 levels, it is clear that the recent changes in the index show no signs of a rapid rebound in global demand (Graph 2).

Graph 1. Quantity Index for Base Metal Exports (Annual Percentage Change)



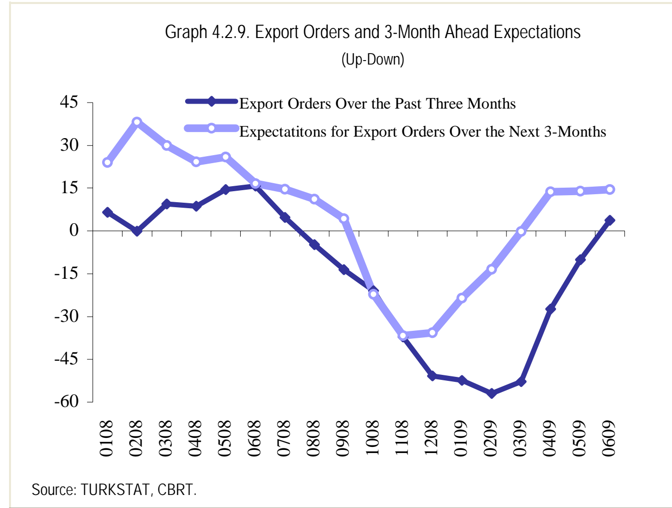
* April-May figures.
Source: TURKSTAT, CBRT.

Graph 2. Quantity Index for Exports Excluding Gold (Seasonally Adjusted, 2003=100)

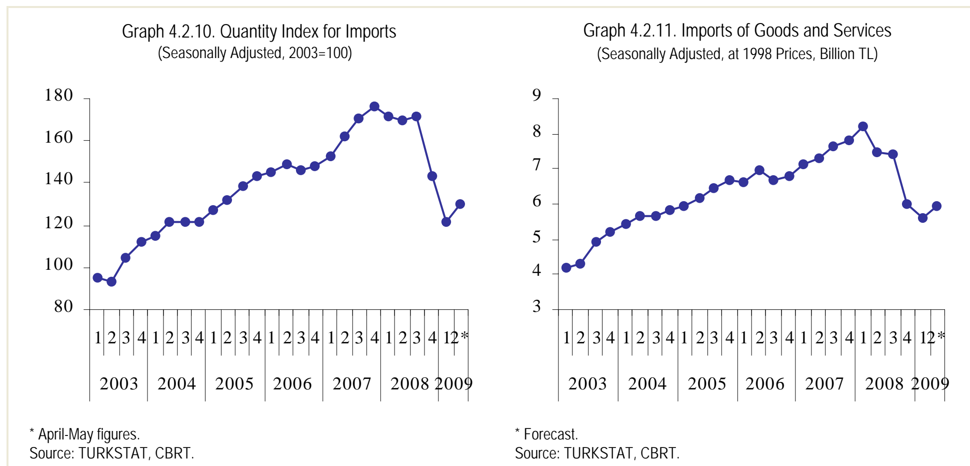


* April-May figures.
Source: TURKSTAT, CBRT.

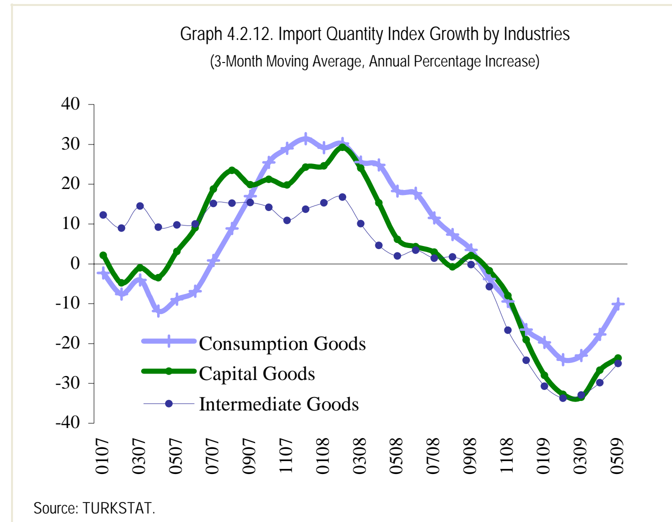
Export orders over the past three months, a CBRT Business Tendency Survey indicator, confirm the abovementioned second-quarter outlook, and the flattening of upcoming orders contributes to the slow recovery in exports (Graph 4.2.9). Solid signs of recovery have yet to emerge, therefore foreign demand is expected to put further pressure on total demand for a long time.



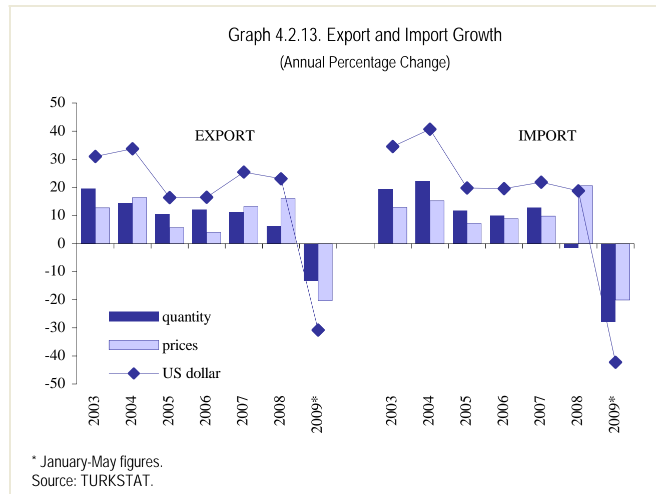
After having contracted with the deepening of the economic slowdown during the first quarter, imports picked up modestly on higher domestic demand in the second quarter, as stated in the April Inflation Report. The import quantity index fell by 22.8 percent year-on-year during April-May, running above its quarter-ago average in seasonally adjusted terms. On balance, despite a potential quarterly rise, imports of goods and services are expected to remain low in the second quarter of 2009 (Graph 4.2.10 and Graph 4.2.11).



Total demand conditions will determine the upcoming direction of the demand for imported goods. As suggested by the main components of the second-quarter import data, the quarterly and yearly rebound across all sub-categories was particularly evident in the imports of consumer goods (Graph 4.2.12). In detail, the subdued rise in goods other than passenger cars points to a less marked recovery in the demand for goods that were not affected by tax cuts. Based on the assumption that both the monetary policy easing cycle and the fiscal measures will help promote domestic demand gradually, imports are expected to rise steadily in the rest of the year. Foreign demand, on the other hand, is expected to turn around at a later time. Therefore, net foreign demand is forecast to make less positive contribution to growth in the third quarter of 2009.



So far, we have sought to assess quantities from a national accounts perspective, but recent developments in terms of trade are also significant for the balance of payments and the inflation outlook. In the midst of the global economic recession, foreign trade prices began to plunge with the downtrend in commodity prices since the final quarter of 2008, causing exports and imports to fall in US dollar terms at a faster pace than in quantity indices (Graph 4.2.13). Although recent developments suggest that commodity prices are likely to rise amid upward revisions to inflation forecasts for advanced economies, foreign trade prices, which still run below year-ago levels, are expected to put downward pressure on domestic prices of imported goods in 2009.



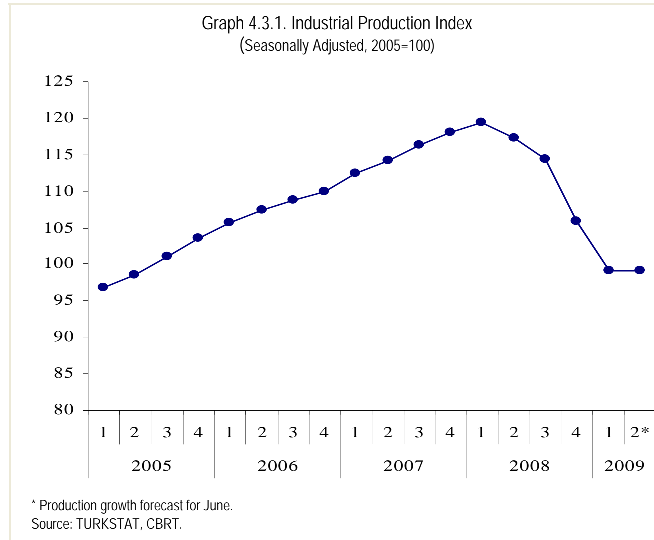
4.3. Output Gap

The first-quarter national accounts data were consistent with projections from the April Inflation Report. The massive deterioration in the global growth outlook during the fourth quarter of 2008 had a growing negative impact on the labor market and domestic demand in the first quarter of 2009. Accordingly, following the sharp contraction in foreign demand during the final quarter of 2008, total final domestic demand fell rapidly quarter-on-quarter in the first quarter of 2009, resulting in a deeper economic slowdown. Domestic demand, particularly from the private sector, made a substantially reduced contribution to growth, whereas, despite sluggish exports, net foreign demand provided a stronger boost to growth than in the previous quarter, thanks to the severe contraction in imports.

On the seasonally adjusted spending data, private demand continued to fall at a more rapid pace, for both consumption and investment, while public spending made a positive contribution to growth. The ongoing global economic turmoil caused foreign demand to remain weak. Given the negative outlook for total demand components and the quicker depletion of inventories, GDP narrowed sharply from a quarter earlier. The current demand has been met by inventories and demand uncertainty has soared to record highs, resulting in a rapid contraction in output and a stronger support from total demand to disinflation during the first quarter of 2009.

Second-quarter indicators point to some rebound in economic activity. Despite having slumped by 17.4 percent year-on-year, industrial production

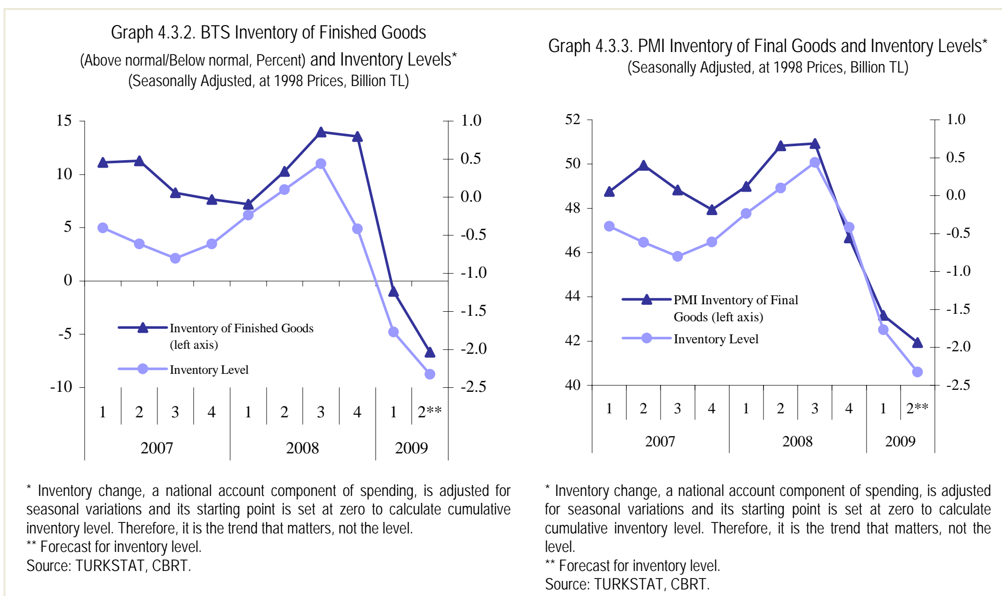
increased month-on-month in seasonally adjusted terms during May. The June data on capacity utilization suggest that output continues to grow, albeit at a slower pace. Accordingly, the downtrend in industrial production since the second quarter of 2008 seems to have reversed in seasonally adjusted and quarterly terms (Graph 4.3.1).



Graph 4.3.1. Industrial Production Index
(Seasonally Adjusted, 2005=100)

* Production growth forecast for June.
Source: TURKSTAT, CBRT.

The modest second-quarter increase in output growth as well as demand indicators point to a further, though slower, depletion of inventories. In fact, CBRT Business Tendency Survey (BTS) and PMI inventory indices continued to fall in the second quarter (Graph 4.3.2 and Graph 4.3.3). Thus, the inventory change made further negative contribution to growth in the second quarter.



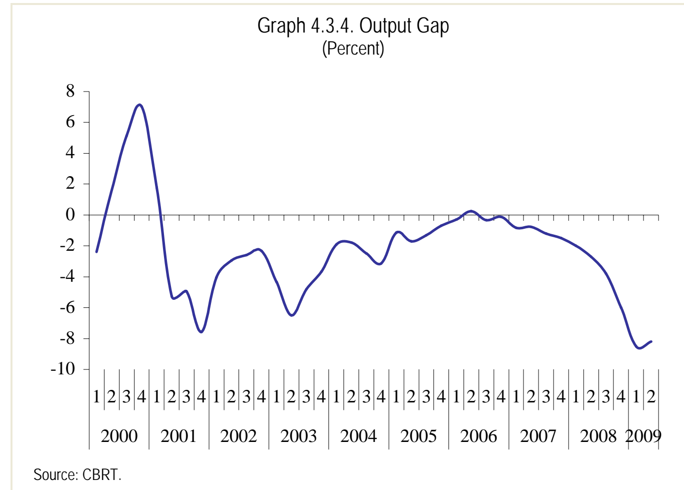
Graph 4.3.2. BTS Inventory of Finished Goods (Above normal/Below normal, Percent) and Inventory Levels*
(Seasonally Adjusted, at 1998 Prices, Billion TL)

* Inventory change, a national account component of spending, is adjusted for seasonal variations and its starting point is set at zero to calculate cumulative inventory level. Therefore, it is the trend that matters, not the level.
** Forecast for inventory level.
Source: TURKSTAT, CBRT.

Graph 4.3.3. PMI Inventory of Final Goods and Inventory Levels*
(Seasonally Adjusted, at 1998 Prices, Billion TL)

* Inventory change, a national account component of spending, is adjusted for seasonal variations and its starting point is set at zero to calculate cumulative inventory level. Therefore, it is the trend that matters, not the level.
** Forecast for inventory level.
Source: TURKSTAT, CBRT.

In sum, recent data releases show signs of a partial recovery in economic activity during the second quarter of 2009. The monetary easing cycle and the fiscal measures helped promote domestic demand, while foreign demand continued to soften. Therefore, GDP is forecast to slump further year-on-year, but expand quarter-on-quarter, during the second quarter. On balance, total demand conditions are expected to bring inflation further down (Graph 4.3.4).[1]

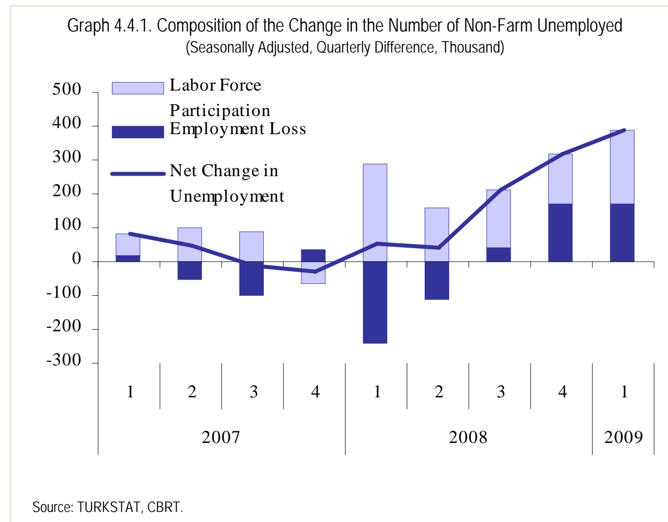


Graph 4.3.4. Output Gap
(Percent)
Source: CBRT.

4.4. Labor Market

With the deepening of the economic slowdown during the first quarter of 2009, the negative labor market outlook worsened further from a quarter earlier, causing unemployment to hit historic highs. Total unemployment increased by 4.2 percentage points to 16.1 percent year-on-year in the first quarter. The fall in employment and the rise in labor force participation accounted for 1.8 and 2.4 percentage points, respectively, of the increase in unemployment (Graph 4.4.1).

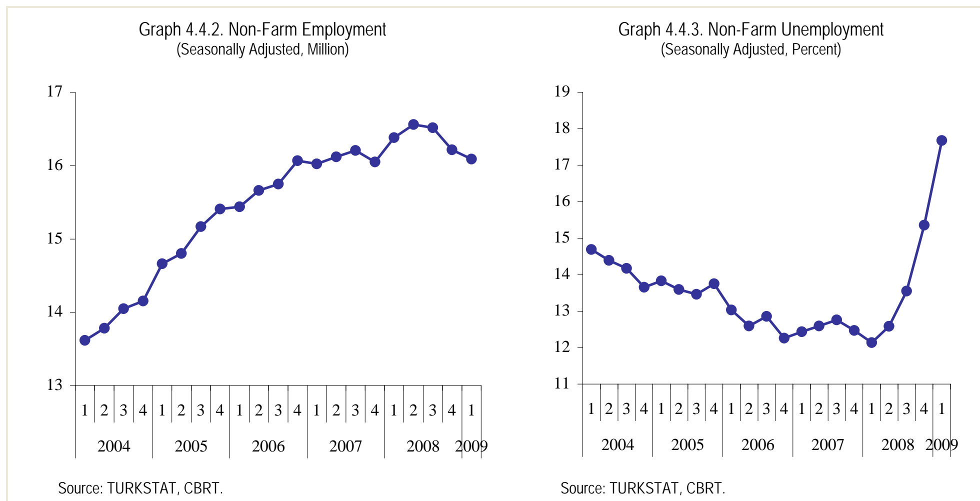
[1] Output gap forecasts for 2009 and onwards are presented in the final chapter of the Report.



Graph 4.4.1. Composition of the Change in the Number of Non-Farm Unemployed
(Seasonally Adjusted, Quarterly Difference, Thousand)

Source: TURKSTAT, CBRT.

The underlying employment trend continued to be downward. Non-farm employment fell by 1.9 percent year-on-year during the first quarter and continued to decline in seasonally adjusted terms (Graph 4.4.2). Given the slowdown in employment, coupled with the sharp rise in labor force participation, non-farm unemployment amounted to 19.8 percent, up 5.6 percentage points from a year ago. In seasonally adjusted terms, non-farm unemployment rose by 2.3 percentage points quarter-on-quarter, up a cumulative 4.1 percentage points since the labor market collapse in the final quarter of 2008 (Graph 4.4.3).



Graph 4.4.2. Non-Farm Employment
(Seasonally Adjusted, Million)

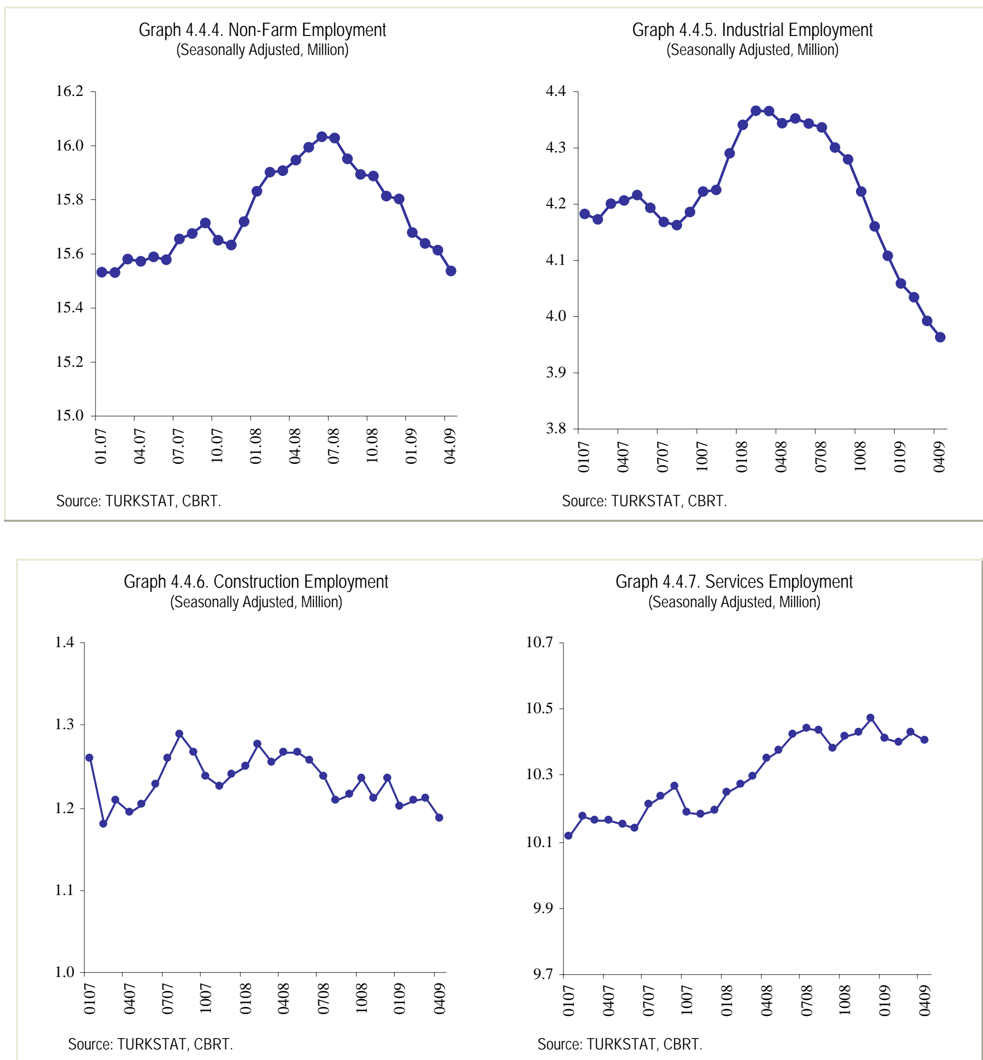
Source: TURKSTAT, CBRT.

Graph 4.4.3. Non-Farm Unemployment
(Seasonally Adjusted, Percent)

Source: TURKSTAT, CBRT.

Recent monthly data indicate that non-farm employment continued to fall in the second quarter. During March-May, non-farm employment dropped by

2.7 percent year-on-year and went further down in seasonally adjusted terms. Broken down by industries, the sharp drop in industrial employment was the main driver of the loss in non-farm employment, while construction employment declined modestly. On the other hand, services employment remained flat, with variations in sub-categories. The falling employment in industries of wholesale/retail trade and transport/communication, which are mostly involved in manufacturing and construction activities, is counterbalanced by the growing employment in financial institutions and public services (Graphs from 4.4.4 to 4.4.7).



Graph 4.4.4. Non-Farm Employment (Seasonally Adjusted, Million)
Source: TURKSTAT, CBRT.

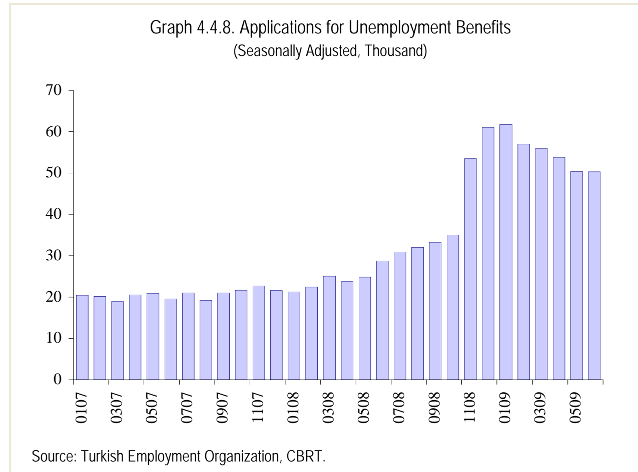
Graph 4.4.5. Industrial Employment (Seasonally Adjusted, Million)
Source: TURKSTAT, CBRT.

Graph 4.4.6. Construction Employment (Seasonally Adjusted, Million)
Source: TURKSTAT, CBRT.

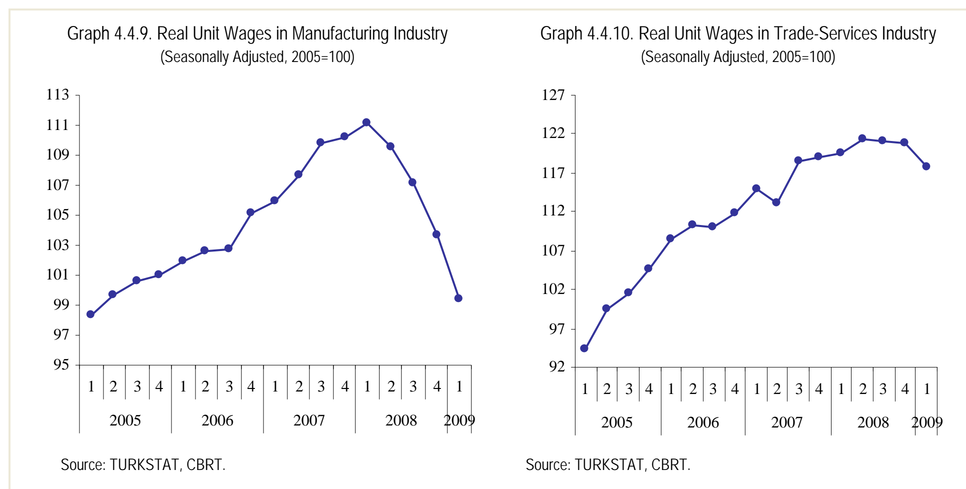
Graph 4.4.7. Services Employment (Seasonally Adjusted, Million)
Source: TURKSTAT, CBRT.

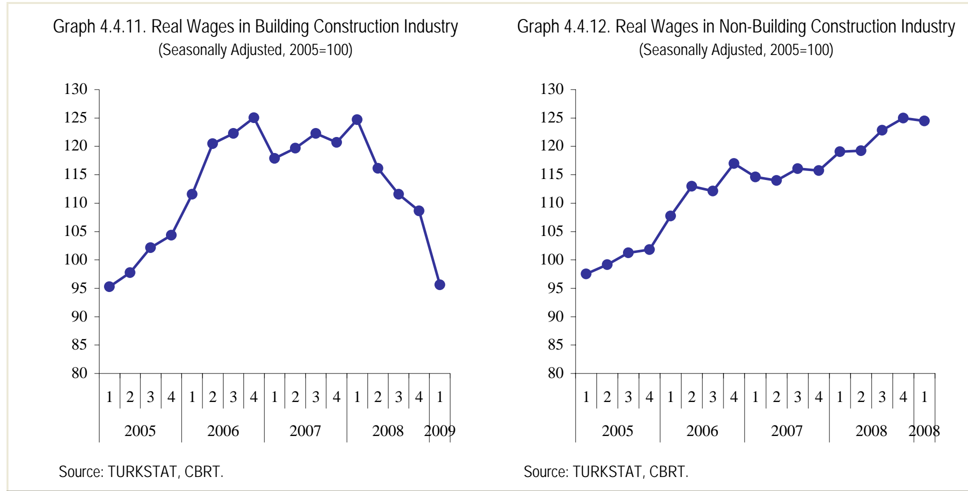
The 2009 March-May data indicate that, apart from the non-farm employment loss, both male and female labor force participation rates rise further. Thus, non-farm unemployment soared to 18.2 percent during March-

May, up 5.9 percentage points from a year earlier. Applications for unemployment benefits slowed in June, compared with the first quarter, but were significantly above their year-ago level (Graph 4.4.8). On balance, non-farm unemployment is expected to rise further in the second quarter, albeit at a more moderate pace in quarterly terms.

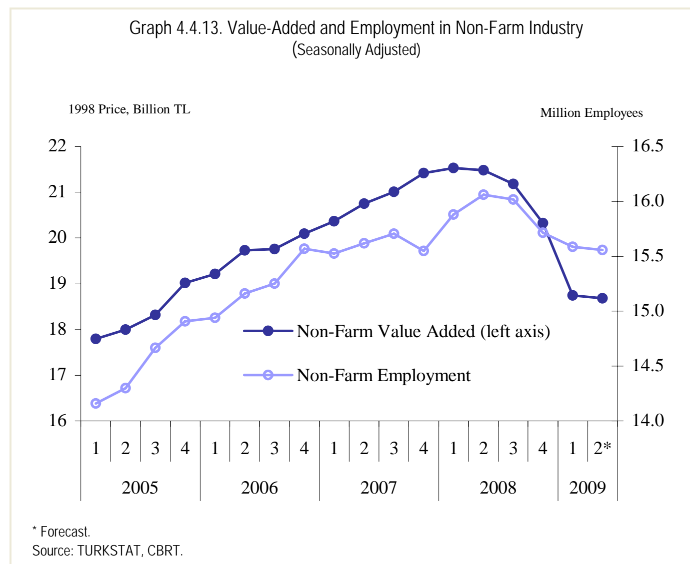


Problems in the labor market put further downward pressure on total wages across the whole economy. Amid falling employment, real wages in the manufacturing industry decreased in both quarterly and yearly terms during the first quarter of 2009. Similarly, the fall in real wages in the trade-services industry deepened in quarterly terms. As for the construction industry, real wages differ widely in building and non-building construction. Real wages in building construction declined rapidly, while those in non-building construction remained unchanged from a quarter ago (Graphs from 4.4.9 to 4.4.12).





The upcoming trend in employment will depend on the speed and timing of the economic recovery. In view of the above outlook, economic activity may increase slightly in non-farm industries during the second quarter, while non-farm employment is expected to fall further, albeit at a slower pace. Accordingly, the yearly rate of decrease in non-farm employment will be higher than previous quarters due to the high base effect from a year ago (Graph 4.4.13).



In sum, the demand uncertainty fuelled by the global economic turmoil has prompted firms to embrace a more cautious stance regarding production activities. Thus, the low rates of capacity utilization and the decline in investment sentiment continue to put pressure on employment prospects. The downtrend in employment and total wages across the whole economy restrains

the growth of domestic consumption through expendable income. Based on the assumption that economic activity is unlikely to recover soon, the labor market downturn is expected to depress total wages and domestic demand for a long time, bringing inflation further down.

5. Financial Markets and Financial Intermediation

5.1. Financial Markets

The global crisis that first erupted in advanced financial markets and spread globally by deepening further starting from the fourth quarter of 2008 continued to weigh on financial markets during the second quarter of 2009. Recent data releases on the financial system and the global economic activity that the worst of the crisis is over and the world economy is now in recovery, which has inspired a guarded optimism in financial markets. However, the modest improvement in key indicators for advanced and emerging economies, the ongoing, yet easing, distress in credit markets and the weakening of employment prospects suggest that the post-crisis recovery is likely to be slow and gradual.

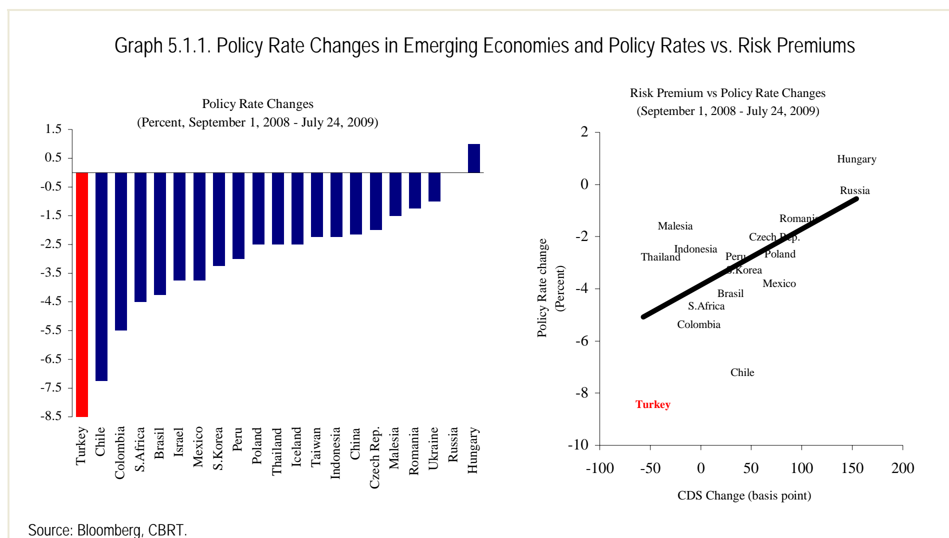
In the second quarter, the remedy actions taken by monetary and fiscal authorities in advanced economies brought some stability into international credit markets and eased the liquidity squeeze. On the other hand, the massive loss encountered by financial institutions during the crisis and the failure to remove distressed assets off their balance sheets have caused financial system originated risks to prevail, though at a lesser degree and restricted loanable funds. The still-elevated credit risk perception causes banks to stay cautious about lending and rules out the possibility that financial conditions will ease in the short run. Moreover, the massive loss also encountered by households in their assets and the mounting concerns over the future boost precautionary savings and put downward pressure on consumer spending in advanced economies. The rise in savings and the ongoing tightening in borrowing conditions lessens the possibility that the world economy will revert to the pre-crisis path of strong growth in the near term.

Emerging economies have also shown signs of bottoming out. However, the ongoing weak foreign demand and the shortage of funds needed to finance the economic recovery impose some risks on the speed of recovery in these economies.

If global credit markets begin to function properly again and risk perceptions continue to improve, emerging economies may gain easier access to global capital in the medium term; yet, returning to pre-crisis levels will take a long time.

Emerging economies have a narrower room for fiscal policy which causes governments to rely more on monetary policy during the crisis and central banks to take measured, yet fast and effective actions. Accordingly, central banks in emerging economies have reduced policy rates at a faster-than-expected pace, intending to limit the adverse impact of the global crisis on economic activity. Countries, where financial markets are relatively more stable and the risk premium is less deteriorated, have benefited from greater room for monetary policy and been able to cut policy rates more aggressively (Box 5.1). Turkey has stood out from other emerging economies, thanks to the sound banking system and the relatively less deteriorated risk premium. In view of this, the CBRT has lowered policy rates aggressively and assumed a leading role among emerging economies (Graph 5.1.1). In the meantime, the data released on the economic activity and inflation have justified CBRT's decisions. Rate cuts began to affect money and credit markets by the second quarter, alleviating financial strains (Graph 5.1.5).

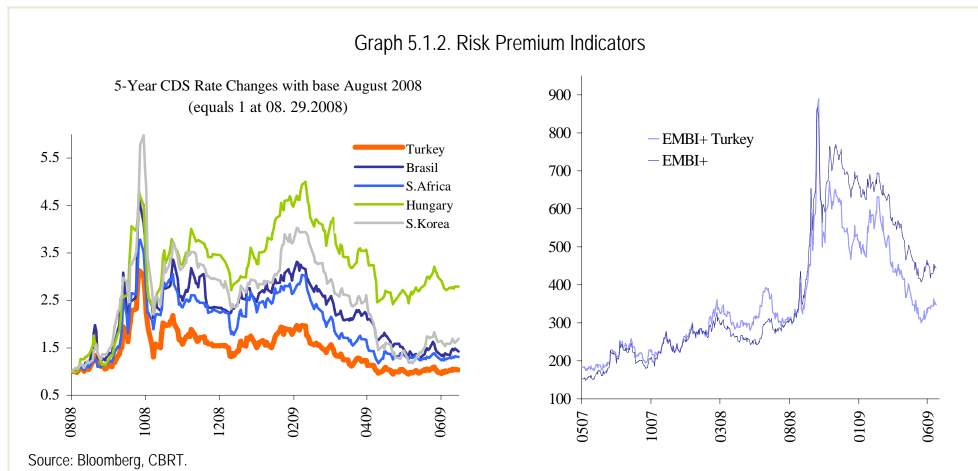
Graph 5.1.1. Policy Rate Changes in Emerging Economies and Policy Rates vs. Risk Premiums



Source: Bloomberg, CBRT.

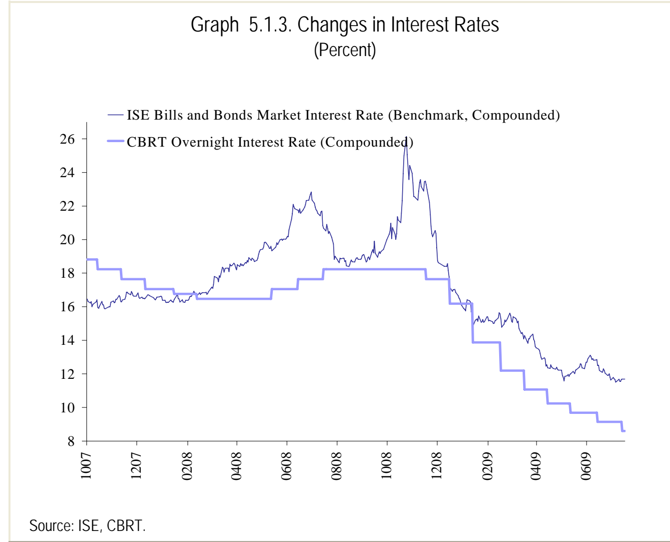
Although there is a consensus that the world economy is unlikely to revert to the path of strong growth in the short run, the growing sense that the worst of the crisis is over, fuelled optimism in financial markets and boosted risk appetite during the second quarter. Investors shifted towards riskier assets, encouraging a flow of capital into emerging markets through portfolio movements. Meanwhile, emerging market currencies appreciated and stock exchange indices moved up at a faster pace than those in advanced economies. With the improvement in global risk perceptions, the risk premium in emerging economies converged to pre-Lehman Brothers bankruptcy levels (Graph 5.1.2). In the second quarter of the year and throughout the crisis as well, Turkey's risk premium continued to be lower than other emerging economies.

Graph 5.1.2. Risk Premium Indicators



Source: Bloomberg, CBRT.

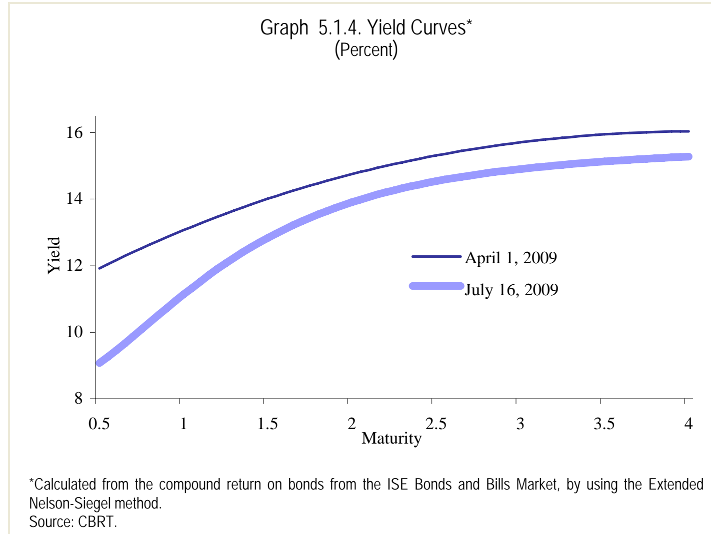
Many central banks in emerging economies continued to cut policy rates in the second quarter, albeit at a slower pace. In view of the weakening aggregate demand, the ongoing tightening in credit conditions and the improved inflation outlook, the CBRT continued the policy rate cuts, which started in November 2008, into the second quarter of 2009, and reduced policy rates by a total of 850 basis points as of July 2009. As the second-quarter data on inflation and economic activity substantiated CBRT's strategy of rapid rate cuts, policy rates began to have a greater effect on market rates, causing market rates to fall further (Graph 5.1.3). In addition to policy rate cuts, CBRT's downward flexibility in monetary policy and the second-quarter improvement in risk perceptions accelerated the downtrend in market rates.



Graph 5.1.3. Changes in Interest Rates
(Percent)

Source: ISE, CBRT.

On the maturity side, government bond yields on July 16, 2009 dipped below those on April 1, 2009 in every maturity range (Graph 5.1.4). The downtrend in short-term interest rates became more evident, while the long end of the yield curve fell more moderately amid the growing sentiment that the worst of the economic downturn is over.



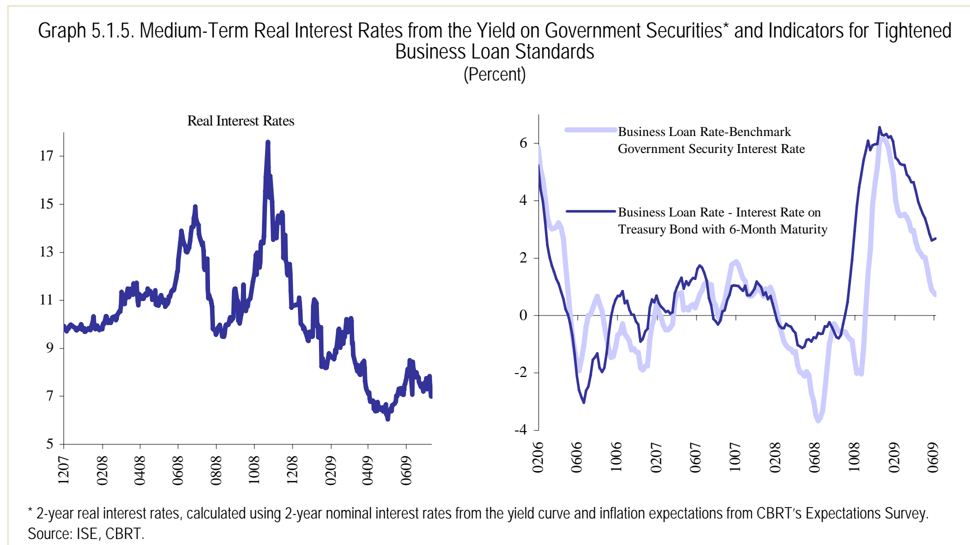
Graph 5.1.4. Yield Curves*
(Percent)

*Calculated from the compound return on bonds from the ISE Bonds and Bills Market, by using the Extended Nelson-Siegel method.
Source: CBRT.

The downtrend in market rates spilled over into medium-term real interest rates, and real market rates went further down from the first quarter, hovering below their pre-crisis level. Real rates are likely to fall in well-functioning economies during times of recession, which, however, is quite unprecedented for Turkey. Therefore, the current level of real rates is an indicator for the improved effectiveness of monetary policy. Nevertheless,

despite the recently improved outlook, credit risk perceptions still remain elevated, which lessens the effect of falling market rates on economic activity. Although credit risk perceptions have been running above pre-crisis levels as of July, financial conditions began to ease gradually in the first half of 2009 thanks to CBRT's policy rate cuts. In fact, the spread between relatively higher-risk business loans and lower-risk Treasury bond rates remains decreased markedly during the second quarter (Graph 5.1.5).

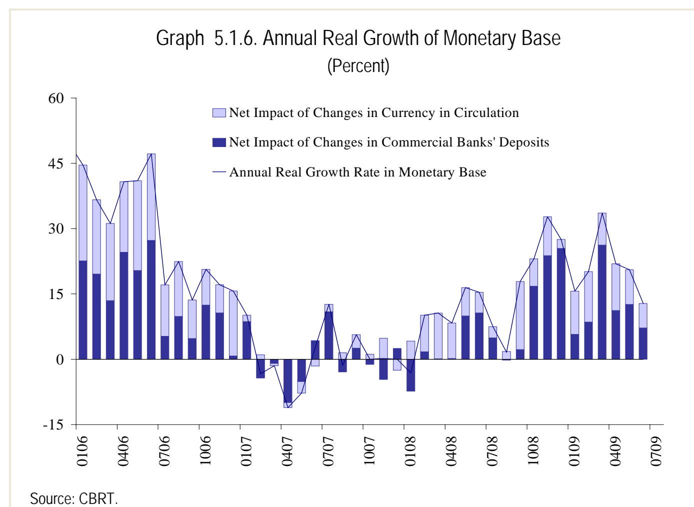
Graph 5.1.5. Medium-Term Real Interest Rates from the Yield on Government Securities* and Indicators for Tightened Business Loan Standards
(Percent)



* 2-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from CBRT's Expectations Survey.
Source: ISE, CBRT.

Despite the optimism surrounding financial markets, the sense of uncertainty, a measure of investment sentiment in economic agents, remained above its pre-crisis level during the second quarter, causing economic agents to hold relatively low-risk assets and cash. As a result, despite weak economic activity, monetary base continued to grow in yearly terms, albeit slowly (Graph 5.1.6).

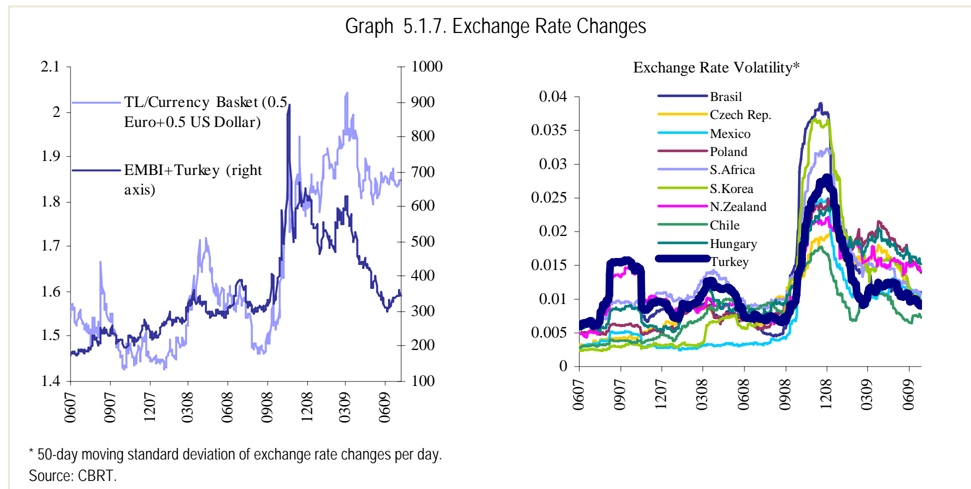
Graph 5.1.6. Annual Real Growth of Monetary Base
(Percent)



Source: CBRT.

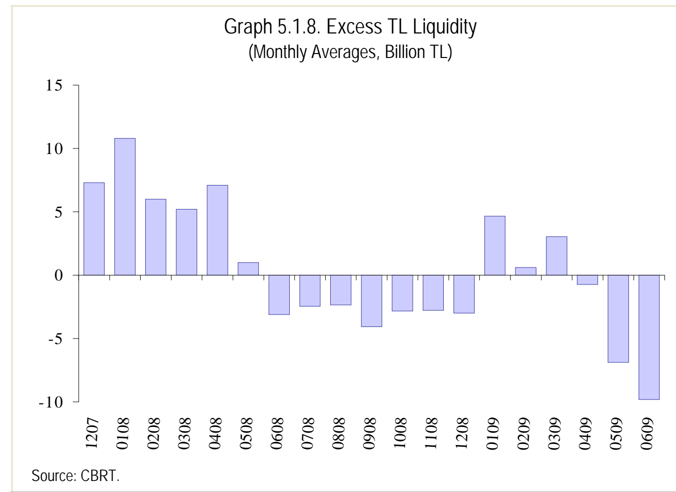
The improved perception of global risk helped emerging market currencies appreciate. In terms of changes in currency values, the Turkish lira did not significantly differ from other emerging market currencies. Though remaining at historically high volatility levels and extremely sensitive to global risk appetite, the Turkish lira continued to be relatively less volatile during the second quarter of 2009, when countries' own experiences began to unfold following the worst period of the crisis (Graph 5.1.7). Moreover, as has been the case since the outburst of the crisis, emerging economies that slashed policy rates more aggressively suffered less currency depreciation in the second quarter, which is due to the fact that mid-crisis changes in risk premiums play a major role in determining exchange-rate yields and monetary policy decisions.

Graph 5.1.7. Exchange Rate Changes



* 50-day moving standard deviation of exchange rate changes per day.
Source: CBRT.

The excess liquidity in the overnight market during the first quarter of 2009 was replaced by a liquidity shortage in the second quarter (Graph 5.1.8). The liquidity shortage was caused by the fact that the amount borrowed by the Treasury exceeded the amount redeemed, owing to the increased need for public financing. Meanwhile, the CBRT provided liquidity through regular 1-week repo auctions. These auctions are intended to provide efficient and stable functioning of money markets by preventing excessive volatility in short-term money market rates, and offer an amount of liquidity that helps overnight rates to remain close to CBRT's borrowing rate and the overnight borrowing rate to function as the reference rate for monetary policy.



In addition to the main funding instrument of one-week auctions, the Bank launched three-month repo auctions on June 19, in order to facilitate the liquidity management of banks and to help enhance the transmission mechanism. On July 17, the total liquidity injected into the market by these auctions amounted to 9 billion Turkish liras.

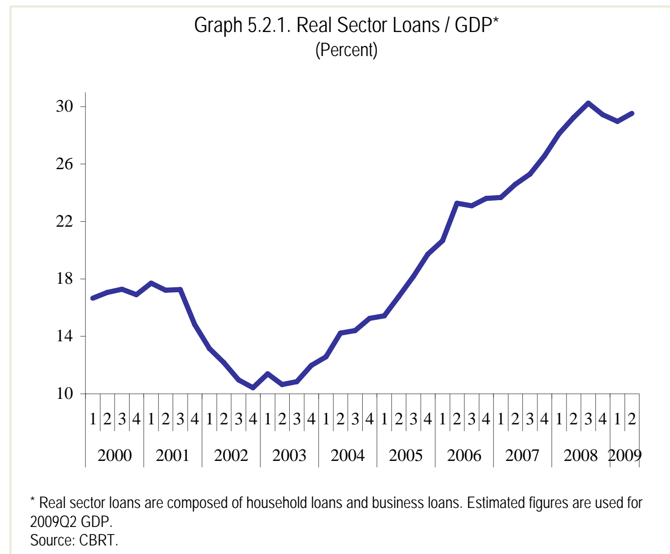
Long-term repo auctions are not designed to put a limit on short-term interest rates, a key indicator of CBRT's monetary bias, but are intended to ease the structural liquidity shortage. Therefore, the amount is announced prior to auctions, and auction rates are only determined by market conditions and can be misleading as an indicator of monetary stance. Moreover, if current liquidity conditions prove to be permanent, the Bank may opt for a technical rate cut, details of which were previously announced, and consider purchasing government bonds or lowering Turkish lira reserve requirements of banks, depending on the liquidity shortage and the effectiveness of long-term repo auctions.

To sum up, in addition to its main objective of maintaining price stability, the CBRT continued, and will continue, to take the necessary measures against the potential adverse impact of the global financial turmoil on financial stability, which is the key prerequisite of price stability.

5.2. Financial Intermediation and Loans

After having slumped since the deepening of the global crisis during the final quarter of 2008, business loans started to rise modestly in the second quarter of 2009 (Graph 5.2.1). Corporate loans flattened out during the second

quarter, while consumer loans recovered slightly. As suggested by balance of payments statistics, the corporate sector that had access to both domestic and foreign funds has become a net repayer of foreign debt by the first two months of the second quarter.

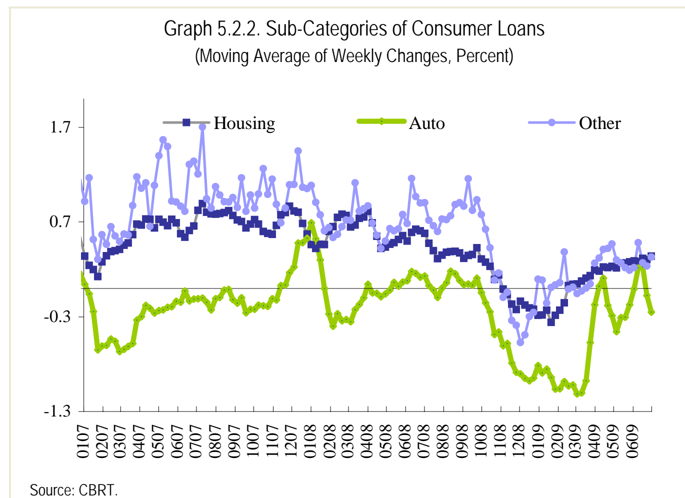


Graph 5.2.1. Real Sector Loans / GDP*
(Percent)

* Real sector loans are composed of household loans and business loans. Estimated figures are used for 2009Q2 GDP.
Source: CBRT.

Consumer loans performed better quarter-on-quarter across all sub-categories. While housing and other loans increased steadily at a modest rate, auto loans stopped falling (Graph 5.2.2).

Financing costs dropped quarter-on-quarter. Interest rates on fixed-rate consumer loans with relatively longer maturities declined slightly, while business loans with floating-rates and shorter maturities fell sharply (Graph 5.2.3).

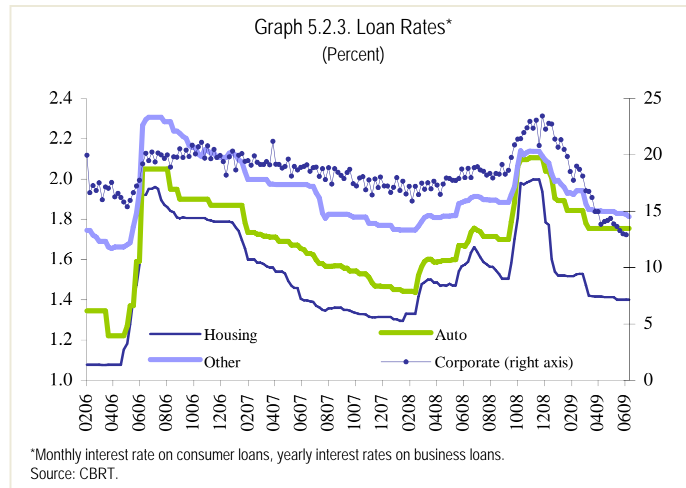


Graph 5.2.2. Sub-Categories of Consumer Loans
(Moving Average of Weekly Changes, Percent)

Source: CBRT.

Managing the decomposition of contributions from credit supply and credit demand is highly important for ensuring a better understanding of the effects of financial conditions on the business sector. The Banks' Loans Tendency Survey, which is conducted quarterly among major banks, contains material information in this respect. The latest May survey includes first-quarter figures and second-quarter expectations.

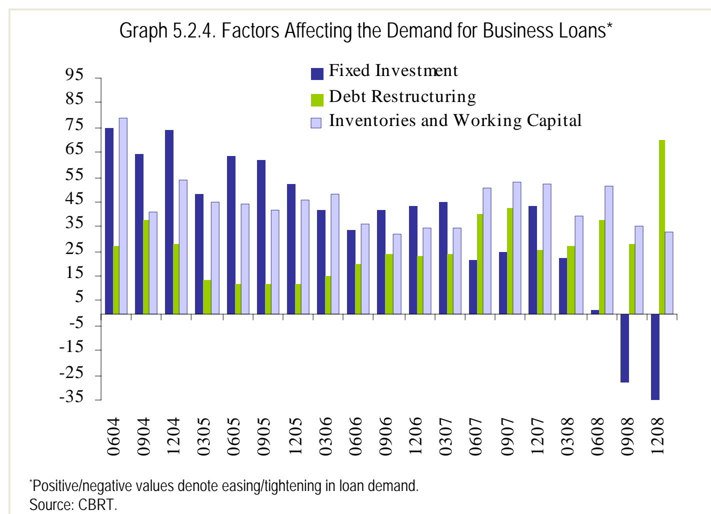
Graph 5.2.3. Loan Rates*
(Percent)



*Monthly interest rate on consumer loans, yearly interest rates on business loans.
Source: CBRT.

According to the survey, the demand for corporate loans was flat during the first quarter, and shifted from long to short-term loans. Moreover, the main driver of the demand for corporate loans was debt restructuring and financing of working capital rather than investment (Graph 5.2.4). Expectations suggest that this behavior will continue into the second quarter. The ongoing decline in investments and the weak rebound in industrial production are consistent with the second-quarter expectations.

Graph 5.2.4. Factors Affecting the Demand for Business Loans*

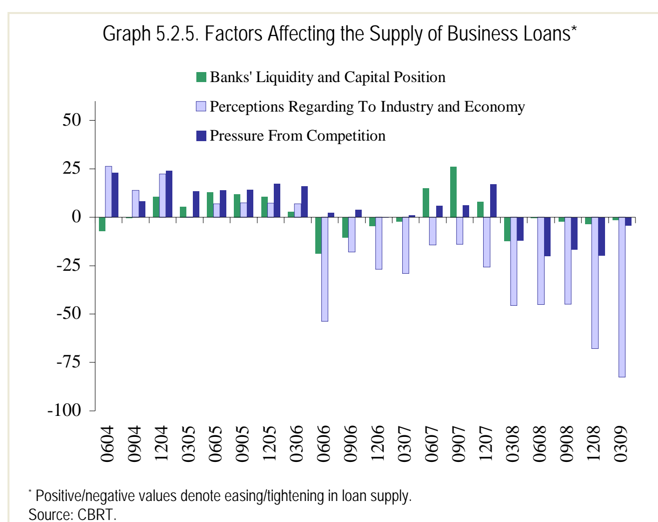


*Positive/negative values denote easing/tightening in loan demand.
Source: CBRT.

The demand for investment loans is unlikely to rise as the economic recovery is expected to be sluggish and the corporate sector currently operates with high idle capacity. The crisis-driven imbalances in cash flows is expected to gradually disappear, as firms would adapt to falling demand conditions in the remainder of the year, which, in fact, is partly signaled by the depletion of inventories. Thus, the loan demand for working capital and debt restructuring is unlikely to increase dramatically.

The main drivers of consumer loan demand are household incomes, changes in consumer confidence, and loan rates. During the second quarter, consumer confidence bounced back sharply, while loan rates declined slightly. In addition, the SCT cuts were also put into effect in this quarter to stimulate the household consumption. However, falling employment put downward pressure on household incomes, causing consumer loans to rise only modestly.

Having an altered scope and size, the SCT cuts will be in place during the third quarter, and add further to the demand for consumer loans. Given the rise in consumer confidence, consumer loans are expected to grow more significantly. Yet, the rebound in consumer loans can only be durable if employment prospects improve.



On the loan supply side, the Loan Tendency Survey indicates that banks are likely to remain cautious on new lending in the second quarter, largely owing to mounting concerns about the overall macroeconomic outlook (Graph 5.2.5). CBRT's policy rate cuts since November 2008 helped reduce the credit risk by limiting the overall macroeconomic deterioration. On balance, loan

standards are expected to improve further in coming months, albeit at a slow and measured pace, given the prospects of economic recovery.

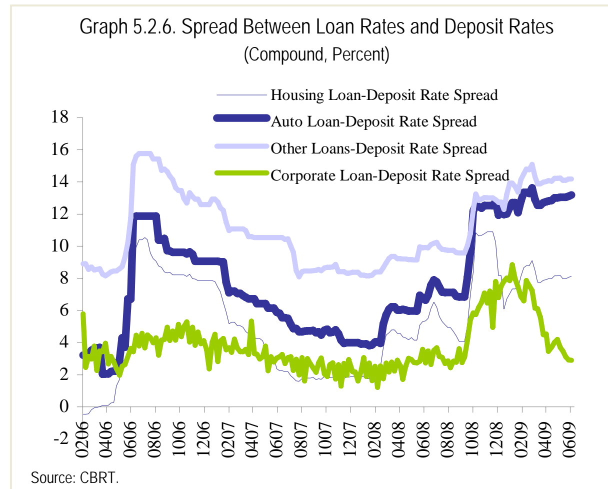
Table 5.2.1 Overdue Debt
(Quarter-on-quarter, Percent)

	Consumer loans	Home loans	Auto loans	Other	Credit Cards	Business loans
2008-II	1.66	0.78	4.66	2.06	6.49	3.19
2008-III	1.78	0.90	4.60	2.21	6.40	3.15
2008-IV	2.25	1.15	5.95	2.82	7.22	3.51
2009-I	3.06	1.59	8.31	3.82	9.16	4.21
2009-II	3.50	1.80	9.43	4.48	9.95	4.63

Source: CBRT.

The fact that the spread between rates on consumer loans and deposits hover around historic highs shows that credit conditions remain tight (Graph 5.2.6). It is known that the spread is sensitive to the rate of overdue debt, which is particularly affected by the general economic climate. The rate of increase in overdue debt decelerated more evidently in the second quarter (Table 5.2.1). Given the partial economic recovery, the rate of overdue debt is likely to stabilize over the upcoming period. Accordingly, the steady fall in policy rates may have a more pronounced effect on loan rates.

Graph 5.2.6. Spread Between Loan Rates and Deposit Rates
(Compound, Percent)



Source: CBRT.

During the weakening of loan demand in the first half of the year, fund raising did not serve to restrict asset growth. The high idle capacity is expected to lower the need for new investments throughout economic recovery, while the need for corporate funds is likely to be short-term due to the need for working capital. Considering CBRT’s attitude towards the cost and amount of the liquidity it offers to the banking sector, fund raising does not seem to restrain the recovery of the business sector, at least in the short term.

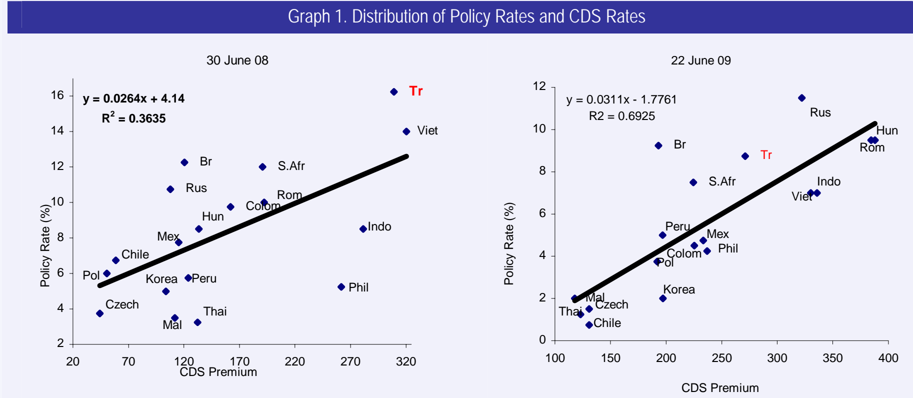
In sum, although financial conditions eased significantly during the first quarter amid CBRT's policy rate cuts, the relatively high credit risk leads banks to avoid long-term fixed-rate lending.

Box 5.1

MID-CRISIS IMPACT OF COUNTRY RISK ON POLICY RATES

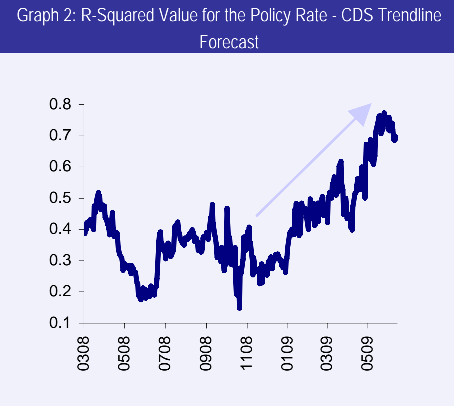
The financial crisis that first erupted in advanced economies deepened further in the final quarter of 2008 and spread across the whole world. Thus, central banks in advanced and emerging economies have lowered their policy rates rapidly and aggressively. There are two factors behind these rate cuts: firstly, the massive loss in the assets of financial and non-financial institutions and households as well as the heightened uncertainty about the future encouraged precautionary savings, but curtailed investments. Considering the depth, extent and duration of the crisis, savings will continue to rise while investments will continue to fall for a long time and the related equilibrium interest rate will remain lower from previous periods in the long run, which prompts central banks to cut policy rates although they have no intention of monetary easing.

The second and key factor behind rate reductions is the incentive of monetary authorities to curb the effects of the global crisis on economic activity, fueled by the severe drop in world inflation rates resulting from falling commodity prices and the sharp contraction in total demand. Nevertheless, tensions in financial markets and mounting fears about the implications of policy rate cuts on portfolio flows, particularly in emerging economies, deterred central banks from lowering policy rates further. In the face of possible restrictions on financial markets and credit mechanisms, countries facing a significantly higher risk premium and/or a serious financial crisis were urged to cut policy rates at a more modest pace, which led risk premiums to play a major role in determining policy rates among emerging economies. In other words, the fact that global inflation will potentially plunge to record lows and all countries will seek to ease monetary policy as aggressively as possible helped risk premiums become one of the main drives of policy rate cuts.



Graph 1. Distribution of Policy Rates and CDS Rates

The increasing impact of risk premiums on policy rates is also evident in distribution graphs that illustrate the relationship between 5-year CDS rates and policy rates. Graph 1 shows that countries moved less away from the policy rate/CDS trendline on June 19, 2009 than on June 30, 2008. In fact, the R-squared value of the trendline forecast for each day following the first quarter of 2008 has been rising since the deepening of the crisis during the final quarter of 2008 (Graph 2).



Graph 2: R-Squared Value for the Policy Rate - CDS Trendline Forecast

Given the current economic climate, where the world economy recovers slowly and gradually, savings achieve a long-lasting high and investments remain low, policy rates are expected to continue to run below pre-crisis levels for a long time. However, although the current crisis has changed the way that investors perceived country risks, with global economic re-stabilization, country risk premiums will become increasingly less restrictive, allowing individual economic and inflation conditions of countries to determine policy rates. Yet, country risk premiums are still anticipated to have a major impact on policy rates. From a medium-term perspective, risk premiums in countries with a timely fiscal exit strategy are likely to remain relatively low and put less upward pressure on policy rates.

6. Public Finance

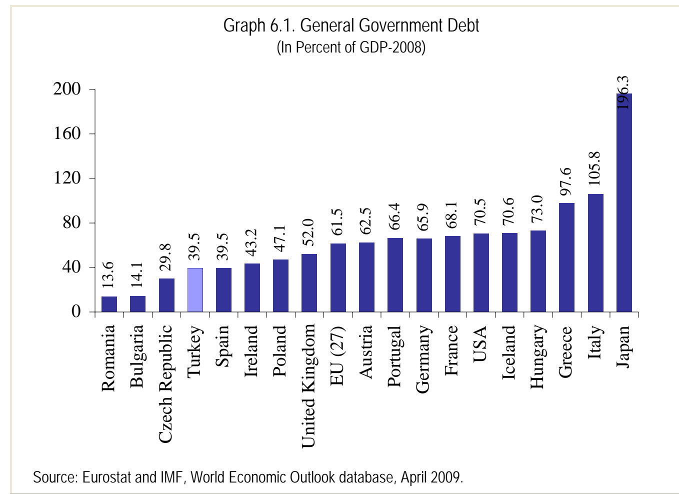
Countercyclical fiscal measures designed to limit the damage of the global recession continue to raise fiscal deficits all around the world. In addition, the contraction-driven drop in tax revenues accelerates the deterioration of fiscal balances (Box 6.1 and Table 6.1).

Table 6.1. Public Fiscal Balance
(In percent of GDP)

	2007	2008	2009*	2010*
United States	-2.9	-6.1	-13.6	-9.7
Germany	-0.5	-0.1	-4.7	-6.1
Austria	-0.5	-0.4	-3.5	-4.2
France	-2.7	-3.4	-6.2	-6.5
South Korea	3.5	1.1	-3.2	-4.7
UK	-2.6	-5.4	-9.8	-10.9
Ireland	0.2	-6.4	-14.2	-17.2
Spain	2.2	-3.8	-7.5	-7.5
Israel	-0.8	-2.8	-6.2	-6.6
Italy	-1.5	-2.7	-5.4	-5.9
Iceland	5.4	-1.2	-13.0	-10.4
Japan	-2.5	-5.6	-9.9	-9.8
Portugal	-2.6	-2.6	-5.9	-6.1
New Zealand	2.6	0.1	-2.8	-4.5
Greece	-3.5	-3.7	-4.5	-5.2

* Forecast.
Source: IMF, World Economic Outlook database, April 2009.

Countercyclical fiscal policies bolster economic spending unless they rekindle concerns over fiscal sustainability (Box 2.1). If not, they may depress expectations by heightening fears of debt sustainability and weaken the potential for long-term economic growth. Turkey has a relatively smaller public debt compared to other countries, and thus, seems to benefit from a broader fiscal space (Graph 6.1). Yet, considering the debt maturity, the level of interest rates and the depth of financial markets, there simply is not enough room to implement countercyclical fiscal policies, and therefore a strong medium-term framework is needed to promote fiscal easing in the short term.



Parallel to the global trend, budget deficits displayed a rapid increase in Turkey during the first half of 2009. Indirect tax revenues dropped rapidly amid economic contraction in this period. Moreover, the fall in employment creates an additional drop in income tax revenues and puts downward pressure on revenues from social security premiums, thereby accelerating the capital transfers into the Social Security Agency.

Countercyclical fiscal measures adopted to lessen the impact of the global crisis on economic activity cause a rapid rise in the budget deficit. In this context, the 3-month VAT and SCT cuts that were enacted in March to boost domestic demand are partly extended to the end of September to further support economic recovery. In order to offset the burden of extended tax cuts on budget, the government hiked taxes on tobacco products and the SCT on fuel products. Furthermore, in early June, the government announced a new package of “investment incentives and employment”, which is comprised of three parts: “government support for investment”, “enhancing active labor programs” and “credit guarantee fund for SMEs”. The new stimulus package aims to reduce the gap between developed and less-developed regions, promote competitiveness, support sectoral clustering and highlight the criteria for economies of scale.

Increase in budget deficit and relatively smaller fiscal space urge to strengthen the budget discipline during the remainder of 2009. Therefore, it is necessary to adopt a more effective and efficient framework that particularly limits the deficits of the Social Security Agency and local governments. In addition, broader tax base and better compliance can boost tax collection and

help restrain unregistered economy. A duly adopted medium-term program is likely to ensure a better management of expectations by enhancing the institutional structure of fiscal policy and its medium-to-long term predictability.

In sum, the budget deficit has widened dramatically from a year earlier due to economic contraction and countercyclical fiscal policies in the first half of 2009. The uptrend in public sector debt requirement may dampen the positive effect of monetary policy decisions on economic activity. Therefore, the short-term expansion of the budget deficit needs to be offset by a strong fiscal framework that restores a balanced fiscal position and maintains debt sustainability over the medium term.

6.1. Budget Developments

Central government non-interest expenditures continued to rise during the first half of 2009, while the budget performance weakened considerably on lower tax revenues and higher interest expenditures. The central government primary balance delivered a surplus of 4.0 billion Turkish liras, while the fiscal balance produced a deficit of 23.2 billion Turkish liras during the first half of the year. Interest expenditures increased by 31.4 percent, owing to the substantial first-half domestic debt redemption (Table 6.1.1).

Table 6.1.1. Central Government Budget Aggregates
(Billion TL)

	Jan-June 2008	Jan-June 2009	Rate of Increase (Percent)	Realization/Budget Target (Percent)
Central government expenditures	100.6	124.8	24.1	48.2
Interest expenditures	20.7	27.2	31.4	47.4
Non-interest expenditures	79.8	97.6	22.2	48.4
Central government revenues	102.5	101.6	-0.9	40.9
I. Tax revenues	82.8	79.1	-4.4	39.1
II. Non-tax revenues	16.7	19.2	15.0	47.0
Budget balance	1.9	-23.2	-	-
Primary balance	22.7	4.0	-	-

Source: Ministry of Finance.

Non-interest expenditures rose by 22.2 percent during the first half of 2009 amid soaring current transfers (up 30.9 percent), which account for the largest portion of non-interest expenditures (Table 6.1.2). The first-half rise in current transfers for health, pension and social benefits account for 45.8 percent of the total increase in non-interest expenditures. The steep rise these expenditures was largely driven by the social security reform that was launched in late 2008 and the employment package that offers budget transfers to the Social Security Agency. Moreover, transfers made to the Social Security

Agency, of which premium revenues decreased due to the contraction in economic activity, for financing the deficit has been influential on the increase in expenditures on health, pension and social benefits.

Table 6.1.2. Non-Interest Expenditures
(Billion TL)

	Jan-June 2008	Jan-June 2009	Change (Percent)	Share of Change (Percent)
Non-interest expenditures	**79.8**	**97.6**	**22.2**	**100.0**
1. Personnel expenditures	24.5	28.5	16.2	**22.3**
2. Purchase of goods and services	9.2	10.7	16.8	8.7
a) Defense-security	2.6	3.0	14.5	2.2
b) Healthcare expenditures	3.1	3.5	13.2	2.3
3. Current transfers	**35.2**	**46.1**	**30.9**	**61.3**
a) Duty losses	**0.8**	**2.3**	**204.4**	**8.9**
b) Treasury aids to Social Security Inst.	**0.4**	**0.5**	**9.7**	**0.2**
c) Health, pension, social benefit	17.6	25.7	46.2	**45.8**
d) Agricultural support	4.5	3.7	-17.7	-4.5
e) Shares reserved from revenues	9.3	10.3	10.5	5.5
4. Capital expenditures	4.7	5.0	6.6	1.7
5. Capital transfers	1.1	1.2	4.5	0.3

Source: Ministry of Finance.

Among current transfers, duty losses have registered a prominent year-on-year increase. Transfers made to the Turkish Grain Board account for almost all of the TL 1.6 billion rise in duty losses. Other non-interest spending items are on track with year-end targets.

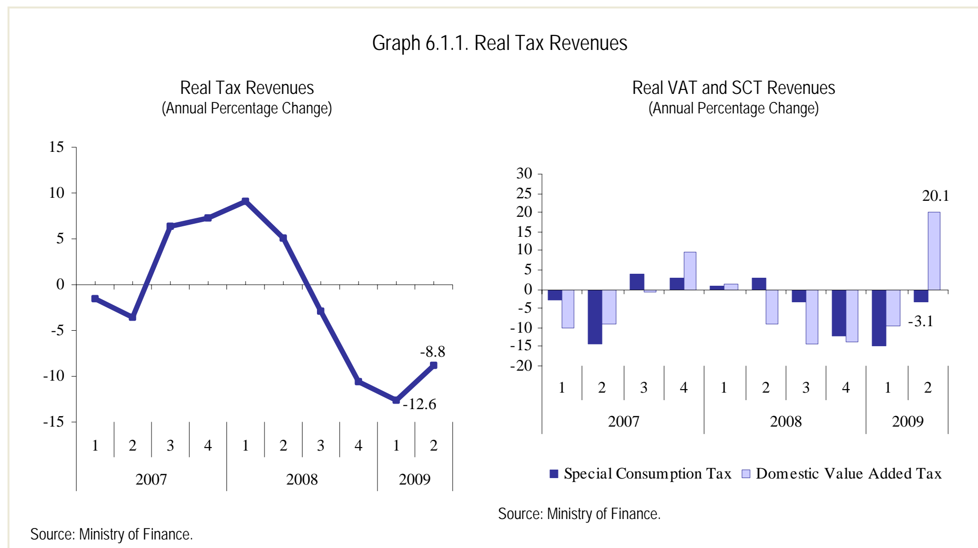
Central government budget revenues dropped by 1.2 percent year-on-year during January-March 2009. Non-tax revenues rose by 19.2 percent, while tax revenues fell by 4.4 percent. The notable growth of non-tax revenues was driven by the capital transfer of TL 1.3 billion from the Unemployment Fund to the budget in February and the GSM license fee of TL 1.9 billion that was recorded as revenue in April. The VAT on imports declined by 25.2 percent year-on-year during the first half of 2009 owing to the sharp contraction in imports. Domestic VAT, on the other hand, increased by 12.7 percent. Income tax rose slightly, whereas corporate tax and SCT fell by 7.6 and 2.4 percent, respectively (Table 6.1.3).

Table 6.1.3. General Budget Revenues
(Billion TL)

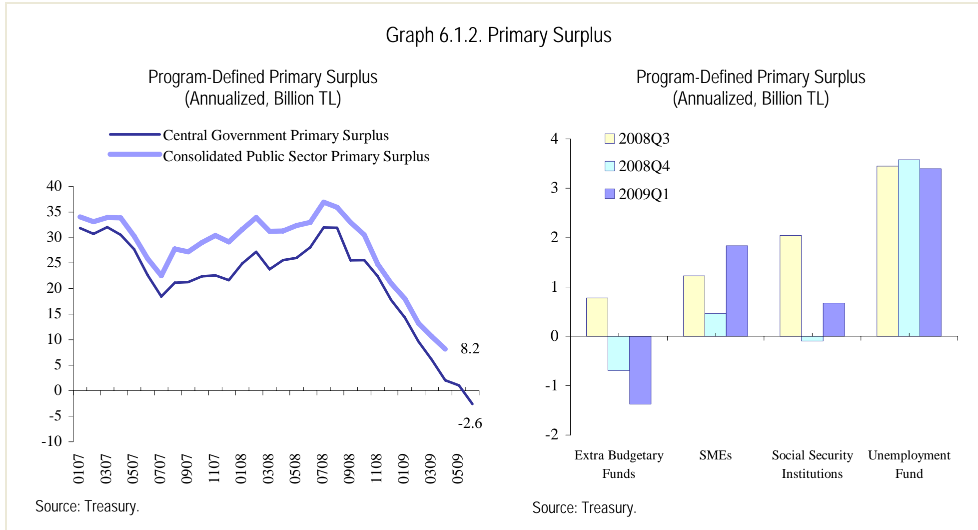
	Jan-June 2008	Jan-June 2009	Change (Percent)
General budget revenues	**99.5**	**98.3**	**-1.2**
I-Tax revenues	**82.8**	**79.1**	**-4.4**
Income tax	18.9	19.0	0.3
Corporate tax	7.7	7.1	-7.6
Domestic VAT	8.4	9.5	12.7
Special consumption tax	19.8	19.3	-2.4
VAT on import	15.6	11.7	-25.2
II-Non-tax revenues	**16.7**	**19.2**	**15.0**
Enterprise and property income	5.0	7.3	45.2
Capital revenues	2.0	1.4	-31.2

Source: Ministry of Finance.

When tax revenues are assessed in real terms, the contraction which started in the third quarter of 2008 accelerated afterwards. Yet the pace slowed down in the second quarter of 2009. In fact, VAT and SCT cuts on certain goods and services in the second quarter and the relative improvement in economic expectations led to a significant rise in VAT revenues in real terms. Moreover, the decline in SCT slowed remarkably (Graph 6.1.1).



The public-sector primary surplus performance has been weakening since September 2008 (Graph 6.1.2). In annualized terms, the program-defined central government and the consolidated public sector primary surpluses fell during the first half of 2009 back to their lowest levels in recent years. With the poor performance of the central government primary balance, the primary surplus of extra-budgetary funds narrows, while that of SMEs, social security institutions and the Unemployment Fund display a relatively positive performance (Graph 6.1.2). The deterioration in the public fiscal balance is expected to continue in the remainder of 2009, albeit more modestly, and the program-defined central government and the consolidated public sector are expected to run a primary deficit by the end of the year.



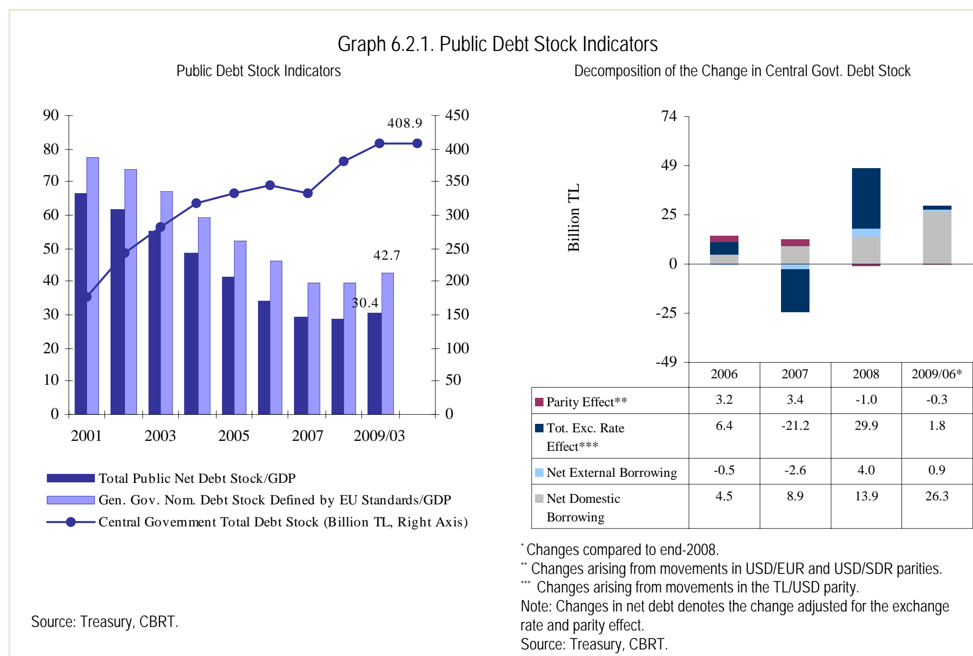
Graph 6.1.2. Primary Surplus

With the acceleration in central government primary budget expenditures starting from the third quarter of 2008, the contribution of public investments and public spending to GDP growth increased during the first quarter of 2009. In the rest of the year, primary budget expenditures are expected to slow down compared to the first half, and public spending is expected to be gradually less contributive to GDP growth. Accordingly, medium-term forecasts presented in the final chapter of this Report are built on the projection that public spending will provide less support for the economic activity in the remainder of 2009.

6.2. Developments in Debt Stock

The fully implemented prudent fiscal framework of the past few years reduced the debt burden rapidly and improved the maturity and currency composition to a large extent. However, both the contraction in domestic demand and the countercyclical fiscal measures adopted to dampen the impact of the global crisis on the economy, weakened the budget performance and caused total public primary surplus to fall sharply starting from the fourth quarter of 2008, which drove public sector's need for borrowing higher. The reduced risk appetite and the downtrend in inflation boosted banks' demand for government papers and avoided pressure on public borrowing costs. Yet, if budget indicators continue to deteriorate in coming months, the increase in the need for financing is likely to put strain on borrowing costs.

The central government debt stock increased by 7.6 percent to TL 408.9 billion in June 2009 from end-2008, mainly on account of net domestic debt growth and slightly due to exchange rate movements and net foreign debt growth. Meanwhile, the ratios of net total public debt stock and EU-defined central government nominal debt stock to GDP climbed to 30.4 and 42.7 percent, respectively, during the first quarter of 2009 (Graph 6.2.1). With the anticipation that the public sector will fail to register a primary surplus and the economy will contract in 2009, public debt stock ratios are likely to rise further in the remainder of 2009.



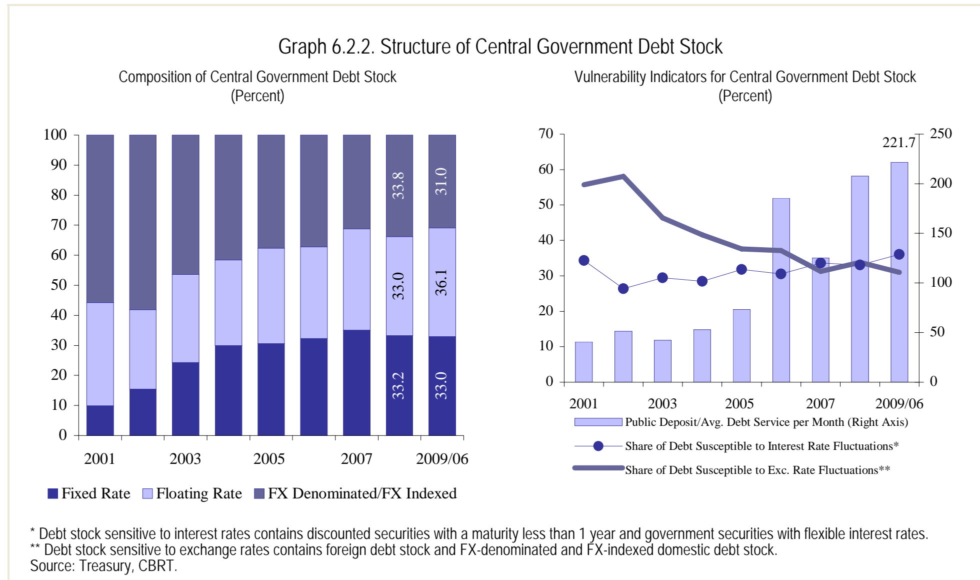
Graph 6.2.1. Public Debt Stock Indicators

	2006	2007	2008	2009/06*
Parity Effect**	3.2	3.4	-1.0	-0.3
Tot. Exc. Rate Effect***	6.4	-21.2	29.9	1.8
Net External Borrowing	-0.5	-2.6	4.0	0.9
Net Domestic Borrowing	4.5	8.9	13.9	26.3

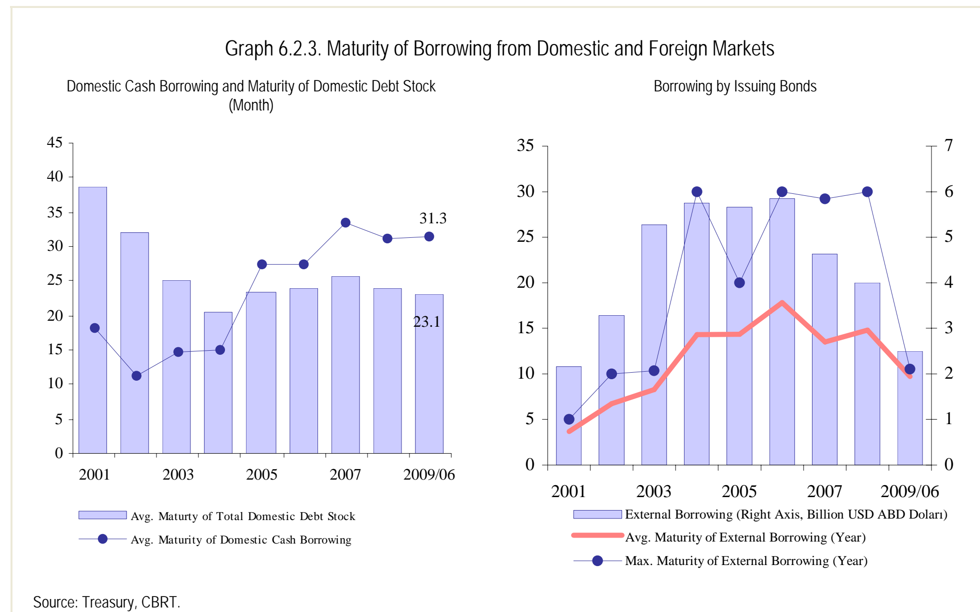
Source: Treasury, CBRT.

* Changes compared to end-2008.
** Changes arising from movements in USD/EUR and USD/SDR parities.
*** Changes arising from movements in the TL/USD parity.
Note: Changes in net debt denotes the change adjusted for the exchange rate and parity effect.
Source: Treasury, CBRT.

In the first half of 2009, the share of fixed-rate instruments and exchange-rate sensitive (FX-denominated and FX-indexed) instruments in central government debt stock decreased compared with end-2008, while the share of floating-rate instruments increased (Graph 6.2.2). With the debt and risk management policies that have been implemented since 2003 as part of the strategic criteria and the macroeconomic stability that has been maintained, the sensitivity of the public debt portfolio to risks of liquidity, interest rate and exchange rate has decreased considerably. The recent increase in the share of floating-rate instruments was largely driven by the issue of CPI-indexed bonds with a relatively longer maturity.



Following the financing strategy intended for reducing the liquidity risk, the ratio of public deposits to average monthly debt service ended June 2009 at 221.7 percent (Graph 6.2.2). The average maturity of domestic cash borrowing was down from the 2008 average, causing the average maturity of total domestic debt stock to fall to 23.1 months in June 2009. Moreover, bond issues yielded a USD 2.5 billion worth of long-term foreign debt in June 2009 with an average maturity of 10.5 years (Graph 6.2.3).



With the increased public financing requirement in 2009, the domestic debt rollover ratio is expected to increase rapidly from 2008 and hit above 100 percent, which will put some pressure on the downward spiral in medium-term market rates and is likely to reduce the positive effects of the monetary easing since November 2008. Therefore, a strong fiscal framework that maintains debt sustainability over the medium term will be highly accommodative for containing the spillovers from the global crisis.

Box 6.1 THE FISCAL IMPLICATIONS OF THE GLOBAL CRISIS ON ADVANCED AND EMERGING ECONOMIES

The expansionary fiscal measures designed to stimulate domestic demand that has plunged owing to the global financial uncertainty and to curb the economic slowdown in the short run not only vary across countries in extent and nature, but also deteriorate already weak fiscal balances and public finances in countries where they have been implemented. Mirroring the global trend, the public fiscal deficit has been on a significant rise in Turkey. The economic contraction since the final quarter of 2008 put downward pressure on tax revenues, particularly those related to consumption. Moreover, fiscal measures that are adopted to alleviate the implications of the global crisis on the Turkish economy and to spur domestic demand place additional pressure on public fiscal balances. This Box analyzes the fiscal implications of the global crisis on both advanced and emerging economies, including Turkey, and discusses major fiscal risks with respect to macroeconomic forecasts of national and international institutions.

The implications of the crisis on fiscal balances and public finances can be analyzed under two headings:

1) Factors resulting from the impact of the recession (non-discretionary):

   a. *Automatic stabilizers*: Automatic stabilizers, such as reduced income tax collection and increased unemployment benefits, are forecast to play a major role in widening fiscal deficits in advanced economies that have a budget with a greater share of indirect taxes and an effective labor market security.[1]

   b. *Falling commodity and asset prices*: Lower commodity prices have an immediate impact on fiscal balances of countries that heavily rely on the exports of these commodities, while lower asset prices have an indirect effect on fiscal balances through reduced wealth and consumption. Thus, falling commodity prices account for most of the weakening of fiscal balances in emerging economies. [1]

2) Measures to alleviate the recession (discretionary):

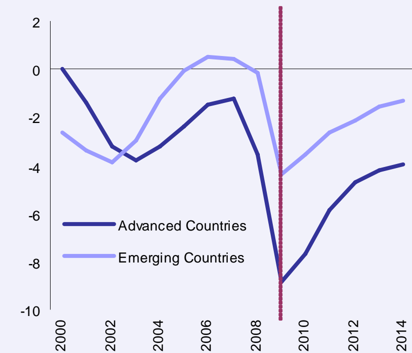
   a. *Financial sector support packages:* are in the form of direct purchases of illiquid assets, capital injections or nationalization of distressed banks and investment firms.

[1] For further information, see: “Fiscal Implications of the Global Economic and Financial Crises”, June 2009, IMF Staff Position Note, SPN/09/13.

b. *Fiscal stimulus packages:* are in the form of expenditure measures, such as infrastructure investments and subsidies to SMEs, or revenue measures targeting households, through cuts in income and indirect taxes, and businesses, through cuts in corporate tax.

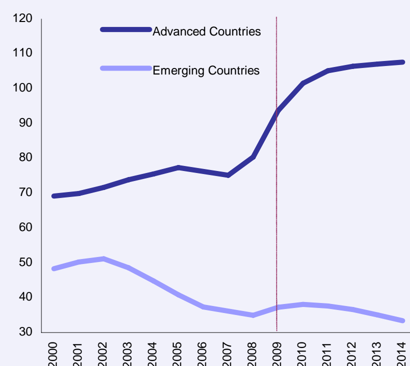
The opinion that the above fiscal measures will have a negative impact on fiscal deficit and total public debt, particularly in advanced countries, in the short to medium term is also supported by the forecasts of international institutions. In fact, according to IMF's medium-term projections for G-20 states, the fiscal deficit-to-GDP ratio of advanced countries is expected to climb to 8.9 percent, while the fiscal deficit-to-GDP ratio of emerging economies will rise to 4.4 percent in 2009. Starting from 2010 and onwards, the fiscal deficit is expected to improve gradually in both advanced and emerging countries, but restoration to pre-crisis levels will take quite a long time (Graph 1 and 2). The fact that fiscal measures addressing the global crisis have particularly raised the deficits in advanced economies and the exit strategy remains to be clarified pose upside risks to global inflation in the long run and, therefore, to long-term interest rates.

Graph 1. Fiscal Deficit in Advanced and Emerging Economies (In percent of GDP)



Source: IMF World Economic Outlook, April 2009.

Graph 2. Total Gross Public Debt Stock in Advanced and Emerging Economies (In percent of GDP)



Source: IMF World Economic Outlook, April 2009.

Compared with national forecasts, 2009 and 2010 projections for advanced economies made by their corresponding official agencies are consistent with IMF forecasts. Fiscal deficit and total public debt stock forecasts of the US Congressional Budget Office (CBO) for 2009 and 2010 expect the US to post the highest deficit since WWII. Similarly, the European Commission's forecasts for 2009 and 2010 expect the euro area and the UK to significantly overshoot the Maastricht ceiling for fiscal deficit and total debt stock (by 3 and 60 percent, respectively, in ratio to GDP) (Table 1 and Table 2).

Table 1. Fiscal Deficit in Selected Advanced Economies (In Percent of GDP)

	US	Euro Area	UK	Japan
2005	-2.6	-2.5	-3.4	-5.0
2006	-1.9	-1.3	-2.7	-4.0
2007	-1.2	-0.6	-2.7	-2.5
2008	-3.2	-1.9	-5.5	-5.6
2009*	-13.0	-5.3	-11.5	-9.9
2010*	-9.9	-6.5	-13.8	-9.8

* Forecast
Source: CBO and European Commission Report.

Table 2. Total Gross Public Debt Stock in Selected Advanced Economies (In Percent of GDP)

	US	Euro Area	UK	Japan
2005	62.7	70	42.3	191.6
2006	62.1	68.3	43.4	191.3
2007	63.1	66	44.2	187.7
2008	70.2	69.3	52	196.3
2009*	85.5	77.7	68.4	217.2
2010*	91.2	83.8	81.7	227.4

* Forecast
Source: CBO and European Commission Report.

Among emerging economies, fiscal deficits are expected to deteriorate, albeit at a slower pace than in advanced economies. Particularly in China, who launched the most side-effect-prone fiscal stimulus packages relative to GDP, fiscal balance is expected to worsen at a marked rate. Meanwhile, with the deterioration in fiscal balances, public debt stocks are expected to rise, albeit slightly (Table 3 and Table 4).

Table 3. Fiscal Deficit in Selected Emerging Economies (In Percent of GDP)

	Turkey	China	India	Argentina	Brazil
2007	-2.1	0.9	-5.2	-2.0	-2.2
2008	-2.7	-0.3	-8.4	-0.5	-1.5
2009*	-5.9	-3.6	-10.2	-3.3	-1.9
2010*	-5.1	-3.6	-8.7	-2.8	-0.8

*Forecast
Source: IMF World Economic Outlook, April 2009.

Table 4. Total Gross Public Debt Stock in Selected Emerging Economies (In Percent of GDP)

	Turkey	China	India	Argentina	Brazil
2007	39.4	20.2	80.4	67.9	67.7
2008	39.5	17.7	81.9	57.7	64.5
2009*	47.2	19.8	86.8	50.4	65.4
2010*	50.4	21.6	88.9	50.6	64.0

*Forecast
Source: IMF World Economic Outlook, April 2009.

However, the global crisis is expected to have its most severe and prolonged impact on the public debt in advanced countries. The public debt stock-to-GDP ratio of advanced economies is forecast to hit above 100 percent in the medium term and hover around those highs for a long time. The massive expansion of central banks' balance sheets in advanced economies, particularly owing to measures (direct purchase of illiquid assets, liquidity pumps, capital injection), has been supported by new bond issues, which is the key factor that raises total public debt stock.

In sum, the marked widening of fiscal deficits worldwide may pose an upside risk to inflation expectations in the long run and, therefore, to long-term global interest rates. If the global recession lasts longer than expected, new fiscal stimulus packages will be launched and the amounts allocated for financial sector support will be raised, while the risk premium created by the rising public debt stock will increase the real cost of borrowing. Furthermore, large fiscal deficits and high public debt stock levels pose a serious challenge for advanced economies in the medium term, due to a severe demographic pressure (effects of rapid population aging on security expenditures).

Yet, if concerns about fiscal balances moderate in the short term, fiscal stimulus and financial sector support packages will secure a rapid exit from the recession and improve fiscal balances over the medium term. Therefore, it is important that budget discipline is maintained in the medium term to benefit the most from the stimulus packages, and, thus, governments introduce a transparent fiscal framework that ensures the maintenance of fiscal discipline in the medium term and restore confidence in this respect.

7. Medium-Term Projections

This chapter summarizes the assumptions underlying forecasts, and presents relating medium-term inflation and output gap forecasts and the monetary policy outlook over a three-year horizon.

7.1. Current State of the Economy, Short-Term Outlook and Assumptions

Although there were both downward and upward risks to inflation forecasts during the past quarter, recent data releases largely confirmed the outlook presented in the April 2009 Inflation Report. The deeper-than-expected economic contraction, the slightly lower-than-projected inflation rate and the weakening in euro area growth prospects for 2009 had a downward impact on revised forecasts, while higher-than-anticipated oil prices and new tax adjustments to strengthen the budget balance drove forecasts higher (Table 7.1.1).

Table 7.1.1. Revisions to the Assumptions in 2009 April Inflation Report

	2009 April Inflation Report				2009 July Inflation Report			
CPI Inflation	-				0,5 points below the end-Q2 forecast			
Output Gap	Q1 2009 :-7.8 Q2 2009 :-7.6				Q1 2009 :-8.5 Q2 2009 :-8.2			
Food Prices	2009: 7.5% 2010: 6% 2011: 6%				Unchanged			
Price Hikes in Tobacco	-				0.54 point contribution to end-2009 inflation			
Oil Prices	$55				$60 during 2009 $70 afterwards			
Euro Area Growth Forecasts	2009		2010		2009		2010	
	CF[1]	*WEO*[2]	*CF*	*WEO*	*CF*	*WEO*	*CF*	*WEO*
	-3.4	-4.2	0.3	-0.4	-4.4	-4.8	0.4	-0.3

[1] Consensus Forecasts.
[2] World Economic Outlook, IMF.
* Consensus Forecasts, April 2009 and July 2009 Bulletins; World Economic Outlook, April 2009 and July 2009 Bulletins.

First-quarter GDP data indicate that the global economic slowdown has a more severe impact on domestic economic activity. The contraction in economic activity and private demand has deepened. In the previous Report, we had projected that annual GDP growth would slump to a historic low in the first quarter of 2009 and start to recover gradually by the second quarter. Corroboratively, coincident indicators for the second quarter suggest that the contraction in domestic economic activity has ceased with the monetary easing

cycle and the fiscal measures in place. Moreover, tentative signs of improvement in global economy contribute to our projection of a more protracted recovery in foreign demand than in domestic demand. Thus, we expect aggregate demand conditions to edge up gradually by the second quarter of 2009, but support disinflation for an extended period of time. Accordingly, first-half output gap forecasts are revised slightly down from the previous Report (Table 7.1.1).

Underlying inflation continued to trend further down in the second quarter of 2009, causing inflation to fall about 0.5 percentage points below our estimates in the first half. The major reason behind this decline has been the lower-than-expected services inflation, driven by the extended SCT cuts and the increased likelihood of a protracted recovery in aggregate demand conditions.

The hike in tobacco prices in July is expected to add 0.54 percentage points to year-end inflation in 2009. With the expiration of temporary tax cuts by October, inflation may rise modestly in core goods during the second half of the year. Yet, we expect aggregate demand conditions to continue to repress services prices, keeping underlying inflation at low levels.

As of June, the annual rate of increase in food prices runs by about 2 percentage points above the year-end forecast of 7.5 percent presented in the April Inflation Report. While unprocessed food prices have been volatile, the annual rate of increase in processed food prices fell to an all-time low. The annual rate of increase in unprocessed food prices is expected to slow moderately in the second half of 2009. Therefore, our assumptions regarding food prices are based on the baseline scenario offered in the 2009 April Inflation Report. Accordingly, our assumptions for food inflation are maintained at 7.5 percent for end-2009 and 6 percent afterwards (Table 7.1.1).

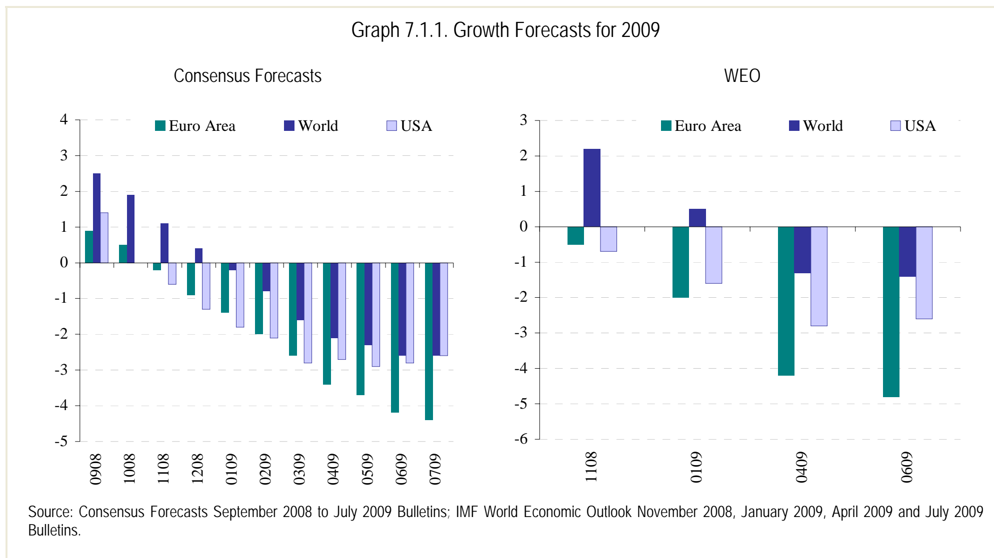
After having stabilized between USD 40 to 50 per barrel in the first quarter, Brent crude oil prices headed on an upward spiral and averaged USD 70 per barrel by mid-June due to growing perceptions of global economic turnaround starting from the first quarter, the deprecation in US dollar and OPEC supply cuts. The hike in oil prices caused fuel prices to rise in the second quarter, keeping energy prices from falling further and driving inflation higher. However, the worse-than-expected US employment figures raised concerns

about a prolonged global economic recovery, causing Brent crude oil prices to plunge again by early July. In view of the current uncertainty surrounding oil prices, we revised our assumptions based on the mid-July average in the futures market. Accordingly, oil prices are assumed to average USD 60 in 2009 and USD 70 in 2010 and thereafter (Table 7.1.1).

Given the current economic climate, assumptions on foreign economic activity remain increasingly important in building medium-term forecasts. Therefore, we have incorporated the growth forecasts of international institutions released within three months after the April 2009 Report into our medium-term forecasts.

The global growth forecast for 2009 that had been steadily revised downward since the deepening and widening of the global crisis in September 2008 has stabilized somewhat since April 2009, leading to a more moderate downward revision recently. Consensus Economics revised its global contraction forecast upwards from 2.1 percent in April to 2.6 percent in July. Similarly, in its World Economic Outlook July 2009 issue, the IMF raised its 2009 forecast for global contraction from 1.3 to 1.4 percent (Graph 7.1.1).

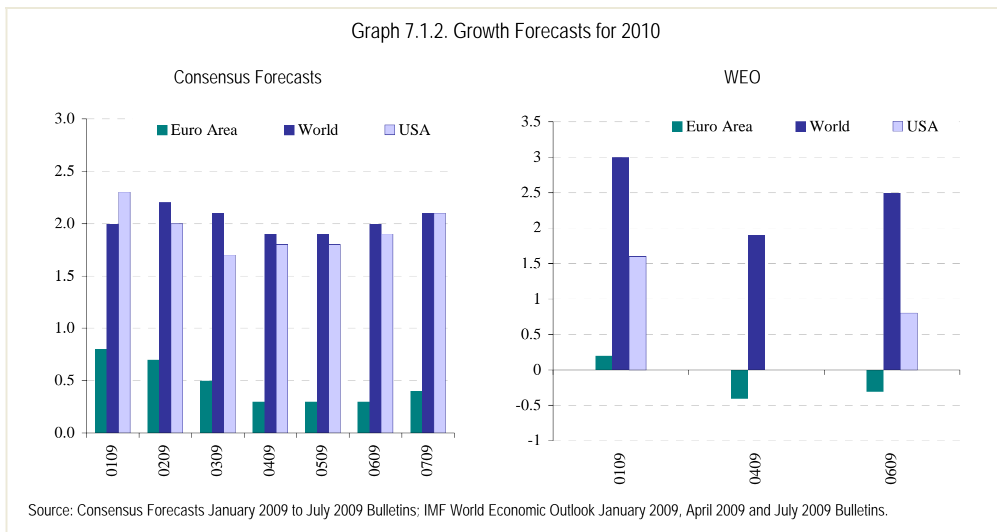
Graph 7.1.1. Growth Forecasts for 2009



Source: Consensus Forecasts September 2008 to July 2009 Bulletins; IMF World Economic Outlook November 2008, January 2009, April 2009 and July 2009 Bulletins.

Among regions, the recovery in the euro area – Turkey's biggest export destination – is expected to be more limited and prolonged than in the US (Graph 7.1.1). Since the latest Report, US growth forecasts have remained very stable, while euro area forecasts have been downgraded. In fact, Consensus Economics revised up its 2009 forecast for euro area contraction from 3.4 percent in April to 4.4 percent in July, while IMF raised its forecast for euro area contraction from 4.2 to 4.8 percent in July (Table 7.1.1).

Meanwhile, global growth forecasts for 2010 have been revised slightly upwards in three months. Consensus Economics raised its end-2010 global growth forecast from 1.9 percent in April to 2.1 percent in July. Similarly, IMF revised up its 2010 global growth forecast by 0.6 percentage points, from 1.9 to 2.5 percent. Among regions, the end-2010 growth forecast for euro area is revised up more modestly than that for the US economy (Graph 7.1.2).



Graph 7.1.2. Growth Forecasts for 2010

Source: Consensus Forecasts January 2009 to July 2009 Bulletins; IMF World Economic Outlook January 2009, April 2009 and July 2009 Bulletins.

Overall, global growth forecasts stabilized somewhat during the past three months. Yet, the recovery in euro area – Turkey's biggest trade partner – is increasingly believed to be slow and protracted.

In view of the deepening and widening of the global crisis, the CBRT has abandoned its gradual and measured rate cut policy that had been in place since the fourth quarter of 2008 and adopted an aggressive rate cut strategy. With a stronger banking system and less deteriorated risk premium in Turkey, the Bank has been able to cut policy rates at a dramatic pace. Given the current

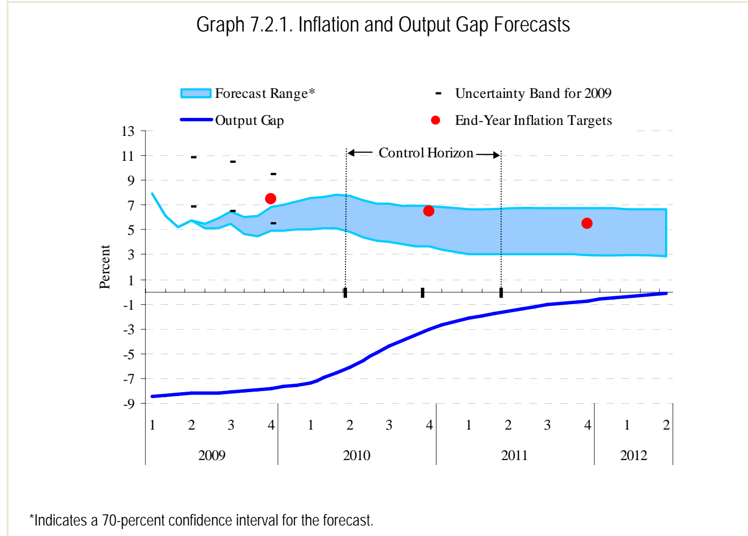
outlook for global and domestic economy, the Bank continued to lower policy rates in the second quarter. Accordingly, the Bank cut policy rates by 225 basis points from April to July, totaling a reduction of 850 basis points since November 2008.

CBRT's massive rate cuts started to affect loan rates by the second quarter and eased financial tightening to some extent (Graph 5.1.5). In fact, consumer loan rates declined slightly, whereas business loan rates dropped at a rapid pace. On the borrowing side, business loans remained flat, while consumer loans increased modestly. Moreover, business loans were borrowed for debt restructuring rather than investment purposes, whereas the second-quarter SCT cut was the main driver behind the growth of consumer loans. Therefore, although policy rate cuts have affected money and credit market rates, which is the foremost channel of the monetary transmission mechanism, during the second quarter, no strong credit recovery was available to boost aggregate demand. The reason behind this is the ongoing perception that it will take quite a while for the global financial recovery and the potential output level of the economy to be achieved. Thus, we built our medium-term forecasts on the assumption that the tightening in credit conditions continues, albeit to a lesser extent compared to the previous Report period.

7.2. Medium-Term Outlook

This part presents our inflation and output gap forecasts and the monetary policy outlook built on the baseline scenario that is developed within the framework of the abovementioned short-term assumptions and projections.

Accordingly, assuming some further easing in the near term, and constant policy rates until the end of 2010, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 4.9 and 6.9 percent (mid-point of 5.9 percent) at the end of 2009, and between 3.7 and 6.9 percent (mid-point of 5.3 percent) at the end of 2010. Furthermore, inflation is expected to come down to 4.9 percent by the end of 2011 and to 4.8 percent by mid-2012 (Graph 7.2.1).



Graph 7.2.1. Inflation and Output Gap Forecasts

*Indicates a 70-percent confidence interval for the forecast.

Our output gap forecasts based on the above assumptions are shown in Graph 7.2.1. Revised forecasts suggest that even though policy rates were kept very low for a long time, aggregate demand conditions would support disinflation over the next two years.

The revised forecasts also indicate that significant base effects may lead to some inflation volatility in the short term (up to one-year ahead). Cumulative inflation during the first half of 2009 was as low as 1.83 percent, indicating that inflation would rise in the first half of 2010 due to base effects (Graph 7.2.1). As the effects of tax and price adjustments on annual inflation would disappear gradually, inflation is expected to trend downwards starting from the second half of 2010, stabilizing slightly below the 2011 target of 5.5 percent. Thus, if economic agents use these forecasts as benchmark for their medium-term contracts and plans as well as pricing decisions, inflation would be less persistent and foster economic recovery.

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 on the future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

7.3. Risks and Monetary Policy Options

Despite having partially receded, the risks regarding the global economy are still important for the inflation and monetary policy outlook. In particular,

ongoing problems in credit and labor markets pose downside risks on global activity. Should the global conditions and consequently domestic economic activity further deteriorate, the CBRT would consider another cycle of rate cuts, and then maintain policy rates at low single digits for an extended period.

Another possible scenario is a surge in capital flows into emerging markets owing to the relative improvement in creditworthiness of these countries. In this context, receding risk premiums and appreciating currencies would present downside risks regarding inflation prospects. These circumstances could also trigger an acceleration in rate cuts, or another easing cycle, which could then help policy rates hover around low single digits for a prolonged period of time.

Increasing budget deficits on a worldwide scale continue to pose risks on inflation expectations and thus on global interest rates in the long term. The medium-term forecasts presented above envisage that the slow recovery in the global economic activity and rising saving rates will keep global interest rates at low levels for an extended period. However, the lack of a clear exit strategy from the global fiscal stimulus packages creates upside risks regarding global inflation rates and therefore longer-term global interest rates.

The outlook for fiscal policy in Turkey, would therefore be a key input for monetary policy strategy to be followed in the medium term and especially after 2011. The relatively strong performance of the risk indicators of the Turkish economy during the global crisis, owing to the soundness of its financial system, have created a conducive environment for rapid monetary policy easing. As a consequence, policy rates are now at historically low levels. Medium- and long-term government bond yields, on the other hand, still hover at high levels. Current global conditions provide an important opportunity to bring longer-term government bond yields to single digits and keep them at single digits over the three-year forecast horizon. Bringing medium- and long-term yields to single digits would be largely conditional on the establishment of a solid fiscal framework. A credible fiscal framework will not only bring down risk premiums, but also allow monetary policy to keep interest rates at low levels for an extended period. Therefore, the establishment of a credible medium-term program ensuring fiscal discipline and debt sustainability should make it possible to keep longer-term rates at single digit levels.

In sum, increased perceptions that low growth and low interest rates in the global economy will persist for an extended period allows monetary policy to provide more solid information regarding the future policy path. Accordingly, inflation and output gap forecasts have been presented under the assumption of some further easing in the near term and constant policy rates until the end of 2010. The course of monetary policy during 2011 and thereafter would depend on the factors affecting inflation. Assuming that fiscal discipline will be restored progressively and decisively once the crisis is over, policy rates could remain at single digit levels over the whole three-year forecast horizon.

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ABBREVIATIONS

BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CDS	Credit Default Swap
CPI	Consumer Prices Index
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
Fed	Federal Reserve
GDP	Gross Domestic Product
GS	Goldman Sachs
HICP	Harmonized Index of Consumer Prices
IFS	International Financial Statistics
IMF	International Money Fund
ISE	Istanbul Stock Exchange
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PEP	Pre-Accession Economic Program
PMI	Purchasing Managers Index
SCT	Special Consumption Taxes
TARP	Troubled Asset Relief Program
TL	Turkish lira
TURKSTAT	Turkish Statistical Institution
USA	United States of America
VAT	Value Added Taxes
WEO	World Economic Outlook