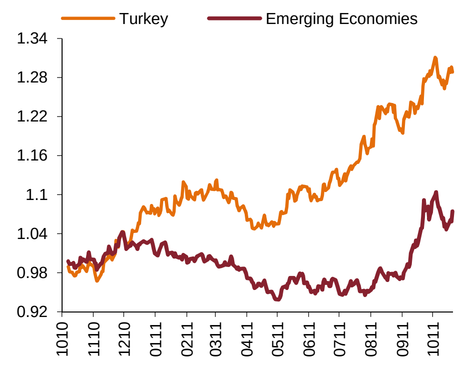
# 1. Overview

In the third quarter of 2011, mounting concerns regarding sovereign debt sustainability problems across the euro area coupled with the slower-than-expected recovery in the U.S. real estate and labor markets, intensified the downside risks regarding the global economic activity. Accordingly, global economic activity forecasts were revised downwards and expectations for a further delay in the normalization of monetary policy in advanced economies grew stronger. Mounting uncertainties regarding the global economy and the deterioration in risk appetite led to capital outflows from emerging economies. This outlook not only fed into short-term inflationary pressures in emerging economies, but also highlighted concerns over growth and financial stability.

## 1.1. Monetary Policy Developments and Monetary Conditions

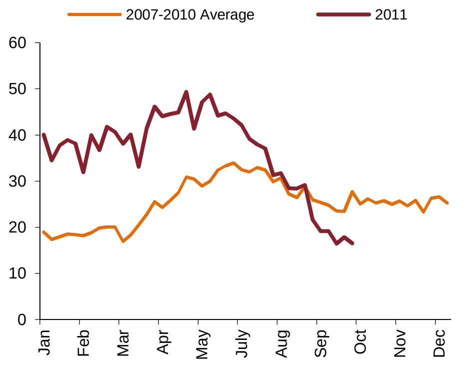
Since end- 2010, the Central Bank of the Republic of Turkey (CBRT) has been implementing policies with the objective to gradually lead the economy to a robust growth composition without hampering the medium-term inflation outlook. Accordingly, policies were pursued to prevent excessive deviation of exchange rates from economic fundamentals in either direction, while necessary measures were taken with the support of other institutions, to ensure reasonable loan growth rates (Charts 1.1.1 and 1.1.2).

**Chart 1.1.1.**
TL and Emerging Market Currencies*
(October 2010=1)




* Average of emerging market currencies including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea and Colombia, against USD. Increases denote depreciation of the currency.
Source: Bloomberg, CBRT.

**Chart 1.1.2.**
Loan Growth Rates*
(13-Week Average, Annual Percent Change)




* Adjusted for exchange rate effect.
Source: CBRT.

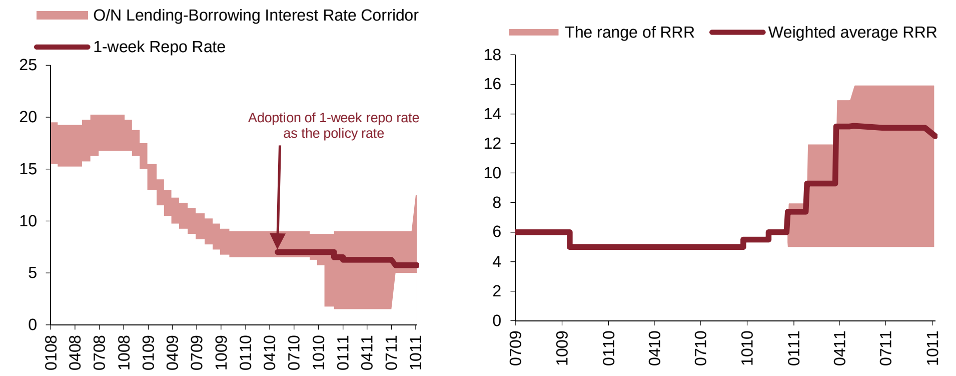
In the baseline scenario presented in the July Inflation Report, global economic activity was assumed to maintain its gradual recovery given the forecasts by international institutions. It was also highlighted in the Report that the downside risks on the global economy became more pronounced. Indeed, subsequent to the publication of the Report, risk perceptions deteriorated rapidly, debt problems in the euro area intensified further, thereby changing the baseline scenario. The Monetary Policy Committee (MPC) held an interim meeting on August 4, 2011 to contain the potential adverse effects of these developments on financial stability and economic activity, and announced a comprehensive package of measures. These measures laid the background for a timely, controlled and effective provision of liquidity to markets in the event of a financial turmoil due to developments in the global economy. The MPC opted for a modest cut in the policy rate in order to contain the risk of a recession in economic activity that may be posed by the escalating global economic problems (Chart 1.1.3).

Having highlighted the uncertainties regarding the global economy in its August and September meetings, the MPC stated the significance of closely monitoring the developments and taking necessary policy measures without any delay. In this context, with an emphasis on downside risks, the MPC also reiterated that all policy instruments might be eased if global economic problems further intensify and the slowdown in domestic economic activity becomes more pronounced. Upon the acceleration of capital outflows from emerging economies during this period, a series of liquidity measures were taken to contain the fluctuations in the FX market. Moreover, the Turkish lira required reserve ratios were also adjusted in order to extend the maturities of the banking system liabilities (Chart 1.1.3.)

The ongoing deterioration in global risk appetite since August has led to an excessive depreciation of the Turkish lira. Having reached 30 percent since November 2010 in accumulated terms, the depreciation started to pose risks on the inflation outlook. Moreover, in October, the adjustments in administered prices were far beyond the assumptions of the July Inflation Report, thereby necessitating a sizeable upward revision to short-term inflation forecasts. Accordingly, in its October meeting, the MPC underlined that medium-term inflation expectations and outlook will not be allowed to be affected by these developments, and hence, widened the interest rate corridor via a significant increase in lending rates (Chart 1.1.3).

**Chart 1.1.3.** CBRT Policy Mix

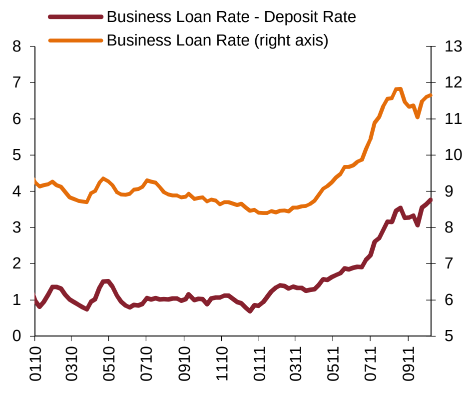
CBRT Policy Rates (Percent) | TL Required Reserve Ratios (RRR) (Percent)




Source: CBRT. Source: CBRT.

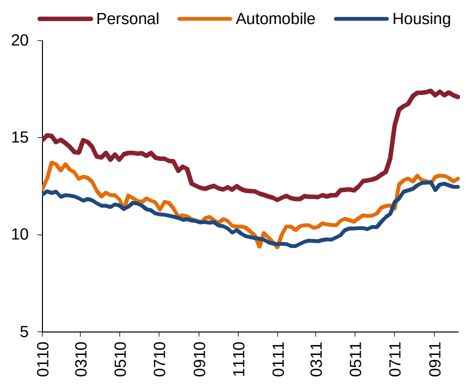
Loan rates continued to rise in the third quarter (Charts 1.1.4 and 1.1.5). A marked slowdown was observed in credit growth owing to the lagged effects of the adopted measures as well as the deceleration in the economic activity. Even though, this slowdown was also driven by seasonal factors, comparisons with the past years suggest that the observed slowdown is more pronounced than envisioned by seasonal normals (Chart 1.1.2). Accordingly, the annual credit growth rate adjusted for exchange rate effect is expected to reach around 25 percent by the year-end.

**Chart 1.1.4.**
TL Business Loan Rates
(Flow, 4-Week Average, Percent)




Source: CBRT.

**Chart 1.1.5.**
TL Consumer Loan Rates
(Flow, Annualized, Percent)



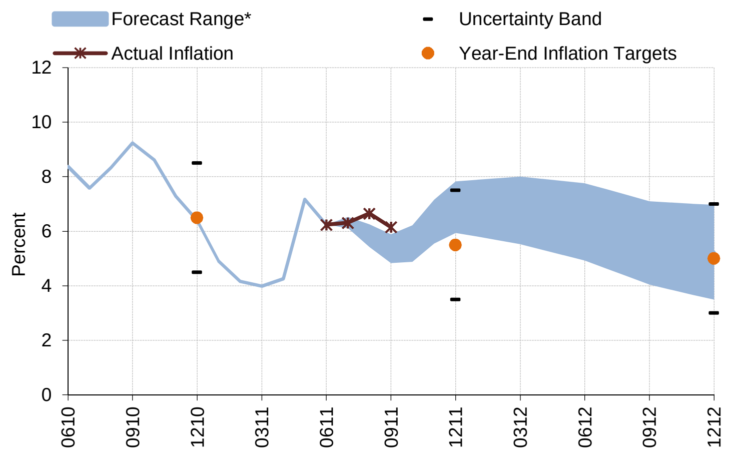

Source: CBRT.

## 1.2. Macroeconomic Developments and Main Assumptions

### Inflation

Prices of core goods posted a more-than-envisaged increase in the third quarter amid the excessive depreciation of the Turkish lira. The annual rate of change in food prices plunged due to base effect from the unprocessed food prices. Inflation followed a flat course during the third quarter as these two effects largely offset each other; yet, actual inflation slightly exceeded the forecast range presented in the July the Inflation Report as the depreciation effect outweighed the base effect (Chart 1.2.1).

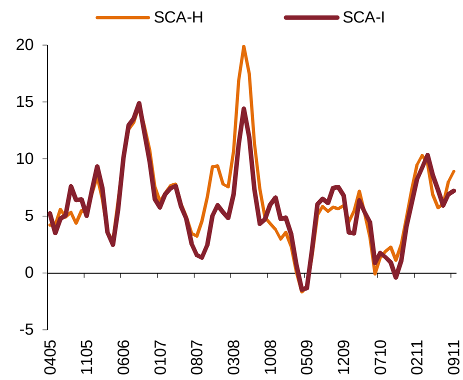
**Chart 1.2.1.**
July 2011 Inflation Forecasts and Realizations




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

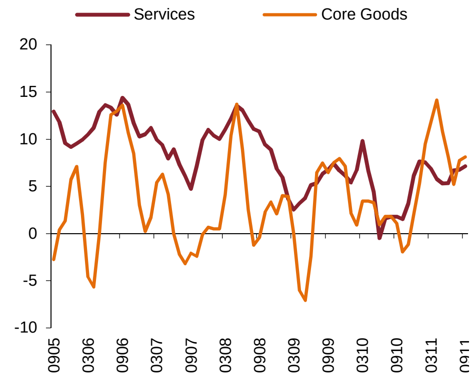
Amid the exchange rate developments, the underlying core inflation indicators also headed upwards in the third quarter (Chart 1.2.2). The upward trend was mainly driven by the increase in prices of core goods, while the underlying services inflation remained relatively moderate (Chart 1.2.3). The depreciation of the Turkish lira passed through to all subcategories of core goods prices, whereas, among services prices, the depreciation was only effective on transport services with the secondary effects remaining limited until October.

**Chart 1.2.2.**
Core Inflation Indicators SCA-H and SCA- I
(Seasonally Adjusted, 3-Month Average, Annual Percent Change)




Source: TurkStat, CBRT.

**Chart 1.2.3.**
Prices of Core Goods and Services
(Seasonally Adjusted, 3-Month Average, Annual Percent Change)



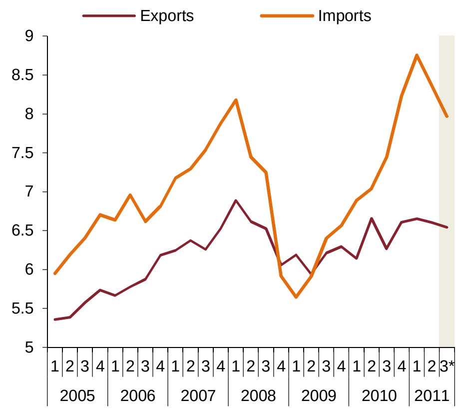

Source: TurkStat, CBRT.

## Supply and Demand Developments

Gross Domestic Product (GDP) data indicated a more robust economic activity in the second quarter of 2011, compared to the outlook presented in the July Inflation Report. Hence, the output gap estimates of this period were revised upwards. Economic activity remained robust despite a quarter-on-quarter slowdown, and growth was mainly driven by private sector spending on consumption and investment. While exports followed a weak course amid the developments in the global economy, imports recorded a significant decline due to the slowdown in domestic demand as a result of the adopted policy measures. Thus, the net external demand provided a positive contribution to quarterly growth for the first time after a long term. In other words, the composition of growth started to change in the desired direction (Chart 1.2.4).

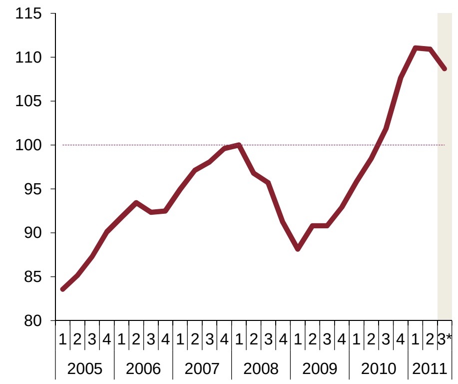
Owing to the lagged effects of contractionary policies on reserve requirement and liquidity, domestic demand continued to lose pace in the third quarter. The measures taken by the Banking Regulation and Supervision Agency (BRSA) as well as the tight fiscal policy stance also brought domestic demand growth to a sustainable level in the third quarter. Data on credit, production and sales as well as confidence indices pointed to a continuing deceleration in the private consumption demand in this period. Accordingly, the third quarter outlook assumes an ongoing slowdown in domestic demand (Chart 1.2.5).

**Chart 1.2.4.**
Exports and Imports of Goods and Services
(Seasonally Adjusted, 1998 Prices, Billion TL)




* Estimate.
Source: TurkStat, CBRT.

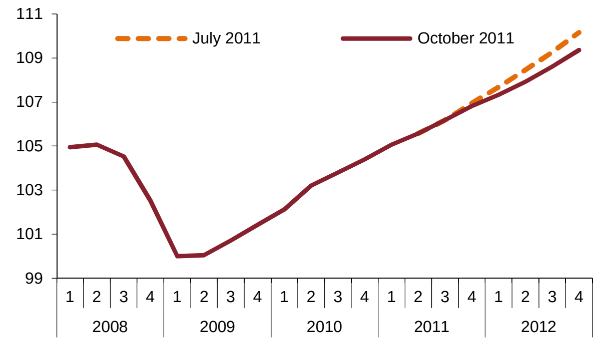
**Chart 1.2.5.**
Final Domestic Demand
(Seasonally Adjusted, 2008Q1=100)




* Estimate.
Source: TurkStat, CBRT.

Global growth forecasts were subject to substantial downward revisions in the third quarter, especially in advanced economies. In this respect, projections for Turkey's export-weighted global growth index point to a weaker medium-term outlook compared to the previous period (Chart 1.2.6). Therefore, compared to the previous period, a weaker external demand outlook is assumed for our forecasts.

**Chart 1.2.6.**
Export-Weighted Global Economic Activity Index*
(2009Q1=100)



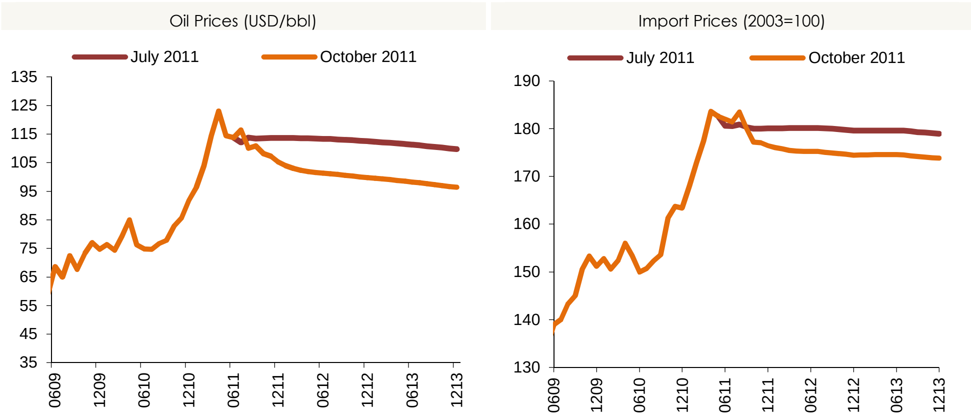

* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

In sum, the output gap was revised upwards for the short term and downwards for the medium term. While this revision leaves the 2011 year-end inflation forecast virtually unchanged, it pulls the 2012 year-end forecast down by 0.2 percentage points.

## Commodity and Food Prices

Considering the recent developments in spot and futures prices, assumptions for oil prices were revised downwards from USD 115 to USD 110 per barrel for 2011, and from USD 115 to USD 100 for 2012. Accordingly, import prices were also revised downwards (Chart 1.2.7). These revisions lowered the 2011 and 2012 year-end inflation forecasts by 0.1 and 0.2 percentage points, respectively. In addition, assumption for annual food inflation was maintained at 7.5 percent.

**Chart 1.2.7.**
Revisions to Oil and Import Price Assumptions




Source: Bloomberg, CBRT.

Source: TurkStat, CBRT.

## Fiscal Policy and Tax Adjustments

In the July Inflation Report, price adjustments to tobacco products were assumed to be consistent with the inflation target, adding approximately 0.3 percentage points to inflation. However, in view of the recent developments, the estimated contribution of the price adjustment in tobacco products to inflation is revised upwards to 0.9 percentage points, pulling short-term inflation forecast by 0.6 percentage points.

The medium-term forecasts are based on the outlook presented in Medium Term Program (MTP) regarding fiscal policy. Therefore, the baseline scenario envisages that the ratio of primary expenditures to GDP would be reduced gradually starting from 2012, the ratio of public debt to GDP would continue to fall, and the risk premium would remain broadly unchanged. Moreover, tax adjustments and administered prices are assumed to be consistent with inflation targets and automatic pricing mechanisms.

## 1.3. Inflation and Monetary Policy Outlook

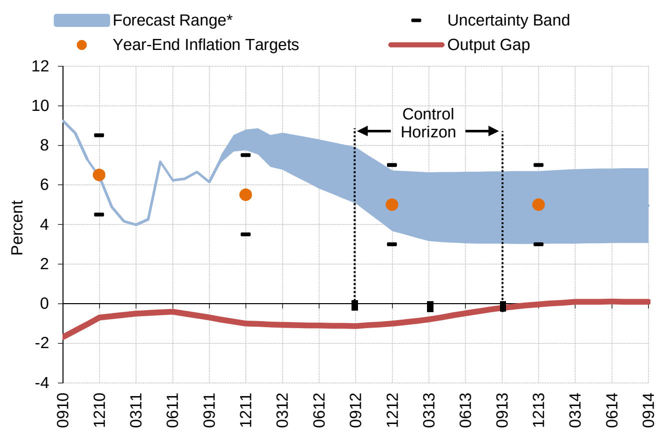
### Short-Term Inflation Forecasts

Emerging economies have faced rapid capital outflows amid the deteriorating risk appetite since the publication of the July Inflation Report, thereby causing the excessive depreciation of the Turkish lira to become more pronounced. This, when coupled with soaring administered goods prices, increased the risk of deterioration in the pricing behavior. The CBRT reacted aggressively to these developments with a marked lending rate hike in its October meeting (Chart 1.1.3). Although the monetary tightening is expected to contain inflationary pressures, annual inflation is expected to soar in the short term owing to the low base effects in unprocessed food prices. Accordingly, year-end inflation is expected to be realized at 8.3 percent.

### Medium-Term Forecasts

Assuming that annual rate of credit growth decelerates gradually, and monetary conditions are tightened significantly in the final quarter in line with the policy measures taken in October, inflation is expected to be, with 70 percent probability, between 7.8 and 8.8 percent with a mid-point of 8.3 percent at the end of 2011, and between 3.7 and 6.7 percent with a mid-point of 5.2 percent at the end of 2012. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

**Chart 1.3.1.**
Inflation and Output Gap Forecasts




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

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

Forecasts are based on the assumption that CBRT's policy stance is designed so as to hinder the secondary effects. Moreover, in view of the weak outlook for the global economy, commodity prices are also expected to be disinflationary (Table 1.3.1). Accordingly, inflation is expected to decelerate gradually starting from early 2012, nearing the target by the end of 2012 (Chart 1.3.1).

**Table 1.3.1.**
Revisions to Year-end Inflation Forecasts

| | 2011 | 2012 |
|---|---|---|
| **July 2011 Forecast** | **6.9** | **5.2** |
| *Additional Tax Adjustment in Tobacco Products* | 0.6 | - |
| *Exchange Rate Developments* | 0.9 | 0.4 |
| *Commodity Prices* | -0.1 | -0.2 |
| *Output Gap* | - | -0.2 |
| **October 2011 Forecast** | **8.3** | **5.2** |

Source: CBRT.

In sum, short-term inflation forecasts were revised upward due to exchange rate developments as well as administered price hikes. It should be highlighted that these factors reflect a temporary movement in relative prices rather than a permanent increase in inflation, as the secondary effects will be hindered on the back of the envisioned monetary tightening in the last quarter owing to the CBRT's recent aggressive policy reaction.

### How Would Inflation Evolve Had The CBRT Not Reacted?

The recent tightening of the CBRT's policy stance is essentially a step towards preventing deterioration in inflation expectations due to inflationary pressures from the exchange rate. At this point, it is important to answer the question of how inflation would have evolved had the CBRT not reacted. For a better understanding of this issue, Chart 1.3.1 depicts the possible accumulated price increases resulting from exchange rates and administered price developments assuming that CBRT shows no reaction for a long time. Accordingly, the contribution of these factors to inflation is estimated to reach 6 percentage points by end-2011 assuming no policy measure is taken by the CBRT. Under this scenario, consumer inflation reaches double digits at 10.1 percent, mainly owing to the excessive depreciation of the Turkish lira in addition to the effect of the deterioration in inflation expectations (Table 1.3.2). Hence, also considering the backward-looking pricing behavior in the services sector, inflation will be likely to remain elevated for a long time, causing inflation expectations to deteriorate while also jeopardizing the hardly-earned achievements of the recent years on the path to price stability. In such a case, bringing inflation back to reasonable levels would be more costly. Therefore, in order not to allow for such adverse developments, the CBRT actively intervened in the FX market in October, and in line with its primary objective of price stability, reacted aggressively by an O/N rate hike. In this respect, all necessary measures will be taken in the upcoming period in order to keep inflation under control and to ensure the attainment of inflation targets.

**Chart 1.3.2.**
Possible Contribution of Exchange Rate Developments and Tax Adjustments in Tobacco Products to Annual Inflation without the CBRT's Policy Response (Percent)

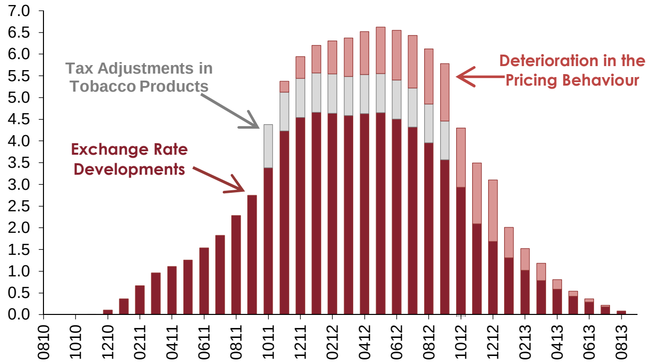



**Table 1.3.2.**
Revisions to Year-end Inflation Forecasts without the CBRT's Policy Response

| | 2011 | 2012 |
|---|---|---|
| **July 2011 Forecast** | **6.9** | **5.2** |
| *Additional Tax Adjustment in Tobacco Products* | 0.6 | - |
| *Exchange Rate Developments* | 2.2 | 1.5 |
| *Commodity Prices* | -0.1 | -0.2 |
| *Output Gap* | - | -0.1 |
| *Deterioration in the Pricing Behavior* | 0.5 | 1.4 |
| **Inflation Forecast without the CBRT's Policy Response** | **10.1** | **7.8** |

Source: CBRT.

## 1.4. Risks and Monetary Policy

The fact that inflation will hover above target in the short term poses risks regarding inflation expectations and the pricing behavior. As of October, the CBRT has adopted a policy stance aiming to eliminate these risks. These risks will be closely monitored in the upcoming period as well, and necessary measures will be taken to avoid deterioration in the inflation outlook.

The medium-term outlook of the Report assumes that global economic activity will stay weak for a long period with no further worsening in the current circumstances. Nevertheless, uncertainties regarding the global economy remain crucial. In particular, escalating problems of the euro area economies regarding sovereign debt continue to pose downside risks on the global economy. Concerns regarding the debt sustainability problems in the EU were further intensified in the interreporting period, and perceptions about a possible spillover of these problems to the banking sector in the region were heightened. The probability for a failure to solve the banking sector problems in the euro area as well as the further deepening of the global problems via a possible spread constitute a major risk factor. In order to maintain stability in the domestic markets, the CBRT will continue to take the required measures promptly by closely monitoring the global developments in line with the strategy formulated at the interim meeting of August 4, 2011.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. The baseline scenario forecasts of the Report are based on the MTP framework, therefore fiscal discipline is assumed to be maintained. A revision in the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

In the period ahead, monetary policy will continue to focus on achieving price stability on a permanent basis, while observing financial stability. To this end, the impact of the macroprudential measures taken by the CBRT and other relevant institutions on the inflation outlook will be assessed carefully. Maintaining fiscal discipline in the medium term and strengthening the structural reform agenda will contribute to the relative improvement of Turkey's sovereign risk, thereby supporting macroeconomic stability and price stability. Maintaining fiscal discipline will also provide room for monetary policy maneuver, and support the social welfare by keeping interest rates permanently at low levels. In this respect, steps to be taken in order to implement the structural reforms envisaged by the recently announced MTP remains to be of utmost importance.