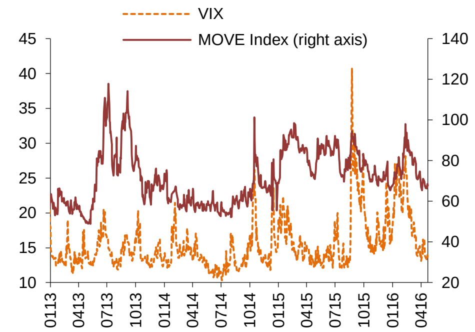
1. Overview

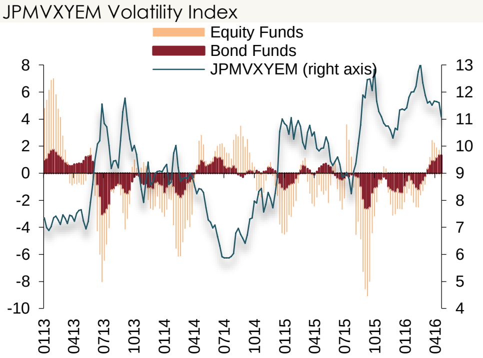
In the recent period, the global volatility has continued to decline and global financial conditions have improved (Chart 1.1). The deceleration in global economic activity and the ongoing low levels of inflation have led the central banks of advanced economies to continue with their accommodative policies. The Fed stated that policy rate hikes would be slower, while the ECB and the Bank of Japan announced new easing measures. Moreover, uncertainties related to the Chinese economy lessened recently. Against this background, financial conditions in emerging economies have improved as well. Portfolio flows towards these countries posted a rebound, while risk premiums and market interest rates decreased and their currencies appreciated (Chart 1.2).

Chart 1.1.
VIX and MOVE Volatility Indices
(Basis Points)



Source: Bloomberg.

Chart 1.2.
Portfolio Flows to Emerging Economies and JPMVXYEM Volatility Index



Source: EPFR, Bloomberg.

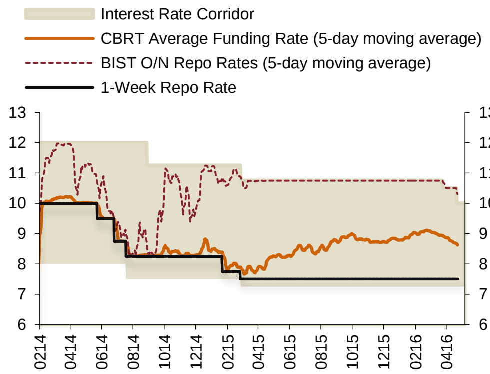
Favorable developments in global markets had positive reverberations on the Turkish economy as well. Moreover, the recently released data disclose a sustained trend of recovery in macroeconomic indicators. Inflation saw a notable decline driven mostly by unprocessed food prices, while cumulative exchange rate effects waned, which led core inflation to improve to some extent. The current account deficit continued to decrease in this period, while the released data and the leading indicators showed that economic activity sustained a moderate and stable course of growth. Against these developments, the CBRT maintained its policy stance, which is tight against the inflation outlook, stabilizing for the foreign exchange liquidity and supportive of financial stability while steps were taken towards simplification of the monetary policy.

1.1. Monetary Policy and Financial Conditions

In the first quarter of 2016, the CBRT maintained the tight liquidity policy stance on account of inflation expectations, pricing behavior and other factors affecting inflation. In addition to alleviated global volatilities, the effective use of policy tools described in the road map released in August 2015 reduced the need for a wide interest rate corridor. Accordingly, the CBRT decided to take moderate steps towards simplification by reducing the marginal funding rate by 25 basis points in March and by 50 basis points in April. The one-week repo auction rate and overnight borrowing rate were kept unchanged at 7.5 and 7.25 percent, respectively (Chart 1.1.1).

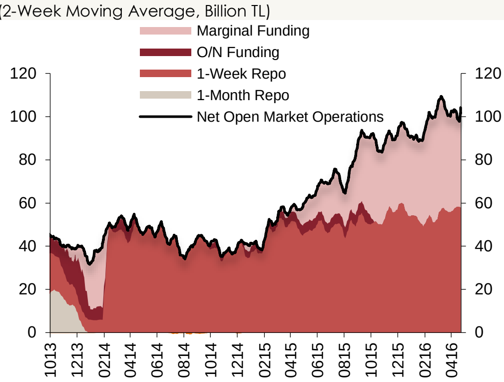
One-week repo auctions continued to be the main tool for the CBRT funding, while the share of the marginal funding remained high (Chart 1.1.2). The weighted average funding rate, which hit 9.1 percent in February 2016, receded to approximately 8.6 percent in April. Interbank overnight repo rates recorded a decline parallel to the total reduction of 75 basis points in the upper band of the interest rate corridor. In the upcoming period, the monetary policy stance will remain dependent on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, the CBRT will maintain the tight monetary policy stance as long as deemed necessary.

Chart 1.1.1.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



Source: BIST, CBRT.

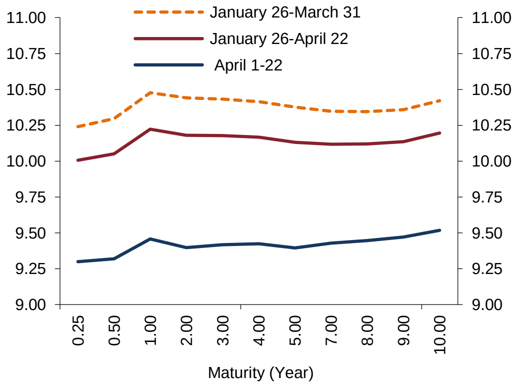
Chart 1.1.2.
CBRT Funding*
(2-Week Moving Average, Billion TL)



* Marginal funding is overnight funding provided at the upper band of the interest rate corridor.
Source: CBRT.

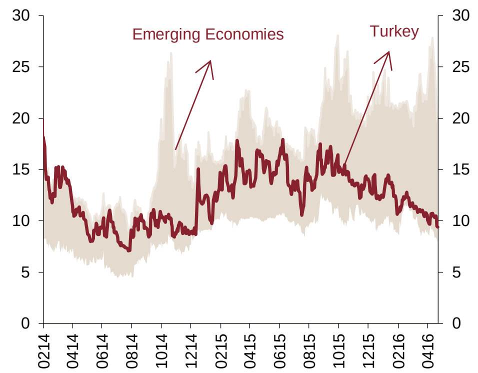
The yield curve shifted downwards in all maturities (Chart 1.1.3). This was led by the sustained accommodative policy stances of the emerging market central banks, the strengthened perception that interest rates in these economies will remain low for a prolonged period, waning global uncertainties and improvement in global financial conditions. The favorable course of macroeconomic indicators in Turkey, the fall in market-based and survey-based inflation expectations and reductions in the marginal funding rate also contributed to this development. The slope of the yield curve remained almost flat in this period.

Chart 1.1.3.
Yield Curve
(Percent)



Source: Bloomberg.

Chart 1.1.4.
Implied FX Volatility*
(1-Month, Percent)



*Emerging economies include Brazil, Chile, Czech Republic, Hungary, India, Mexico, Poland, South Africa, Indonesia, Romania and Colombia.
Source: Bloomberg.

It is important to contain negative spillovers of global developments into the Turkish economy. In terms of the economic fundamentals, the significant improvement in the current account balance over the past few years, reasonable growth rates in loans and a loan composition that supports price stability and financial stability, all contributed to reducing economic fragilities. Maintenance of the fiscal discipline also stood among the main factors enhancing the resilience of the economy in this period. Moreover, the effective implementation of the measures laid out in the August road map has alleviated the excessive fluctuations in exchange rates and loan rates (Chart 1.1.4). The current tight monetary policy stance reduces the economy's sensitivity to global shocks, thus supporting financial stability. The CBRT maintains the view that tight monetary policy may be implemented within a narrower interest rate corridor, should the global volatility decline persistently or policy measures that would maintain and improve the gains in external balance and financial stability be implemented effectively. Accordingly, additional simplification steps may be taken in the upcoming period when circumstances allow.

The annual growth rate of loans extended to the non-financial sector, which decelerated partly due to the CBRT's tight monetary policy stance and the macroprudential measures introduced by the BRSA regarding consumer loans excluding mortgages, fell to 10.9 percent in the first quarter of 2016 (Chart 1.1.5). In this period, commercial loans continued to grow at a higher rate than consumer loans as they have since the start of 2014. These developments in loan growth and composition not only contribute to the re-balancing process and financial stability, but also limit the cost-side pressures on inflation. The annualized growth rates in 13-week averages show that both consumer and commercial loans have displayed a trend of rebound since early 2016 (Chart 1.1.6). The adjustments made to the risk weights of consumer loans, wage developments and improvement in financial conditions can support the credit growth in the upcoming period. However, owing to the tight monetary policy stance and macroprudential policy framework, annual loan growth rates are expected to remain at reasonable levels in the months to come.

Chart 1.1.5.
Annual Loan Growth
(Adjusted for Exchange Rate, Annual Percent Change)

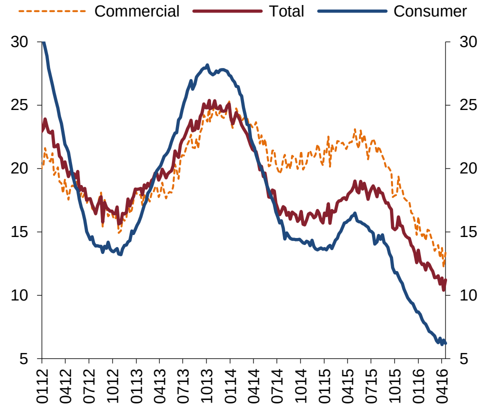
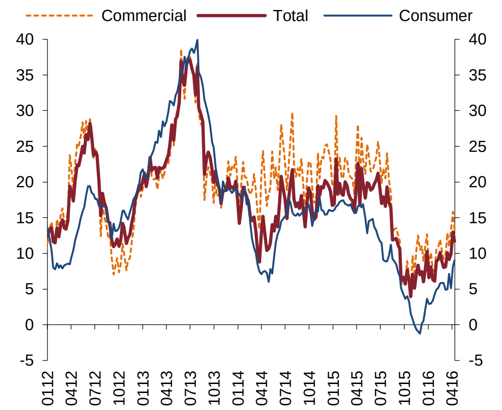


Chart 1.1.6.
Annualized Loan Growth (Adjusted for Exchange Rate, 13-Week Moving Average, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the first quarter of 2016, consumer inflation fell by 1.35 points quarter-on-quarter to 7.46 percent, and stood below the January Inflation Report forecasts (Chart 1.2.1). The higher-than-expected fall in annual inflation was mainly driven by unprocessed food prices. In fact, inflation excluding unprocessed food and tobacco was consistent with the January Inflation Report forecast (Chart 1.2.2). In this period, effects of the cumulative depreciation in the Turkish lira on annual inflation continued to diminish and import prices remained low, leading to a limited decline in annual inflation in core goods and energy. On the other hand, adjustments to administered prices, high levels of inflation expectations and wage developments limited the fall in inflation.

Chart 1.2.1.
Inflation Forecasts and Realizations*
(Percent)

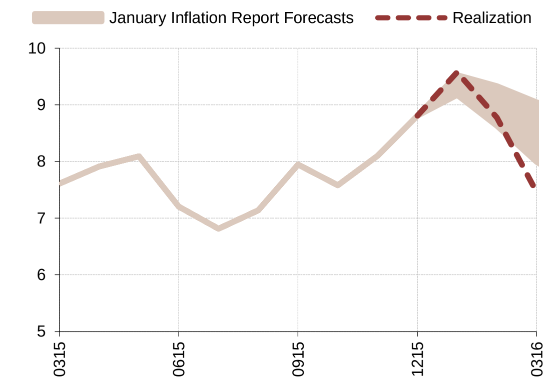
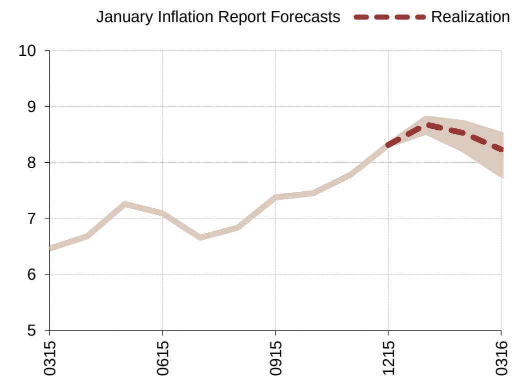


Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco* (Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

Mild weather conditions in the first quarter increased the supply of fresh fruits and vegetables, which pulled unprocessed food prices remarkably down. Unprocessed food products other than fresh fruits and vegetables were also effective in this decline. This is also attributed to the adopted measures for certain products, especially red meat. As a result, plummeting to 6.31 percent in the first quarter amid the sharp decrease in food inflation, annual inflation in food and catering services stood below consumer inflation excluding food and catering services after three years (Chart 1.2.3).

Due to the waning cumulative exchange rate effects in the first quarter, the core goods inflation exhibited a significant improvement. In the same period, services inflation remained elevated due to the increases in items sensitive to the exchange rate accompanied by wage developments and the rigidity caused by high levels of the headline inflation. Accordingly, the underlying core inflation indicators witnessed a notable slowdown driven by the prices of core goods (Chart 1.2.4). In sum, improvement in food inflation coupled with the favorable course of import prices led to a marked decrease in the consumer inflation in the first quarter. However, due to the cumulative exchange rate effects and particularly the rigidities in the services inflation, the desired improvement in core indicators is yet to be seen.

Chart 1.2.3.
Food and Non-Food Prices
(Annual Percent Change)

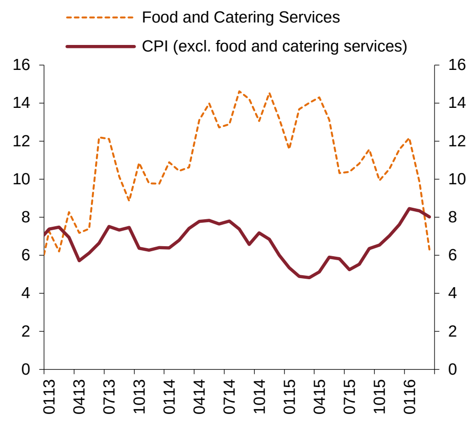
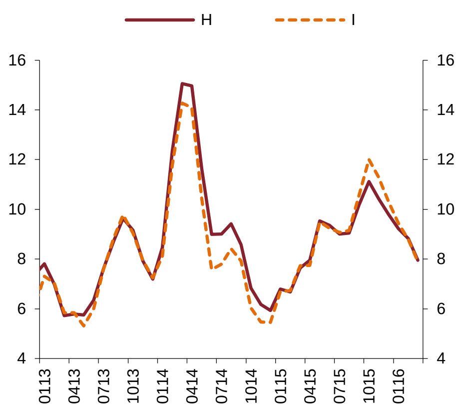


Chart 1.2.4.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



Source: TURKSTAT, CBRT.

Supply and Demand

According to the GDP data of the fourth quarter of 2015, economic activity was in line with the outlook presented in the January Inflation Report, and the GDP grew by 0.7 and 5.7 percent in quarterly and annual terms, respectively (Chart 1.2.5). Thus, growth stood at 4.0 percent in 2015. On the spending front, final domestic demand was the main driver of growth in the last quarter, and net exports contributed positively to the GDP growth after a four-quarter break (Chart 1.2.6).

Chart 1.2.5.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)

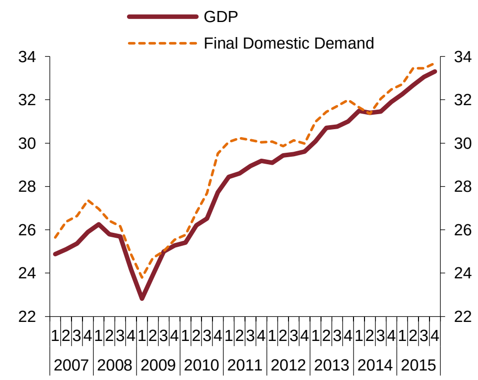
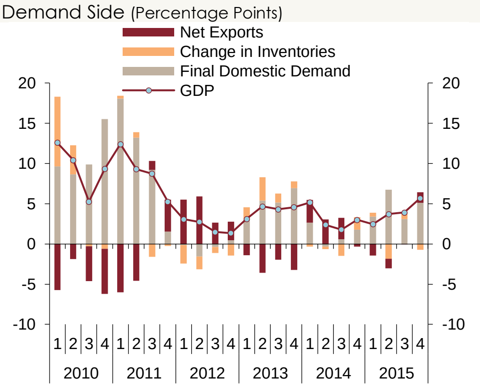


Chart 1.2.6.
Annual GDP Growth and Contributions from the Demand Side (Percentage Points)



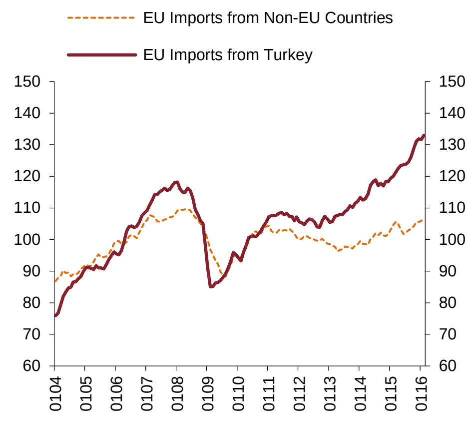
Source: TURKSTAT.

Data on the first quarter of 2016 indicate that the mild and steady increase in economic activity continues. Industrial production saw successive monthly increases in the December-February period. Thus, production stood 1.6 percent above the figures of the previous quarter in the January-February period. The first-quarter data disclose contributions to growth offered by both domestic and external demand.

Based on the demand outlook for 2016, economic activity is expected to be stronger than that in 2015. Owing to the strong employment performance following the global crisis and the increase in the minimum wage in early 2016, the income channel is expected to support domestic demand. Amid waning domestic uncertainties compared to 2015, rising consumer and investor confidence may boost domestic demand. Sustained easing in global volatilities and the improvement in global financial conditions have a favorable effect on domestic financial conditions. Against this background, income and confidence channels and financial conditions are likely to support domestic demand in the upcoming period. Downside risks to exports of services have recently grown amid continuing risks to external demand due to geopolitical developments and languishing global growth. Rising demand from the EU, on the other hand, continues to support our exports at a stronger pace (Chart 1.2.7).

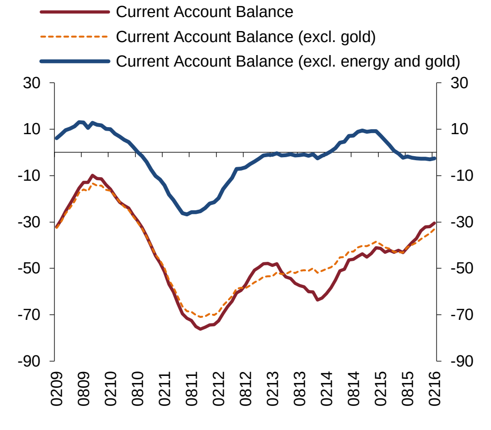
Overall, domestic demand is expected to be slightly stronger in 2016 relative to 2015, while external demand is recovering on the back of rising EU demand despite geopolitical risks. The current account deficit is likely to narrow further thanks to ongoing macroprudential policy measures and favorable developments in the terms of trade (Chart 1.2.8). A narrower current account deficit and strong public finances provide room for policy responses against possible shocks.

Chart 1.2.7.
EU Imports
(Real, Seasonally Adjusted, 3-Month Average, 2010=100)



Source: Eurostat.

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



Source: CBRT.

Oil, Import and Food Prices

Oil prices edged up in the inter-reporting period, whereas the downtrend in international commodity prices continued into the first quarter of 2016. Thus, compared to January, assumptions for crude oil prices were revised up while those for USD-denominated import prices were revised down (Chart 1.2.9). With regard to annual averages, the crude oil price assumption was increased from 37 to 40 USD for 2016. Also, assumptions for annual percentage changes in average import prices were revised downwards by 3.4 points for 2016. Food inflation saw a marked decline due to unprocessed food prices in the first quarter, which is expected to continue in the short term. However, given the high volatility in unprocessed food prices, the assumption for food price inflation was kept unchanged at 9 percent for 2016 and at 8 percent for 2017.

Chart 1.2.9.
Revisions in Oil Prices*
(USD/bbl)

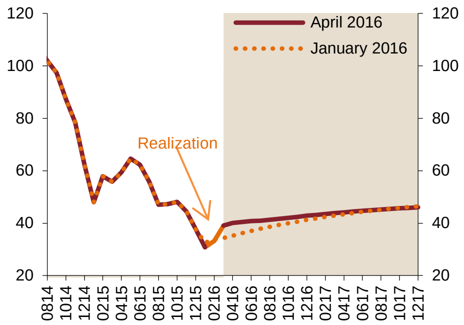
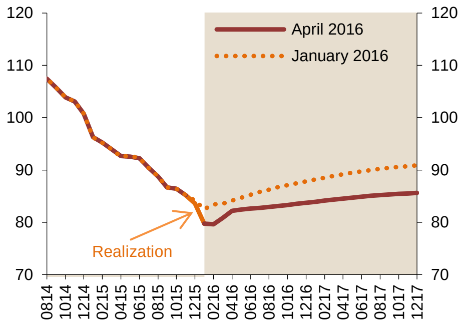


Chart 1.2.10.
Revisions in Import Prices*
(USD, 2010=100)



* Shaded area denotes the forecast horizon.
Source: Bloomberg, CBRT.

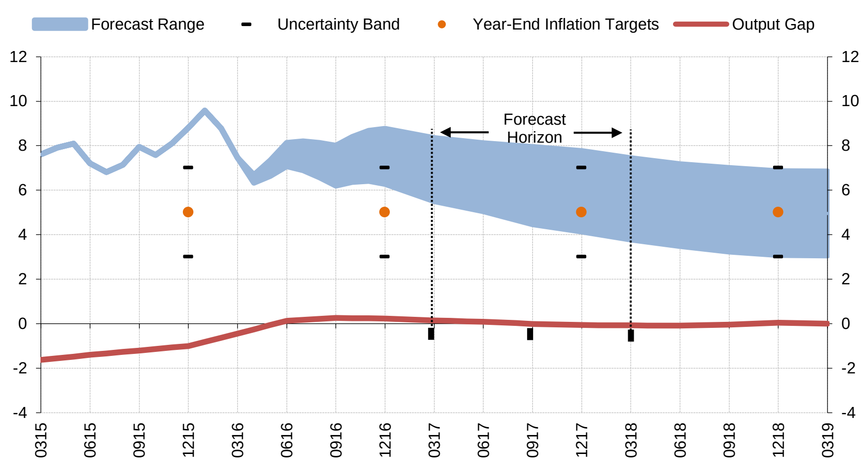
Fiscal Policy and Tax Adjustments

Medium-term forecasts are based on an outlook that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance depends on the MTP projections covering the 2016-2018 period. The effects of the minimum wage rise at the beginning of 2016 on producer costs, aggregate demand and inflation are being closely monitored.

1.3. Inflation and Monetary Policy Outlook

In view of the above economic conditions, policy stance and assumptions, inflation forecasts for the upcoming period are left unchanged from the previous Report. Given a decisive policy stance that focuses on reducing inflation, the 5-percent inflation target is expected to be achieved gradually; inflation is likely to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. Accordingly, inflation is expected to be, with 70 percent probability, between 6.3 percent and 8.7 percent (with a mid-point of 7.5 percent) at end-2016 and between 4.2 percent and 7.8 percent (with a mid-point of 6 percent) at end-2017 (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts*
(Percent)



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

The Turkish lira maintained a steady pattern following the January Inflation Report, while oil prices inched up and import prices edged down. Accordingly, the impact of TL import prices was not significant enough to lead to any change in inflation forecasts. Food prices are expected to drive consumer inflation further down in the short term. Rising later amid base effects, inflation is expected to follow a volatile course in the second half of 2016 and end the year at 7.5 percent. Given the high volatility in food prices, assumptions for food inflation are preserved, yet it should be noted that there are downside risks posed by food prices to the year-end inflation forecast.

1.4. Risks and Monetary Policy

Annual loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. After slowing down in the fourth quarter of 2015, particularly for consumer loans, the growth trend of loans picked up in the first quarter of 2016. Risk weight and minimum wage arrangements and improving financial conditions are likely to boost loan growth in the upcoming period via loan supply and household income channels. Thus, annual loan growth rates are expected to remain at reasonable levels. With respect to the composition of loans, commercial loans continue to grow faster than consumer loans. This composition not only limits medium-term inflationary pressures but also supports the improvement in the current account balance.

Recent data and the leading indicators show that economic activity displays a moderate and stable course of growth. In the forthcoming period, domestic demand is likely to contribute more strongly to growth while the growing EU demand will further stimulate exports in spite of geopolitical risks. Strengthened investor and consumer confidence driven by reduced domestic uncertainties, recently improved financial conditions, robust post-crisis employment performance, and the early 2016 minimum wage hike are all expected to support domestic demand. On the foreign demand front, geopolitical developments and weaker global growth continue to pose downside risks, with those to exports of services recently being on the rise. Nevertheless, the economic recovery in Europe and the market flexibility of our exports contain these downside risks. In fact, the rising EU demand has had a favorable effect on exports recently, which is conducive for both economic growth and re-balancing prospects. Moreover, improvements in the terms of trade mainly led by the cumulative fall in commodity prices, coupled with the modest course of consumer loans, support the improvement in the current account balance. Against this background, the monetary policy stance is based on an outlook, where economic activity will remain on a moderate growth path while the current account deficit will narrow further, albeit at a slower pace.

The CBRT assesses that the effective use of the policy tools announced in the road map of August 2015 bolsters the resilience of the economy against global shocks. The introduction of these new instruments helped to curb the excessive volatility in both exchange rates and credits. In fact, the relative volatility of the Turkish lira has decreased notably since September compared to other emerging market currencies. This process is supported by the gradually falling demand for foreign exchange amid the improving current account balance and lower energy prices. Also, foreign currency liquidity instruments are used to stabilize the value of the Turkish lira. All these developments alleviate the need for a wide interest rate corridor.

Other factors that have recently reduced the need for a wide interest rate corridor are the continued decline in global volatility and the improving global financial conditions. Mounting prospects for a slow global economic recovery and the sustained monetary easing by central banks in advanced economies have recently fostered the expectations of a prolonged period of low interest rates across advanced economies. Accordingly, capital flows into emerging economies increased while risk premiums and market interest rates fell significantly.

In sum, the recent lasting decline in global volatility and the effective use of the policy instruments laid out in the road map announced in August 2015 have reduced the need for a wide interest rate corridor. Thus, the CBRT took measured steps towards simplification by lowering the marginal funding rate.

On the other hand, the improvement in the underlying trend of core inflation remains limited, necessitating the maintenance of the tight liquidity policy stance. Although recent developments regarding imported input costs have eased the upside risks to the inflation outlook, the improvement in core inflation is still limited. The lagged effects of cumulative exchange rate movements, high levels of inflation expectations and wage developments restrain the improvement in the underlying trend of inflation. Food inflation has recently seen a marked decline on the back of unprocessed food prices. The falling food inflation led to a decrease in consumer inflation as well, which is expected to continue in the short run. Yet, given the high volatility in unprocessed food prices, it is important to remain cautious about the inflation outlook. Hence, the CBRT stated that the current tight liquidity stance should be maintained in order to ensure that the recently observed disinflation becomes permanent.

In the upcoming period, monetary policy stance will be conditional on the inflation outlook. Taking into account inflation expectations, the pricing behavior and the course of other factors affecting inflation, the tight monetary policy stance will be maintained. Moreover, global and domestic volatilities will be monitored closely and necessary measures will be taken for the foreign exchange and Turkish lira markets. In sum, the policy stance will remain tight against the inflation outlook, stabilizing for the FX liquidity and supportive of the financial stability.

Notwithstanding the significant external shocks in recent years, the current policy framework limited the worsening in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience with inflation targeting has shown that the fight against inflation requires collaboration from all relevant parties. Therefore, bringing inflation permanently down to the 5-percent target requires all institutions to continue resolutely with the efforts made in recent years.

Developments in the fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

Sustained fiscal discipline has become essential in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the gains from maintaining and further advancing these achievements are significant. Any measure that would ensure the sustainability of fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.