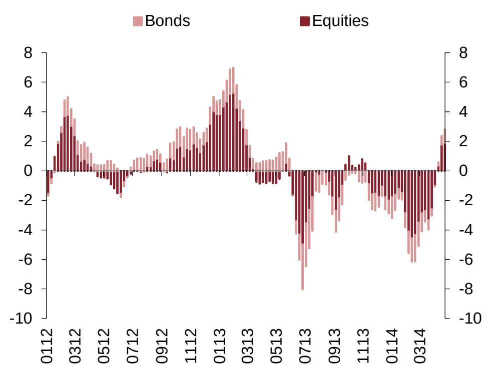
# 1. Overview

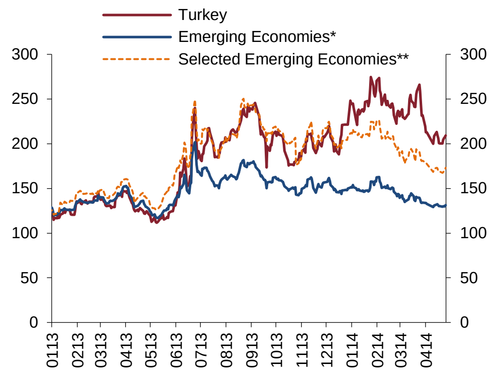
Due to the ongoing global uncertainty about monetary policies, portfolio flows to emerging economies remained weak in the first quarter of 2014. On the other hand, emerging economies saw slightly positive portfolio flows in early second quarter (Chart 1.1). The main driver of growth in global economic activity during the final quarter of 2013 was advanced economies. The strengthening in global economic recovery that was observed in 2013 is expected to continue into 2014. In line with a positive growth prospect for advanced countries, export conditions across emerging economies may improve to make a positive contribution to growth, while weak portfolio flows and tight financial conditions may continue to restrain domestic demand. On the global financial markets front, following the significantly decreased uncertainty about how the Fed will terminate its quantitative easing program, expectations about the timing and pace of interest rate hikes are important for pricing. However, as the transmission mechanism of the interest rate channel is better known than that of quantitative easing and the dependence of monetary policy on high-frequency data has decreased; the uncertainty associated with a policy rate hike may weigh less on financial markets than the exit from the quantitative easing program.

**Chart 1.1.**
Portfolio Flows to Emerging Economies
(4-Week Moving Average, Billion USD)




Source: EPFR.

**Chart 1.2.**
CDS Rates for Emerging Economies and Turkey
(Basis Points)




* Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile.
** Brazil, Indonesia and South Africa.
Source: CBRT, Bloomberg.

In addition to global developments, the recently heightened uncertainty in Turkey was an influential factor affecting the domestic economic outlook. As a result of the heightened uncertainty in late 2013, Turkey's risk premium indicators deteriorated noticeably (Chart 1.2). The subsequent movements in exchange rate and rising volatility across financial markets had an adverse impact on the inflation outlook and macro financial stability. The strong and front-loaded monetary tightening implemented on January 28 aimed to control the deterioration in the inflation outlook and to support financial stability. The tight monetary policy stance and the recently alleviated uncertainty helped to contain the deterioration in medium-term inflation expectations; reduced the financial market volatility and slightly improved the risk premiums.

## 1.1. Monetary Policy and Financial Conditions

Following the global financial uncertainties that started in May 2013, Turkey, along with other emerging economies, experienced portfolio outflows, as well as increased risk premiums and depreciated exchange rates. Mostly due to exchange rate developments, Turkey's inflation climbed in the second half of 2013 and rose to 7.4 percent at year-end, exceeding the uncertainty band. To contain the deterioration in the inflation outlook, the CBRT used a cautious monetary policy stance and enhanced the policy predictability. In late 2013 and early 2014, domestic and external market uncertainties increased substantially. Compared to other emerging market currencies, the Turkish lira depreciated more and risk premium indicators increased significantly (Charts 1.2 and 1.1.3). These developments increased the risk of inflation to remain significantly above the target for an extended period. In order to contain the deterioration in inflation expectations and pricing behavior and also to maintain macroeconomic and financial stability, the CBRT delivered a strong and front-loaded monetary tightening at its interim MPC meeting on January 28 (Chart 1.1.1). Moreover, the operational framework was simplified and the CBRT funding was henceforth provided primarily from the one-week repo rate (Chart 1.1.2). Before the rate hike, the CBRT continued to inject ample foreign exchange liquidity into the market via foreign exchange selling auctions. In addition, when the pricing was impaired in the foreign exchange market in January, the CBRT intervened directly. As a result of these foreign exchange sales, the liquidity need of the financial sector increased and the CBRT funds went up in the first quarter of 2014 (Chart 1.1.2). Meanwhile, the aggravated TL liquidity also strengthened the tight stance of the monetary policy.

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

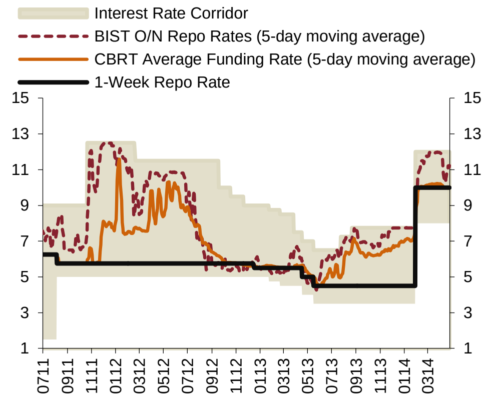
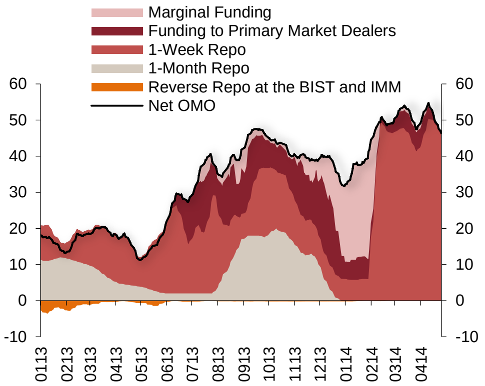



**Chart 1.1.2.**
CBRT Funding*
(2-Week Moving Average, Billion TL)




Source: BIST, CBRT.

During increased global financial uncertainty from May 2013 to end-2013, Turkey, along with other emerging economies, experienced marked currency depreciation and a surge in exchange rate volatility (Charts 1.1.3 and 1.1.4). Yet, with the contribution of a cautious and more predictable monetary policy, the depreciation of the Turkish lira was more limited compared to the depreciation in currencies of selected emerging economies running a current account deficit, and the implied exchange rate volatility continued to be at the relatively lowest level. Following the end-2013 rise in uncertainty, both the Turkish lira depreciated significantly and the implied volatility heightened due to increases in country-specific risks.

After the strong monetary tightening of end-January 2014, the risk sentiment improved, the Turkish lira appreciated slightly, and the implied volatility declined. Recently, due to alleviated uncertainty, the Turkish lira continued to appreciate and the implied exchange rate volatility fell back to a level lower than that in similar countries (Charts 1.1.3 and 1.1.4).

**Chart 1.1.3.**
TL and Emerging Market Currencies vs USD
(01.01.2013=1)

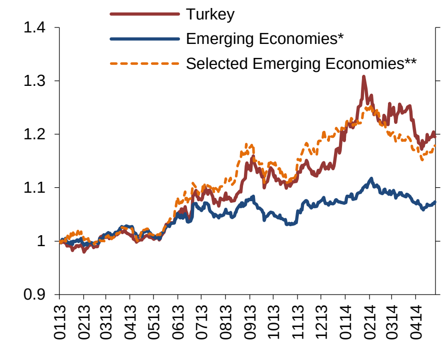
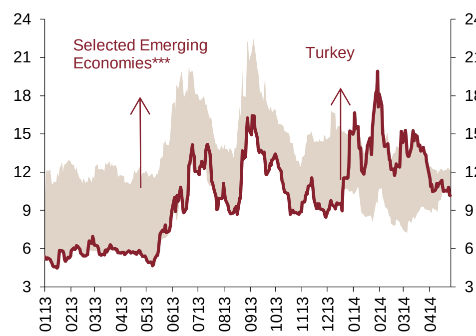


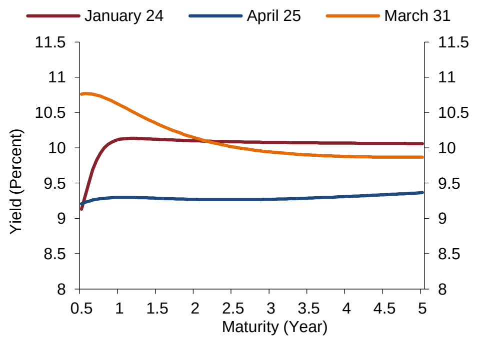

**Chart 1.1.4.**
1-Month Implied Volatility of Exchange Rates
(Percent)




*Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile.
** Brazil, Indonesia and South Africa.
*** Brazil, Indonesia, South Africa and Turkey.
Source: CBRT, Bloomberg.

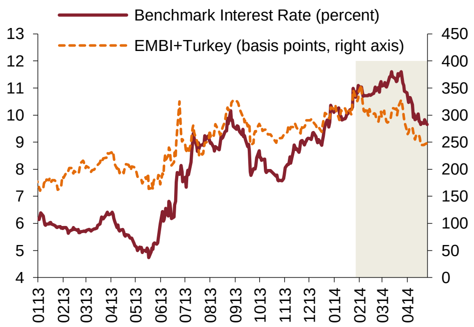
During the last quarter, market rates followed a volatile course amid the CBRT's monetary policy stance, the news about the Fed's quantitative easing and developments regarding uncertainties. Before the interim MPC meeting on January 28, the yield curve sloped upward for all maturities except short-term upon heightened uncertainties and risk premiums as well as deteriorated inflation outlook. After the strong and front-loaded monetary tightening implemented upon the interim meeting, short-term rates trended upwards until end-March in line with the CBRT's average funding and overnight funding rates. Meanwhile, long-term rates fell and the yield curve sloped downward. With the recent improvement in risk premiums and the decrease in uncertainties, interest rates went down across all maturities, causing the yield curve to flatten (Chart 1.1.5). Currently, the horizontal course of the yield curve and its slope turning negative when needed point to the tight stance of the monetary policy. Meanwhile, the benchmark interest rate was on the rise until April in tandem with other interest rates, but declined by April in line with lower risk premiums (Chart 1.1.6).

**Chart 1.1.5.**
Yield Curve*
(Percent)




* Calculated from the compounded returns on bonds quoted at the BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

**Chart 1.1.6.**
Benchmark Interest Rate and EMBI+Turkey




Source: BIST, Bloomberg.

Rising banks' funding costs amid higher market rates were passed on to both consumer and commercial loan rates. Moreover, with the BRSA's macro prudential measures, the growth rates of consumer loans and credit card debts hover significantly below the average of previous years (Chart 1.1.7). Additionally, the raised funding need of the financial system and the shortened funding maturity are estimated to slow consumer loan growth. However, the growth rate of commercial loans remains broadly unchanged compared with past years (Chart 1.1.8). The fact that consumer loan growth returns to a reasonable level while commercial loan growth remains steady is expected to support macro financial stability, the re-balancing process and the decrease in inflation.

**Chart 1.1.7.**
Consumer Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)

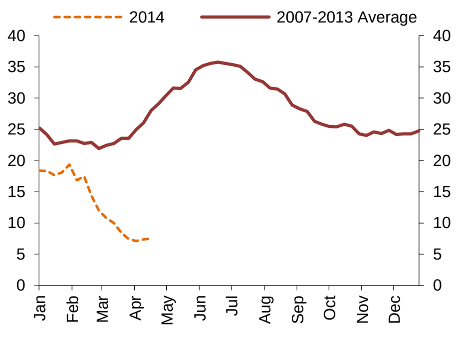
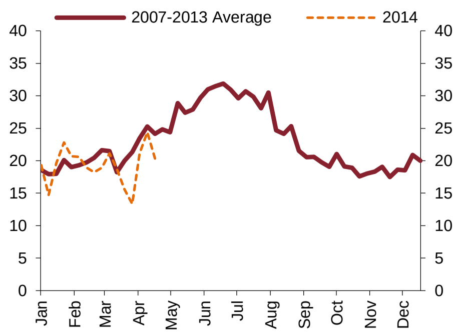



**Chart 1.1.8.**
Commercial Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)




Source: CBRT.

The FCI for Turkey, weighted average of various financial indicators summarizing above-mentioned factors, implies a substantial tightening for the first quarter of 2014 (Chart 1.1.9). This was largely driven by the depreciation of the Turkish lira, weak portfolio flows, the falling stock index and soaring market rates (Chart 1.1.10). The tight course of financial conditions is expected to contribute to disinflation and to support the current account balance. With reduced uncertainty and partially improved risk premiums, the financial tightness is expected to ease slightly in the second quarter.

**Chart 1.1.9**
Financial Conditions Index

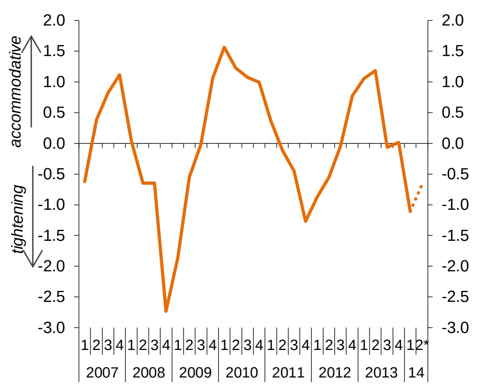
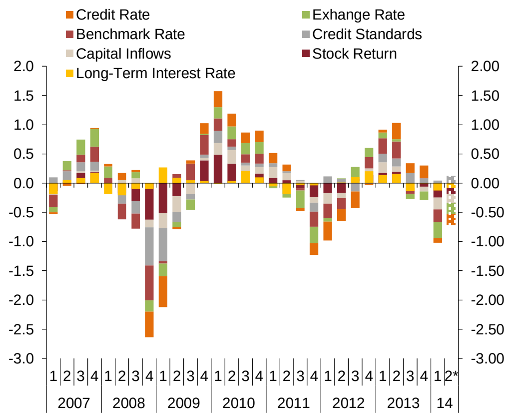



**Chart 1.1.10**
Contributions to FCI




*Estimate for 2014Q2. The last observation for FCI is estimated using provisional data of the second week of April, while the latest data on price is used to represent price variables. Credit standards are assumed to remain flat while capital inflows are assumed to remain unchanged from 2013Q2. For further details on measuring the FCI, see the CBT Research Notes in Economics No. 12/31.
Source: CBRT.

## 1.2. Macroeconomic Developments and Main Assumptions

### Inflation

Consumer inflation increased by 1 percentage point from end-2013 to 8.39 percent in the first quarter of 2014, while inflation excluding unprocessed food and tobacco stood at 8.51 percent (Charts 1.2.1 and 1.2.2). This first-quarter rise in inflation was mainly attributed to the marked increase in prices of core goods, especially automobiles, driven by the depreciation of the Turkish lira. Additionally, services inflation moved upward as well; thus core inflation indicators surged rapidly (Chart 1.2.3). The upward shift in food prices caused by exchange rate developments and adverse weather conditions was another factor affecting the inflation outlook negatively. Thus, indicators regarding the underlying trend of inflation, inflation expectations and the pricing behavior deteriorated in the first quarter.

**Chart 1.2.1.**
January 2014 Inflation Forecasts and Realizations
(Percent)

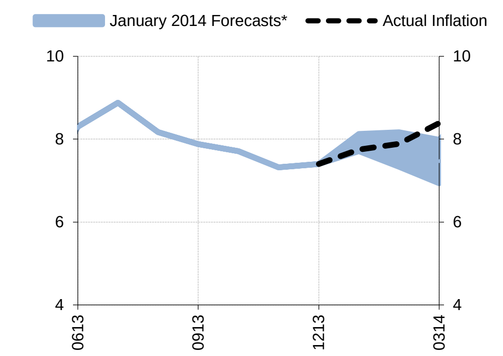
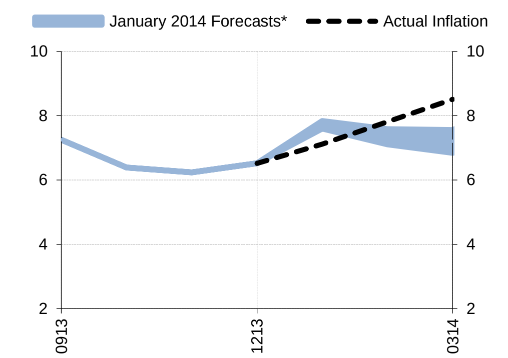



**Chart 1.2.2.**
January 2014 Inflation Forecasts and Realizations
Excluding Unprocessed Food and Tobacco (Percent)

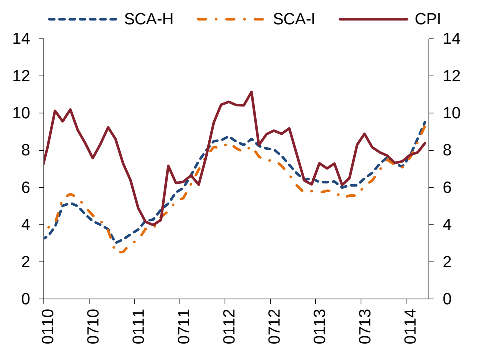



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

The first-quarter rise in inflation mostly reflects the effects of increases in costs. On the services front, wages, demand conditions, the backward-looking pricing behavior as well as food prices and exchange rates contributed to the rise in inflation. As for core goods, tax hikes and the exchange rate pass-through were the main drivers of the rise in inflation. However, both the increases in the prices of core goods that were higher than implied by the cost effects and the fact that services inflation hit the 5-year high suggest that there was a surge beyond cost pressures in the first-quarter course of inflation.

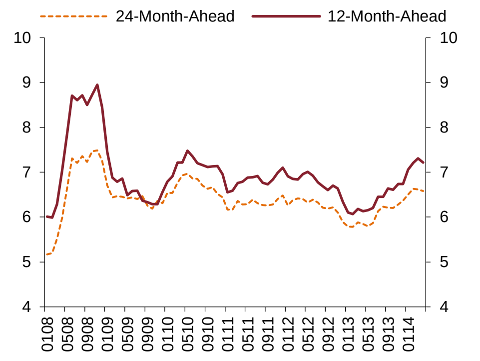
The 2014 outlook for inflation indicators will be determined by the course of economic activity and exchange rates as well as food prices. Annual inflation will remain on the rise for a while due to the still-present effects of tax adjustments and exchange rate developments, but it may slow down in the upcoming period in case the recent appreciation of the Turkish lira proves to be permanent, the moderate course of domestic demand continues and supply-side risks on food prices ease. Moreover, given the tight monetary policy stance, inflation expectations are envisaged to be anchored. In fact, the deterioration in inflation expectations paused as of April (Chart 1.2.4).

**Chart 1.2.3.**
CPI and Core Inflation Indicators
(Annual Percent Change)




Source: TurkStat, CBRT.

**Chart 1.2.4.**
12- and 24-Month-Ahead CPI Expectations
(Annual Percent Change)




Source: CBRT.

## Supply and Demand

According to the GDP data for the fourth quarter of 2013, economic activity was largely consistent with the outlook presented in the January Inflation Report. Final domestic demand was more robust than in the second and third quarters of 2013 (Chart 1.2.5). Analysis of the final domestic demand components shows that public demand grew more rapidly than private demand. Exports increased at a faster pace than imports on a quarterly basis, which contributed to the re-balancing of demand components.

**Chart 1.2.5.**
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)

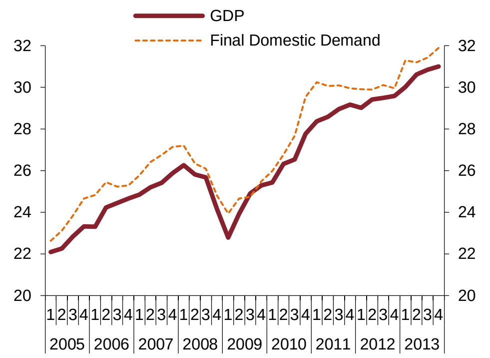
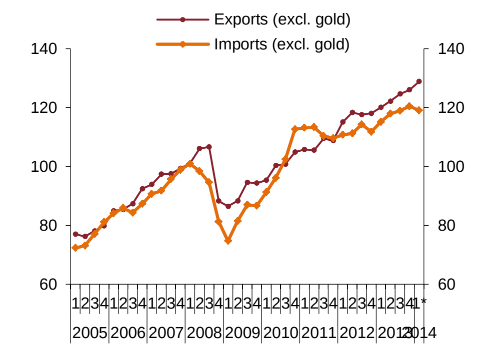



**Chart 1.2.6.**
Export and Import Quantity Indices
(Seasonally Adjusted, 2010=100)

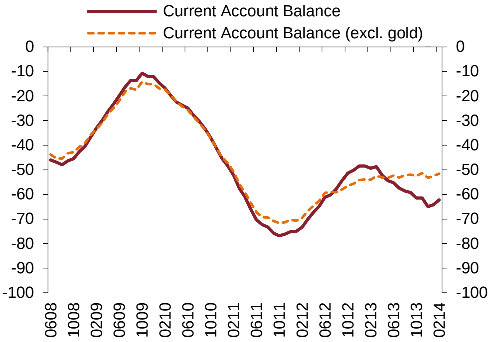



* Estimate for March.
Source: TurkStat, CBRT.

Data releases for the first quarter of 2014 suggest a mild economic growth. On the production side, the industrial production index continued on a steady quarterly growth, while expenditures data indicate a weak private demand. In fact, the consumption of durable goods and machinery and equipment investments have declined due to financial conditions and domestic uncertainties. Yet, with construction investments and the consumption of non-durable goods that remain robust, this decline is offset partly.

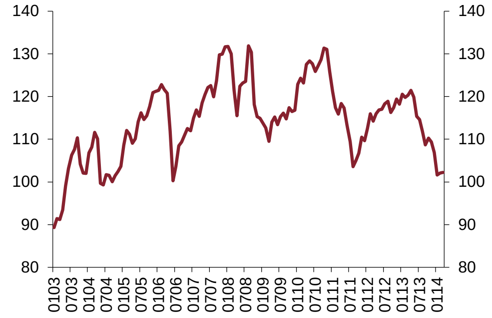
Exports of goods and services increased owing to the depreciation of the Turkish lira and the global economic recovery, while imports of goods and services decreased due to exchange rate and domestic demand developments. Thus, re-balancing of the goods trade excluding gold continued and the current account balance improved slightly (Charts 1.2.6 and 1.2.7). The real exchange rate, on the other hand, depreciated after May 2013 (Chart 1.2.8). The real exchange rate developments are expected to further support the improvement in the current account balance.

**Chart 1.2.7.**
Current Account Balance
(12-Month Cumulative, Billion USD)




Source: TurkStat, CBRT.

**Chart 1.2.8.**
Real Effective Exchange Rate
(CPI based, 2003=100)



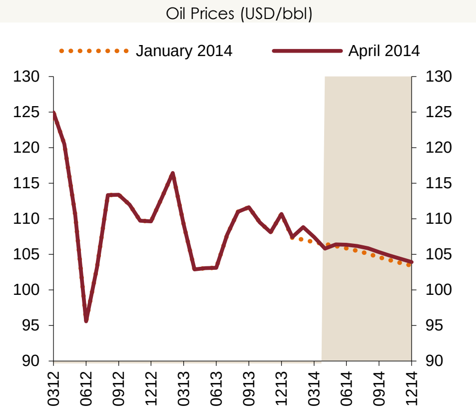

Source: CBRT.

Early data releases for the second quarter signal a partial improvement compared to the first quarter. Private domestic demand is expected to recover by the second quarter on the back of the decreased uncertainty perception, the appreciation of the Turkish lira and the improvement in consumer confidence, but will continue on its weak course in the first half of the year as uncertainties have yet to fully dissipate and financial conditions remain tight. However, net exports and public demand are expected to compensate for this course of private domestic demand. In the second half of the year, private demand may display a more favorable outlook thanks to less uncertainty. Yet, it should be noted that there are downside risks to domestic demand. Accordingly, domestic demand conditions are expected to support disinflation and contribute to the recent improvement in the current account deficit.

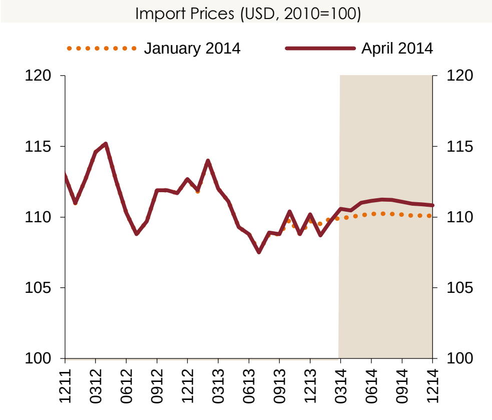
### Energy, Import and Food Prices

In the first quarter of the year, oil and import prices proved mostly consistent with the January Inflation Report forecasts (Chart 1.2.9). However, the assumption for the average increases in oil and import prices in 2014 was revised slightly upwards (Table 7.1.1). This revision pushed the end-2014 inflation forecast up by about 0.1 percentage points. Food prices increased recently. These increases were evident across all subcategories except for fresh fruits and vegetables. In addition, adverse weather conditions in the first quarter appear to have posed a significant risk to fruit and vegetable production. Against this background, the assumption for the end-2014 food price inflation was raised from 8 percent in the January Inflation Report to 9 percent in this reporting period. This revision added about 0.3 percentage points to the end-2014 inflation forecast.

**Chart 1.2.9.** Revisions to Oil and Import Price Assumptions




Source: Bloomberg, CBRT.




Source: TurkStat, CBRT.

## Fiscal Policy and Tax Adjustments

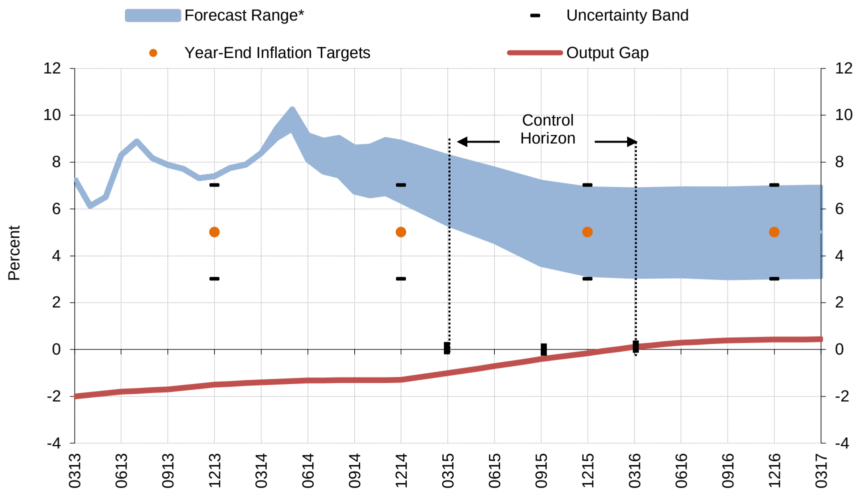
Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with the inflation targets and automatic pricing mechanisms. Thus, end-2014 inflation forecast has been subject to no revision stemming from the fiscal policy.

The medium-term fiscal policy stance is based on the MTP projections covering the 2014-2016 period. Accordingly, it is assumed that the cautious fiscal stance will be preserved and primary expenditures will be kept under control.

## 1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the assumption that the tight stance of the monetary policy will be maintained until the inflation outlook recovers significantly and the improvement in the risk premium indicators is sustained. Moreover, it is assumed that the annual loan growth rate will near 15 percent by the end of 2014 on the back of the adopted macro prudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.4 percent and 8.8 percent (with a mid-point of 7.6 percent) at end-2014 and between 3.2 percent and 6.8 percent (with a mid-point of 5 percent) at end-2015. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

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




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

Annual inflation is expected to remain elevated for a while due to high food prices and the lagged effects of the depreciation of the Turkish lira, and considerably exceed the 5-percent target at year-end. On the back of reduced cost pressures from exchange rates, the favorable impact of the lagged effects of monetary tightening on inflation and the weakness of private demand conditions, inflation is envisaged to fall by the second half of the year to 7.6 percent at the year-end (Chart 1.3.1).

The end-2014 inflation forecast was revised upwards by 1 percentage point from the January Inflation Report. Of this revision, 0.3 percentage points stemmed from the higher-than-anticipated depreciation of the Turkish lira, and 0.1 percentage points from the slight upward revisions to import and oil price assumptions for 2014. The upward revision to food price inflation also drove the year-end forecast up by 0.3 percentage points. The relatively deteriorated pricing behavior compared with the previous reporting period is expected to add about 0.3 percentage points to year-end inflation via its effect on the underlying inflation trend.

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

## 1.4. Risks and Monetary Policy

Loan growth rates continue to slow down in response to the tight monetary policy stance and the recent macro prudential measures. The slowdown in loan growth is mostly driven by consumer loans and credit cards, while the growth rate of commercial loans remains close to past years' average. This positive development in loan growth composition is expected to contribute to financial stability, the re-balancing process and the decrease in inflation. As a matter of fact, data releases in the first quarter of 2014 indicate some deceleration in private final domestic demand. Meanwhile, net exports are expected to contribute positively to economic growth thanks to the recovery in external demand, particularly from European countries, and real exchange rate developments. Given such a demand composition, the CBRT expects that aggregate demand conditions will contain inflationary pressures and the current account deficit will see a significant improvement in 2014.

The CBRT closely monitors inflation expectations and the pricing behavior. The slowdown in consumer loans and the weak private demand are expected to restrict the effect of the cost-push shocks on inflation in the coming period. However, lagged effects of the exchange rate movements and the unfavorable course of food prices are likely to cause inflation to remain above the target for some time. Given the elevated level of inflation, it is important to prevent the negative effects on the pricing behavior and on the inflation trend. The strong and front-loaded monetary tightening delivered at the January interim meeting has contained the potential adverse impact of the upside risks on the medium-term inflation expectations. Yet, considering that the positive impact of the monetary tightening will be observed on inflation with some lag, inflation might continue to increase in the short term, partly reflecting the base effects. In the meantime, the CBRT will closely monitor inflation expectations and the pricing behavior and maintain the tight monetary policy stance until there is a significant improvement in the inflation outlook.

In times when negative effects on the inflation outlook are strong and uncertainties are large, the CBRT may tighten the liquidity policy further to restrict these developments. During additional tightening, the yield curve may be inverted as well. The recent decline in uncertainties and the partial improvement in risk premium indicators have reduced the need for an additional tightening in liquidity policy. With the deceleration in private demand and the significant decline in consumer loans, the current tight monetary policy stance is believed to suffice to attain a target-consistent inflation outlook in the medium term. In case of further deterioration in the trend of inflation or a dramatic rise in uncertainties, the CBRT might implement additional tightening in its liquidity policy.

As the uncertainty about the Fed's quantitative easing program has recently faded to a great extent and thanks to the global economic recovery, the risk sentiment across global financial markets has become more upbeat. Yet, expectations about the timing and pace of a Fed rate hike are of importance for pricing in financial markets. However, as the transmission mechanism of the interest rate channel is better known than that of quantitative easing and the dependence of monetary policy on high-frequency data has decreased; the uncertainty associated with a policy rate hike may weigh less on financial markets than the exit from the quantitative easing program. Accordingly, capital flows to emerging economies may re-accelerate. Moreover, a possible quantitative easing by the ECB might be another supporting factor for capital flows. If this scenario materializes, the CBRT might take steps to accumulate foreign exchange reserves.

On the other hand, should there be prolonged elevation in uncertainties and the risk premium, the economy may face an additional slowdown through the confidence and balance sheet channels. If such a risk materializes, the CBRT will pursue an accommodative policy by using its policy instruments to reduce the intermediation costs of the banks. In such a scenario where it is necessary to tighten the liquidity policy, macro prudential tools might be used as a stabilizer to contain the repercussions on banking costs. Similarly, in a scenario where the external funding conditions tighten for banking sector, macro prudential policies might be implemented as a supporting tool. Accordingly, paying interest on the portion of reserve requirements held in Turkish liras may be an option.

The CBRT closely monitors developments on fiscal policy and tax adjustments 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 to administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the MTP remains to be of utmost importance.