1. Overview

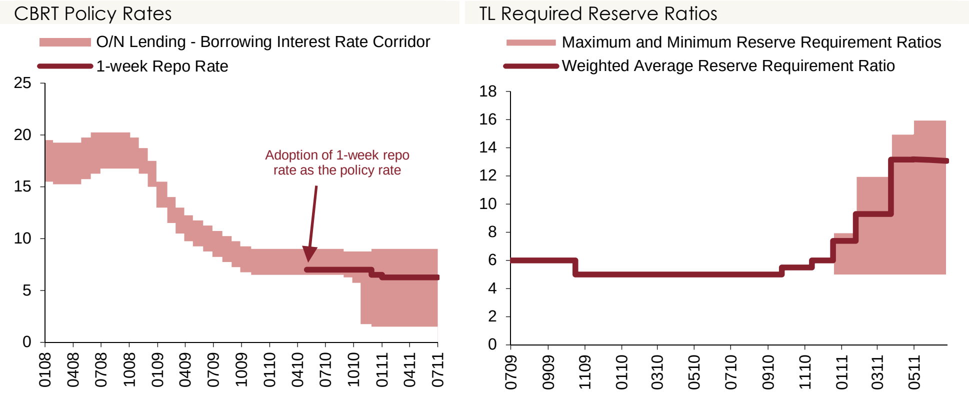
The global economic growth slowed down in the second quarter of 2011, while advanced and emerging economies continued to grow at different paces. Mounting concerns regarding sovereign debt sustainability problems across the euro area, especially in Greece, and the slower-than-expected recovery in the U.S. labor market has intensified the downside risks regarding the global economic activity. Accordingly, expectations for a delay in normalization of the monetary policy in advanced economies were heightened. Meanwhile, emerging economies, faced with inflationary pressures arising from strong domestic demand and elevated commodity prices, continue to tighten monetary policy while resorting to macroprudential measures to contain the adverse effects of the global imbalances on their domestic markets.

1.1. Monetary Policy Developments and Monetary Conditions

In order to restrain macro financial risks in the domestic economy posed by rapid credit growth and widening current account deficit due to short-term capital inflows, the Central Bank of the Republic of Turkey (CBRT) designed and launched a new policy strategy by the end of 2010. The new policy approach preserves the priority for price stability, while also observing financial stability as a supporting objective. In this context, in addition to the policy rates, complementary tools such as reserve requirement ratios and the interest rate corridor are jointly utilized.

In order to contain risks associated with diverging domestic and external demand and short-term capital inflows, the CBRT has kept the policy rates at low levels, while resorting to monetary tightening through reserve requirement hikes since the last quarter of 2010. This strategy aims to rebalance economic growth without hampering the medium-term inflation outlook. Accordingly, weighted average reserve requirement ratio was raised significantly and monetary policy assumed a more cautious stance (Chart 1.1.1).

Chart 1.1.1. CBRT Policy Mix



Source: CBRT.

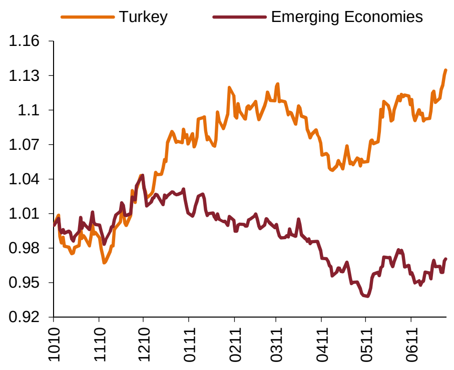
Source: CBRT.

The measures taken by the Banking Regulation and Supervision Agency (BRSA) regarding the loan-to-value ratios, loan-loss provisions, and capital adequacy, as well as the tight fiscal stance supported the policy mix implemented by the CBRT, and contributed to the rebalancing of domestic and external demand. In this respect, the impact of the policy mix has become more evident in the second quarter.

The Monetary Policy Committee (MPC), observing the moderating domestic economic activity and mounting uncertainties regarding the global economy, kept the policy rate and Turkish lira reserve requirements constant since the publication of the April Inflation Report. Moreover, in the July meeting, the MPC, by putting an increased emphasis on global risks, stated that all policy instruments may be eased should global economic problems intensify and lead to a contraction in the domestic economic activity.

As a consequence of the policies implemented by the CBRT, the Turkish lira continued to favorably diverge from currencies of peer emerging economies (Chart 1.1.2). This development, coupled with the coordinated measures implemented by other institutions, contributed to the rebalancing of domestic and external demand. In fact, recent data suggest that, in real terms, the upsurge in imports has stopped while exports continued to grow (Chart 1.1.3).

Chart 1.1.2.
TL and Emerging Market Currencies*
(October 2010 =1)



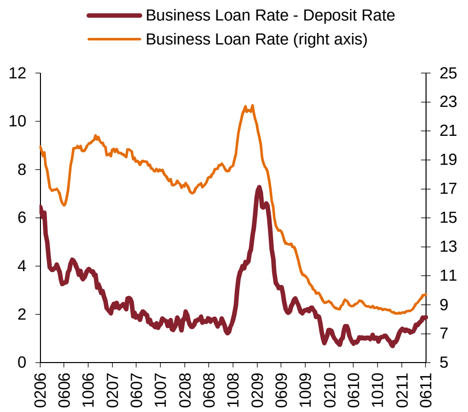
* Average of emerging market currencies including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea and Colombia, against USD.
Source: Bloomberg, CBRT.

Chart 1.1.3.
Exports and Imports of Goods and Services
(Seasonally Adjusted, 1998 Prices, Billion TL)

* Estimate.
Source: TurkStat, CBRT.

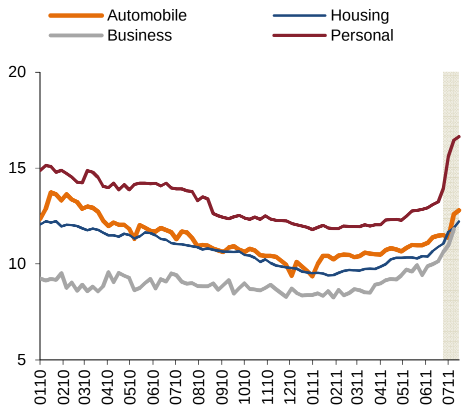
Credit conditions continued to tighten in the second quarter due to measures taken both by the CBRT and the BRSA (Chart 1.1.4). Although credit growth rate has yet to decline to levels compatible with financial stability, it is expected to slow down further in the second half of the year on lagged effects of the ongoing tightening. In fact, consumer loan rates have displayed a significant rise recently (Chart 1.1.5).

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



Source: CBRT.

Chart 1.1.5.
TL Loan Rates
(Percent)



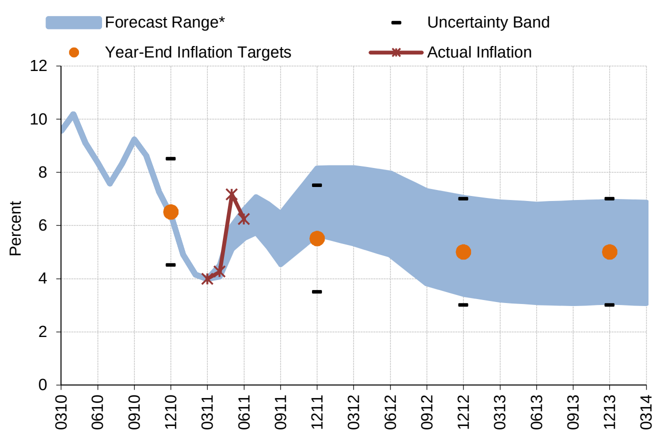
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

Annual inflation, by following an upward trend, increased to 6.24 percent in the second quarter on the accumulated impact of import prices, rising food prices and base effects. Although inflation displayed a more volatile path than expected due to excessive volatility in unprocessed food prices, the end-quarter realization was close to the forecast presented in the April Inflation Report (Chart 1.2.1).

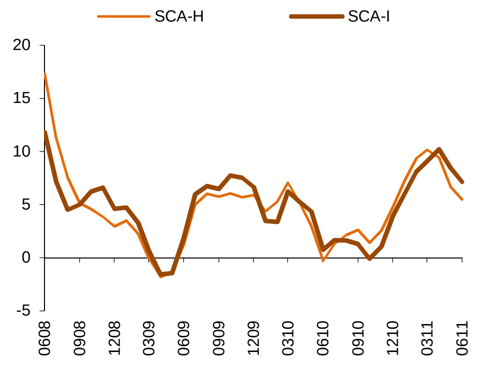
Chart 1.2.1.
April 2011 Inflation Forecasts and Realizations



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

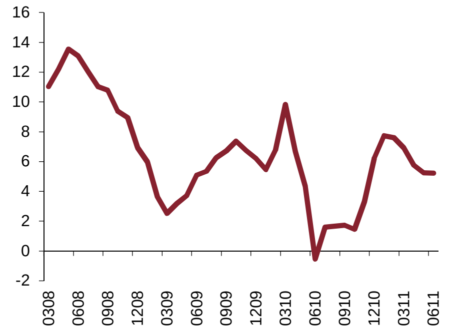
Higher commodity prices and the depreciation of the Turkish lira continued to weigh on core prices during the second quarter. Yet, the second round effects were contained at this stage. Although annual core inflation increased, seasonally adjusted data signal a recently declining trend (Chart 1.2.2). Moreover, services inflation also hover around at historic lows recently (Chart 1.2.3).

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 Services
(Seasonally Adjusted, 3-Month Average, Annual Percent Change)



Source: TurkStat, CBRT.

Supply and Demand Developments

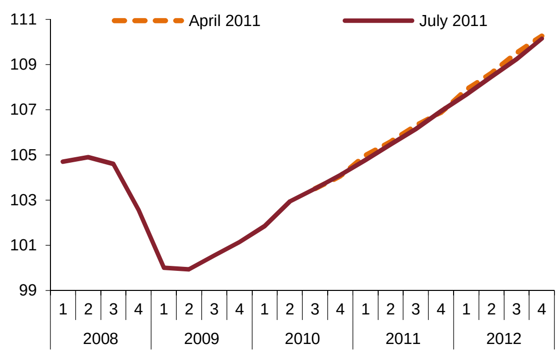
The first-quarter GDP data are consistent with the outlook presented in the April Inflation Report. Economic activity remained robust, albeit having a slower rate of growth than in the first quarter, while the main driver of growth was private sector demand. Meanwhile, exports remained weak and imports continued to accelerate, causing net external demand to make a negative contribution to growth. The divergence between domestic and external demand growth continued during this period, vindicating a new policy mix.

Economic activity slowed down due to the lagged effects of the tightening policies and the weak external demand. During this period, industrial production and capacity utilization rates declined on a quarterly basis after a long time. Therefore, our output gap estimates for the second quarter are revised slightly downward compared to the previous reporting period.

Revisions to Other Assumptions

Although downside risks to global economic growth increased, downward revisions to global growth forecasts remained limited at this stage (Chart 1.2.4). Accordingly, projections for Turkey's export-weighted growth index remained broadly unchanged. Therefore, assumptions regarding external demand conditions were not subject to any major revisions that may affect inflation forecasts.

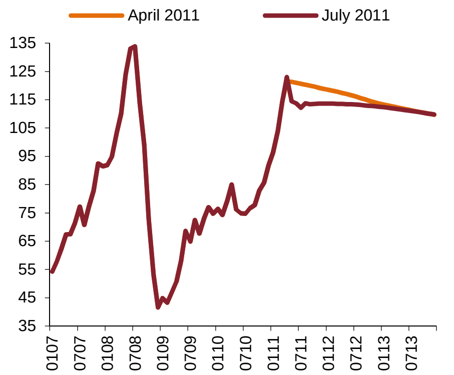
Chart 1.2.4.
Export-Weighted Global Economic Activity Index*
(2009Q1=100)



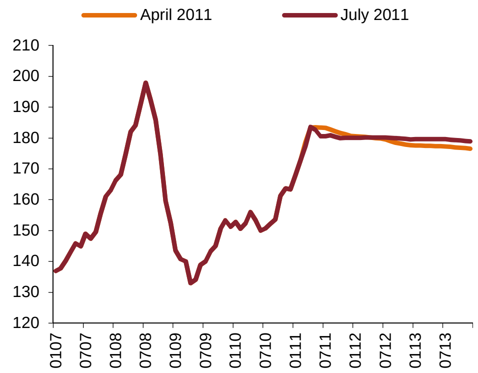
* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

Assumptions about oil prices for 2011 and onward were kept at 115 USD/bbl, and there has been no significant revision for import price projections, which are constructed by future commodity prices (Chart 1.2.5). Moreover, assumption for food inflation was maintained at 7.5 percent for end-2011 and thereafter.

Chart 1.2.5.
Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.



Source: TurkStat, CBRT.

In sum, there has been no revision for end-2011 inflation forecast as the outlook for factors affecting inflation remained broadly unchanged.

Fiscal Policy

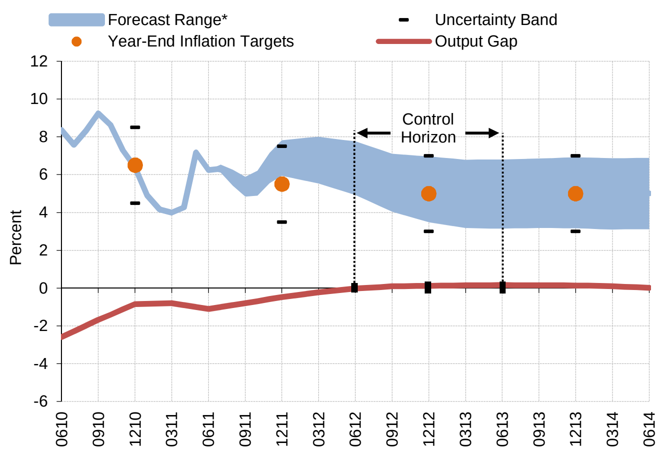
Inflation forecasts are based on the assumption that the additional revenues incurred via the restructuring of tax claims would be used to reduce public debt, and hence, fiscal policy would tighten. It is also assumed that the ratio of primary expenditures to GDP would slightly decline, the debt-to-GDP ratio would continue to fall, and the risk premium would remain broadly unchanged over the forecast horizon. Furthermore, tax adjustments are assumed to be consistent with inflation targets and automatic pricing mechanisms.

1.3. Inflation and Monetary Policy Outlook

Under the current economic climate, slowing down credit growth is not only critical for controlling domestic demand, and therefore to contain inflationary pressures, but also for preventing excessive borrowing, and hence, to restrain macro financial risks. Moreover, in an environment where multiple policy tools are jointly utilized, credit growth deserves particular emphasis with regard to the communication of the monetary and financial conditions that underlie our forecasts. Therefore, in addition to inflation forecasts, our assumptions for the annual rate of credit growth will be publicly shared in this Report.

Against this background, assuming that annual rate of credit growth declines to 25 percent by the end of 2011, and policy rate remains constant until the end of 2011, inflation is expected to be, with 70 percent probability, between 5.9 and 7.9 percent with a mid-point of 6.9 percent at the end of 2011, and between 3.5 and 6.9 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.

In sum, inflation forecast path remains broadly unchanged as there has been no significant revision to our underlying assumptions compared since the previous reporting period.

The revised forecasts suggest that credit growth should grow at a controlled and healthy pace to keep inflation in line with the medium-term targets. Although the rate of credit growth has not declined to desirable levels in the second quarter, the credit growth is expected to slow down markedly over the coming period given the lagged effects of the adopted measures by the CBRT, as well as the measures taken by the BRSA regarding consumer credits.

Over the second half of the year, inflation is expected to display significant fluctuations mainly due to base effects driven by food prices. Annual food inflation is expected to decline in the third quarter and increase in the last quarter. As shown in Chart 1.3.1, these fluctuations will largely determine the course of inflation.

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

Under current circumstances, risk factors and the associated monetary policy measures are assessed within a framework where both price stability and financial stability are observed. Accordingly, risk factors are not only assessed with respect to their impact on the level; but also, on the composition of the aggregate demand since the level of the aggregate demand is related to price stability, while its composition is directly related to financial stability. Hence, risk factors regarding global economy are also evaluated against this backdrop.

The baseline scenario, and hence, our inflation forecasts are built on the assumption that the second-quarter slowdown in global economic activity will mainly be temporary, given the forecasts by international institutions. However, developments since the previous reporting period have intensified downside risks regarding the global economy.

Problems in credit, real estate and labor markets in advanced economies are yet to be fully solved. Moreover, concerns on fiscal dynamics in these economies still persist. In particular, mounting problems regarding sovereign debt in the euro area peripheral economies have intensified downside risks to the global economy. Should the sovereign debt problems regarding some European economies and the concerns on global growth continue to have adverse impact on the risk appetite, the interest rate corridor may be narrowed gradually. Moreover, an outcome whereby global economic problems intensify and domestic economic activity contracts may require an easing in all policy instruments.

Even if debt problems in the euro area are resolved before they turn into a global crisis, it is still likely to experience a prolonged period of weak economic activity in advanced economies coupled with continued economic growth in emerging markets driven by domestic demand. In such a case, there may be a resurge in short-term speculative capital inflows to emerging markets which may render itself as weak external demand and elevated commodity prices with rising capital inflows, feeding into macro financial risks for the domestic economy. Should this scenario materialize, the policy mix of low policy rates and high reserve requirements may be implemented for a long period, in order to contain risks to price stability and financial stability.

Developments in exchange rates and import prices have been adversely affecting core inflation since the last quarter of 2010. The additional tariffs on fabrics and apparels are another leading factor that may lift up core inflation indicators in the coming period. Under current circumstances, the increase in core inflation reflects only the relative price movements while the current level of aggregate demand contains the second round effects of these price movements. However, core inflation is expected to increase in the forthcoming period, posing upside risks to inflation expectations and price-setting behavior. Should such a risk materialize and hamper the attainment of medium-term inflation targets, the CBRT will not hesitate to tighten monetary policy. In such a case, the mix of policy tools to be used for tightening will depend on developments regarding domestic demand, capital flows, current account and credit growth.

The impact of the ongoing tightening measures on credit volume and domestic demand is expected to be more significant during the second half of the year. However, the extent and the timing of the impact may vary depending on the developments beyond the control of monetary policy. The lagged effects of the policy measures on price stability and financial stability will be closely monitored, and further measures will be taken if deemed necessary.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. Sustaining the fiscal discipline under current circumstances is essential to limit risks posed by the current account deficit driven by the divergence between domestic and external demand. Saving the additional tax revenues acquired both within the law on restructuring of public claims and also owing to strong economic activity would not only reduce risks to price stability and financial stability, but also increase the effectiveness of the new policy mix. In this respect, our forecasts presented in the baseline scenario assume that the additional budget revenues will be saved to a large extent. 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. Fulfillment of the commitments to fiscal discipline in the medium term and strengthening the structural reform agenda will contribute to the improvement of Turkey's sovereign risk, thereby supporting macroeconomic stability and price stability. Sustaining the 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, timely implementation of the structural reforms envisaged by the MTP and the European Union acquis communautaire remains to be of utmost importance.