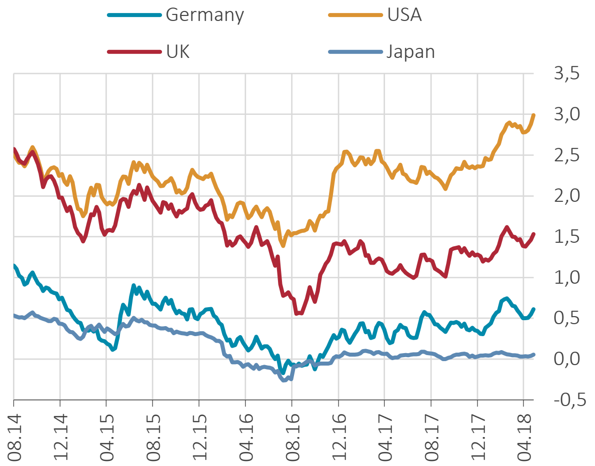
1. Overview

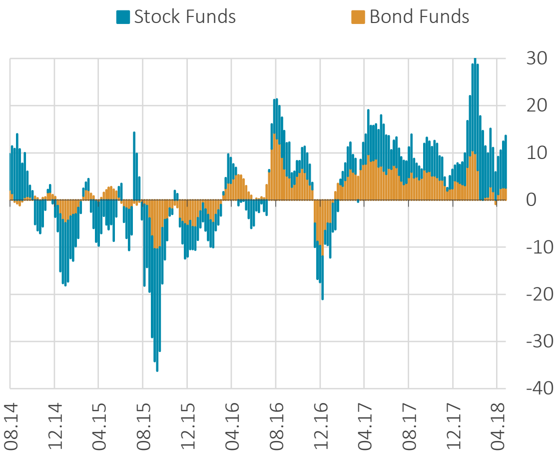
As global economic activity continues to expand steadily, global inflation remains subdued. Global growth forecasts for the first quarter point to a quarter-on-quarter increase, while year-over-year growth forecasts are also revised upwards for both advanced and emerging economies. With the Fed and ECB in the lead, major central banks have taken further steps towards monetary policy normalization as expected, driving long-term bond yields higher. However, concerns over the possible adverse spillovers of rising protectionism in international trade on global growth, inflation and capital flows have led to a slight decline in bond yields since early March (Chart 1.1). Capital flows to emerging economies have been volatile due to the deterioration in global risk appetite in February (Chart 1.2).

Chart 1.1: 10-Year Bond Yields (%)



Source: Bloomberg.

Chart 1.2: Portfolio Flows to Emerging Economies (4-Week Cumulative, Billion USD,)



Source: EPFR.

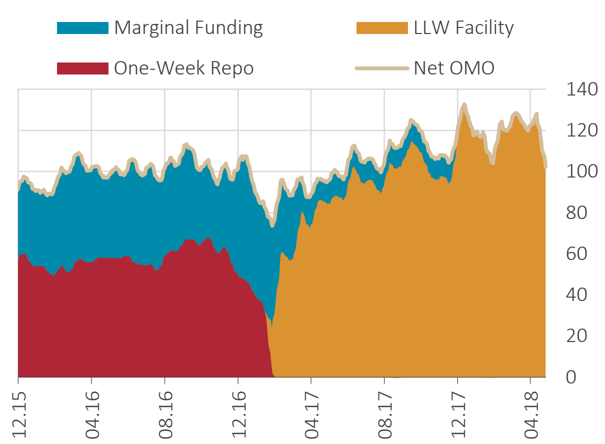
The volatility in global financial markets since the beginning of February and the ongoing dispute between the US and China about foreign trade protectionism in the recent period have led to higher risk premium in emerging countries. Turkey has reacted similar to other emerging economies in terms of risk premium. The higher risk premium and reduced portfolio inflows also affected the value and implied volatility of the Turkish lira. Although loan rates increased due to rising funding rates, banks' loan standards were hardly tighter in the first quarter. Following the end of the credit rally driven by the CGF-backed collateral facility in 2017, commercial loan growth has converged to historical averages while personal loans and mortgages, both consumer loans, have grown at a slightly slower pace since the fourth quarter of 2017.

Consumer inflation fell by 1.69 points from end-2017 to 10.23 percent in the first quarter of 2017. This slowdown, which was spread across subcategories, was largely driven by base effects; while core inflation indicators barely improved, and pricing behavior remained essentially the same. On the other hand, both producer-price-driven cost pressures and strong demand conditions have persistent effects on consumer inflation. As projected in the January Inflation Report, the robust fourth-quarter growth was triggered by private and public spending. In the first quarter, economic activity lost momentum but remained strong. Thanks to favorable labor market conditions, consumer spending has continued to support growth in the first quarter, while machinery and equipment investments have increased in sectors with high capacity utilization, and net exports have made a larger contribution to quarterly growth.

1.1 Monetary Policy and Financial Markets

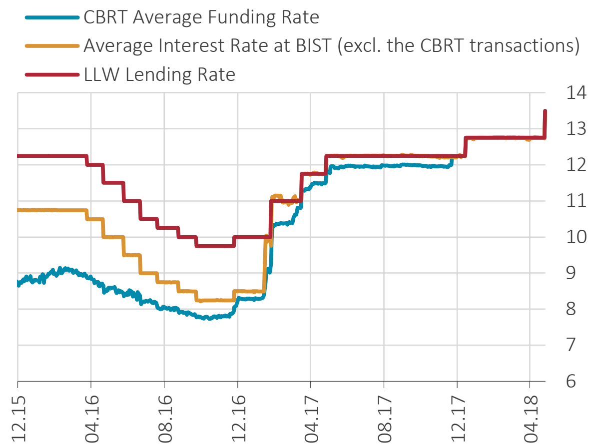
The CBRT adopted a gradually tighter monetary policy stance in the final quarter of 2017 due to ongoing risks to pricing behavior. In particular, a series of measures were taken for TL and FX liquidity in order to safeguard price stability and financial stability against any spillovers stemming from the exchange rate volatility in November. In addition, after a rate hike in December, the CBRT announced at the January and March MPC meetings that the tight monetary policy stance will be maintained decisively until the inflation outlook displays a significant improvement, and further monetary tightening will be delivered if needed. At the April MPC meeting, the CBRT decided to implement a measured monetary tightening to contain inflationary risks. Accordingly, the LLW lending rate was raised from 12.75 to 13.50 percent. Funding has been provided entirely through the LLW facility since November, and the market overnight repo rate has settled at the LLW lending rate (Charts 1.1.1 and 1.1.2).

Chart 1.1.1: CBRT Funding (2-Week Moving Average, Billion TL)



Source: CBRT.

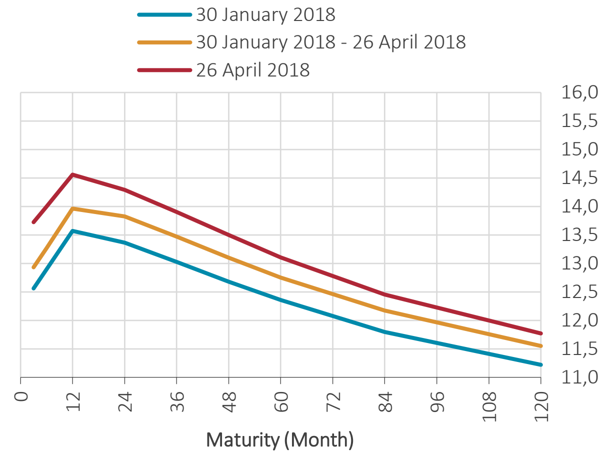
Chart 1.1.2: Short-Term Interest Rates (%)



Source: BIST, CBRT.

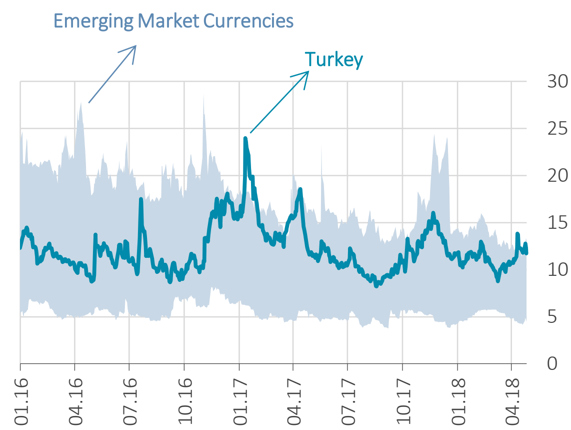
The rise in Turkey's risk premium pushed currency swap rates, a key indicator for monetary conditions, up across all maturities in the inter-reporting period (Chart 1.1.3). In line with the geopolitical developments and the rising risk premium, the Turkish lira depreciated faster than other emerging market currencies and followed a more volatile path (Chart 1.1.4).

Chart 1.1.3 Swap Yield Curve (%)



Source: Bloomberg.

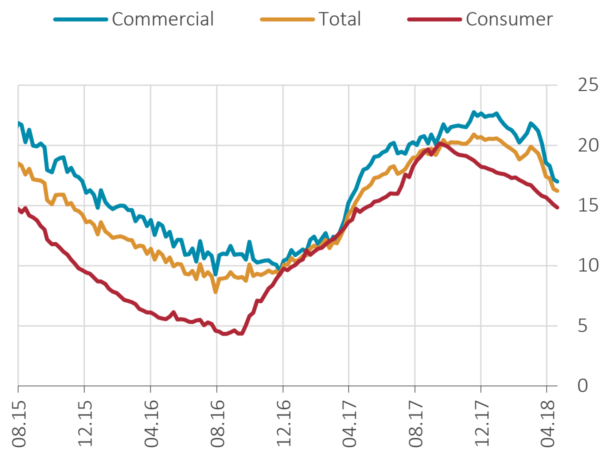
Chart 1.1.4: Implied FX Volatility against US Dollar* (1-Month-Ahead, %)



Source: Bloomberg.
* Emerging market currencies include those of Brazil, Chile, Colombia, Hungary, India, Indonesia, Malaysia, Mexico, Philippines, Poland, Romania and South Africa.

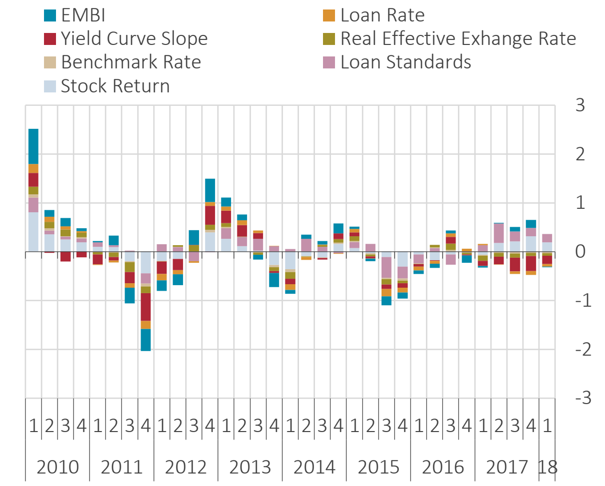
The commercial loan growth rates have been converging to historical averages (Chart 1.1.5). Consumer loans show a similar downtrend. Against this background, financial conditions tightened slightly in the first quarter.

Chart 1.1.5: Annual Loan Growth (Adjusted for Exchange Rate, Y-o-Y % Change)



Source: CBRT.

Chart 1.1.6: Contributions to FCI*



Source: CBRT.

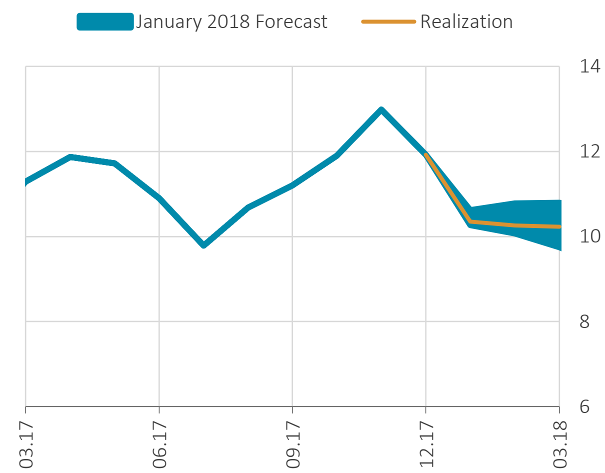
* For further details on measuring FCI, see the CRBT Working Paper No. 15/13.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation was down by 1.69 points from end-2017 to 10.23 percent in the first quarter of 2018, as projected in the January Inflation Report (Chart 1.2.1). A similar pattern was observed for the consumer inflation excluding unprocessed food, alcoholic beverages and tobacco products (Chart 1.2.2). Food inflation in the first quarter was also broadly in line with predictions. Although annual inflation was down across all subcategories in this period, consumer inflation remained elevated due to ongoing cumulative cost pressures, strong demand conditions and rising inflation expectations.

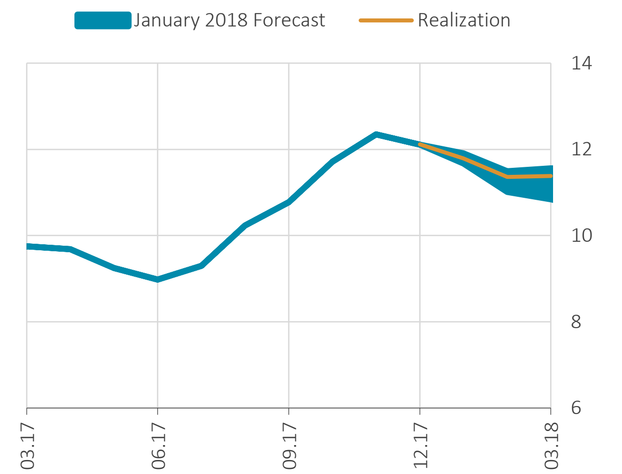
Chart 1.2.1: Inflation Forecast and Realization* (%)



Source: CBRT, TURKSTAT.

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

Chart 1.2.2: Inflation Forecast and Realization Excluding Unprocessed Food, Alcoholic Beverages and Tobacco Products* (%)



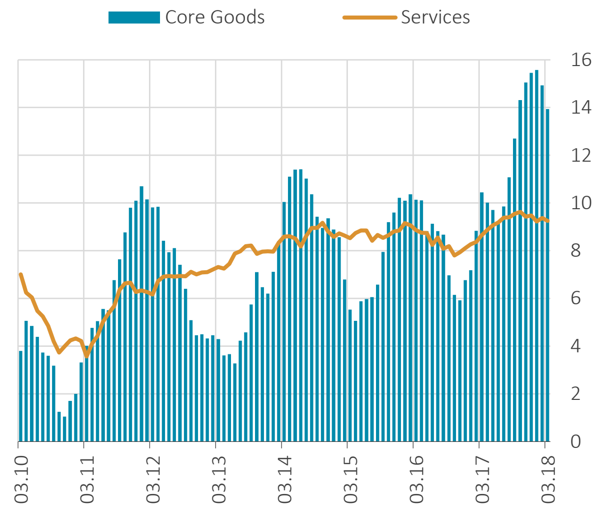
Source: CBRT, TURKSTAT.

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

The decline in annual food inflation was driven by unprocessed food as a result of the low rate of increase in fruit and vegetable prices due to favorable weather conditions in the first quarter of the year. On the other hand, processed food inflation was up in this period. Processed food inflation was driven higher by prices of cheese and other dairy goods and increased bread prices due to accumulated cost pressures owing to the weight adjustment in the Bread Regulation. Despite the early 2018 hike in electricity prices, annual energy inflation edged down amid relatively moderate oil prices and exchange rates in the first quarter. Annual core goods inflation was down, but remained high due to cumulative exchange rate effects and robust demand. As for services, the decline in annual inflation remained limited due to backward indexation and rising cost pressures resulting from wage increases (Chart 1.2.3).

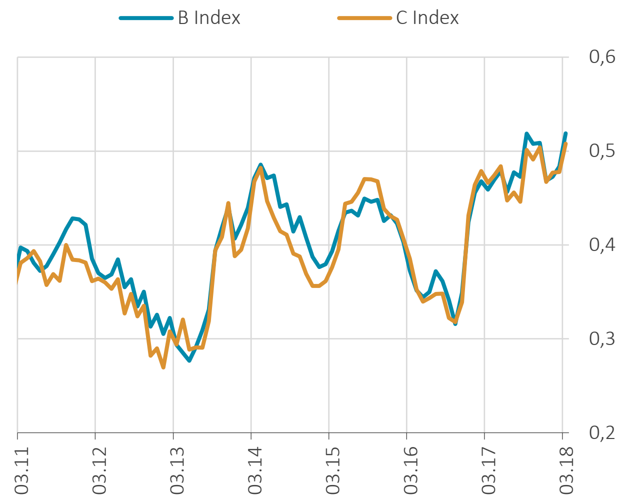
Producer-price-driven cost pressures still weigh on consumer prices, particularly in sectors facing stronger demand. The fall in the annual rate of change of core inflation indicators and their underlying trend, which is calculated using seasonally adjusted data, remained limited with respect to the previous quarter. High inflation and rising inflation expectations keep risks to pricing behavior brisk. The tendency for price hikes, which is captured by diffusion indices for core inflation indicators, grew stronger quarter-on-quarter and hit a new historic-high of the recent years (Chart 1.2.4). To sum up, the indicators for the underlying trend and pricing behavior suggest that the underlying trend of inflation remained high in the first quarter.

Chart 1.2.3: Prices of Core Goods and Services
(Y-o-Y % Change)



Source: TURKSTAT.

Chart 1.2.4: Diffusion of B and C Indices
(Seasonally Adjusted, 3-Month Average)



Source: CBRT, TURKSTAT.

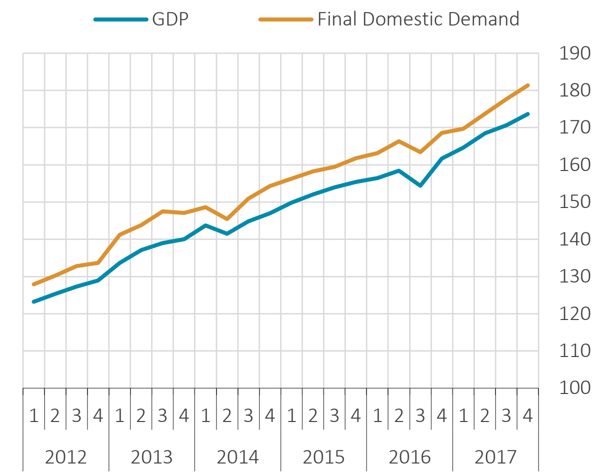
Supply and Demand

In the last quarter of 2017, economic activity remained strong in line with the outlook presented in the January Inflation Report (Chart 1.2.5). GDP posted a quarterly increase by 1.8 percent in this quarter, while the annual growth rate stood at 7.3 percent. Thus, growth in 2017 accelerated considerably compared to 2016 and reached 7.4 percent.

The main driver of the quarterly and annual growth in the last quarter was domestic demand (Chart 1.2.6). In terms of demand components, private consumption remained robust despite the expiration of tax incentives, while public consumption provided higher support to growth. Investments continued to add to annual growth, yet limited the quarterly growth. On the other hand, the contribution of net exports to both quarterly and annual growth was negative.

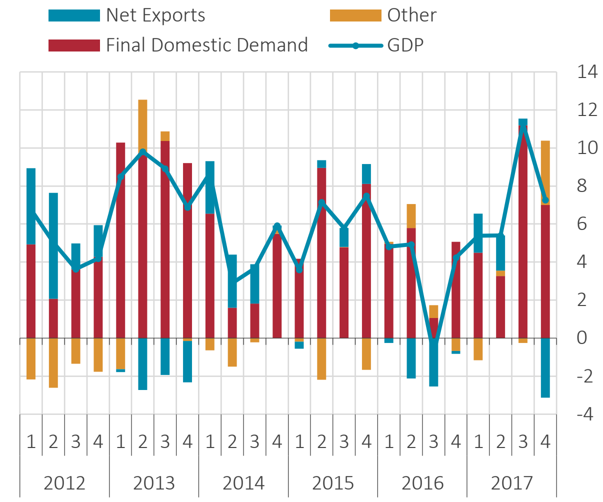
Measures and incentives enforced as of the last quarter of 2016 enabled the resurgent domestic demand and economic activity to spill over into other sectors and played a great role in the acceleration of economic growth in 2017. On the investments side, construction investments increased across the year, while machinery and equipment investments started to move up in the second half of the year. Despite favorable external demand conditions that underpinned exports and the evident contribution from the recovering tourism sector, the contribution of net exports to growth remained limited at 0.1 points due to the increase in gold imports, which remained above historical averages. Excluding gold imports, the contribution of net exports to growth is estimated to be around 1.3 points.

Chart 1.2.5: GDP and Final Domestic Demand
(Real, Seasonally Adjusted, 2009=100)



Source: CBRT, TURKSTAT.

Chart 1.2.6: Contributions to Annual GDP Growth from the Expenditures Side* (% Point)



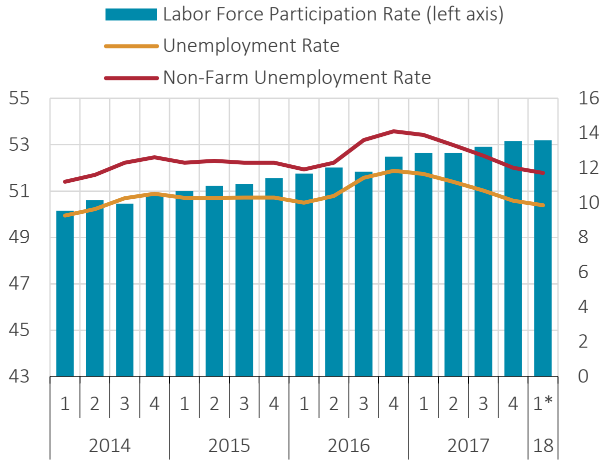
Source: CBRT, TURKSTAT.

* Other includes changes in inventories and statistical discrepancy due to the use of chain-linked index.

Data for the first quarter suggest that economic activity remains robust, albeit with some deceleration. The course of economic activity has favorable repercussions on the labor market (Chart 1.2.7). This outlook in the labor market underpins private consumption particularly through expenditures on non-durable goods. Indicators point to a rise in construction activity due to favorable weather conditions and a rebound in machinery and equipment investments on a quarterly basis. The public sector remains supportive through consumption and investment expenditures. On the foreign trade front, exports of goods and services continue, while the imports thereof lost some pace. Despite this outlook, rising import prices, particularly in oil, had an adverse impact on the current account balance (Chart 1.2.8).

In 2018, economic activity is projected to reach its underlying trend and converge to its potential level gradually. Exports of goods and services are expected to boost growth and continue to have a favorable effect on the current account balance amid the cumulative depreciation of the real exchange rate, the recovery in tourism and the improvement in global growth. It is estimated that the projected course of economic activity will continue to affect the labor market favorably, and unemployment rates will decline further.

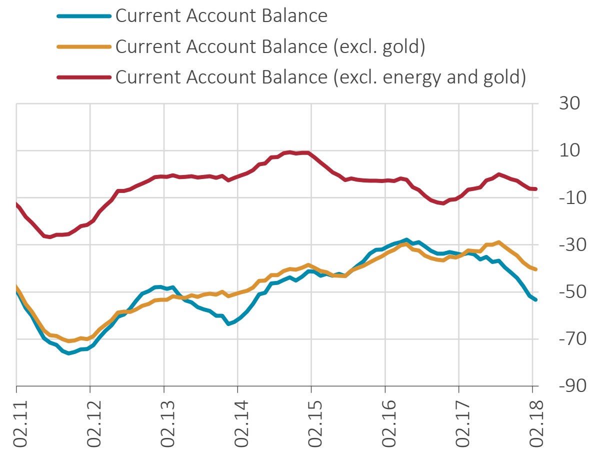
Chart 1.2.7: Unemployment and Labor Force Participation Rates (Seasonally Adjusted, %)



Source: TURKSTAT.

* As of January period.

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



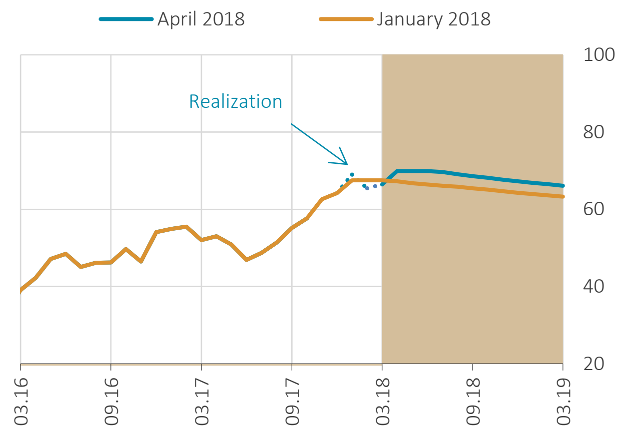
Source: CBRT.

Oil, Import and Food Prices

Recent increases in crude oil prices drove futures prices up as well. Therefore, assumptions for crude oil prices in the January Inflation Report were revised upwards for 2018 from 66 USD to 68 USD and from 62 USD to 65 USD for 2019 (Chart 1.2.9). Meanwhile, despite the increases in some metal prices like aluminum, the assumption for average annual rate of increase in the USD-denominated import prices was revised downwards for 2018 due to the notable fall in the import unit value index announced by TURKSTAT in February (Chart 1.2.10). However, the projected rates of quarterly change in import prices did not change significantly for the remainder of 2018, indicating that risks driven by import prices have not faded since the previous reporting period.

Having decreased to 10.4 percent at the end of the first quarter, the actual food inflation was quite close to the January Inflation Report forecast of 10.3 percent. In view of the measures on the agenda of the Food and Agricultural Products Markets Monitoring and Evaluation Committee (Food Committee), the assumption for food inflation is kept unchanged at 7 percent for both end-2018 and end-2019.

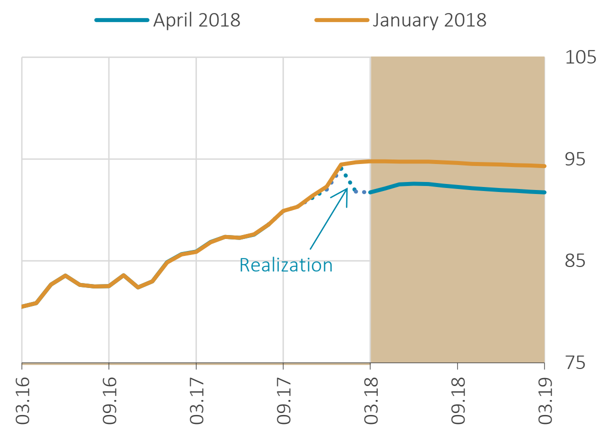
Chart 1.2.9: Revisions in Oil Price Assumptions* (USD/bbl)



Source: Bloomberg, CBRT.

* Shaded area denotes the forecast period.

Chart 1.2.10: Revisions in Import Price Assumptions* (2010=100)



Source: CBRT, TURKSTAT.

* Shaded area denotes the forecast period.

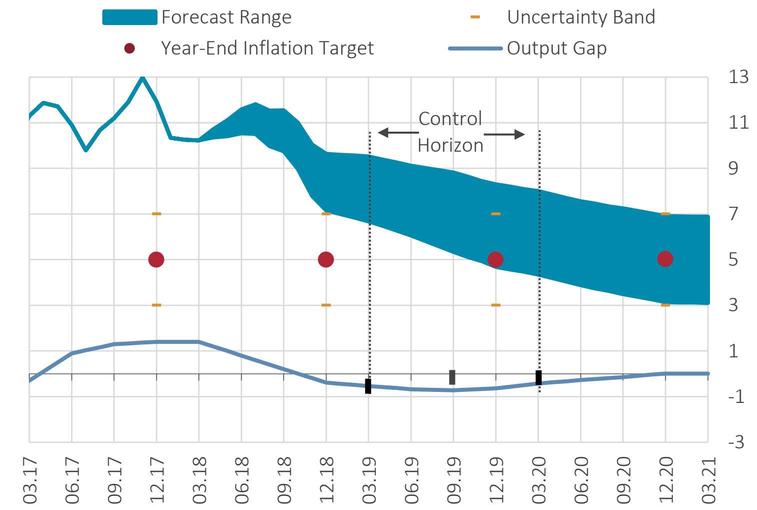
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that fiscal discipline will be maintained, and administered prices and taxes will not be subject to any unanticipated increase. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with MTP projections and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2018-2020 period.

1.3 Inflation and the Monetary Policy Outlook

Given a tight policy stance that focuses on bringing inflation down, inflation is projected to converge gradually to the 5-percent target, falling to 8.4 percent and 6.5 percent at the end of 2018 and end-2019, respectively, and stabilizing around 5 percent over the medium term. Thus, with a 70 percent probability, inflation is expected to be between 7.2 percent and 9.6 percent (with a mid-point of 8.4 percent) at end-2018 and between 4.7 percent and 8.3 percent (with a mid-point of 6.5 percent) at end-2019 (Chart 1.3.1).

Chart 1.3.1: Inflation and Output Gap Forecasts* (%)



Source: CBRT, TURKSTAT.

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

The year-end consumer inflation forecast for 2018, which was announced as 7.9 percent in the January Inflation Report, was revised up to 8.4 percent. Of the upward revision to the end-2018 inflation forecast, 0.4 points stemmed from the adjustment in the TL-denominated import price assumption due to oil prices and exchange rate developments. Meanwhile, the output gap forecast was revised upwards in the inter-reporting period due to the strong domestic demand, which added 0.1 points to the end-2018 inflation forecast.

On the other hand, the year-end inflation forecast for 2019 remained unchanged at 6.5 percent, given an outlook that the tight monetary policy stance will be maintained decisively.

Annual consumer inflation is projected to fluctuate in the short term due to the lagged effects of exchange rate and oil price developments as well as base effects, while risks are judged to be on the upside. Inflation is expected to return to its downward trajectory on the back of recent monetary policy decisions and measures (Chart 1.3.1). Under the assumption that there will be no additional increase in the risk premium due to global and domestic developments, the disinflation process will continue in 2018 on the back of the decisive implementation of the tight monetary policy and convergence of economic activity and loan growth to a milder growth path. In this period, it is important that tax adjustments and administered prices are set in a way to support the disinflation process as part of the stronger coordination between monetary and fiscal policies.

1.4. Risks and Monetary Policy

Current data on the global economy point to stable and strong growth across both advanced and emerging economies. Global growth is estimated to have accelerated in the first quarter, leading to upward revisions to forecasts for 2018. Despite rising commodity and energy prices amid the solid growth outlook, consumer and core inflation rates are moderate across the globe.

The risks to the global economic outlook are tilted to the downside for the upcoming period. The primary downside risks to the global growth outlook are the geopolitical tensions and the growing protectionist discourse in international trade. The newly passed US tax reform is poised to provide a growth boost to the US and its trading partners, which is considered as an upside risk factor for global growth.

The US government's announcement in March to impose additional customs tariffs on imported steel and aluminum might spark more protectionism in international trade on a global basis. The extent to which such policies will affect global growth will depend on how other trading partners will respond.

An analysis of risks to global inflation reveals that geopolitical developments coupled with uncertainties regarding trade policies are likely to pose upside risks to commodity prices, particularly to energy and metal prices. Moreover, in line with the falling unemployment rates in advanced economies, the possibility of wages to accelerate is among the major risk factors to push inflation up.

Unless notable upside surprises occur in global inflation under the mentioned risk factors, it is considered that major central banks, the Fed and the ECB in particular, will continue to normalize monetary policy in line with expectations, and the impact on financial markets will remain limited. However, the possibility of accelerated inflation amid strong demand conditions accompanied by surging commodity prices in advanced economies may trigger a faster-than-projected tightening in these countries. In such a case, global financial markets may witness fluctuations as in early February, and emerging economies may face higher volatility in exchange rates and weakening portfolio flows.

For the upcoming period, the baseline outlook envisages a sustained support from the favorable global economic outlook to Turkey's external demand, an increase in portfolio flows and a decline in commodity prices as implied by the futures markets. Under a scenario that global growth weakens and commodity prices rise, the Turkish economy may face cost-push inflationary pressures and a widened current account deficit. In such a case, the CBRT will formulate the monetary policy response assessing the disinflationary impact of weaker demand conditions in tandem with the second-round effects of cost pressures on inflation. Should this scenario be accompanied by portfolio outflows, the extent of the pass-through from exchange rate depreciation to consumer prices and its possible impact on overall financial stability will shape the monetary policy response as well.

The volatility in global financial markets in February had reflections on domestic financial conditions also due to the geopolitical developments. Accordingly, the risk premium crept up, portfolio flows declined, the Turkish lira depreciated and became more volatile, and market rates as well as loan rates increased. The credit market reveals that the stimulus created by the CGF support in 2017 has dissipated to a great extent. In addition to commercial loans, the deceleration in consumer loans is also monitored closely with respect to its effects on economic activity. All in all, the domestic financial conditions are envisaged to remain on the current trajectory should foreign policy rates continue to increase as expected.

The fiscal measures and incentives to support the economic activity as well as the CGF-backed credit expansion produced a strong recovery in domestic demand in 2017, thereby weakening the disinflationary transmission of monetary policy. The expansionary effect of these policies, also taking into account the lagged effects, are estimated to have peaked in the first quarter of 2018, and the economic activity is expected to start to revert to its underlying trend as of the second quarter, which will gradually lessen the effect of aggregate demand conditions on inflation. Turkey's flexibility in diversifying export markets and the cumulative depreciation of the real exchange rate as well as the favorable global growth outlook for 2018 are expected to provide further support to exports and growth. As a result of the waning effect of the supportive policies, the domestic demand is expected to be relatively moderate. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments remain as downside risks to growth. Exchange rate volatility to stem from these factors poses a downside risk to the timing and strength of the support that financial conditions could provide to economic activity.

In the first quarter of 2018, cost pressures played a significant role in shaping not only producer prices but also consumer prices due also to the robust demand conditions. High levels of inflation and the rise in inflation expectations keep the risks to the pricing behavior brisk. For instance, the fact that the producer price inflation improved only slightly in the first quarter despite the relatively mild course of input costs indicates that firms can raise prices more easily in a high inflation environment. Indeed, the diffusion indices provide evidence that the economic agents' tendency to raise prices rose to quite high levels in the first quarter.

In addition, wage increases hinder the improvement in services inflation because of the sector's labor-intensive structure. As a result of the significant backward indexation behavior in the services sector, inflation inertia is strong in this sector. Productivity gains are imperative to contain the adverse effects of rigidities arising from wage and price-setting behavior on price stability.

The risks are on the upside for food inflation, another significant factor underlying the inflation forecasts. Despite a decline in the second half of 2017 due to the import measures, the red meat prices surged in the first quarter of 2018. Given the supply conditions in the sector, the red meat prices constitute an upside risk factor to food prices in the remainder of the year. The projections for food inflation are based on the assumption that measures taken by the Food Committee will considerably balance the upside risks to food prices.

The MPC judges that the rigidity in the underlying inflation indicators and the high levels of core inflation in the first quarter continue to pose risks to the pricing behavior, and in addition, that the recent rise in import prices also weighs on these risks. Accordingly, the Committee decided to implement a measured monetary tightening in April to support price stability.

The Committee also evaluated the technical presentations on finalizing the simplification process of the monetary policy's operational framework and enhancing the predictability of monetary policy.

The CBRT will continue to use all available instruments in pursuit of the price stability objective. The tight monetary policy stance will be maintained decisively until the inflation outlook displays a significant improvement, independent of base effects and temporary factors, and becomes consistent with the targets. Inflation expectations, the pricing behavior and other factors affecting inflation will be closely monitored, and, if needed, further monetary tightening will be delivered.

Public finance has been providing more support to disinflation, which confirms the stronger coordination between monetary and fiscal policies. Inflationary pressures driven by tax hikes remained well below historical averages in 2017. The joint efforts to transform policy coordination into a continuous and systematic framework will contribute to disinflation in 2018 as well.

Developments in 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 and taxes. 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.

In recent years, sustaining fiscal discipline has been one of the key factors in alleviating the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of an expansionary fiscal policy. Structural measures to provide room for counter-cyclical fiscal policies will enhance the coordination of monetary and fiscal policy and improve macroeconomic stability. Moreover, sustaining structural steps to reduce inertia and volatility in inflation will contribute positively to the price stability and social welfare.