1. Overview

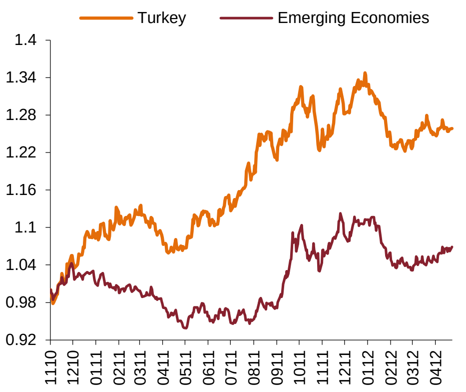
In the first quarter of 2012, global economic activity continued to slow down as projected, while global risk appetite improved notably on easing concerns over the Euro Area. The prevention of a disorderly Greek default amid the completion of debt restructuring, as well as ECB's embarking on another round of 3-year liquidity operation, partially improved perceptions over the Euro Area debt crisis. Furthermore, the better-than-expected outlook in the U.S. economy also contributed to the air of confidence. As a result, global risk appetite was heightened, thereby accelerating capital flows to emerging economies in the first quarter of the year. However, the recent resurge of bond yields amid mounting concerns over the Spanish economy, as well as the lower-than-anticipated rise in the U.S. employment, interrupted the improvement of perceptions about the global economy. Consequently, capital flows to emerging economies have been more volatile as of early second quarter.

Developments in the inter-reporting period indicate ongoing fragilities in the global financial markets. Despite the 4-year period since the outbreak of the global crisis, advanced economies are still going through deleveraging. The problems in the Euro Area, uncertainties regarding the U.S. economy and China as well as supply-side risks on energy prices are still present. Moreover, debt markets remain stagnant and concerns over financial market actors are heightened even in a period of rapidly surging asset prices and loose monetary policy stance, thereby suggesting persistent volatility in global risk perceptions, thus confirming the significance of adopting a flexible monetary policy framework.

1.1. Monetary Policy Implementation and Monetary Conditions

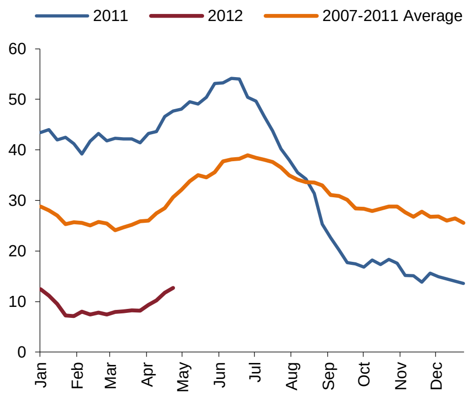
Against heightening macro financial risks in the first half of 2011, the Central Bank of the Republic of Turkey (CBRT) aimed at steering the economy gradually towards a more balanced growth composition. Accordingly, in order to slow down loan growth, necessary measures were adopted with the support of other institutions. Moreover, policies were implemented against excessive deviation of exchange rates from economic fundamentals in either direction (Charts 1.1.1 and 1.1.2).

Chart 1.1.1.
TL and Emerging Market Currencies*
(11.01.2010=1)



* Emerging economies include Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, Indonesia, South Korea, Colombia and Turkey. Increases denote depreciation of the currency.
Source: Bloomberg, CBRT.

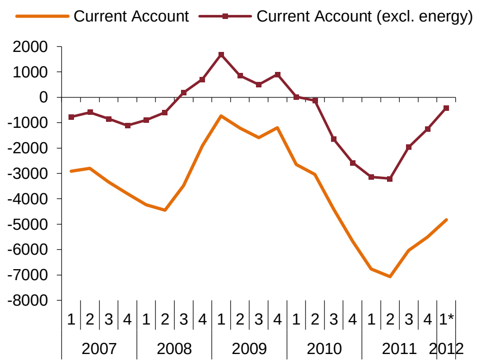
Chart 1.1.2.
Consumer Loan Growth
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)



Source: CBRT.

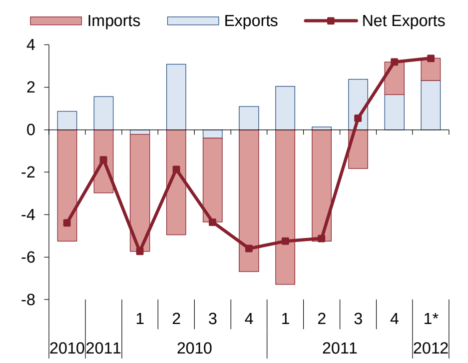
New data releases in the inter-reporting period indicate that the balancing process in the economy continues as envisaged. Accordingly, loan growth has slowed down significantly since the second half of 2011, thereby improving the current account balance remarkably (Chart 1.1.3). Domestic demand growth was controlled in this period, while the contribution of net exports increased markedly (Chart 1.1.4). In other words, the composition of growth assumed a robust outlook.

Chart 1.1.3.
Current Account Balance
(Seasonally Adjusted, Billion USD)



* As of February.
Source: TurkStat, CBRT.

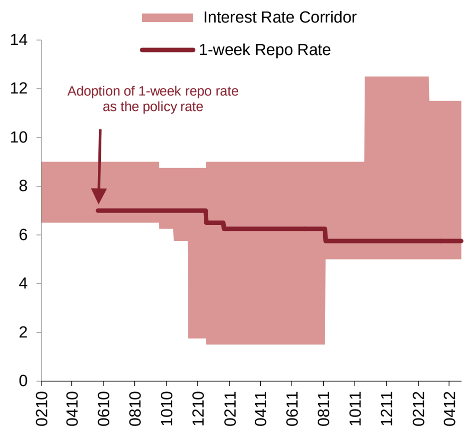
Chart 1.1.4.
Contribution of Net External Demand to Annual GDP Growth (Percent)



* Estimate.
Source: TurkStat, CBRT.

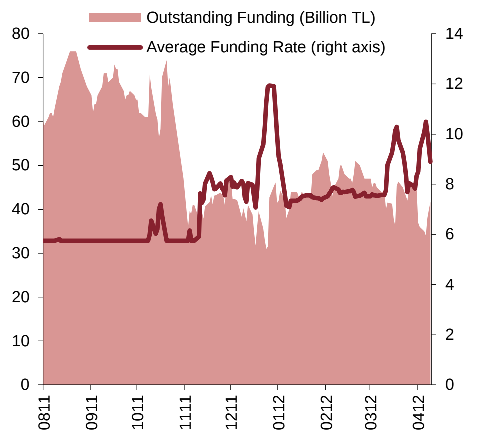
Having achieved the desired outcomes with respect to alleviating macro financial risks, monetary policy has focused on maintaining price stability as of October 2011. The cumulative effects of the rises in import prices and the depreciation of the Turkish lira, tax adjustments in administered prices (tobacco and energy items) and hikes in unprocessed food prices led to a surge in inflation in the last quarter of the year. Although these developments are mostly temporary, the resulting high inflation brought about the risk of deterioration in inflation expectations. Accordingly, in order to prevent a worsening in the pricing behavior, the CBRT has implemented a strong monetary tightening as of October, by widening the interest rate corridor upwards and effectively using the liquidity operations (Charts 1.1.5 and 1.1.6).

Chart 1.1.5.
CBRT Policy Rate and the Interest Rate Corridor
(Percent)



Source: CBRT.

Chart 1.1.6.
CBRT Funding and the Average Funding Rate
(Percent)

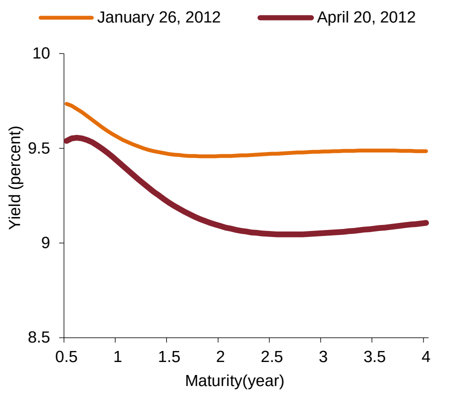


Source: CBRT.

Utilizing the flexibility offered by the interest rate corridor, an additional monetary tightening has been delivered three times since October (in December, March and April) (Chart 1.1.6). During the episodes of additional monetary tightening, the CBRT significantly raised the average cost of liquidity provided to the market by reducing the funding supplied through quantity auctions. On the other hand, the upper limit on the interest rate corridor was slightly lowered in February, following the heightening in the global risk appetite owing to the improvement in perceptions regarding the Euro Area debt crisis (Chart 1.1.5). In the meantime, the CBRT still maintained its tight monetary policy stance. Accordingly, in April, the MPC underlined that additional monetary tightening might be implemented more frequently in order to prevent a deterioration in the inflation outlook that may be driven by price adjustments to energy items and other temporary factors. In addition, the MPC stated that it would be appropriate to preserve flexibility in monetary policy in the event that uncertainties regarding the global economy persist.

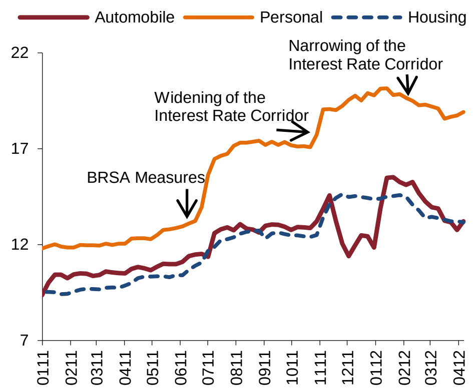
Keeping the interest rate corridor wide, while occasionally implementing additional tightening ensures a tight monetary policy stance. As a matter of fact, the downward slope of the yield curve and the slowdown in consumer loan growth rates as well as the relatively high interest rates on loans confirm that monetary and financial conditions are tight (Charts 1.1.7 and 1.1.8).

Chart 1.1.7.
Yield Curve*



* Calculated from the compounded returns on bonds quoted in ISE Bonds and Bills Market by using Extended Nelson Siegel (ENS) method.
Source: ISE, CBRT.

Chart 1.1.8.
Consumer Loan Rates
(Flow, Annualized, Percent)



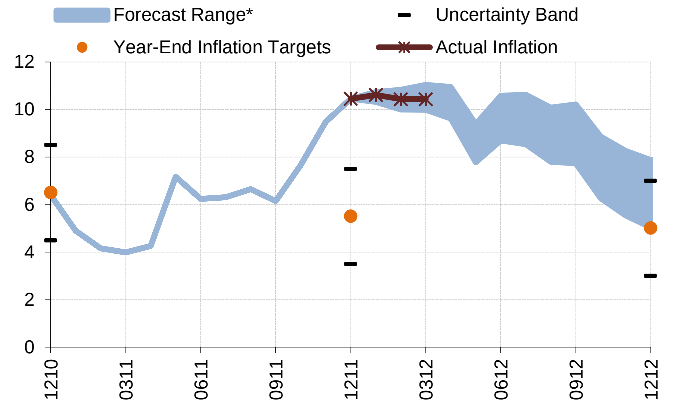
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the first quarter of 2012, inflation remained in tandem with the January Inflation Report projections, standing at 10.43 percent at end-March (Chart 1.2.1). The higher-than-envisioned increases in oil prices in this period drove energy prices above projections. In the meantime, unprocessed food prices followed a more favorable course than envisaged.

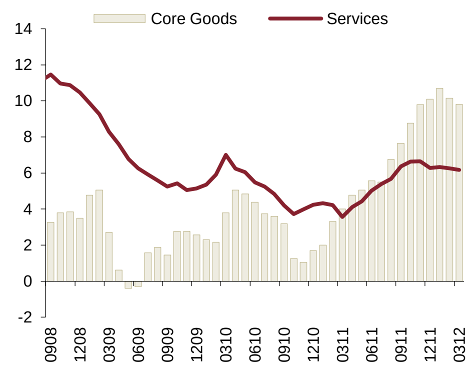
Chart 1.2.1.
January 2012 Inflation Forecasts and Realizations (Percent)



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

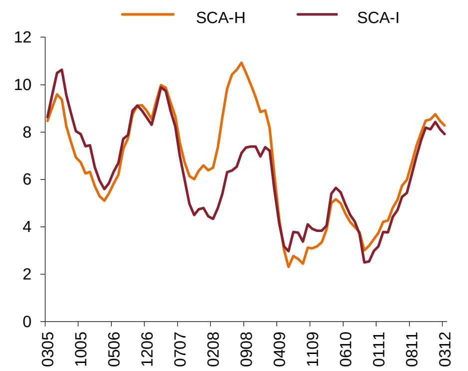
As the cumulative effects of exchange rate movements faded, the annual core inflation trended downwards in the first quarter of the year. Meanwhile, prices of services maintained a mild course (Chart 1.2.2). Against these developments, core inflation indicators exhibited a downward trend after an extended period (Chart 1.2.3).

Chart 1.2.2.
Prices of Core Goods and Services
(Annual Percent Change)



Source: TurkStat, CBRT.

Chart 1.2.3.
Core Inflation Indicators SCA-H and SCA-I
(Annual Percent Change)

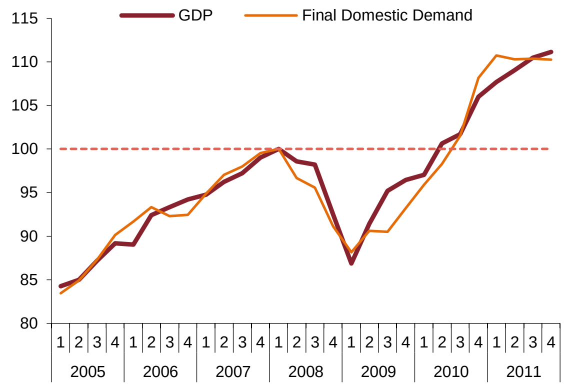


Source: TurkStat.

Supply and Demand

National income data regarding the last quarter of 2011 indicate that aggregate demand conditions were broadly in line with the outlook presented in the January Inflation Report. Economic activity, which continued to decelerate owing to weaker domestic demand, sustained its growth at a slower pace due to the positive contribution of net exports (Chart 1.2.4).

Chart 1.2.4.
GDP and the Final Domestic Demand
(Seasonally Adjusted, 2008Q1=100)



Source: TurkStat, CBRT.

Industrial production data regarding early-2012 indicate that economic activity was weaker than expected in the first quarter of the year. Nevertheless, this is considered to stem largely from temporary factors like unfavorable weather conditions and uncertainties regarding global economy. Hence, a mild recovery is expected as of the second quarter. Indeed, the upward course of the indicators on orders and consumption goods for February and March points that the decline in the economic activity is temporary.

In the first quarter of the year, the indicators for the global economy and external demand were also in line with the expectations. Growth rates in both advanced and emerging economies continued to slow down, while the Euro Area growth outlook especially remained weak.

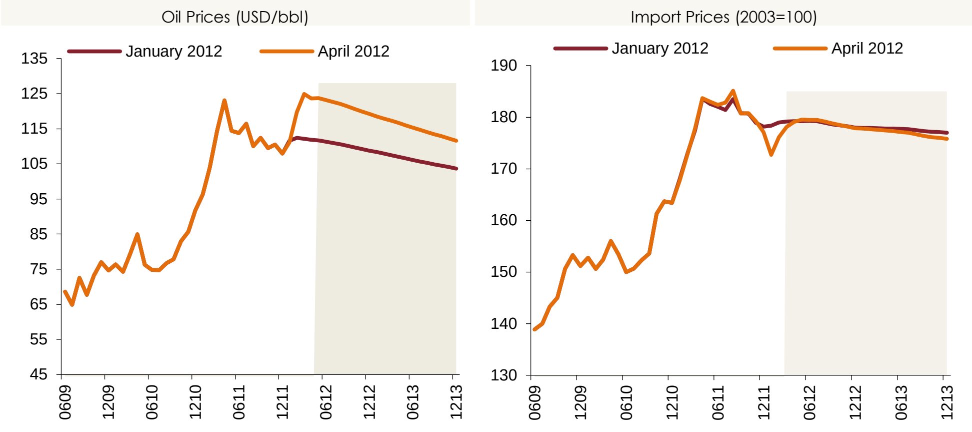
In sum, the outlook for domestic and external economic activity remained broadly unchanged in the inter-reporting period. Accordingly, as in the previous reporting period, inflation forecasts are based on the assumption that the economy will assume a mild path of growth by the second quarter and aggregate demand conditions will continue to support the fall in inflation.

Commodity, Import and Food Prices

Since the publication of the January Inflation Report, oil prices remained significantly above the assumed path due to supply-side developments (Chart 1.2.5). Accordingly, oil price assumption, which was USD 110 per barrel in the previous reporting period, was increased to USD 120 per barrel for 2012, and

USD 115 per barrel for 2013. The contribution of this revision to the inflation forecast for end-2012 was 0.4 percentage points on the upside. On the other hand, in tandem with the decline in non-energy import prices, import price index displayed a better-than-expected course (Chart 1.2.5), pulling down the inflation forecast for end-2012 by around 0.2 percentage points. Meanwhile, import price projections based on commodity futures remained broadly unchanged in the inter-reporting period.

Chart 1.2.5.
Revisions to Oil and Import Price Assumptions*



* Shaded region indicates the forecast period.
Source: Bloomberg, CBRT.

* Shaded region indicates the forecast period.
Source: TurkStat, CBRT.

In sum, despite the better-than-expected prices in non-energy imports in the first quarter of the year, import prices slightly pulled up the inflation forecast for end-2012, due to the upward revision in energy prices, which have a stronger effect on the consumer price index. Meanwhile, the assumption for annual food inflation was maintained as 7.5 percent throughout the forecast horizon.

Fiscal Policy and Tax Adjustments

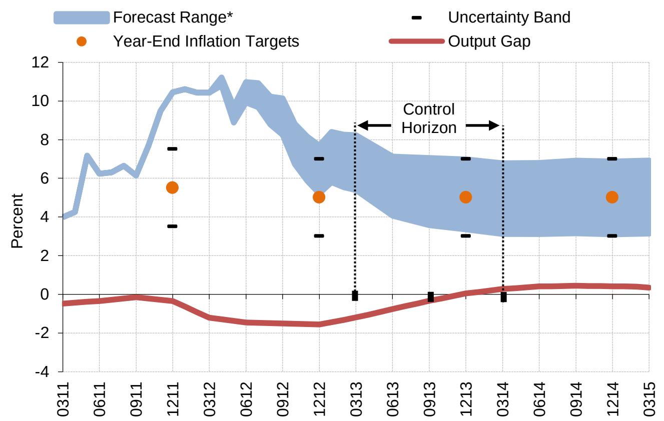
Regarding the fiscal outlook, the medium-term inflation forecasts take the revised projections of the MTP as given. Hence, the baseline scenario envisages that the ratio of primary expenditures to GDP will remain flat, and the structural budget balance will not deteriorate. Moreover, the stipulated tax cuts and government incentives within the new incentive system, which was publicly announced on April 5, are considered to have no adverse effects on the fiscal balance.

Tobacco prices are assumed to remain constant throughout 2012 amid tax adjustments to tobacco products in October 2011, while increasing in January 2013 as implied by the tax adjustments in October 2011. Furthermore, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms.

1.3. Inflation and Monetary Policy Outlook

Forecasts are based on the assumption that additional monetary tightening will be implemented more frequently, and consequently, annualized loan growth rate will hover around 14 percent. Accordingly, inflation is expected to be, with 70 percent probability, between 5.3 and 7.7 percent (with a mid-point of 6.5 percent) at the end of 2012, and between 3.4 and 7.0 percent (with a mid-point of 5.2 percent) at the end of 2013. 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.

Overall, notwithstanding the adverse effect of the upward revisions to energy prices in 2012, the year-end inflation forecast was kept unchanged at 6.5 percent, envisioning that an additional monetary tightening would be implemented to counterbalance this effect. In this respect, the inflation forecast is based on the assumption that loans will grow milder, and aggregate demand conditions will further support disinflation compared to the previous reporting period.

Inflation is expected to follow a highly volatile course in the second quarter. The direct effects of electricity and natural gas price hikes in April will be around 0.5 percentage points to consumer inflation. Therefore, inflation will temporarily increase, reaching its peak in April. Due to base effects in unprocessed food prices, annual inflation is expected to display a sharp fall in May, while increasing back in June (Chart 1.3.1).

Inflation is expected to follow a downward course, as the tight monetary policy implemented by the CBRT since October contains the second round effects, and hence, the cumulative impacts of the temporary price movements taper off. Accordingly, inflation will decline gradually starting from the third quarter, assuming a markedly downward trend by the final quarter of the year (Chart 1.3.1).

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

The high course of inflation and the recent deterioration in the short-term inflation expectations pose risk on the pricing behavior. Due to sharp price increases in the third quarter of 2011, inflation is envisioned to remain remarkably above the target until the last quarter of 2012, requiring a close monitoring of the pricing behavior. Although the delivered monetary tightening of the CBRT since October, besides mild domestic demand conditions have alleviated upside risks on inflation by containing secondary effects, inflation expectations will be cautiously and carefully monitored in the upcoming period, and necessary measures will be taken to keep medium-term inflation outlook consistent with the target.

Ongoing uncertainties regarding global economy require further flexibility in monetary policy against volatility in capital flows. Notwithstanding the alleviating concerns regarding the Euro Area sovereign debt problem in the first quarter of 2011, the unfavorable course of growth as well as the currently elevated borrowing costs across the region keep debt sustainability debates alive. Moreover, ongoing deleveraging in the Euro Area banking system feeds into financial fragilities, increasing the probability of a renewed deterioration in the risk appetite. On the other hand, the risk appetite may recover faster than expected, should problems regarding the global economy are solved sooner and more decisively than envisaged. Overall, the possibility that global capital flows will continue to be volatile in the forthcoming period confirms the appropriateness of the existing flexibility in the monetary policy framework. Hence, the CBRT will continue to monitor global developments closely, and take the required measures promptly.

Another risk factor in the forthcoming period is the uncertainty regarding oil prices. Although the weak course of the global economy largely contains the upside risks to commodity prices, ongoing supply-side problems pose upside risk to energy prices in the short term. Should such a risk materialize, the CBRT will not react to temporary price movements, yet will not tolerate any deterioration in expectations.

Unprocessed food prices pose downside risk to inflation outlook over 2012. The probability for a downward correction in unprocessed food prices after hitting the recent-high in end-2011, besides the favorable precipitation during the recent months, increase the likelihood of a better-than-envisioned course for unprocessed food prices throughout the year. Inflation may reach the target faster than projected in the baseline scenario, should the food prices follow a more favorable course than expected.

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

Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving deficit will contribute to the relative improvement of Turkey's sovereign risk, thereby supporting price stability and the financial stability. Making progress in this direction will also provide room for monetary policy maneuver and support social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, taking necessary steps towards implementation of the structural reforms envisaged by the MTP is of utmost importance.