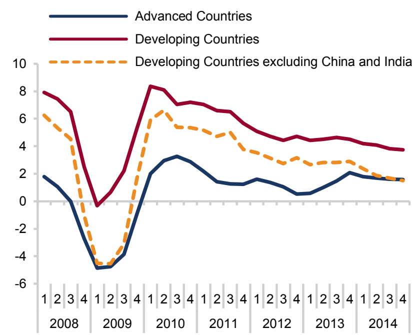
I. Macroeconomic Outlook

The global economy displayed a moderate growth in 2014 while the discrepancies continue between recovery trends of countries. Inflation in advanced economies hovers below the target rates owing to the fall in commodity prices, especially oil prices. In emerging markets, however, inflation rates display an uptrend due to the depreciation in national currencies. The discrepancies between growth and the inflation outlook are reflected in national monetary policies of advanced economies. Global markets remain highly sensitive to data flows due to these developments coupled with low predictability in global economy and elevated uncertainties. Consequently, the volatility in risk perceptions and capital flows persists. The global economic developments offer both opportunities and challenges to emerging economies. The low oil prices are positively affecting the inflation, current account deficit and growth outlook of emerging economies that import commodities. Meanwhile, subdued global economic activity poses a downside risk to the growth prospects of the emerging economies via the foreign trade channel. The significant appreciation of the US dollar against all other currencies on the global foreign exchange market stands out as a risk factor for those emerging economies running a high level of FX indebtedness.

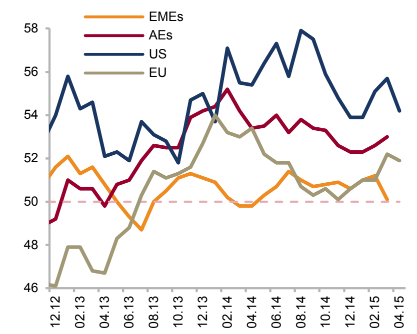
In Turkey, economic activity remains moderate. Weak export trend is the main factor decelerating growth. While aggregate demand conditions are underpinning disinflation; food prices and the lagged effects of exchange rate developments curb improvement in the inflation outlook. While portfolio flows to Turkey remain weak, there are fluctuations in the risk premium and the value of the Turkish lira. The CBRT sustains its cautious monetary policy stance and maintains a tight monetary policy to curb the impact of the volatility in the global markets on Turkey's inflation outlook and inflation expectations. While the current account deficit is improving on the back of the cautious monetary stance coupled with the sustained macroprudential measures, the risk premia remains low thanks to the fiscal discipline and the banking sector's strong position. In the upcoming period, the course of economic activity and

Chart I.1.1
Global and Advanced Economies' Growth Rates[1]
(Percent, Annual)



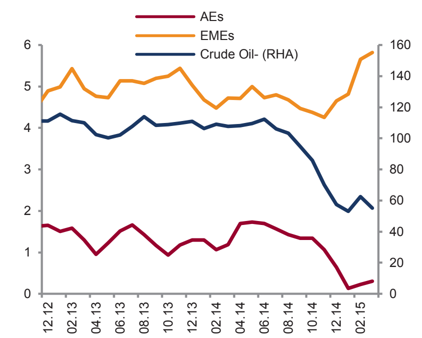
(1) Weighted by each country's share in global GDP.
Source: Bloomberg, CBRT.

Chart I.1.2
Manufacturing Industry PMI Indices



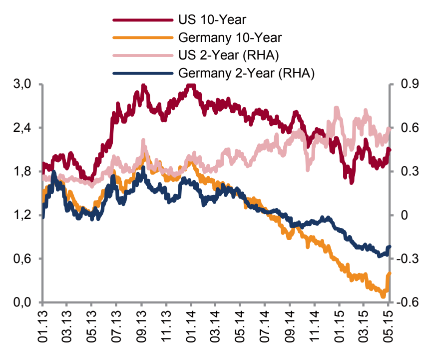
Source: Bloomberg

Chart I.1.3
Inflation in Advanced and Emerging Economies and Crude Oil Prices (Percent, Annual, USD)



Source: Bloomberg

Chart I.1.4
US and Germany Treasury Bond Yields
(Percent)



Source: Bloomberg

the volatility in the markets will be the factors affecting financial stability. While the CBRT maintains its cautious monetary stance on one hand, on the other it aims to mitigate macro-financial risks by introducing measures supporting foreign exchange liquidity, core liabilities and long-term borrowing.

I.1. International Developments

Global growth realized at moderate levels in 2014 and the recovery trends in the economic activity of countries has continued to diverge. The USA enjoys a stronger growth performance compared to other advanced economies. Despite signs of recovery, growth in the euro area is still subdued. The growth pace of advanced economies, which comprises 75 percent of global growth, is slowing down (Chart I.1.1). The manufacturing industry PMI indices exhibit signals that the slowdown in the growth pace of the emerging economies will likely continue throughout 2015. However, the manufacturing industry PMI indices for advanced economies suggest that the economic outlook in the euro area may improve whereas recovery in the USA will likely lose some pace (Chart I.1.2).

Inflation outlook in advanced economies and emerging economies diverge significantly. The decline in commodity prices, particularly in oil prices, reduces inflationary pressures. Moreover, inflation rates in advanced economies remain below targets due to weak demand in countries like the euro area and Japan. However, inflation rates in emerging economies, display an uptrend due to the depreciation in national currencies (Chart I.1.3).

The monetary policies of advanced economies diverge due to the discrepancies in the growth and the inflation outlook. The ECB drove lending rates down to negative and expanded the asset purchase program that it initiated in October 2014 by including public sector bonds. Interest rates in the euro area are falling rapidly on the back of monetary expansion and the fall in inflation expectations (Chart I.1.4). On the other hand, the Fed is giving signals of a start of an interest rate hike with the improvement in the US economy. Overall, these developments have led to the appreciation of US dollar against the euro

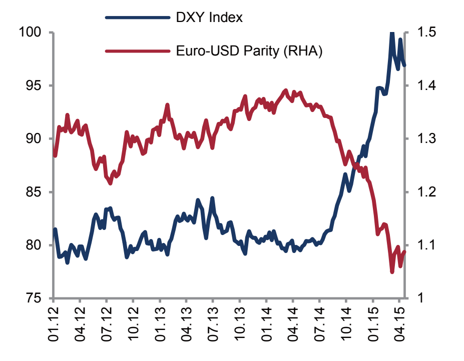
(Chart I.1.5). Even though the change in the euro / US dollar parity is welcomed as this will support recovery in the euro area, there is not a noteworthy improvement in credit supply yet. The high NPL ratios in the balance sheets of the banks in the euro area prevents effective operating of the credit market.

The implementation of an effective communication strategy by the Fed regarding its monetary policy is of crucial importance. The low inflation trend coupled with lower-than-expected US data is elevating uncertainties over the normalization process of the US monetary policy. These uncertainties lead to a discrepancy between the expectations of the Federal Open Market Committee members and those of the market. Market participants are expecting a smoother increase in the Federal funds rate than the FOMC members (Chart I.1.6). An earlier and faster than expected rise in the rate might lead to fluctuations in the global financial system.

Capital movements in emerging economies have been fluctuating due to the uncertainties in the United States' monetary policy. Moreover, currencies of emerging economies have depreciated and exchange rate volatility has increased in these countries. Nevertheless, the depreciation in currencies of the emerging economies was partly offset when the FMOC members revised their interest rate expectations downwards in the March meeting. The CDS premiums of emerging economies is rising due to capital outflows (Chart I.1.7 and I.1.8). Expectations for the Federal funds rate, growth performances of emerging and advanced economies and commodity prices will have a significant impact on the global risk appetite as well as the capital flows toward emerging economies.

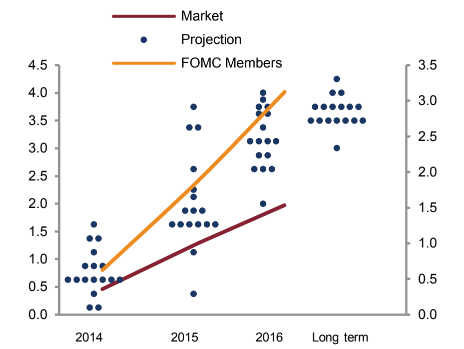
The differences between monetary policies of advanced economies increase the sensitivity of emerging markets to exchange rate. FX borrowing in most of the emerging economies has moved upwards compared to the pre-crisis period (Chart I.1.9). Appreciation of the US dollar increases the debt burden of emerging economies and accordingly, some concerns about roll-over of especially short-term debts. In this framework, amid the current global low interest rate environment, extending

Chart I.1.5
EUR/USD Parity and DXY Index



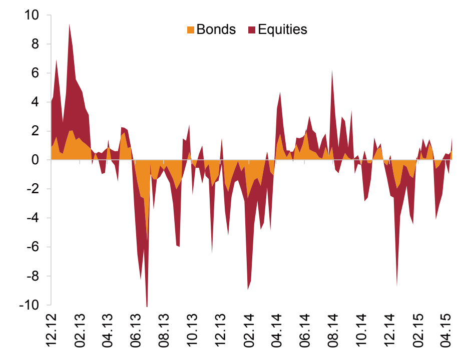
Source: Bloomberg

Chart I.1.6
Expectations of the FOMC Members and the Market
(End-year, percent)



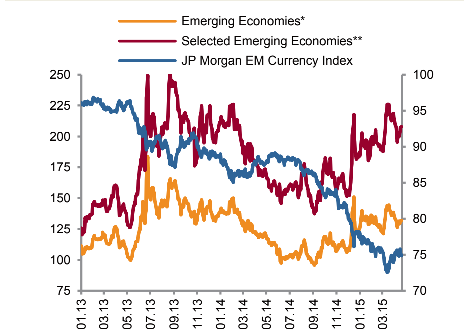
* Fed fund futures rates have been used for market expectations. Median of FOMC Members' interest rate expectations have been used.
Source: CME Group, Fed

Chart I.1.7
Capital Flows to Emerging Economies
(Weekly, Billion USD)



Source: EPFR

Chart I.1.8
CDS Premiums for Emerging Economies and JP Morgan Exchange Rate Index

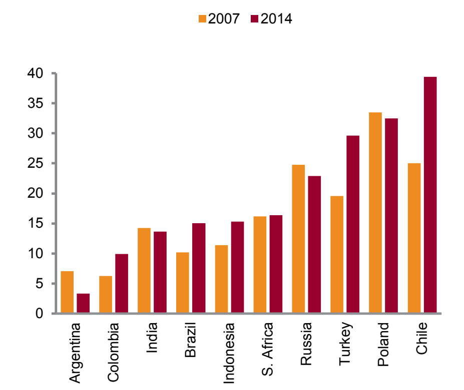


Source: Bloomberg
* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania, Chile and Turkey.
**CDS premia of Brazil, Indonesia and South Africa have been used to calculate the average of selected emerging economies.

foreign debt maturities and supporting prudent borrowing will strengthen financial stability.

The global economic developments offer both opportunities and challenges for emerging economies. The decline in commodity prices, particularly in oil prices, reduces upside risks in inflation in emerging economies that are importing commodities. Moreover, this decline is expected to have a positive impact on the current account deficit and the growth. Recovery in the US economy and the signs of recovery in the euro area due to measures taken will make a positive effect on the growth outlook of emerging economies.

Chart I.1.9
FX Indebtedness of Households and the Corporate Sector
(Percent of GDP)

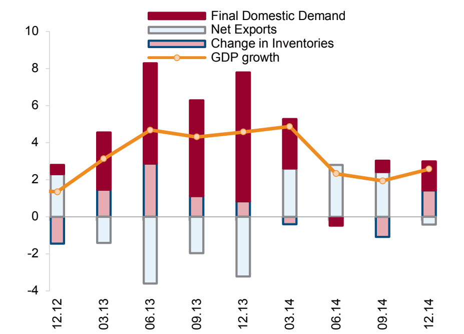


Source: IMF

I.2. Domestic Developments

Growth was slightly slower in 2014 compared to 2013. Despite the weak external demand, net exports contributed positively to growth (Chart I.2.1). Industrial production slightly accelerated in the first quarter of 2015. This acceleration was mainly driven by the robust vehicle production. While consumer confidence and investment tendency implies moderate private sector domestic demand, the leading indicators suggest that external demand is relatively weak. The weak global economic activity coupled with the geopolitical developments pulls down growth by curbing exports growth. The excessive volatility in the euro/dollar parity is also adversely affecting exports. Signs of recovery in the euro area are expected to be one of the factors supporting external demand in the upcoming period. An analysis of the developments in economic activity with respect to labor market reveals that the unemployment rate climbed because the rise in employment in 2014 fell short of the growth in the labor supply. Recently, both industrial production data and survey results point to a moderate recovery in the labor market.

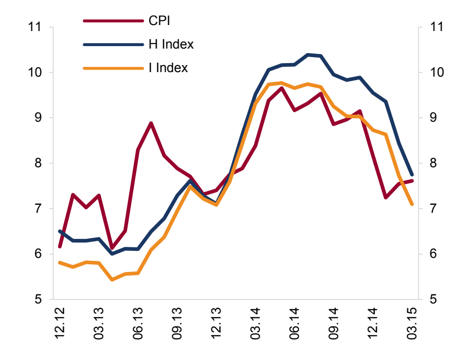
Chart I.2.1
Contribution to Growth From The Spending Side
(Percentage Point)



Source: CBRT, TURKSTAT

Despite the decline in demand, the fall in inflation was more limited than forecasted due to cost-side pressures. The cautious monetary and fiscal policies coupled with the macroprudential measures are having a positive impact on core inflation indicators (Chart I.2.2). Moreover, the low level of commodity prices underpins the improvement in inflation.

Chart I.2.2
Price Indices
(Annual Percentage Change)



Source: CBRT, TURKSTAT

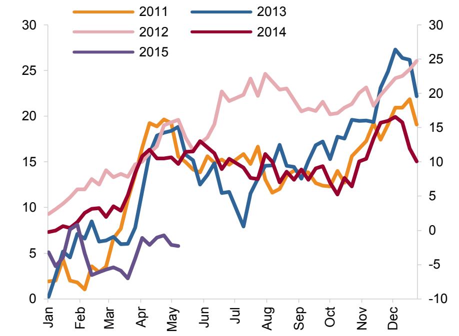
Nevertheless, the high level of food inflation and the lagged effects of exchange rate developments on domestic prices curb further improvement in the inflation outlook. A significant correction in food prices is expected to take place in the near future as the adverse weather conditions seem to have subsided and the Food Committee started to operate. But still, food prices and exchange rate volatility continue to be the primary risk factor on inflation outlook.

While portfolio flows to Turkey remain weak, there are fluctuations in the risk premium and the value of the Turkish lira. Uncertainties over the normalization process of the Fed's monetary policy lead to fluctuations in financial markets. The Turkish lira has depreciated against the US dollar and has displayed a more stable trend against the euro (Chart I.2.3 and I.2.4). Meanwhile, the yield from government domestic debt securities has increased significantly.

The CBRT has sustained its cautious monetary policy stance by maintaining a tight liquidity policy. The CBRT introduced measured rate cuts in the first quarter of 2015 and maintained the yield curve almost flat by sustaining the cautious monetary policy (Chart I.2.5). The cautious stance in the monetary policy need to be maintained taking into account the adverse impact of the global uncertainties and exchange rate volatility on core inflation and the fluctuations in energy and food prices. In addition, the CBRT has introduced some additional measures for the FX liquidity in response to the elevated exchange rate volatility. While the export rediscount credits continue to contribute to the CBRT's FX reserves, these reserves can be used as a supporting tool in times of excessive volatility.

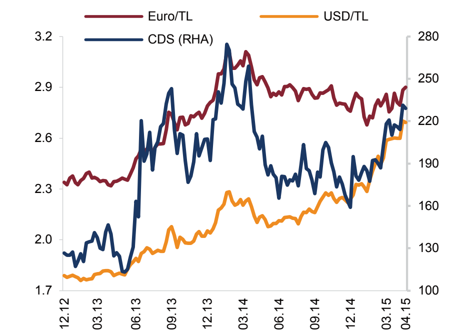
The current account balance has been improving. The decline in commodity prices are having favorable impacts in terms of the current account deficit, inflation and growth in Turkey (Chart I.2.6). The credit growth, which was kept at reasonable levels by maintaining the cautious monetary policy stance and the macroprudential measures, contributed to the recovery in the current account balance. The financing of the current account deficit is mostly made by long-term sources.

Chart I.2.3
Cumulative Portfolio Flows[1]
(Billion USD)



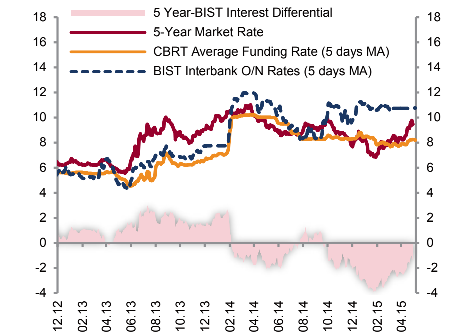
(1) Calculated by weekly net portfolio flows. Includes data on repo, GDDS and securities portfolio as well as banks' off-balance sheet FX position.
Source: BRSA, CBRT

Chart I.2.4
Exchange Rates and Turkey's 5-Year CDS Prices



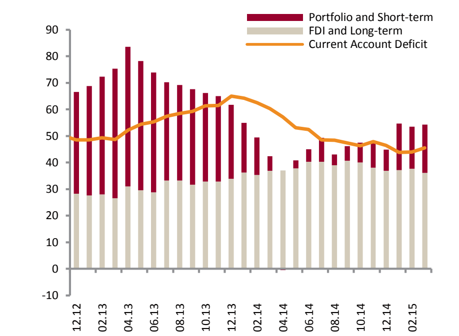
Source: CBRT, Bloomberg

Chart I.2.5
CBRT Rates and BIST Interbank O/N Rates
(Percent)



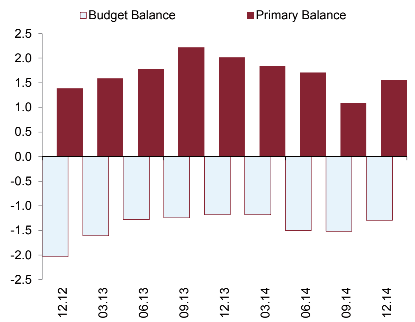
Source: CBRT, BIST

Chart I.2.6
Current Account Deficit and Financing Items
(12-Month Cumulative, Billion USD)



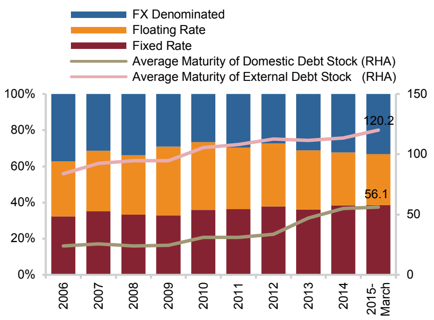
Source: CBRT

Chart I.2.7
Central Government Budget Balances
(12-Month Cumulative, Percent of GDP)



Source: Ministry of Finance

Chart I.2.8
Composition of Central Government Debt Stock and Average Days to Maturity[1] (Month)



(1) Data of days to maturity pertains to October 2013.
Source: Undersecretariat of Treasury

The fiscal discipline contributes to bringing down both the risk premium and inflation. Even if the central government budget deficit slightly increased, it was still below the pre-defined target (Chart I.2.7). The downward tendency in public debts continues. The fact that borrowing is mostly in fixed rate, TL denominated and has long maturities contributes to financial stability (Chart I.2.8).

The course of the economic activity and level of volatility in financial markets will be the key factors affecting financial stability in the upcoming period. From the economic activity stance, external demand remains weak while domestic demand offers a moderate support to growth. Volatility in financial markets might curb the contribution of the private sector final demand to growth. Meanwhile the weak global demand conditions are having negative impact on external demand. The recent signs of recovery in the euro area might be promising for external demand. The global uncertainties, the risk appetite and volatility in capital flows still persist. While the CBRT maintains its cautious monetary stance on one hand, on the other, it aims to mitigate the macro-financial risks by introducing measures to support foreign exchange liquidity, core liabilities and long-term borrowing. In the upcoming period, the macro-financial risks will be closely monitored and additional measures will be introduced if required.