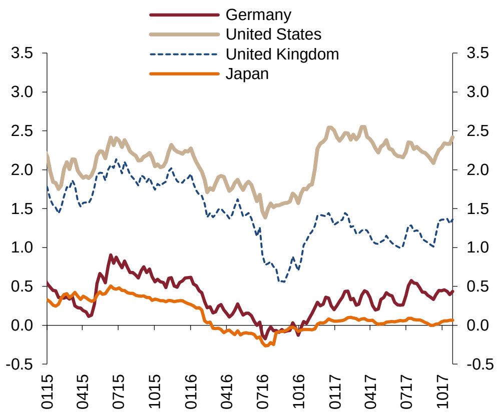
1. Overview

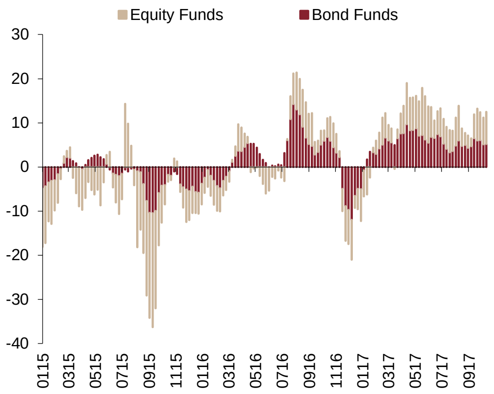
Recently, the prominent recovery in advanced economies coupled with the uptrend in global trade volume implies a promising global economic growth performance, albeit more limited than the previous report. Despite rises in oil and other commodity prices, global inflation rates remain moderate in this reporting period. However, the communication after the September FOMC meeting has shown that the Fed is sticking to its projected normalization plan, which caused a limited rise in market volatility and bond rates of advanced economies (Chart 1.1). Still, portfolio inflows to emerging economies have remained robust in recent times, thanks to the sustained global risk appetite (Chart 1.2).

Chart 1.1.
10-Year Bond Rates
(Percent)



Source: Bloomberg.

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



Source: EPFR.

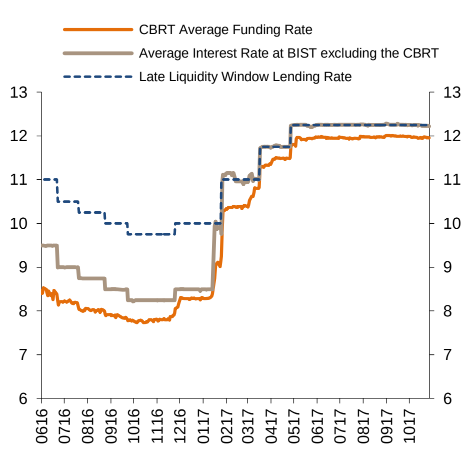
Changes in perceptions regarding the normalization in monetary policies of major economies increased the risk premiums of emerging economies to some extent, while Turkey diverged negatively due to geopolitical risks. Portfolio inflows to Turkey lost pace in the inter-reporting period, yet remained above past years' averages in cumulative terms. Credit use appeared to be balanced at historical averages as Credit Guarantee Fund-guaranteed loans hit the upper limit and the loan demand of enterprises was normalized in the third quarter. Despite the tight monetary policy, developments in banks' lending conditions paved the way for aggregate financial conditions in Turkey to continue to support economic activity in the third quarter.

After hitting the lowest level in July, consumer price inflation climbed to 11.2 percent in September due to the depreciation in the Turkish lira against the exchange rate basket and soaring import prices, mainly oil and base metals. In addition to cost-side pressures, the disinflationary contribution from demand conditions has disappeared as a result of the robust course of economic activity. Indicators of economic performance show that the economy was strong in the third quarter and the recovery has become more widespread across sectors. However, as the stimulating effect of accommodative policies will fade in the last quarter, domestic demand is likely to lose some momentum, yet continue to be the main driver of growth. Net exports on the other hand, are expected to contribute to growth further, particularly thanks to the rebound in the tourism sector, the improvement in global growth prospects, and the competitive level of exchange rates.

1.1. Monetary Policy and Financial Markets

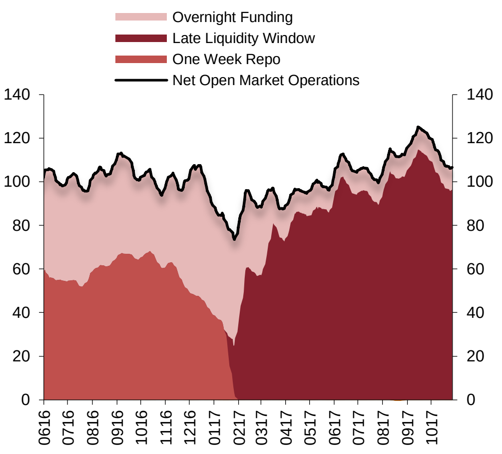
To prevent the cost-induced rise in inflation, the CBRT opted for gradual monetary tightening from January to April 2017. In the following months, the CBRT decided to maintain the tight monetary policy stance with unchanged policy rates owing to the high levels in inflation and the risk posed by the developments in core inflation indicators to the pricing behavior (Chart 1.1.1). In addition, the CBRT strengthened the caution level of its monetary policy stance with the communication conducted in recent months. As in the previous reporting period, the funding provided through the overnight lending rate was kept intact and the CBRT continued to provide the greater portion of the funding need of the system from the LLW (Chart 1.1.2). The CBRT's statements that a tight monetary policy stance will be maintained until the inflation outlook improves significantly and the fact that funding is made mostly through one channel (LLW) alleviate the uncertainty about the monetary policy.

Chart 1.1.1.
Short-term Interest Rates
(5-Day Moving Average, Percent)



Source: BIST, CBRT.

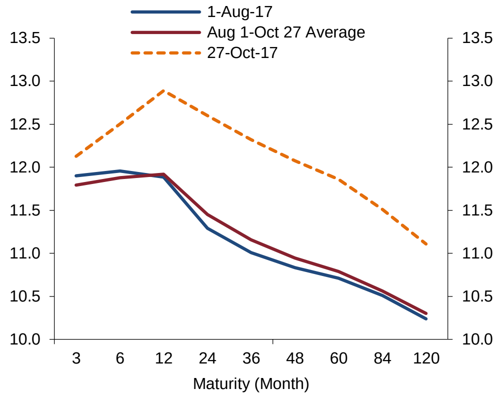
Chart 1.1.2.
CBRT Funding
(2-Week Moving Average, Billion TL)



Source: CBRT.

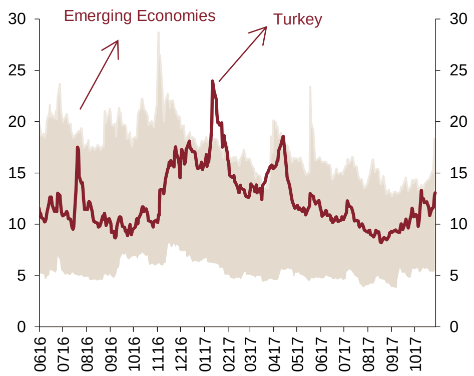
Since the second half of September, geopolitical developments and statements regarding the monetary policy normalization of major economies have caused temporary fluctuations in exchange rate markets. Cross-currency swap yields inched up in the inter-reporting period (Chart 1.1.3). Upon a brisk performance across 2017, currencies of emerging economies have settled on a depreciating trend against the US dollar since September. Due to the geopolitical developments, divergence rose between the Turkish lira and currencies of other emerging economies against the dollar both in terms of currency depreciation and implied exchange rate volatilities (Chart 1.1.4).

Chart 1.1.3.
Yield Curve on Cross Currency Swaps
(Percent)



Source: Bloomberg.

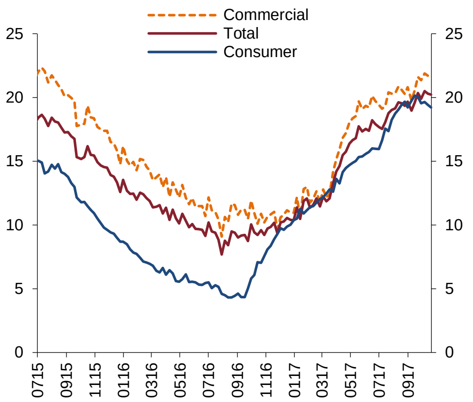
Chart 1.1.4.
Implied FX Volatility*
(1 Month, Percent)



*Emerging economies include Brazil, Chile, Colombia, Mexico, Poland, Philippines, Malaysia, S. Africa, Indonesia, Romania and Hungary.
Source: Bloomberg.

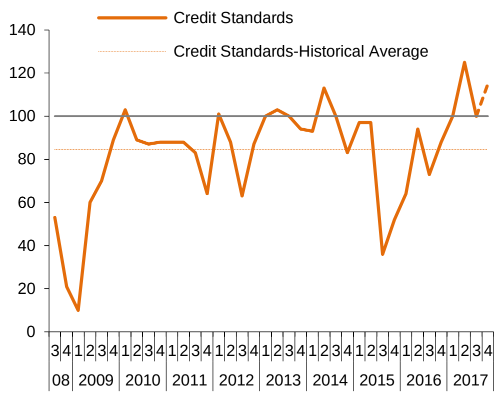
In the third quarter, the Treasury-backed Credit Guarantee Fund facility neared the pre-determined limits, leading to deceleration in commercial loans. On the other hand, lagged effects of macroprudential measures and the improvement in domestic demand caused consumer loans to follow a robust course (Chart 1.1.5). In the second quarter, banks' standards for business loans were loosened compared to both the previous quarter and historical averages with no further easing in the third quarter (Chart 1.1.6). Bank Loans Tendency Survey suggests that demand for retail loans is quite strong, while demand for business loans has been normalized.

Chart 1.1.5.
Annual Credit Growth
(Adjusted for Exchange Rate, Percent)



Source: CBRT.

Chart 1.1.6.
Credit Standards for Loans to Enterprises*



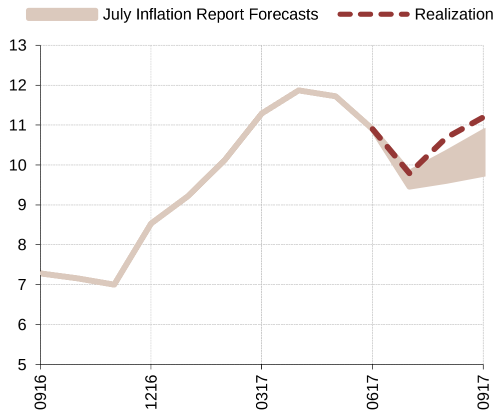
*Fourth quarter data for 2017 is forecast. Index values above 100 indicates easing in loan standards.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

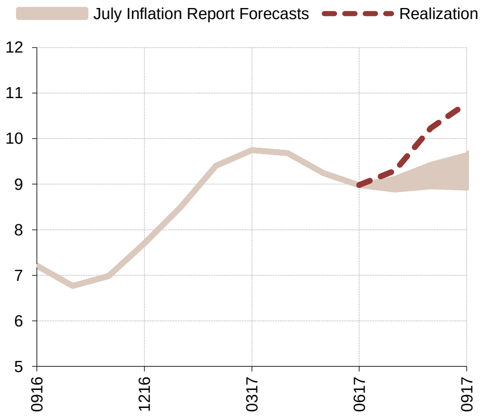
Consumer inflation remained above the July Inflation Report forecasts at 11.20 percent in September (Chart 1.2.1). Consumer inflation excluding unprocessed food, alcoholic beverages and tobacco products proved worse than projections (Chart 1.2.2). Due to the increase in prices of oil and other inputs as well as the depreciation in the Turkish lira against the euro and the robust course of economic activity, annual inflation in core indicators of the energy group stood above forecasts in this period.

Chart 1.2.1.
Inflation Forecasts and Realizations*
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

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

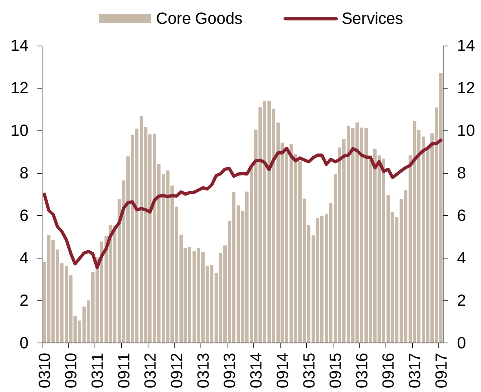


* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

In the third quarter, annual inflation decreased in the food group, but increased in energy, core goods and services groups, which drove consumer inflation upwards compared to the previous quarter (Chart 1.2.1). The surge in oil and other input prices led energy prices to jump significantly, by 3.46 percent. The depreciation in the Turkish lira against the euro in this period transmitted quickly to prices of durable goods that display higher pass-through. In addition, the methodological change in the clothing group also pushed annual inflation in core goods upwards (Chart 1.2.3). Annual services inflation remained on an upward track in the third quarter due to the increases in costs such as food and the exchange rate accompanied by the robust domestic demand and the headline inflation-indexing behavior. On the other hand, price increases spread across the processed food group, yet food inflation proved milder than projected in the July Inflation Report as a result of the relatively positive outlook in fresh fruits and vegetables and falling prices of red meat and pulses partly due to the measures taken.

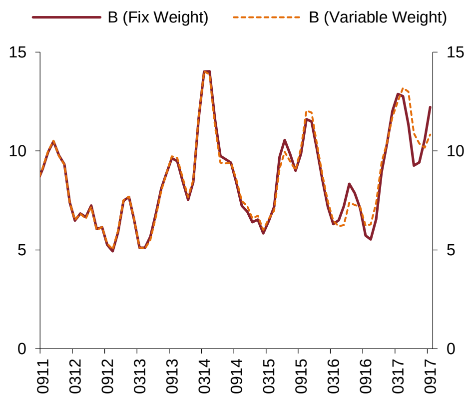
Pressures from producer prices remained elevated in the third quarter particularly through the increase in prices of oil and base metals. The upbeat economic activity eliminated the disinflationary support of demand conditions. Medium term inflation expectations, on the other hand, posted an increase in October after a flat course in the second quarter. Against this background, the diffusion index suggests a stronger tendency of price increases. The rise in the underlying trend of core inflation indicators in this period was triggered by the methodological change in clothing prices. Adjusted for these effects, the core inflation trend receded in July and August, and increased again in September (Chart 1.2.4).

Chart 1.2.3.
Core Goods and Services Prices
(Annual Percent Change)



Source: TURKSTAT.

Chart 1.2.4.
Underlying Trend for B Index
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



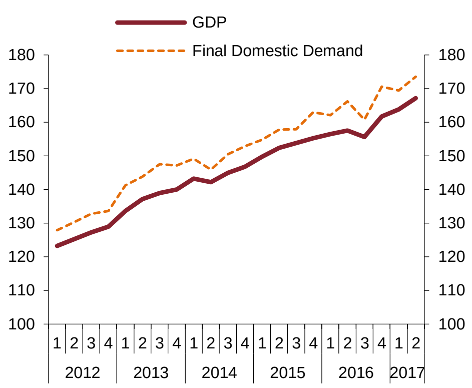
* In January 2017, the weighting system used to incorporate clothing and footwear products in the consumer price index was changed from the "variable weight" method to "fixed weight" method. See the article published on June 6 2017 in the CBRT blog for detailed analysis.
Source: TURKSTAT, CBRT.

In sum, the assessment of monitored indicators of the underlying trend of inflation and the pricing behavior suggests some deterioration on a quarterly basis.

Supply and Demand

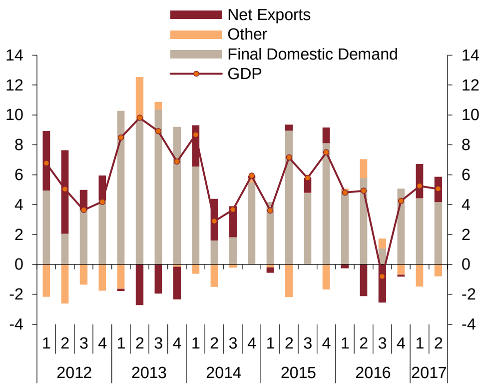
Economic activity in the second quarter proved stronger than the outlook envisaged in the July Inflation Report. GDP grew by 5.1 percent annually and 2.1 percent quarterly in the second quarter of 2017. Unlike the first quarter, quarterly growth is attributed to domestic demand in the second quarter (Chart 1.2.5). The main drivers of growth were private consumption and construction investments in this period, while machinery and equipment investments remained sluggish. Contribution of net exports to growth waned slightly compared to the first quarter due to escalated imports amid the appreciated Turkish lira and improved domestic demand (Chart 1.2.6).

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



Source: TURKSTAT, CBRT.

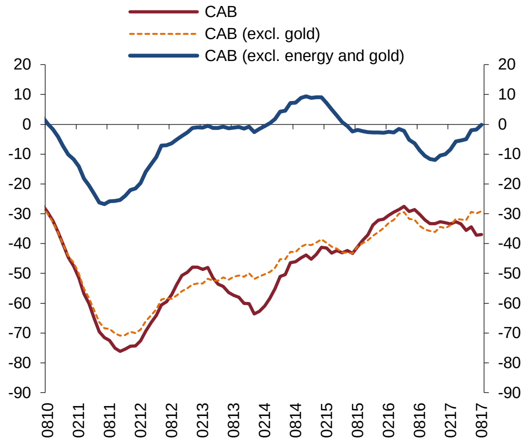
Chart 1.2.6.
Contributions from the Expenditure Side*
(Percentage Points)



* Other item comprises change in stocks and statistical discrepancy due to the use of chain linked index.
Source: TURKSTAT.

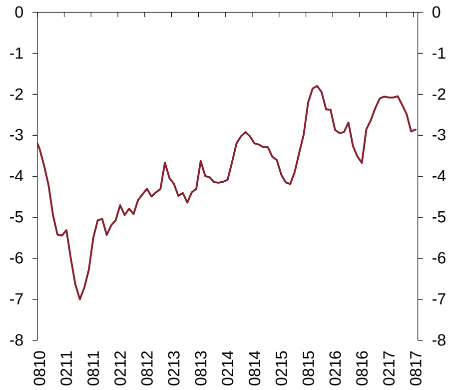
Recent data suggest that economic activity remained robust in the third quarter. Accommodative measures and incentives still had an apparent effect in the third quarter, while growth spread across a wider range of sectors. This period witnessed signs of recovery in machinery-equipment investments, which have been feeble for a long time. On the foreign demand front, despite the favorable course of exports, recovery in imports excluding gold proved more evident and imports of gold surged, which would limit the contribution from net exports to annual growth. These developments may worsen the current account indicators in the last quarter, which have performed well since the start of the year (Charts 1.2.7 and 1.2.8).

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



Source: CBRT.

Chart 1.2.8.
Current Account Balance
(Excl. Gold, SA, 3-Month MA, Billion USD)



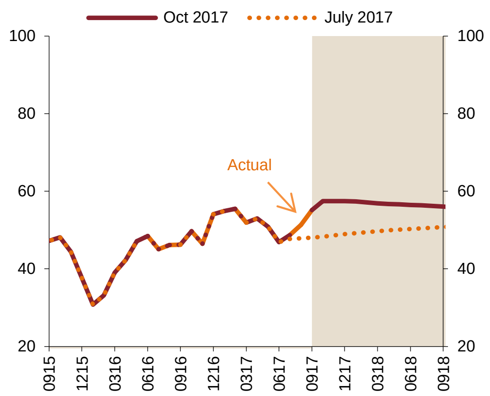
Source: CBRT.

Economic recovery was reflected in the labor market in early 2017, but the recent improvement in the labor market lagged behind that in economic activity which spread across sectors. Lack of strong recovery in small and medium-sized or non-exporting firms is containing the effect of growth on investments and the labor market. It is envisaged that as growth gains stability, employment opportunities will be expanded, investments will be boosted and unemployment rates will decrease further.

Oil, Import and Food Prices

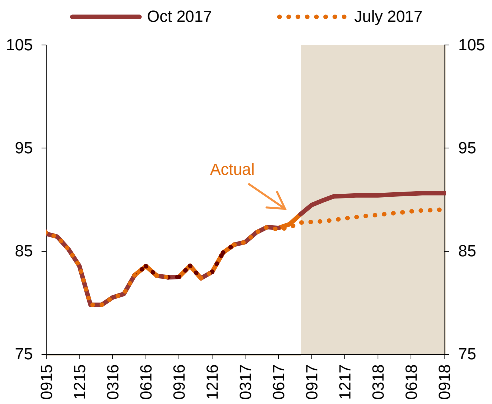
Assumptions for the average crude oil prices in 2017, which were 50 USD in the April Inflation Report, were set as 53 USD for 2017 in light of the recent developments. Moreover, the assumption for the average crude oil price in 2018 is revised up to 55 USD (Chart 1.2.9). Along with crude oil and other energy items, prices of input commodities such as industrial metal have also escalated recently. Thus, the assumption for USD-denominated import prices is also revised upwards for both 2017 and 2018 (Chart 1.2.10).

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



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

Chart 1.2.10.
Revisions in Import Price Assumptions*
(Index, 2010=100)



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

After the rapid rise in the first half of 2017, food inflation slowed to 12.50 percent in the third quarter – coming in slightly below the July prediction –, which is attributed to the slowing unprocessed food inflation driven partly by the measures of the Food and Agricultural Products Markets Monitoring and Evaluation Committee (Food Committee). On the other hand, the robust domestic demand and the recovering tourism industry helped push processed food inflation up in the third quarter. Accordingly, the forecast for food inflation is kept unchanged at 10 and 7 percent for end-2017 and end-2018, respectively.

Fiscal Policy and Tax Adjustments

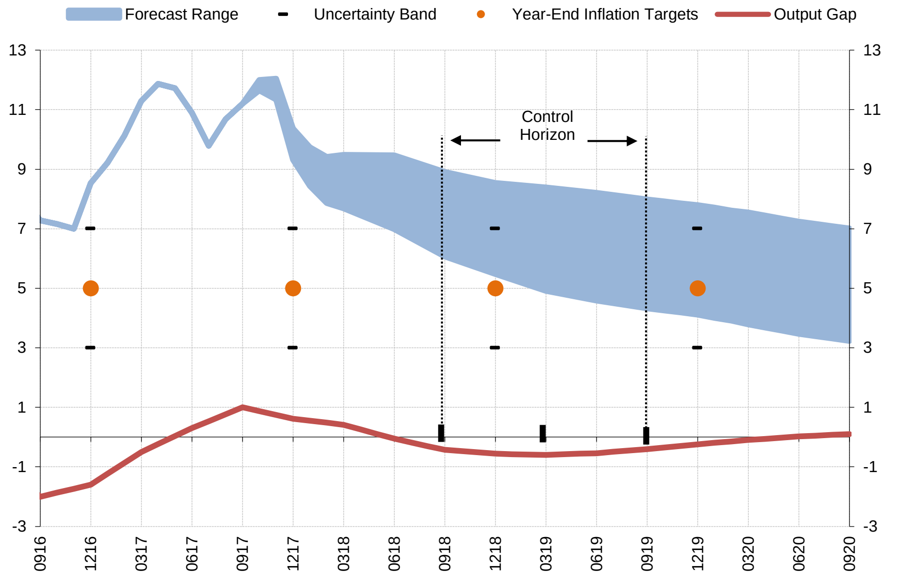
Medium-term projections are based on the assumption that fiscal discipline will be maintained and administered prices and taxes will not be subject to any unanticipated increase. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target 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 estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to be 9.8 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 7 percent by the end of 2018 and to 6 percent the end of 2019. Hence, inflation is expected to be, with 70 percent probability, between 9.3 percent and 10.3 percent (with a mid-point of 9.8 percent) at end-2017 and between 5.5 percent and 8.5 percent (with a mid-point of 7 percent) at end-2018 (Chart 1.3.1).

The year-end inflation forecast is revised upwards by 1.1 points from the July Inflation Report. The key drivers of this updated forecast are the Turkish lira depreciation and the rise in TL-denominated import prices led by surging oil and other commodity prices. The upward revision to the forecast for TL import prices will likely drive the inflation forecast for end-2017 up by 0.5 points. Having been revised up from the previous reporting period amid an improved stance for economic activity, the output gap pushed the end-2017 forecast up by 0.4 points. Moreover, the higher-than-July-forecast inflation realization and the rise in the underlying inflation in the third quarter added 0.2 points to the end-2017 inflation forecast. Accordingly, the year-end consumer inflation forecast for 2017, which was announced as 8.7 percent in the July Inflation Report, is raised to 9.8 percent.

Chart 1.3.1
Inflation and Output Gap Forecasts*
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: CBRT, TURKSTAT.

On the other hand, the consumer inflation forecast for the end of 2018 is revised up by 0.6 points from the July report. More specifically, the assumption for TL-denominated import prices updated in line with higher oil prices pushes the inflation forecast up by 0.4 points. Meanwhile, the upward revision to the output gap is expected to bring the end-2018 inflation forecast up by 0.1 points. In addition, the raised inflation forecast for end-2017 and the rise in underlying inflation has added 0.1 point to the end-2018 inflation forecast. Therefore, the year-end consumer inflation forecast for 2018 is raised to 7 percent from the July's 6.4 percent.

1.4. Risks and the Monetary Policy

The global economic upturn is expected to continue in the rest of 2017 and throughout 2018. Although financial market volatility slightly increased in the third quarter, global financial conditions remain accommodative as the risk appetite is still strong. Despite the third quarter's higher crude oil prices driven by the benign global growth outlook, the OPEC output cut and the hurricanes that hit the US oil production, demand and supply-side factors specific to the oil market are containing the upward pressures on energy prices. On the other hand, risks related to other commodity prices are on the upside due to the global growth outlook.

The primary downside risk to the global economic outlook is the uncertainty surrounding monetary policy normalization across advanced economies. The communication after the September meeting reinforced financial market expectations that the Fed will stick to its previously announced path of normalization. The Fed started reducing the size of its balance sheet in October. If the impending balance sheet downsizing of the Fed and other major central banks is introduced faster than expected, the high risk appetite and low volatility cycle in financial markets may be reversed. In addition to these uncertainties regarding global economic policies, the lack of a clear-cut Brexit strategy, the tendency towards more inward-oriented policies in European economies and the ongoing geopolitical turmoil in Asia and the Middle East stand out as other upcoming downside risks to financial markets and global growth. The fact that the size of private sector debt has reached high levels across some emerging economies, with China in the lead, might aggravate the impact of the risks related to financial markets.

The favorable global economic outlook and trade volume as well as the ongoing global risk appetite prompted an upturn in portfolio flows toward emerging economies recently, but heightened geopolitical risks caused portfolio investments to lose momentum in Turkey. Turkey's portfolio inflows have been more concentrated in government bonds since September whereas flows to the stock market remained volatile and weak. The volatility in the foreign exchange market triggered a rise in long-term inflation compensation. Despite these developments, financial conditions remained mostly accommodative in the third quarter. Loan growth balanced at historical levels in the third quarter, as the loans guaranteed by the Credit Guarantee Fund almost reached the pre-determined upper limit. The strong acceleration of credit growth in the first half of the year and its phase-out in the second half are monitored closely with regard to their impact on aggregate demand and economic activity.

The third quarter's economic activity and aggregate demand were mostly in line with the predictions of the previous Report. After the third quarter, domestic demand might see some slowdown due to the reduced support of the additional credit boost to growth and the termination of tax incentives for durable goods, and the economy is expected to move towards its underlying trend. Both the subsiding effect of the accommodative policies of 2017 and the fiscal measures announced in the recent Medium Term Program (MTP) are being monitored closely with respect to their effect on economic activity. The continued recovery in tourism, the improving global growth outlook and the favorable course of the real exchange rate are expected to contribute further to growth and the current account balance in the coming months through the export channel. The improving perceptions regarding uncertainty will continue to bolster investment in the next quarter, as in the third quarter. As the recovery becomes widespread, it is expected that the favorable tendency will take hold in employment and investment, upholding economic growth. Against this background, uncertainties over monetary policies of major central banks, the course of capital flows and geopolitical developments remain key to economic activity. Exchange rate volatility that may arise from such factors poses a downside risk to the timing and strength of the support that financial conditions could provide to the economic activity.

Following the July Inflation Report, the rise in commodity prices, particularly for oil and metals, and exchange rate changes drove inflation higher through the cost channel, causing core inflation indicators to exceed forecasts. Inflation is expected to remain high in October and November before coming down markedly to a still elevated level in December amid base effects. Base effects from food prices, the termination of temporary tax cuts for home appliances and furniture in October and the methodology change for clothing are the factors that will cause inflation to fluctuate in the short term and core inflation to rise briefly. The inflation outlook is expected to improve gradually from December onwards.

The current elevated levels of inflation and developments in core inflation indicators continue to pose risks to the pricing behavior. These risks and the high levels of inflation expectations might dampen the expected improvement in the inflation outlook from December through the first months of 2018. The fact that inflation expectations and the pricing behavior show no sign of improvement jeopardizes the inflation outlook. All these developments necessitate the maintaining of the tight monetary policy stance. Thus, the CBRT strengthened gradually the caution level of its monetary stance with the communication conducted in September and October.

The tight stance in monetary policy will be maintained until the inflation outlook displays a significant improvement and becomes consistent with the targets. Accordingly, the monetary policy will aim to bring inflation down to 7 percent at end-2018 before gradually falling to 5 percent. Consequently, with the current reading of the data, this stance requires that the tight monetary policy be preserved until a convincing fall in the trend of inflation is reached. The CBRT formulates monetary policy by taking the medium-term inflation into account, thus focusing on the developments in underlying inflation rather than the anticipated fluctuations driven by the base effects during the course of the year. Inflation expectations, pricing behaviors and other factors affecting inflation will be closely monitored and further monetary tightening will be delivered if needed.

Developments in fiscal policy and tax adjustments are being 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 lowering the sensitivity of the Turkish economy to 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.