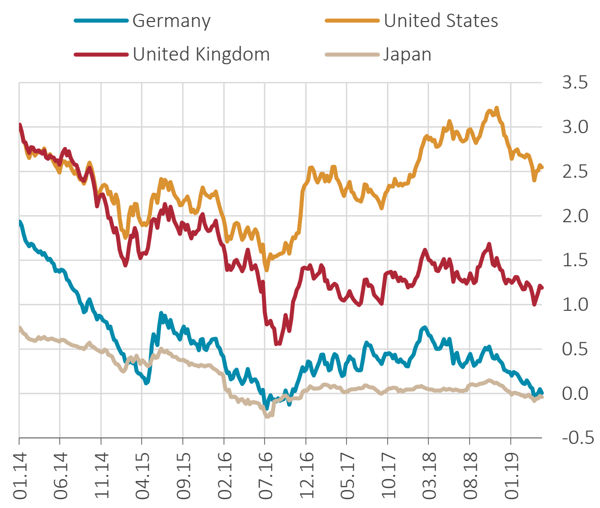
1. Overview

Global economic activity continued to lose momentum in the fourth quarter of 2018. Economic growth decelerated in China, India and Brazil in addition to the euro area and Japan. The heightened uncertainty over global economic policies and the limited room for policy maneuver to counter a deepening economic downturn suggest that the risks to the outlook for 2019 lie more on the downside. Inflation rates were on the decline in advanced economies in the first quarter of 2019 but slightly up in emerging economies. Given the moderate outlook for global growth and commodity prices, global headline inflation rates are likely to remain flat throughout 2019.

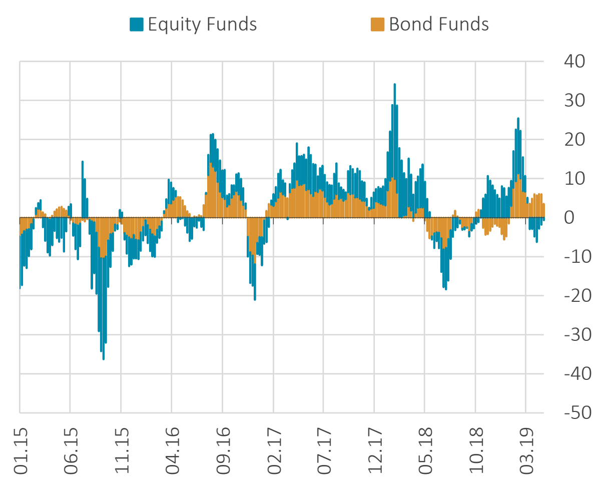
Major central banks seem to have taken a pause in monetary policy normalization in the first quarter of 2019 in view of the elevated uncertainty surrounding global economic policies, the more subdued economic activity and global inflation rates that settled within the target range. The shift in the statements regarding policy normalization caused long-term bond yields to fall (Chart 1.1). Uncertainty over global economic policies and country-specific risks of emerging economies remain significant. Therefore, portfolio flows to emerging economies have been volatile (Chart 1.2).

Chart 1.1: 10-Year Bond Yields (%)



Source: Bloomberg.

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



Source: EPFR.

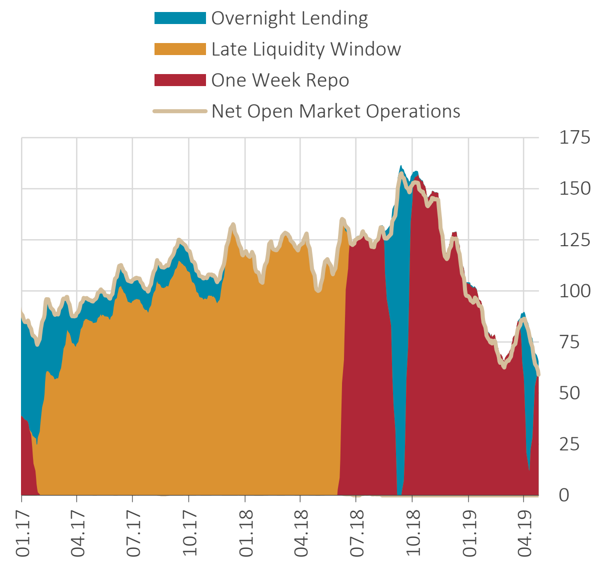
Amid uncertainties and geopolitical tensions, Turkey's country risk premium has diverged from other emerging economies since February. The divergence became more pronounced following the financial market volatility in the last week of March. Despite the limited increase in market rates until the end of March, loan rates continued to decrease due to lower funding costs of banks. Loans have displayed a moderate recovery trend throughout the first quarter. Starting from the final week of March, portfolio outflows were accompanied by higher interest and exchange rates.

Consumer inflation fell by 0.6 points to 19.7% in the first quarter of 2019. Core goods pulled inflation down amid waning lagged effects of exchange rates, extended tax cuts for durable goods and weak domestic demand, whereas food and services put higher pressure on inflation compared to the previous quarter. Notwithstanding the year-on-year decline in producer inflation, producer price-driven cost pressures on consumer prices remained strong in the first quarter. The fourth quarter of 2018 saw a more notable economic rebalancing, while economic activity remained sluggish, as predicted in the January inflation report. Tight financial conditions and the weak labor market continued to weigh on domestic demand in the fourth quarter of 2018, but the contribution of net exports restrained the economic slowdown. Thus, the support from aggregate demand conditions to disinflation has become more significant. Economic rebalancing continued into the first quarter of 2019, yet despite the partial economic recovery, aggregate demand conditions remained weak.

1.1 Monetary Policy and Financial Markets

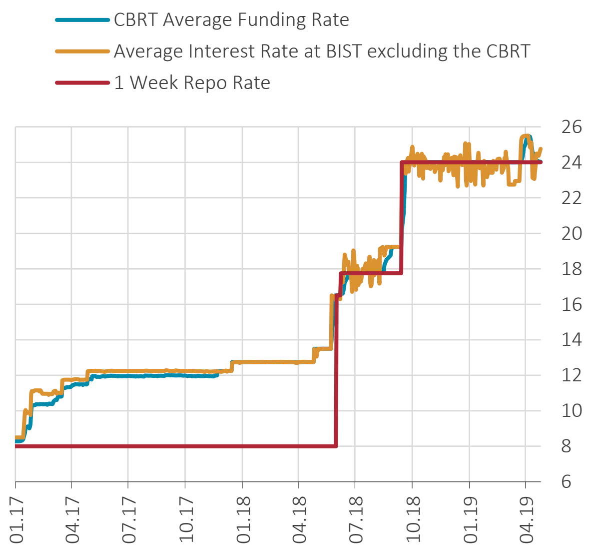
Emphasizing the risks to price stability, the CBRT maintained its tight monetary policy stance in the first quarter and kept its one-week repo auction rate constant at 24%. Moreover, the Bank adopted Turkish lira and foreign exchange liquidity instruments to support the efficient functioning of markets and the transmission mechanism. Owing to the developments in financial markets, weekly repo auctions were suspended between 25 March and 8 April, and funding was provided at the overnight lending rate of 25.5% (Chart 1.1.1). As a result, the average interest rate at the BIST Interbank Repo market, calculated excluding CBRT transactions, increased between 25 March and 8 April but started fluctuating again around the policy rate as soon as funding switched back to one-week repo auctions (Chart 1.1.2). On the other hand, the Bank raised the Turkish lira swap sale limit to alleviate the effects of the Turkish lira liquidity squeeze that caused international swap market rates to rise over the last week of March. Accordingly, the Bank gradually raised the banks' transaction limits at the Turkish lira Currency Swap Market to 40%, which were initially limited to 10% of the Foreign Exchange and Banknotes Market on 4 April 2019, a measure that helped to normalize the Turkish lira shortage in international swap markets.

Chart 1.1.1: CBRT Open Market Operations (2-Week Moving Average, TRY Billion)



Source: CBRT.

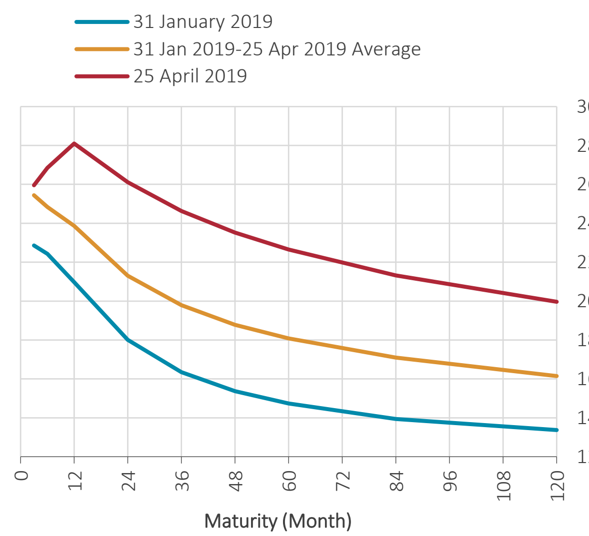
Chart 1.1.2: Short-Term Interest Rates (%)



Sources: BIST, CBRT.

With the CBRT's ongoing tight monetary policy stance in the current reporting period, the yield curve remained inverted, yet the increase in the country risk premium pushed the currency swap rates higher across all maturities from the previous reporting period (Chart 1.1.3). In line with exchange rate developments, the implied volatility of the Turkish lira increased (Chart 1.1.4).

Chart 1.1.3: Swap Yield Curve (%)



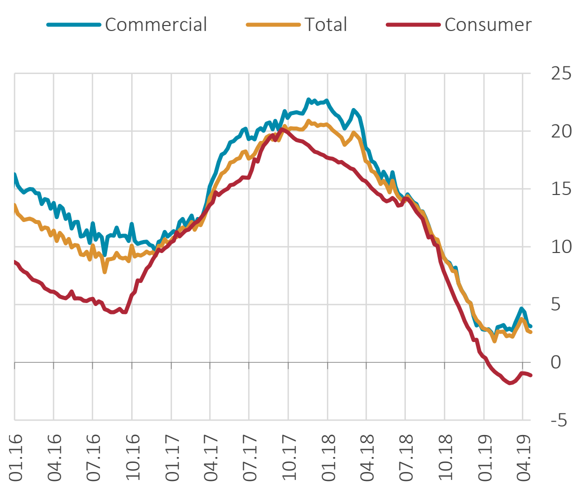
Source: Bloomberg.

Chart 1.1.4: Implied FX Volatility (1-Month Ahead, %)

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

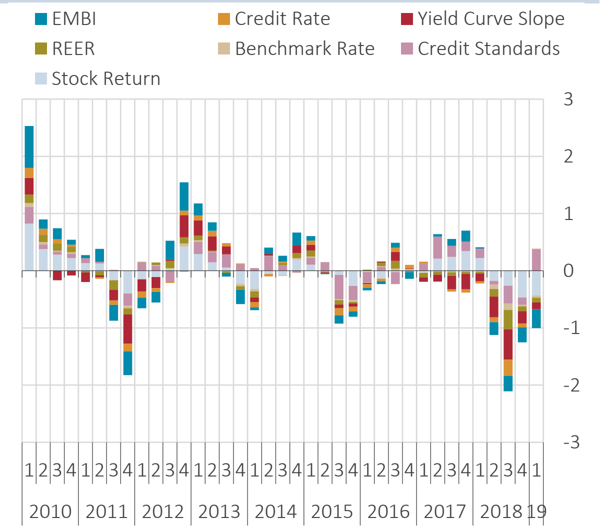
The slightly easing credit conditions and measures taken helped loan growth gain some momentum in the first quarter. This recovery was largely driven by commercial loans (Chart 1.1.5). The Financial Conditions Index (FCI) indicates that financial conditions remained tight in the first quarter of the year, albeit slightly easing (Chart 1.1.6). In this period, the rising risk premium had a more tightening impact on financial conditions compared to the previous quarter (Chart 1.1.6).

Chart 1.1.5: Annual Loan Growth (Adjusted for Exchange Rates, YoY % Change)



Source: CBRT.

Chart 1.1.6: Contributions to FCI*



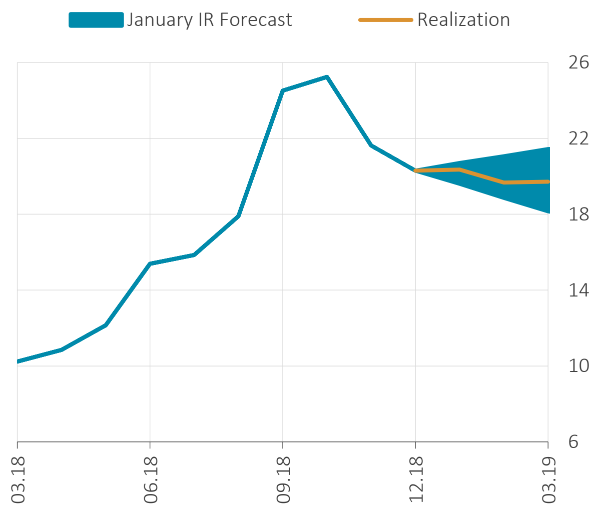
Source: CBRT.
* For further details on measuring the FCI, see the CBRT Working Paper No. 15/13.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation decreased by 0.59 points from the end of the fourth quarter of 2018 to 19.71% in the first quarter of 2019, as projected in the January Inflation Report (Chart 1.2.1). The consumer inflation excluding unprocessed food, energy, alcohol-tobacco and gold (core indicator B) was below the forecast, while unprocessed food prices rose at a much faster pace than predicted (Chart 1.2.2). In the first quarter, inflation expectations remained high, whereas the effect of the exchange rate and import prices on consumer inflation was on the downside compared to the end of the previous quarter. Weak domestic demand conditions caused economic activity to weigh more heavily on inflation. However, unprocessed food prices and real unit labor costs put more upward pressure on consumer inflation.

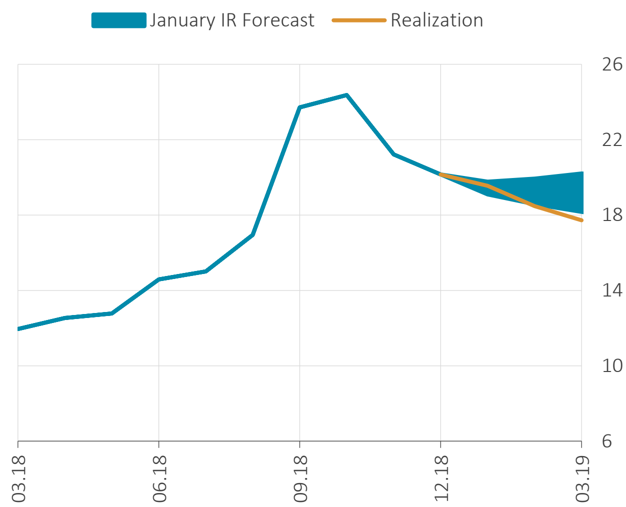
Chart 1.2.1: January Inflation Forecast and Actual Inflation* (%)



Source: CBRT, TURKSTAT.

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

Chart 1.2.2: January Forecast and Actual Rates for Inflation Excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold (B Index) * (%)



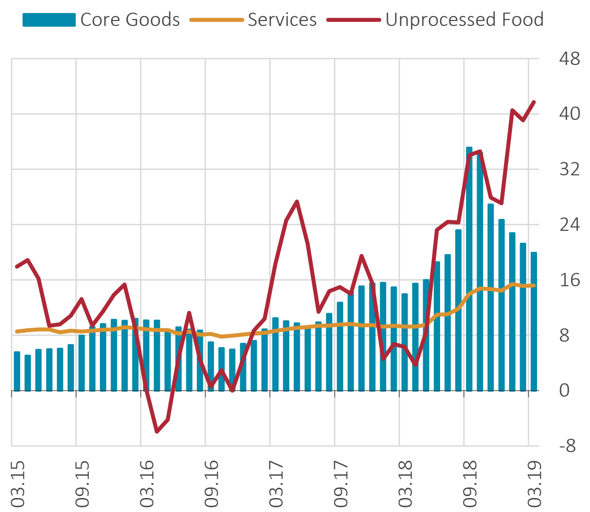
Source: CBRT, TURKSTAT.

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

As in the previous quarter, core goods and energy groups were the main drivers of the decline in annual inflation. Annual core goods inflation maintained its downward trend on the back of waning lagged effects of exchange rates, extension of temporary tax cuts on durable goods, and the persisting weak course of domestic demand (Chart 1.2.3). On the other hand, the fall in annual energy inflation was mainly driven by the decline in administered energy prices such as those of electricity, natural gas, and municipal water. Meanwhile, food inflation displayed an unfavorable course, with significant increases in prices of fresh fruits and vegetables in particular.

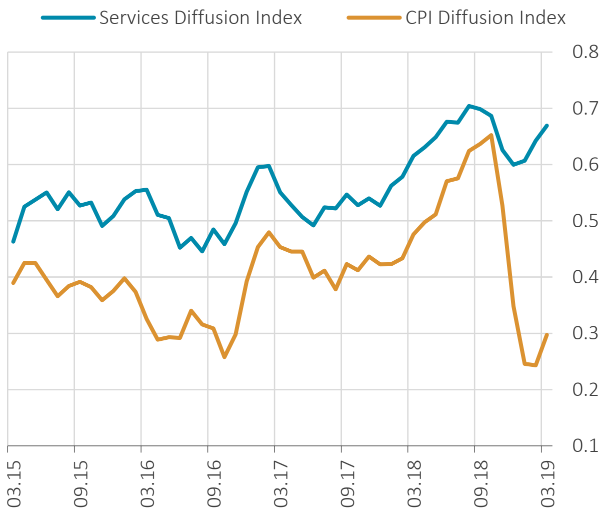
In the first quarter of the year, imported input costs and domestic demand developments led to some improvement in the underlying trend of inflation. Diffusion indices suggest that economic agents were less inclined to hike prices. While this outlook was mainly an outcome of the price developments in the core goods group, indicators for services inflation remained high (Charts 1.2.3 and 1.2.4). Risks to the inflation outlook persist due to elevated levels of inflation and inflation expectations, volatility in exchange rates, accumulated costs in different sectors, and uncertainties over the pricing behavior.

Chart 1.2.3: CPI Sub-component Prices (Y-o-Y % Change)



Source: TURKSTAT.

Chart 1.2.4: CPI and Services Diffusion Indices (Seasonally-Adjusted 3-Month Average)

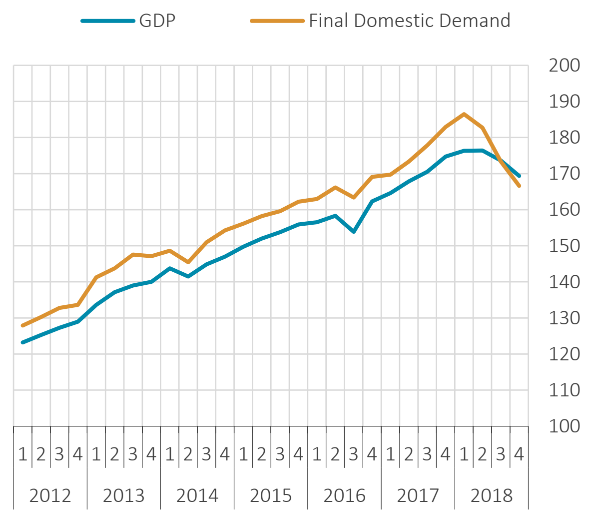


Source: CBRT, TURKSTAT.

Supply and Demand

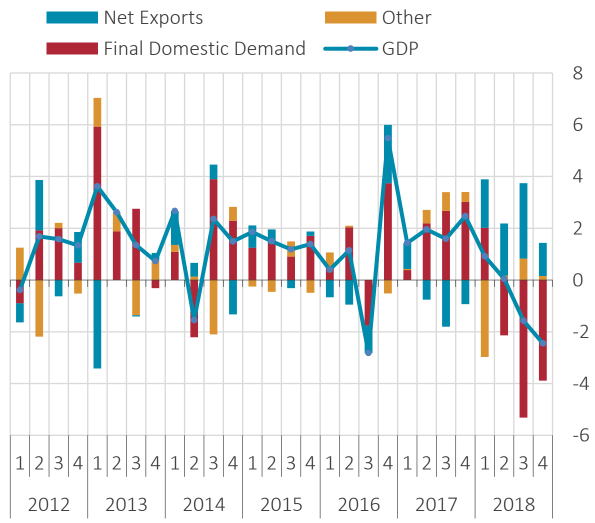
The weak course of the economic activity continued in the final quarter of 2018, as projected in the January Inflation Report (Chart 1.2.5). In this period, gross domestic product (GDP) contracted by 3.0% year-on-year while it narrowed by 2.4% quarter-on-quarter in seasonally and calendar-adjusted terms. On the other hand, supported by tourism, exports of goods and services remained robust whereas import demand declined due to exchange rate developments and the contraction in domestic demand. The strong contribution of net exports continued to limit the domestic demand-driven slowdown in the economy (Chart 1.2.6). Accordingly, the rebalancing process in the economy that started in the second quarter became more pronounced.

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



Source: CBRT, TURKSTAT.

Chart 1.2.6: Contributions to Quarterly GDP Growth by Expenditures (% Points)

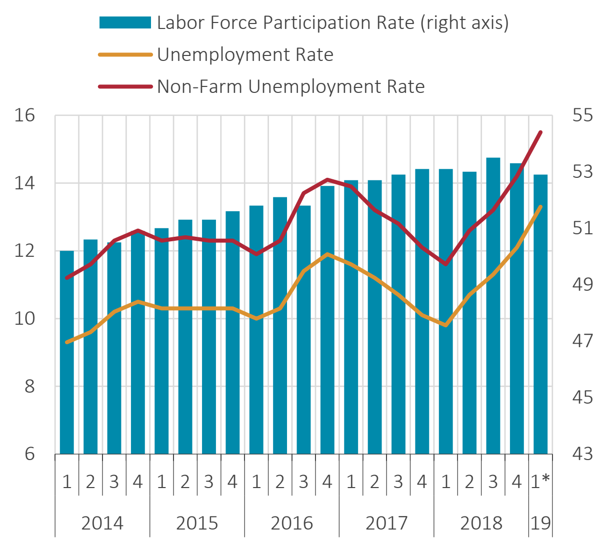


Source: CBRT, TURKSTAT.

The policy actions and measures led to a partial improvement in financial volatility and risk premium indicators in the first quarter of 2019. Thus, following the contraction in the second half of 2018, domestic demand and economic activity posted a recovery underpinned by public expenditures. On the other hand, in spite of the favorable course of exports, the contribution of net exports to quarterly growth decreased as a result of the partial increase in imports triggered by the recovery in domestic demand. However, the strong contribution of net exports to annual growth is forecast to continue.

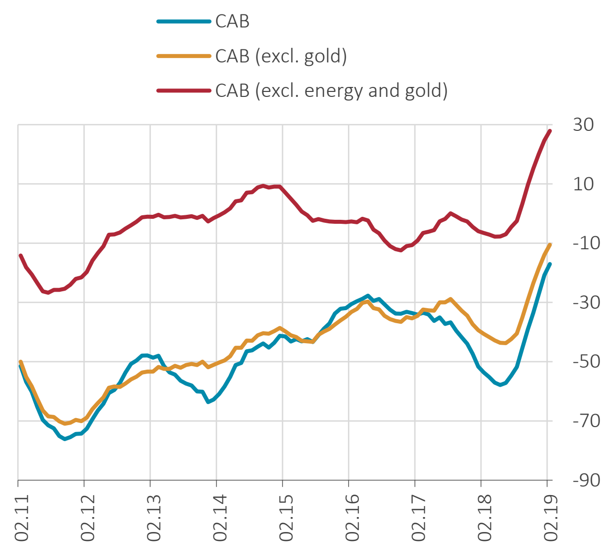
In sum, the rebalancing trend in the economy has continued through the first quarter of 2019. Tight financial conditions and the weak labor market outlook continue to limit domestic demand (Chart 1.2.7). Firms' orientation towards external markets amid sluggish domestic demand, and their flexibility in market diversification stimulate exports of goods. Meanwhile, lagged effects of exchange rates and the weak course of credit and economic activity restrain import demand whereas the improvement in external balance continues at an accelerated pace due to the consistently high levels of services revenues (Chart 1.2.8).

Chart 1.2.7: Unemployment Rates (Seasonally-Adjusted, %)



Source: TURKSTAT.
* January period.

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



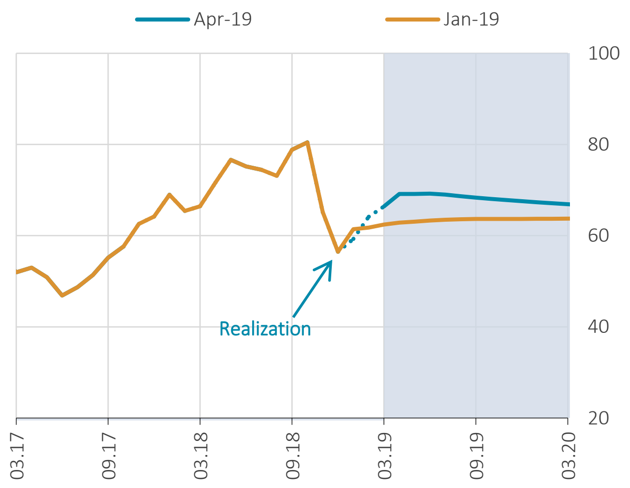
Source: TURKSTAT, CBRT.

Oil, Import and Food Prices

Despite the slowing global demand, crude oil prices on international markets increased significantly in the first quarter of the year compared to end-2018 due to supply-side effects, exceeding the assumptions in the January Inflation Report. Given the developments in spot and futures markets as well as the market expectations, the average crude oil price assumption of 63 USD/bbl presented in the previous report has been revised upwards to 67 USD/bbl (Chart 1.2.9) for 2019. Likewise, the assumption for the average annual increase in USD-denominated import prices has also been revised upwards for 2019 (Chart 1.2.10).

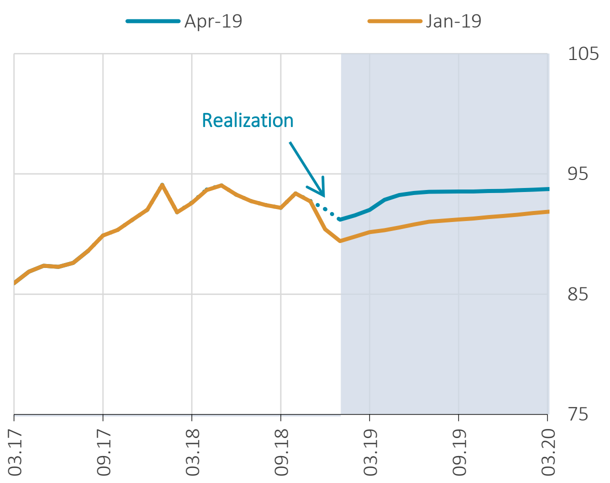
Assumptions for food prices inflation have been revised upwards due to realized inflation figures in the first quarter of the year that were significantly above the historical averages as well as to risks arising mainly from accumulated cost pressures. Accordingly, the year-end food inflation forecasts have been raised to 16% for 2019 and 11% for 2020 from the projections in the January Inflation Report which were 13% and 10%, respectively.

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



Source: Bloomberg, CBRT.
* Shaded area denotes the forecast period.

Chart 1.2.10: Revisions to Import Price Assumptions* (Index, 2010=100)



Source: Bloomberg, CBRT.
* Shaded area denotes the forecast period.

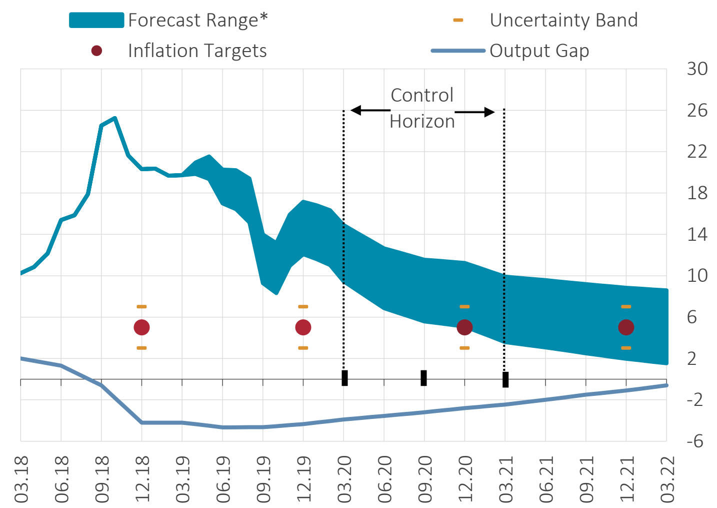
Fiscal Policy and Tax Adjustments

As projected in the previous Inflation Report, fiscal policy supported the economic activity in the first quarter of 2019. The framework drawn for the remainder of the year assumes that the contribution of the public sector to economic activity will be relatively moderate compared to the first quarter. Medium-term projections are based on an outlook where macroeconomic policies are determined with a medium-term perspective and in a coordinated manner with a focus on bringing inflation down. In this context, the current projections are based on the assumption that fiscal policy will continue to contribute to macroeconomic rebalancing in 2019 and that the administered prices will be largely set to support disinflation. The strong policy coordination to lower inflation and to achieve macroeconomic rebalancing is envisaged to gradually improve the risk premium and reduce the perception of uncertainty.

1.3 Inflation and the Monetary Policy Outlook

Under a tight policy stance and enhanced policy coordination focused on bringing inflation down, inflation is projected to converge gradually to the targets. Accordingly, inflation is projected to be 14.6% at the end of 2019 and then fall to 8.2% at the end of 2020 and to 5.4% at the end of 2021, before stabilizing around 5% over the medium term. Thus, with a 70% probability, inflation is expected to be between 12.1% and 17.1% (with a mid-point of 14.6%) at end-2019 and between 5.1% and 11.3% (with a mid-point of 8.2%) at end-2020 (Chart 1.3.1).

Chart 1.3.1: Inflation and Output Gap Forecasts*



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

After the January Inflation Report, the relatively mild course of the Turkish lira, demand conditions and tax cuts have been the drivers of disinflation. In the current reporting period, although the hikes in unprocessed food and Turkish lira-denominated import prices affected the inflation forecasts upwards, the improvement in the underlying trend of inflation under a tight monetary policy stance consistent with the targeted path, widening of the output gap and the downward revision to the administered price hikes offset these upward effects. As these effects balanced out, the inflation forecasts for 2019 and 2020 remained unchanged.

The consumer inflation forecast for end-2019, which was announced as 14.6% in the January Inflation Report, has been left intact in the current reporting period. The upward revision in food inflation assumption to 16% from 13% pushes the consumer inflation forecast up by 0.7 points. The rise in the assumption for TL-denominated import prices stemming from oil adds 0.3 points to the year-end consumer inflation forecast. Meanwhile, the improvement in the underlying trend of inflation compared to the previous reporting period has pulled the end-2019 inflation forecast down by 0.3 points. Moreover, due to the sustained implementation of the sliding scale tariff and tobacco price hikes that materialized below the rates implied by the tax adjustments, changes in administered prices and taxes assumptions decreased end-year inflation forecast by 0.6 points. The output gap, which is expected to be slightly wider during the rest of the year compared to the January Inflation Report projections, contributes to the forecast revision by -0.1 points.

As for the inflation forecast for end-2020, the upward revision to the food price assumption is estimated to increase the end-year inflation by 0.2 points. Meanwhile, the improvement of the underlying trend has pulled the inflation forecast down by 0.2 points. All in all, the inflation forecasts for end-2020 were kept constant at 8.2%.

The above-mentioned forecasts are based on a framework in which the increases in the country risk premium and financial volatility since the previous Report period would be recovered partly and no additional shock would be observed. Against this background, projections rely on an outlook in which decisive implementation of a tight monetary policy stance would continue, and the monetary policy will focus on bringing down inflation to single digit figures in the second quarter of 2020 and ultimately to the 5% target. Additionally, a fiscal policy stance determined in line with the macroeconomic rebalancing process as well as the support of the measures and incentives outlined as a part of the Structural Transformation Steps to the recovery in financial conditions are assumed to contribute to the improvement in the country risk premium and contain the volatility in exchange rates in the rest of the year.

Accordingly, the determinants of the fall in inflation in 2019 are judged to be the moderation of cost pressures driven by a modest appreciation trend in the real exchange rate and subdued domestic demand. Despite the downward pressure of weak domestic demand conditions, cost pressures, deferred hikes in administered prices, high course of inflation expectations and uncertainties over pricing behavior imply that risks to price stability remain significant. Under a tight monetary policy stance and strengthened policy coordination, it is forecast that consumer inflation will come down to single-digit figures in the second quarter of 2020 and approach the 5% target by the end of 2021. Along with the recovery in the risk premium, reducing backward indexation with the support of the stable course of exchange rates and the support of the strengthened policy coordination aimed at disinflation, and pulling medium-term inflation expectations to levels consistent with forecasts and targets are crucial to the success of the disinflation efforts.

1.4 Key Risks to Inflation Forecasts and the Likely Monetary Policy Response

The outlook underlying the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions. The major macroeconomic risks that might lead to a change in the projections and the monetary policy stance associated with the baseline scenario are as follows.[1]

- Delay in the expected partial recovery of the risk premium;
- Uncertainties over pricing behavior and deterioration in inflation expectations;
- Risks to the coordination between monetary and fiscal policies (administered prices and tax adjustments);
- Persistent rise in food prices;
- Tighter financial conditions;
- Persistent weakening in the global growth outlook;
- Weakening in capital flows to emerging market economies;
- Volatility in international crude oil prices.

The partial recovery in indicators related to financial volatility and risk premium in the first quarter of 2019 that came on the back of the policy steps and measures taken, contributed to disinflation particularly via the imported input costs and also played an important role in the recovery in domestic demand and economic activity. In the upcoming period, Turkey's risk premium trend will be decisive in inflation and growth dynamics. The baseline scenario presented in the Report is based on an outlook where the risk premium, which has increased due to the recent uncertainties and geopolitical factors, will partly improve owing to partial normalization in these adverse factors coupled with a tight monetary policy stance and macro policy mix focusing on inflation. In case the improvement in risk premium and exchange rate volatility is delayed, expectations for inflation and the exchange rate may feed each other and make the disinflation process more difficult. Should this risk materialize, even if the likely additional squeeze in financial conditions would mean a more evident slowdown in economic activity than envisaged, there would still be a risk that the expectation and exchange rate channel would dominate due to the likely deterioration in pricing behavior. In such a case, all instruments of monetary policy and liquidity management will continue to be used to achieve price stability and support financial stability, and the monetary policy stance will be determined so as to keep inflation in line with the target path by taking into account all upside and downside factors affecting inflation. In this framework, the tight stance in monetary policy will be maintained and additional monetary tightening may be introduced. In case of such a scenario, in order to support the effectiveness of the monetary policy and to minimize the likely

[1] Evaluations of how and through which channel these risks may affect the inflation forecasts cited in the previous section are summarized in Table 7.3.1. in Chapter 7.

inflation-growth trade-off, it will be crucial that macro-financial policies are determined with a focus on reducing financial volatility and risk premium, and that the predictability of fiscal policy continues to be reinforced.

Despite the restrictive impact of domestic demand conditions on inflation, the elevated levels of inflation and inflation expectations, the course of cost factors and the uncertainties about pricing behavior continue to pose risk to the inflation outlook in the upcoming period. Notwithstanding the recent improvement in inflation, there is no observable improvement in inflation uncertainty indicators[2] and long-term inflation expectations. The elevated levels of inflation and exchange rate expectations have led to an upsurge in FX deposits recently. If this trend in FX deposits continues, it may put an extra cost burden on the banking sector with respect to balance sheet and liquidity management and may weaken the effectiveness of the monetary policy on exchange rates and financial conditions. In order to curb these risks, it is crucial that inflation and exchange rate expectations are anchored with a tight monetary policy stance.

Another factor causing an upside risk to the inflation outlook in the short term is the continued rise in food prices. While accumulated cost pressures increase upside risks mostly to processed food prices, periodic factors may also exert an additional pressure on food and catering services prices. Meanwhile, in case the expected correction in the prices of fresh fruits and vegetables in the new harvest is delayed or lessened due to adverse weather conditions, forecasts of unprocessed food prices may need to be revised upwards.

Due to ongoing risks to price stability, monetary and fiscal policy coordination is crucial for the support from the macroeconomic rebalancing process to disinflation to be continued. It is equally important that backward indexation behavior in administered price and tax adjustments is reduced with a view to anchor expectations and decrease inflation inertia. The medium-term projections in this Report are based on a fiscal policy stance focusing on disinflation and macroeconomic rebalancing, and supporting the monetary policy transmission mechanism in line with the New Economy Program. Accordingly, the projections are based on an outlook where the budget deficit remains under control for the rest of the year. Moreover, it has been assumed that the administered price and tax adjustments would be determined in a way to support the disinflation process and that they will remain broadly consistent with the inflation expectations and targets. In case the fiscal policy significantly deviates from the explained framework, the envisaged improvement in the risk premium and inflation expectations may be delayed, and a revision to the monetary policy stance may become necessary if the medium-term inflation outlook is adversely affected.

Credit conditions, which were tightened beyond historical averages in the third quarter of 2018, started to loosen gradually as of October. In the first quarter of 2019, commercial loan growth converged to historical averages on the back of the support from the partial recovery in financial indicators and the accommodative credit policies, thus the difference between loan and deposit rates significantly decreased. In the upcoming period, the speed, scope and sustainability of normalization in credit conditions will be important with respect to the outlook for economic activity. The steps towards recapitalization of public banks are expected to underpin the recovery in financial conditions, whereas other arrangements concerning financing facilities and liquidity are expected to be decisive on credit growth. Meanwhile, if the recent fluctuations in financial markets continue, credit conditions may be tightened further and thus economic recovery may be delayed.

Besides the tightness in financial conditions, increasing uncertainties over global economic activity keep downside risks on domestic economic activity alive via capital flows and foreign trade channels. The lingering political uncertainties in Europe, the likely additional vulnerabilities that may be observed in the banking sector due to expansionary policies introduced by China, extended trade problems between the

[2] Please see: Box 3.1. Inflation Uncertainty Measures in Inflation Report 2019-I., p.37-41.

USA and China, and geopolitical problems altogether cause an increase in uncertainties over global economic policies and continued vulnerabilities in global financial markets. Because of these factors, the existing downside risks to global economic activity persist.

In case of excessive volatility in markets due to global liquidity conditions and fluctuations in risk perceptions, measures might be taken to provide liquidity to the market in a timely, controlled and effective manner. Moreover, the impact of these risks on inflation as well as on inflation expectations will be monitored and a monetary policy response will be given when necessary.

There are risks to crude oil prices and other commodity prices in both directions. A positive outcome in the USA-China trade negotiations, a sustained slowdown in US shale oil output and continued geopolitical problems in Venezuela, Iran and Libya pose upside risks to crude oil prices. Meanwhile, downside risks to crude oil prices can be listed as the possibility that Russia and OPEC decide to re-increase oil production following the meeting to be held in June as well as the possibility that the trade dispute between the USA and China continues for an extended period and the slowdown in global economic activity becomes aggravated. Meanwhile, the uptrend in industrial metal prices is expected to become more evident due to the expansionary policies introduced by China to underpin domestic economic activity, the recovery in global risk appetite and the upside impact of supply cuts in industrial metal production since 2018. However, this trend might be mitigated by the slowdown in economic activity. Accordingly, in case upside risks stemming from energy and commodity prices become more evident, the monetary policy response will be determined in a way to keep the deterioration in inflation expectations and pricing behavior under control.