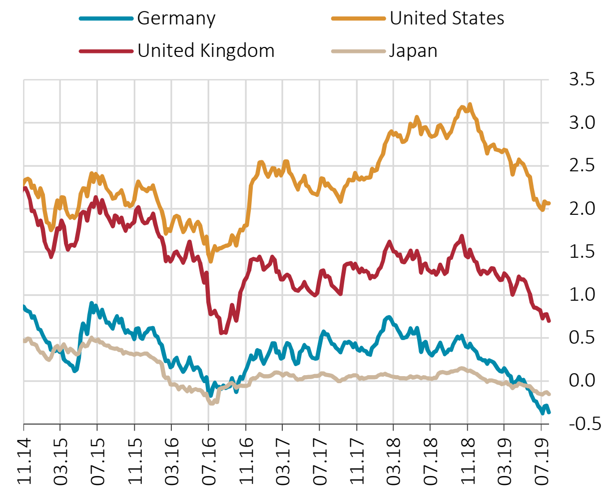
1. Overview

The slowdown in global economic activity, which started in the second quarter of 2018, continued in the first quarter of 2019. In this period, the downturn in emerging economies grew more pronounced -- driven primarily by Eastern Europe and Latin America; while advanced economies offered a more promising outlook mostly owing to the growth performance of the US and Japan. The high level of uncertainty over global economic policies keeps the downside risks to global growth prospects for 2019 elevated. It is envisaged that higher inflation rates across the globe in the second quarter of 2019 will remain flat in the remainder of the year due to the mild course of global growth and commodity prices.

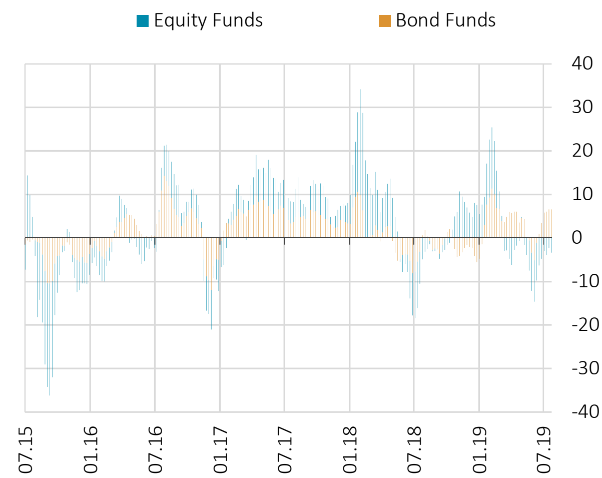
The elevated level of uncertainty in global economic policies accompanied by the aggravated concerns over international trade caused major central banks to opt for stronger easing in their monetary policies in the second quarter of the year. In this regard, long-term bond yields continued to decline (Chart 1.1). However, prolonged geopolitical issues, the revived trend toward protectionism and fragilities specific to emerging economies caused portfolio flows to emerging economies to be subdued in the second quarter (Chart 1.2). More evident easing in monetary policies of major central banks is a development that could lead to higher portfolio flows to emerging economies in the upcoming period.

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.

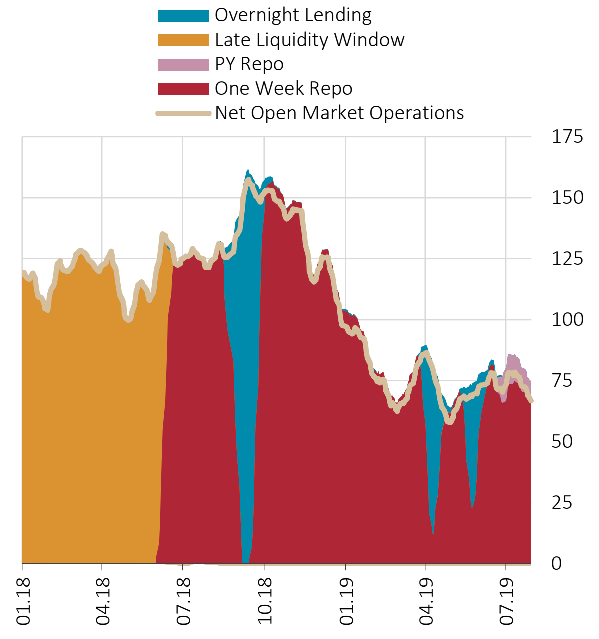
While Turkey's country risk premium diverged negatively from other emerging economies amid uncertainties and geopolitical tensions in the first half of the year, it has registered a significant decline since mid-June. Accordingly, during the second quarter of the year, Turkey saw portfolio outflows until June, followed by portfolio inflows, predominantly equity inflows, in the subsequent period. In the current reporting period, market interest rates fell across all maturities due to the lower sovereign risk premium and favorable macroeconomic developments. On the other hand, as banks reflected the increase in TL funding costs on their loan pricing, personal, vehicle and housing loan rates increased and loan growth rates receded in this quarter. The loss of momentum in loan growth in this quarter stemmed mostly from the tightness in banks' lending standards and the sluggish loan demand.

Consumer inflation fell by 3.99 points to 15.72% in the second quarter of 2019 compared to the end of the previous quarter. The fall in inflation was led mainly by the food, core goods and energy groups, in descending order according to their relative contribution to the decline. Services inflation remained high in this quarter. While factors such as the tight monetary policy stance, the slowdown in unprocessed food inflation due to the rising product supply, the subdued domestic demand and the mild course of commodity prices were instrumental to the disinflation observed in this quarter, robust tourism demand, the course of the exchange rate and real unit labor costs and the backward-indexation in pricing behavior limited this improvement. Against this background, annual consumer inflation exhibited a notable decline in the second quarter of the year. Economic activity displayed a partial recovery in the first quarter of 2019, as envisaged in the April Inflation Report. Domestic demand was the main driver of quarterly growth, while net exports remained flat. The moderate recovery in economic activity continued and aggregate demand conditions supported disinflation in the second quarter of 2019.

1.1 Monetary Policy and Financial Markets

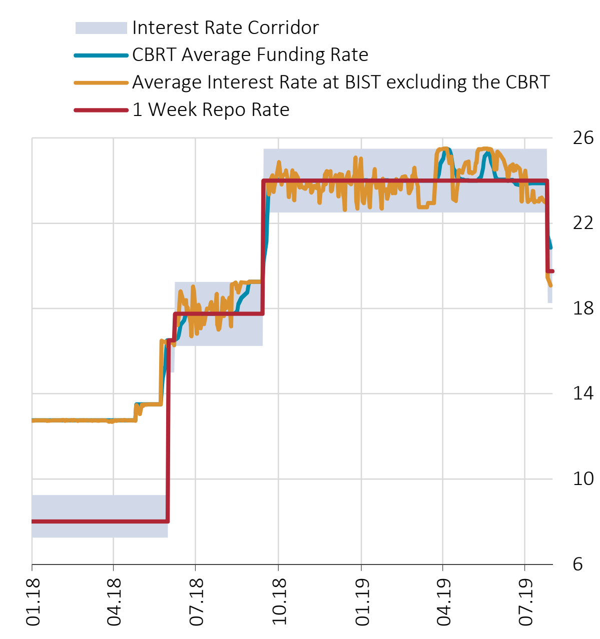
In the first half of the year, the CBRT maintained its tight monetary policy stance against the risks to price stability and kept the one-week repo auction rate constant at 24%. On the other hand, owing to the developments in financial markets, weekly repo auctions were suspended between 9 and 20 May 2019 and the average interest rate at the BIST Interbank Repo market, calculated excluding CBRT transactions, increased temporarily (Chart 1.1.1). Monetary tightening and domestic demand developments underpinned the fall in inflation in the second quarter of the year. Accordingly, in the July MPC Meeting, assessing that underlying inflation trend indicators, supply-side factors and import prices lead to an improvement in the inflation outlook, the tightness of the monetary stance was reduced and the one-week repo auction rate was reduced to 19.75% (Chart 1.1.2). Moreover, regarding the monetary policy outlook, the Committee emphasized that the strength of the monetary tightness will be determined to ensure the continuation of the disinflation process.

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



Source: CBRT.

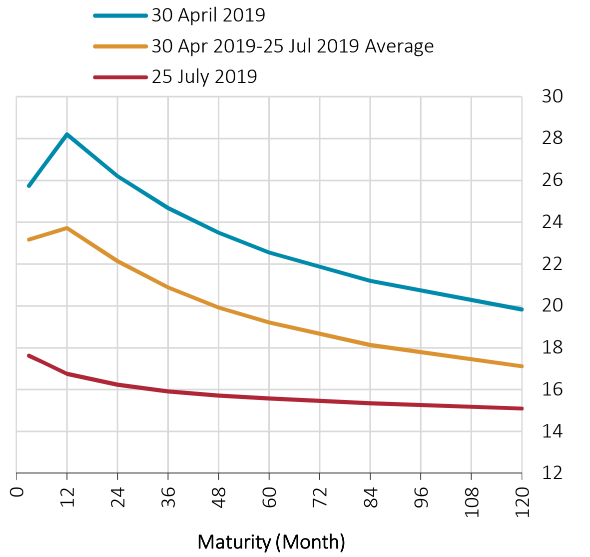
Chart 1.1.2: Short-Term Interest Rates (%)



Sources: BIST, CBRT.

Owing to the CBRT’s tight monetary policy stance, the decline in country risk premium, and the favorable macroeconomic developments, market interest rates receded across all maturities compared to the previous reporting period (Chart 1.1.3). In line with developments in the exchange rate, the implied volatility of the Turkish lira declined in the current reporting period (Chart 1.1.4).

Chart 1.1.3: Swap Yield Curve (%)



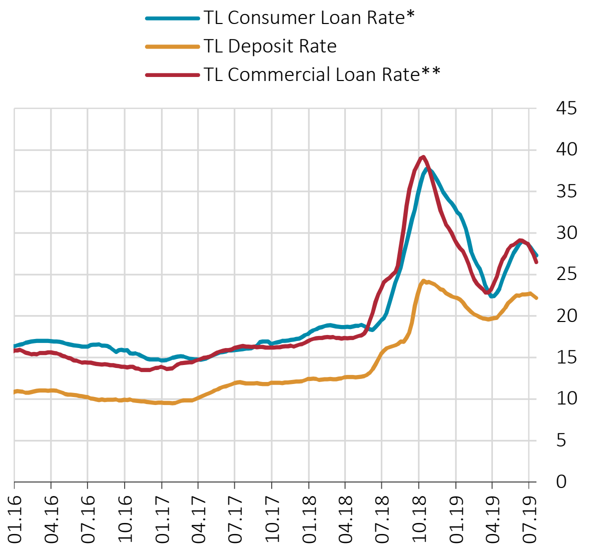
Source: Bloomberg.

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

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

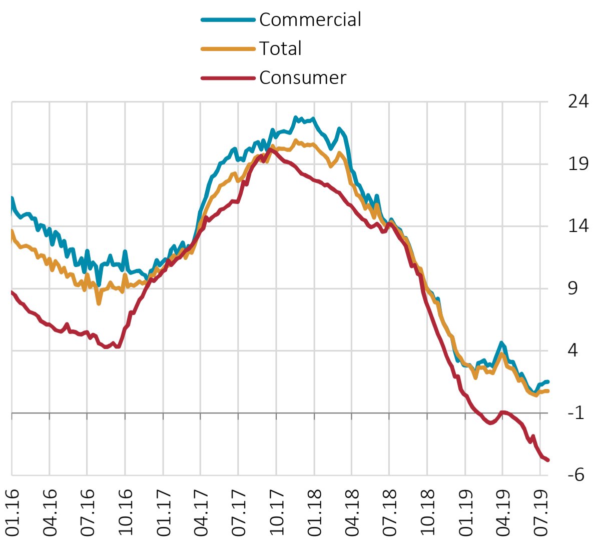
In the second quarter of the year, higher loan rates (Chart 1.1.5) and the overall economic outlook restrained loan growth, most notably for consumer loans (Chart 1.1.6).

Chart 1.1.5: Credit and Deposit Rates (Flow Data, Annual Interest Rates, 4-Week Moving Averages)



Source: CBRT.
* The weighted average of general purpose, vehicle, and mortgage loan rates.
**Excludes overdraft accounts, credit cards, and zero interest rate loans.

Chart 1.1.6: Annual Loan Growth (Adjusted for Exchange Rates, YoY % Change)



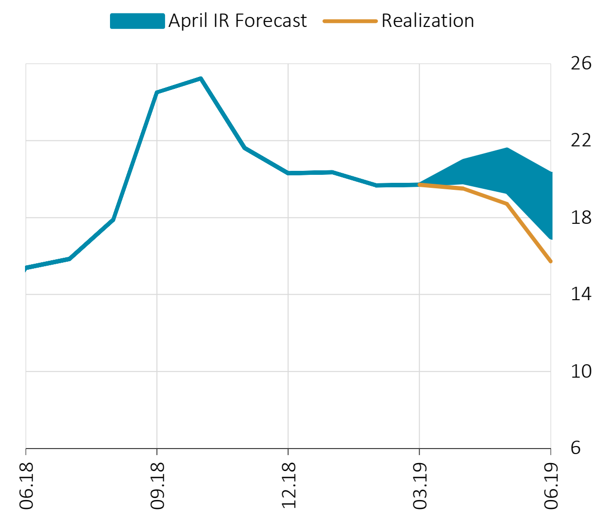
Source: CBRT.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

Consumer inflation fell by 3.99 points, compared to the end of the first quarter, and reached 15.72% in the second quarter of 2019, lower than that envisaged in the April Inflation Report (Chart 1.2.1). In this period, annual inflation of the core indicator, the B index, stood below the earlier projections too (Chart 1.2.2). Unprocessed food inflation, in particular, proved more favorable in this period compared to earlier assumptions. In the second quarter of the year, despite the depreciation in the Turkish lira, the high base effect from the previous year, subdued domestic demand and the decline in commodity prices caused both consumer inflation and annual inflation in core indicators to lose pace.

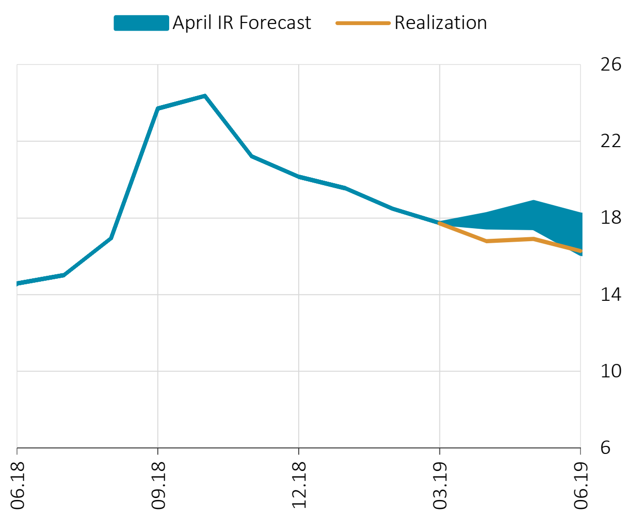
Chart 1.2.1: April Inflation Forecast and Actual Inflation*(%)



Sources: CBRT, TURKSTAT.

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

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



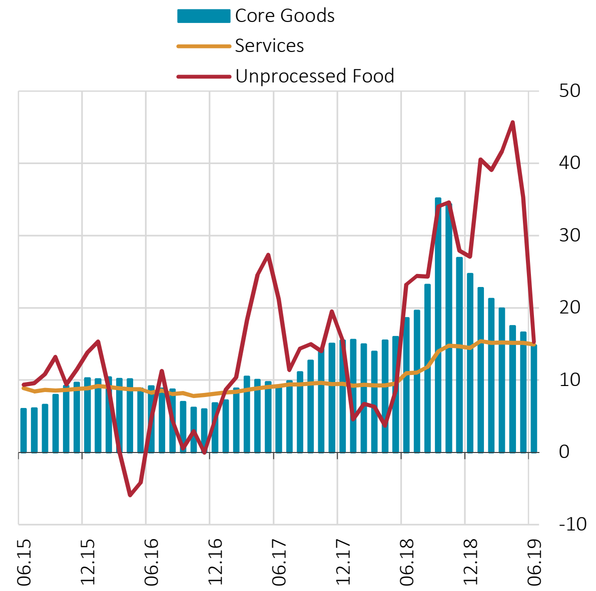
Sources: CBRT, TURKSTAT.

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

The unprocessed food, core goods and energy groups were the main drivers of the decline in annual inflation in this period. Due to the positive supply developments in the unprocessed food group, the notable fall in vegetable prices stood out. Annual inflation in the core goods group maintained its downward trend on the back of the subdued domestic demand and the waning cumulative effects of exchange rates on inflation (Chart 1.2.3). Despite the rise in exchange rates, annual energy inflation fell due to the decline in oil prices and administered energy prices such as municipal water. On the other hand, services inflation inched down in this period, yet remained high. Despite subdued domestic demand, this realization was led by the backward-indexation in inflation, the robust tourism demand and the course of the exchange rate and the real unit labor costs.

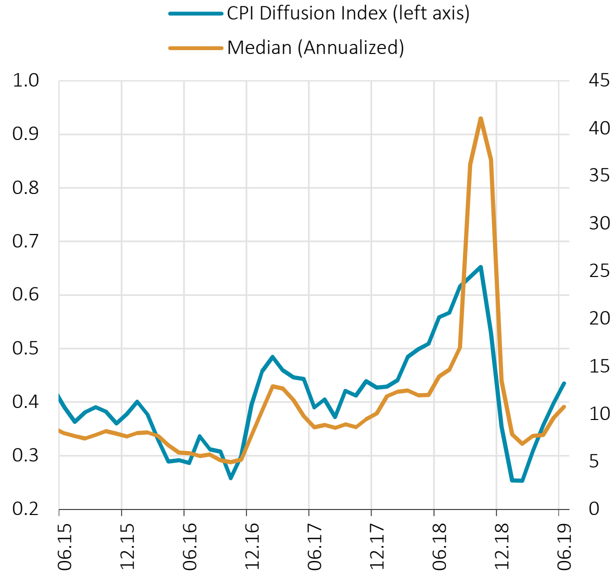
In the second quarter of the year, annual consumer inflation decreased significantly. Although the observed depreciation in the Turkish lira, postponed price adjustments in certain products –including mainly the processed food items-- and the indicators for pricing behavior primarily related to services group prospects were putting a mild upward pressure, cost factors and import prices have a positive effect on the year-end inflation outlook compared to the previous reporting period (Chart 1.2.4). The level of inflation expectations is the primary upside risk factor to the inflation outlook, while demand-driven downside risks remain for inflation due to the course of economic activity.

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



Source: TURKSTAT.

Chart 1.2.4: CPI Diffusion Index and Median Inflation* (Seasonally-Adjusted 3-Month Average)



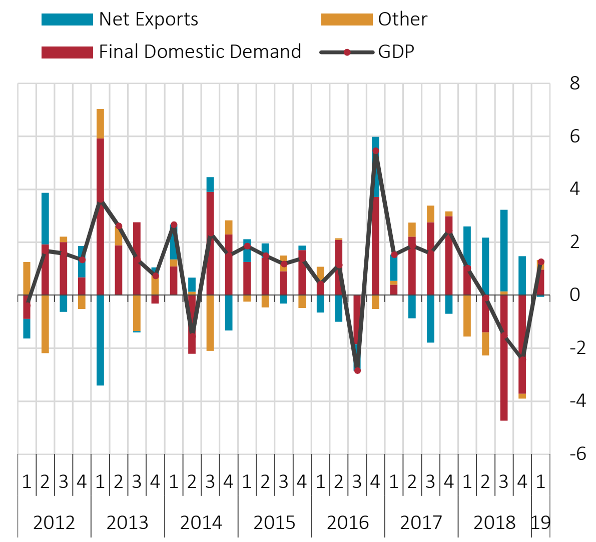
Sources: CBRT, TURKSTAT.

* Median: Median monthly inflation of seasonally-adjusted 5-digit sub-price indices (annualized).

Supply and Demand

Economic activity posted some recovery in the first quarter of 2019 as projected in the April Inflation Report. In this period, gross domestic product (GDP) contracted by 2.6% year-on-year but expanded by 1.3% quarter-on-quarter in seasonally and calendar-adjusted terms. In the first quarter, domestic demand was the driver of quarterly growth while net exports remained flat (Chart 1.2.5). Improvement in the risk premia, narrowing lending-deposit interest rate spreads, the robust loan growth and the accommodating fiscal stance all supported domestic demand.

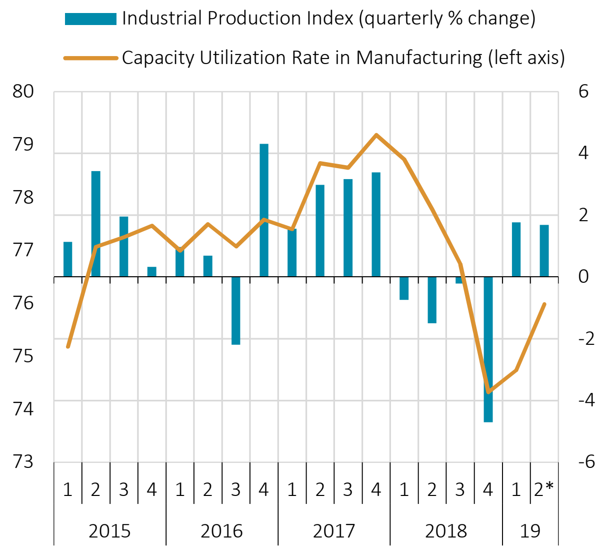
Chart 1.2.5: Contributions to Quarterly GDP Growth by Expenditures (% Points)



Sources: CBRT, TURKSTAT.

* “Other” includes inventories and statistical discrepancy caused by chain-linking.

Chart 1.2.6: Industrial Production Index and Capacity Utilization Rate (%)



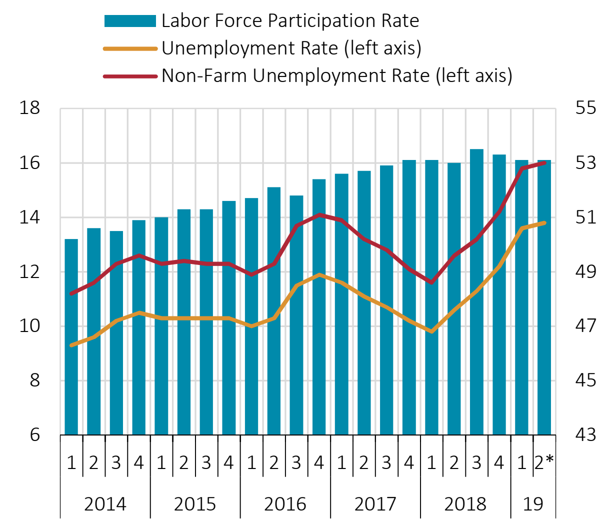
Sources: CBRT, TURKSTAT.

* Industrial production covers April-May period.

Economic activity continued to recover at a moderate pace in the second quarter of the year. The industrial production for the April-May period and the second quarter capacity utilization rate support this outlook (Chart 1.2.6). In this period, the lagged effects of the first quarter's strong loan growth contributed to economic activity, whereas heightened financial volatility and tight financial conditions weighed on private demand, primarily investments. Moreover, weaker public spending put an additional drag on domestic demand. Despite sluggish global growth, goods exports remain on the rise while the robust tourism industry supported economic activity both directly and through associated industries. In sum, the moderate recovery in economic activity continued in the second quarter, with increasing contribution of net exports. On the other hand, weak labor market conditions prevailed (Chart 1.2.7).

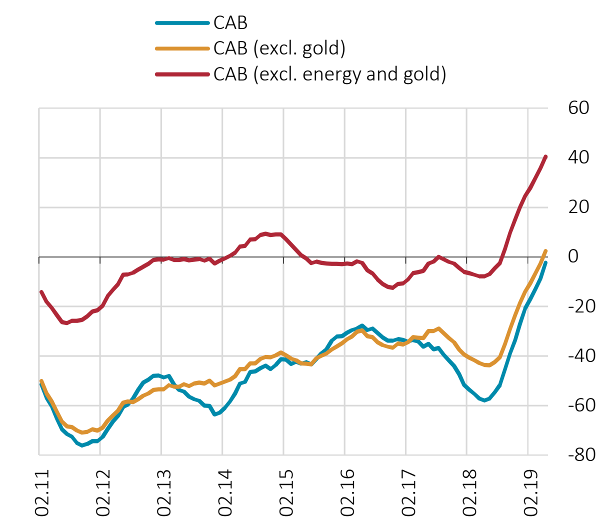
The lagged effects of the exchange rate as well as the weak outlook for credit market conditions and economic activity restrain import demand. Besides, the solid performance of goods and services exports also contributes to the notable improvement in the external balance (Chart 1.2.8). In the remainder of 2019, financial conditions are expected to help support a moderate recovery in domestic demand owing to an improving inflation outlook and reduced country risk premia while the net exports outlook remains favorable. Accordingly, aggregate demand conditions are expected to continue to contribute to disinflation.

Chart 1.2.7: Unemployment Rates (Seasonally Adjusted, %)



Source: TURKSTAT.
* April period.

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



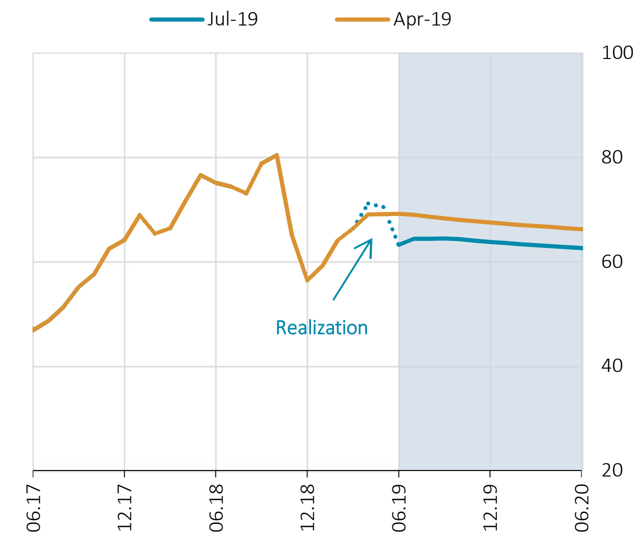
Sources: TURKSTAT, CBRT.

Oil, Import and Food Prices

The annual average growth rate of international crude oil prices and USD-denominated import prices remained below the assumptions of the April Inflation Report. Despite protracted adverse supply side developments, crude oil prices have been revised downward amid muted global trade and economic activity. The average crude oil price assumption has been lowered to 65 USD/bbl for 2019 from 67.2 USD/bbl in the April Report and to 62.6 USD/bbl for 2020 from 66.2 USD/bbl (Chart 1.2.9). Likewise, the assumption for the average annual increase in USD-denominated import prices for 2019 has also been revised downwards (Chart 1.2.10).

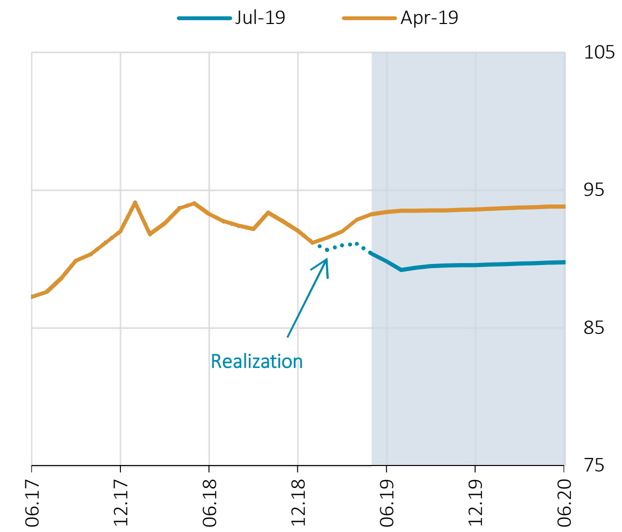
Another exogenous variable on which our medium-term projections are based is food prices. Unprocessed food inflation registered a rapid correction in the second quarter of 2019, whereas processed food inflation remained relatively high due to exchange rates and price hikes across major inputs such as meat and dairy. In light of the processed and unprocessed food price developments balancing each other, the year-end food inflation forecast has been lowered to 15% for 2019 from 16% in the April Inflation Report, and left unchanged for 2020 and 2021.

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



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

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



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

Fiscal Policy, Administered Prices and Tax Adjustments

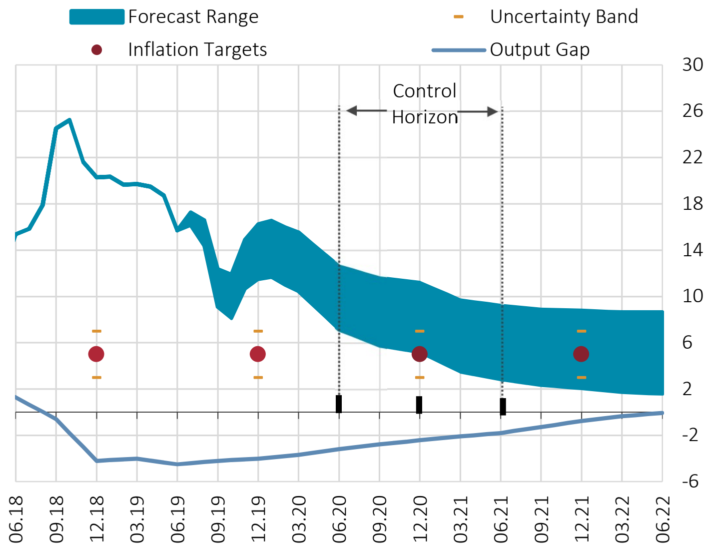
As projected in the previous Inflation Report, fiscal policy supported economic activity in the first half of 2019 through fiscal incentives and measures as well as increased public spending. Our estimates for the rest of the year are built on the assumption that the public sector will provide a more moderate contribution to economic activity than in the first half.

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, our current projections are based on the assumption that fiscal policy will continue to contribute to macroeconomic rebalancing in the remainder of 2019 and that administered prices will be largely set to support disinflation in 2020. The robust policy coordination to lower inflation and ensure macroeconomic stabilization is critical for the continuation of the gradual improvement in risk premium and perceptions of uncertainty.

1.3 Inflation and the Monetary Policy Outlook

Under a tight monetary policy stance and a strong policy coordination focused on bringing inflation down, inflation is projected to converge gradually to the targets. Accordingly, inflation is projected to be 13.9% 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. With a 70% probability, inflation is expected to be between 11.5% and 16.3% (with a mid-point of 13.9%) at end-2019 and between 5.2% and 11.2% (with a mid-point of 8.2%) at end-2020 (Chart 1.3.1).

Chart 1.3.1: Inflation and Output Gap Forecasts*



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

During the period after the April Inflation Report, inflation declined markedly, falling below the forecast band. Improved inflation expectations owing to the disinflation and a tight monetary policy stance as well as the downward revisions to import prices and food prices have a positive impact on the year-end inflation forecast compared to the previous reporting period. However, the mild recovery in output gap outlook and the tax adjustments for alcoholic beverages and tobacco products push year-end inflation forecasts higher. As a consequence, the consumer inflation forecast for end-2019 was lowered to 13.9% from the 14.6% projected in April. Meanwhile, as downward and upward effects balanced out, inflation forecasts for 2020 were left unchanged.

The inflation forecast for end-2019 was revised down by 0.7 points. The second quarter's consumer inflation was down by 2.9 points from the April forecast, and the impending fall in the underlying trend of inflation brought the year-end inflation forecast down by 0.6 points. Moreover, TL-denominated import prices are projected to be lower, having a downward impact of 0.3 points on the inflation forecast. In addition, the decline in the food inflation forecast for end-2019 led to a 0.2 point fall in the inflation forecast. On the other hand, the SCT hike on alcohol and tobacco drives the end-2019 inflation forecast up by 0.2 points. Moreover, the slightly wider-than-expected output gap adds 0.2 points to the consumer inflation forecast.

The inflation forecast for end-2020 is kept unchanged at 8.2%. Revisions to assumptions for oil and import prices are expected to bring end-2020 inflation down by 0.2 points. Additionally, the improvement in underlying inflation trend is projected to pull the end-2020 inflation down by 0.1 point. However, with an upward revision from the previous reporting period, the output gap drives the end-2020 forecast up by 0.3 points.

The above-mentioned forecasts are based on a framework in which the global financial conditions will follow a moderate course and the recent gradual improvement in the country risk premium will continue in the upcoming period. Projections rely on an outlook in which the extent of monetary tightness will be determined in a way to ensure the continuation of the disinflation process and its consistency with the target path. Additionally, it is assumed that the fiscal policy stance will be determined in coordination with monetary policy with a focus on price stability and macroeconomic rebalancing in the remainder of the year.

In addition to the improvement in the outlook for global financial conditions compared to the April Inflation Report period, the lower-than-expected inflation in the second quarter and the improvement in the country risk premium driven by the recovery in the current account deficit have reduced the volatility in financial markets. Along with the favorable impact of these developments on external financing and liquidity conditions of banks, the estimated increase in credit demand due to reduced degree of monetary policy tightness is projected to support a gradual recovery in credit growth. Moreover, assessing that net exports will continue to contribute to economic growth, the output gap has been revised slightly upwards for the rest of the year. Against this background, the disinflationary contribution of demand conditions is projected to continue albeit with a moderate decline compared to the previous reporting period.

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 upward and downward macroeconomic risks that may lead to a change in the baseline projections and the associated monetary policy stance are as follows:[1]

- Fluctuations in the country risk premium,
- Elevated levels of inflation expectations,
- Risks to the coordination between monetary and fiscal policies (administered prices and tax adjustments),
- Risks concerning the evolution of food prices,
- Delay in the credit market recovery,
- Continuation of weakening in the global growth outlook,
- Uncertainty over the evolution of capital flows to emerging market economies,
- Volatility in international crude oil prices.

Although Turkey's risk premium diverged negatively from other emerging market economies in the second quarter of the year due to domestic uncertainties and geopolitical factors, it has declined rapidly since mid-June owing to reduced uncertainties, the tight monetary policy stance, and the improvement in macroeconomic indicators. However, country risk premium and exchange rate volatility hovering at high levels as well as lingering global uncertainties and geopolitical risks keep the upside risks to the medium-term inflation outlook alive. Determining the degree of monetary policy tightness in a way that will keep the disinflation process on track with the target path carry great importance for achieving a sustained improvement in the country risk premium and exchange rate volatility as well as for a stronger recovery in the economy. The Central Bank will continue to use all available instruments in pursuit of price and financial stability objectives, taking into account all macroeconomic indicators including inflation and economic activity in particular. In this regard, in order to support the effectiveness of monetary policy and minimize potential inflation-growth trade-offs, it is deemed 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, elevated levels of inflation continue to pose an upside risk to the inflation outlook in the upcoming period. Anchoring inflation and exchange rate expectations is crucial for the effectiveness of monetary policy in the current period.

[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.

Another factor that may affect the short-term inflation outlook is the course of food prices. While accumulated cost pressures keep the upside risks to processed food prices alive, they may also exert an additional pressure on catering services prices through periodic factors. On the other hand, projections for unprocessed food inflation may be revised downwards depending on the future course of the correction in this group's inflation driven by the increased supply of vegetables due to favorable weather conditions. Against this background, the risks that the course of food prices may pose to the short-term inflation outlook are considered to be balanced.

To keep the disinflation process on track with the target path envisaged in the Report, in addition to the support of macroeconomic rebalancing process to disinflation under the monetary and fiscal policy coordination, it is also important that the backward indexation behavior in administered price and tax adjustments is softened with a view to anchoring expectations and decreasing inflation inertia. The medium-term projections in this Report are based on a fiscal policy stance that focuses on disinflation and macroeconomic rebalancing, and supports the monetary policy transmission mechanism. Accordingly, the projections rely 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 will be determined in a way to support the disinflation process and that they will be 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 the monetary policy stance may be revised if the medium-term inflation outlook is also adversely affected.

In the second quarter of 2019, banks' domestic funding conditions tightened, leading them to reflect the increased Turkish lira funding costs to loan rates. Due to these developments and the expectations for the overall economic outlook, loan growth rates lost pace in this period. A decrease in the degree of monetary policy tightness and the introduction of accommodative credit packages are deemed to be the factors that will support the normalization in credit conditions and credit demand in the upcoming period. The speed, scope and sustainability of the normalization in credit conditions will be important for the economic activity outlook.

Besides geopolitical developments, ongoing uncertainties over the global economic activity pose a downside risk to domestic growth via capital flows and foreign trade channels. The persistent trade tension between the US and China, political uncertainties regarding Brexit, and Middle East-based geopolitical developments cause the uncertainty over global economic policies to remain elevated and the vulnerabilities in global financial markets to continue. All these factors keep the downside risks to global economic activity alive.

If major central banks opt for stronger easing in their monetary policies, portfolio flows to emerging economies might be higher in the upcoming period. On the other hand, the high level of global uncertainties, lingering geopolitical problems, rising protectionism, and vulnerabilities peculiar to emerging economies stand out as major downside risk factors for portfolio flows to these economies.

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.

It is assessed that the downside risks to the long-term course of crude oil prices have become apparent, whereas risks to other commodity prices are balanced. Despite OPEC's decision in July to extend the production cuts, the continuation of geopolitical problems on a global scale, and the ongoing deceleration in US shale oil production, the downside risks to crude oil prices have strengthened due to the high level of uncertainty over global trade and the unfavorable outlook in economic activity. Industrial metal prices displayed an uptrend towards the end of the second quarter due to China's introduction of an additional program to support economic growth and continued supply cuts in industrial metal markets. However, downside risks to industrial metal prices also remain strong due to concerns over the course of global economic activity. On the other hand, vulnerabilities in emerging markets, the easing in monetary policies of advanced economies, and increased economic and geopolitical uncertainties on a global scale make upside risks to precious metal prices evident. Against this background, the monetary policy response will be determined in a way to keep the likely impact of energy and producer prices-driven risks on inflation expectations and pricing behavior under control.