II. Macroeconomic Outlook

The uncertainty surrounding global economic policies has heightened due to the developments in global trade policies. Despite the fact that the Fed monetary policy road map became clear, portfolio flows towards emerging market economies (EMEs) increased during the first quarter of 2018 on account of the positive growth outlook in EMEs and the global risk appetite that rose in that period. This increase was mainly driven by the strong demand towards equity markets, primarily the Asian ones. However, net portfolio movements destined for EMEs have weakened since April 2018, accompanied by a slight increase in risk premiums of these countries. Associated with the developments in global financial markets, the US dollar appreciated in the same period. The global economic activity has hit its highest growth rate since 2011 in response to the positive course of global trade volume, investment-driven growth in advanced economies, recovery in some of the commodity exporting countries such as Russia and Brazil, and the support from EMEs, primarily those in Asia. The global demand-led uptrend in commodity prices prevailing since 2016 has strengthened.

Economic activity remained robust in the last quarter of 2017. Economic growth in 2017, backed by domestic demand, showed a strong performance. The increase in demand was attributable to private and public consumption that remained lively despite withdrawal of tax cuts. Measures and incentives implemented to revive the economic activity allowed the recovery of domestic demand to spread across all sectors and became instrumental in the acceleration of economic growth in 2017. Both construction and machinery equipment investments started to elevate in the second half of the year. Released data regarding the first quarter of 2018 indicate that the economic activity remained strong despite a slight deceleration. This course in economic activity underpins the labor market and supports private consumption indirectly by way of spending on nondurables. Meanwhile, despite the support of positive external demand to exports and the apparent contribution of the recovery in tourism, the contribution of net exports to growth remained limited due to increased gold imports. The increase in goods and services exports continued whereas imports decelerated moderately in the first quarter of 2018. These developments suggest that economic activity turn towards its main trend and converge gradually to its potential level. Owing to cumulative depreciations in real exchange rates, recovery in tourism sector and the strengthening global growth, goods and services exports are expected to preserve their strong support to growth and affect the current account balance positively. It is estimated that this trend in economic activity will be positively reflected in the labor market and unemployment rates will continue to decline.

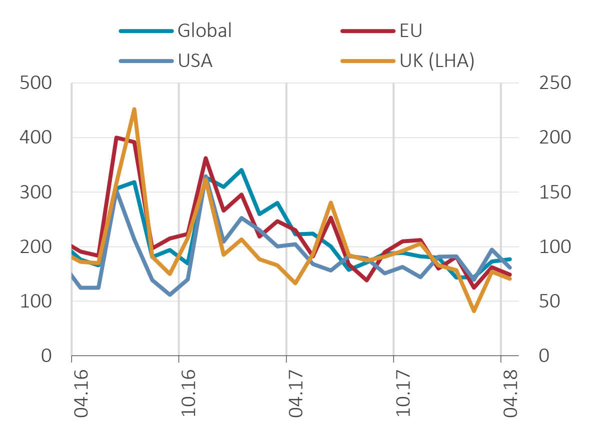
II.1. International Developments

The uncertainty surrounding global economic policies has heightened (Chart II.1.1). The US Government's protectionist approach towards foreign trade policy and evaluations regarding the pace of the normalization process in the Fed monetary policy have had an impact on the predictability of US economic policies. The election process in the EU is over, followed by government formation processes successfully finalized primarily by Germany and Holland, and the Brexit road map became clear, easing the political uncertainty, all of which contributed to the decline of uncertainties over economic policies in the EU and the UK, respectively.

The positive outlook for growth and labor market in the US, along with inflation hovering around the Fed's target of 2 percent, enabled market expectations to substantially converge to policy rate forecasts of Fed members compared to the previous Report period (Chart II.1.2). The US Government's amendment to the tax regulation and other potential fiscal expansion policies, expectations of a continued robustness in economic activity and the unemployment rate hitting historic lows after the global turmoil underpin the expectations of a three-round-rate hike that is considered a baseline scenario for 2018. However, the higher-than-expected wage increases and inflation level as well as the preferences in economic policies in the US are expected to become determinant factors in the road map for rate hikes.

While the profitability issue persists in the euro area banking system, the key component of the European Central Bank (ECB)'s monetary policy transmission mechanism, the non-performing loan ratio, despite an overall decline, remains high in some major banks. Although the ECB has tapered off the monthly amount of asset purchases since January 2017, it announced continuation of purchases until September 2018 and even afterwards if need be. Yet, the ECB is anticipated to maintain its expansionary monetary policy by keeping interest rates constant in the short run. On the other hand, against the backdrop of a moderate course in the economic outlook of Japan despite heightened political uncertainties, Bank of Japan is expected to maintain the expansionary outlook in its monetary policy in line with the endeavors of achieving its inflation target of 2 percent.

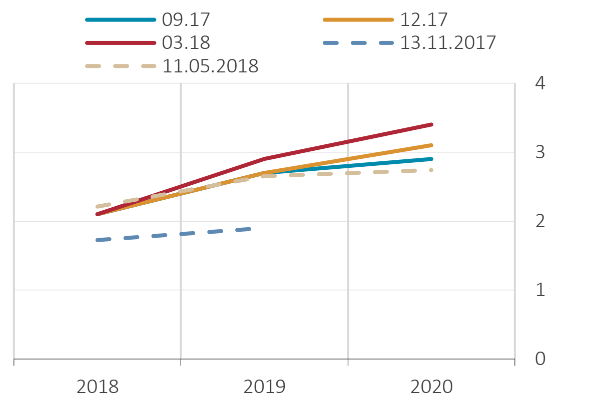
Chart II.1.1: Economic Policy Uncertainty Indices (Index, 2012=100)



Source: Bloomberg Latest Data: 04.18

Note: Indices are not comparable among themselves in terms of level.

Chart II.1.2: FOMC Members' Median Policy Rate Forecasts (Straight Lines) and Market Expectations (Intermittent Lines) (%)



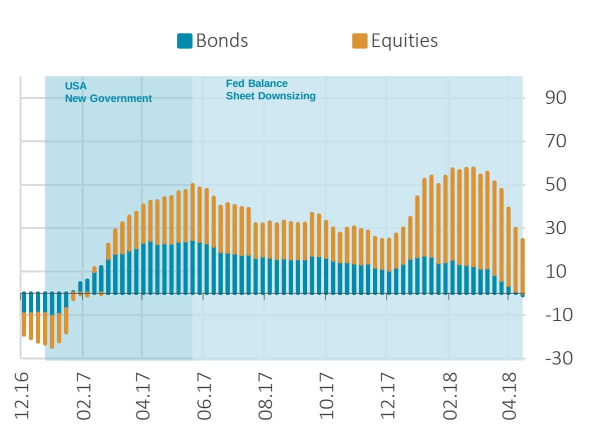
Source: Bloomberg Latest Data: 11.05.18

Note: Intermittent lines indicate 30-day Fed fund futures rates.

While the Fed monetary policy road map is getting clear, portfolio flows towards EMEs rose in the first quarter of 2018 owing to increased global risk appetite and the positive growth outlook in EMEs (Chart

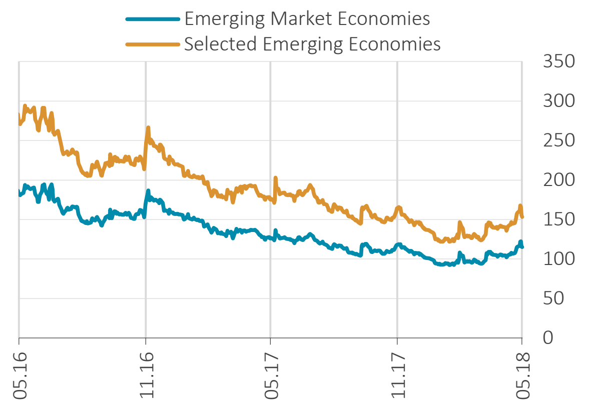
II.1.3). This increase was mainly driven by the strong demand towards equity markets, primarily Asian ones. Meanwhile, fund flows towards EME bond markets, mainly due to China-based flows, were moderate. However, net portfolio movements destined for EMEs have weakened since April 2018 due to the tightening in global financial conditions and decrease in risk appetite while risk premiums of these countries increased slightly (Chart II.1.4). On the other hand, cost of credits from international markets has recently increased in response to the movements in Libor. This increase may lead to cost pressure on foreign debts that will be repriced in the period ahead.

Chart II.1.3: Weekly Capital Flows to Emerging Economies (Billion USD, 13 -Week Cumulative)



Source: EPFR Latest Data: 09.05.18

Chart II.1.4: CDS Premiums in Emerging Economies (Basis Points)

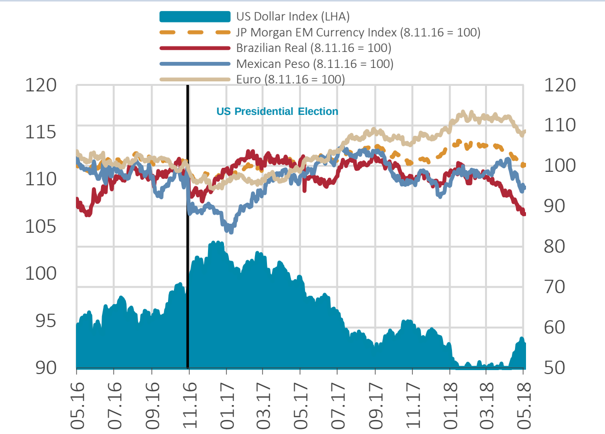


Source: Bloomberg Latest Data: 11.05.18

Note: Emerging economies include Brazil, Czechia, Indonesia, S. Africa, Colombia, Hungary, Poland, Romania, Turkey and Chile. Brazil, Indonesia and South Africa CDS premiums are used for the calculation of the average of selected emerging economies.

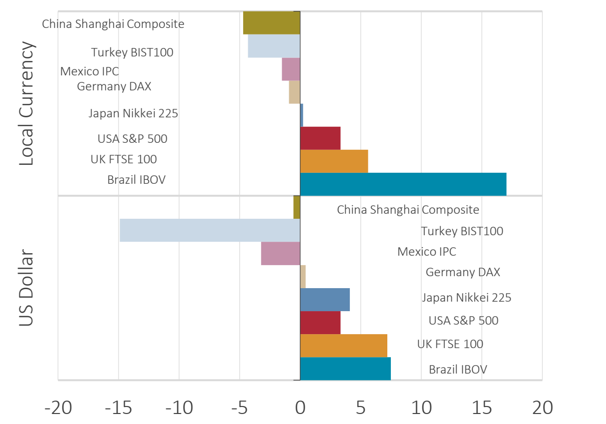
Increased global risk appetite, global portfolio movements towards EMEs, the US Government's sentiment regarding global trade policies and fading political uncertainties in the EU generally played an instrumental role in the appreciation of advanced and emerging market currencies against US dollar in the first quarter of 2018. Whereas, in the subsequent period, the US dollar appreciated against these currencies in connection with the developments in financial markets (Chart II.1.5).

Chart II.1.5: Exchange Rate Indices



Source: Bloomberg Latest Data: 11.05.18

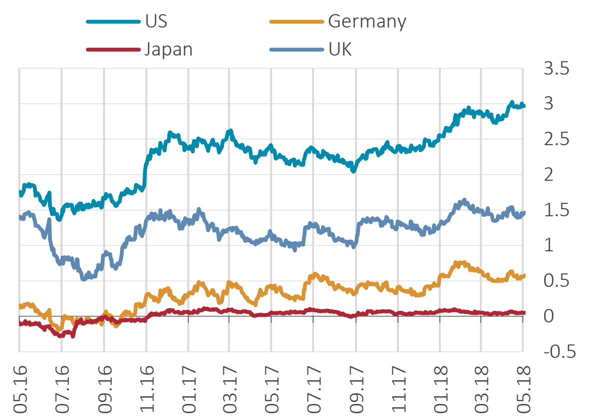
Chart II.1.6: Stock Market Indices (% Change, 12.11.17 – 11.05.18)



Source: Bloomberg Latest Data: 11.05.18

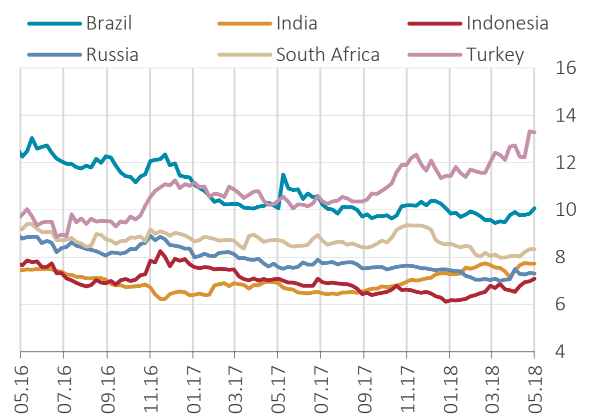
Wage increases in the US labor market negatively reflected on risk perceptions by influencing market expectations in February 2018. This factor and tightening of advanced economy monetary policies, coupled with country-specific developments, have played a role in decoupling of stock market performances of countries since the previous Report period (Chart II.1.6). Due to the positive course of the economic outlook and expectations for tax reform as well as an expansionary fiscal policy, stock market indices in advanced economies led by the US generally trended upwards. In the meantime, despite a positive macroeconomic outlook, EME stock market indices have underperformed due to the recent capital movements and weakening risk appetite at the global level. Compared to the last Report period, bond yields of both advanced economies (Chart II.1.7), primarily the US, and of EMEs (Chart II.1.8) have increased in general.

Chart II.1.7: 10-Year Treasury Bond Yields in Advanced Economies (%)



Source: Bloomberg Latest Data: 14.05.18

Chart II.1.8: 10-Year Treasury Bond Yields in Emerging Economies (%)



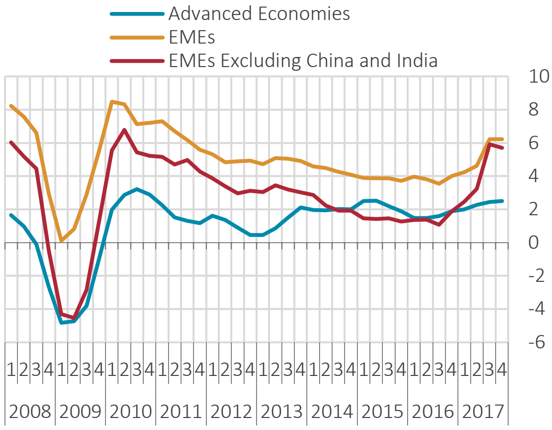
Source: Bloomberg Latest Data: 11.05.18

Note: As South Africa has not issued any 10-year treasury bonds in the recent period, the 9-year bonds yields after December 2017 have been taken into account.

The global economic activity has hit the highest growth rate since 2011 in response to the positive course of global trade volume, investment driven growth in advanced economies, recovery in some of the commodity exporting countries such as Russia and Brazil, and the growth support from EMEs, primarily those in Asia, driven by net exports and private consumption (Chart II.1.9).

Moreover, although leading indicators of growth have lost momentum in some economies, they suggest continued growth in advanced economies (Chart II.1.10). On the other hand, the rate of growth in EMEs excluding China and India has increased substantially, converging to the EME average in the recent period. The strong growth performance of Turkey is noteworthy as a major factor in this increase. Nevertheless, the economic activity in India that accelerated on the back of the reform program and the fact that the growth in China, albeit with a slight decline, will remain above EME growth averages, along with the support from commodity exporting EMEs are anticipated to sustain the momentum of growth in EMEs. In brief, both advanced and emerging economies grow simultaneously.

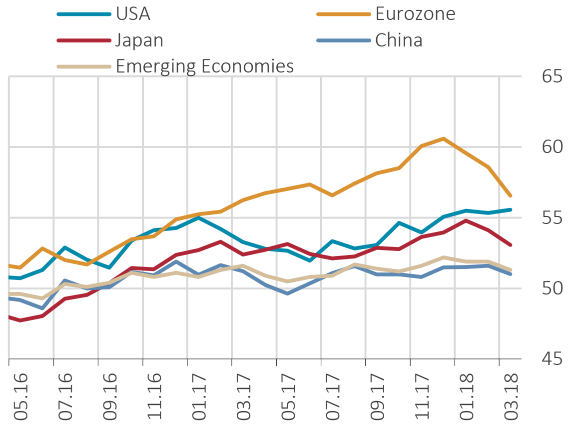
Chart II.1.9: Annual Growth Rates in Advanced and Emerging Economies (% Change)



Source: Bloomberg, CBRT Latest Data: 12.17

Advanced Economies: US, Euro Area, Japan, UK, Canada, S. Korea, Switzerland, Sweden, Norway, Denmark, and Israel. Emerging Economies: China, Brazil, India, Mexico, Russia, Turkey, Poland, Indonesia, S. Africa, Argentina, Thailand, Malaysia, Czechia, Colombia, Hungary, Romania, Philippines, Ukraine, Chile, Peru and Morocco.

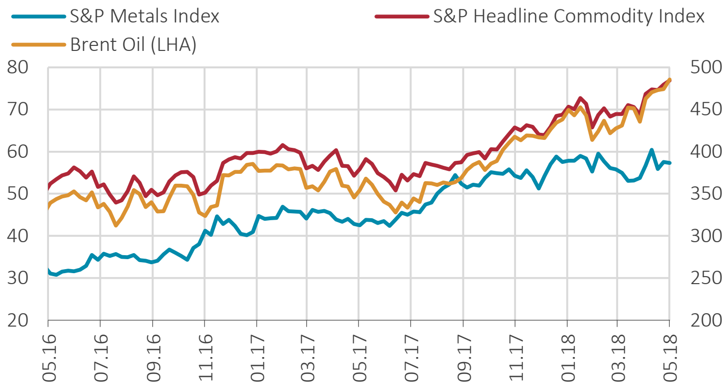
Chart II.1.10: Manufacturing Industry PMI Indices



Source: Bloomberg, CBRT Latest Data: 03.18

The global demand-led uptrend in commodity prices prevailing since 2016 has strengthened (Chart II.1.11). Besides, constraints regarding the production of steel and aluminum in China have been effective in the rise of the commodity index. Among factors influential on oil and natural gas prices increases are successful implementation of OPEC's production restrictions on oil, likely downside shocks related to oil supply due to geopolitical developments, acceleration in global economic activity, and increased demand for liquid natural gas (LNG) thanks to environmental policies in China.

Chart II.1.11: Commodity Indices (USD, Index)



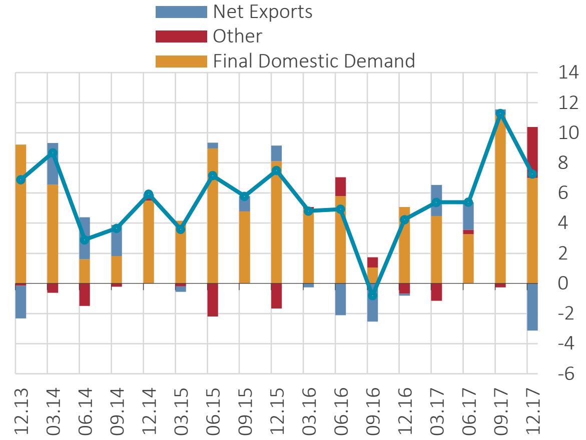
Source: Bloomberg Latest Data: 11.05.18

The spread of the US-led protectionist tendencies in foreign trade onto the global scale, the tightening in financial conditions, low profitability in the EU banking system with high non-performing loan ratios of some major EU banks in particular, and geopolitical developments, primarily in the Middle East, are among the risk factors for global financial stability. Meanwhile, global financial reform studies led by the G20 have largely been finalized (see Special Topic V.2) and impact analyses have started after implementation of reforms. An effective and efficient implementation of macro financial policies in line with the results of the analyses is essential for sustainable and inclusive global growth and for maintaining financial stability on a global basis.

II.2 Domestic Developments

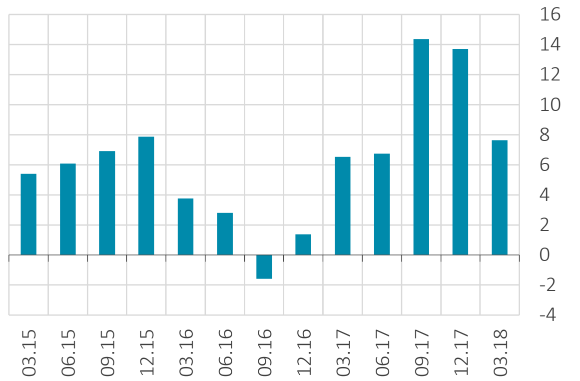
Economic activity remained strong in the last quarter of 2017. Thus, the rate of growth that hovered below the historical averages at 3.2 percent in 2016, became 7.4 percent in 2017. Final domestic demand became the main driver of growth owing to the measures and incentives introduced to support domestic demand. The contribution of private and public consumption to growth continued, with investments presenting a positive outlook thanks to the support of infrastructure and construction investments in particular. The "other" item, covering increased gold stocks driven by gold imports, raised its share in growth (Chart II.2.1). Net exports had a limited effect on growth due to the revival of domestic demand and increase in gold imports. However, net exports excluding gold made a significant contribution (1.3 points) to growth.

Chart II.2.1: Contribution to Annual Growth from the Expenditure Side (%)



Source: TURKSTAT Latest Data: 12.17

Chart II.2.2: Industrial Production Index (Seasonally and Calendar Adjusted Annual % Change)

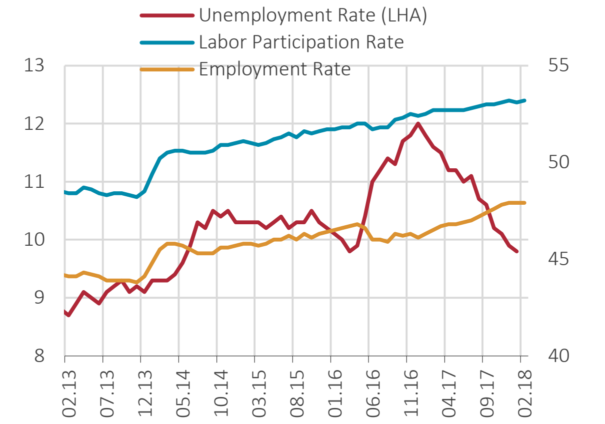


Source: TURKSTAT Latest Data: 03.18

Industrial production figures suggest that in the first quarter of 2018, the economic activity maintained the growth trend -albeit with a slight decline- which it had achieved in the third quarter of 2017. In annual terms, industrial production recorded a substantial increase, hitting 14.4 percent in the third quarter of 2017 (Chart II.2.2). Leading indicators suggest that the contribution of industrial production to growth will continue in 2018.

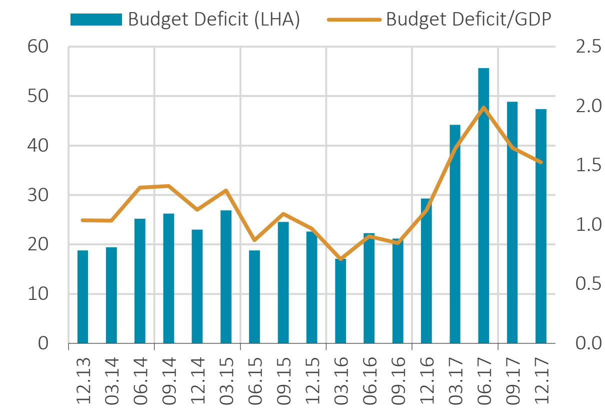
The positive implications of the momentum achieved in economic activity on unemployment rates and employment started to become evident particularly from the first quarter of 2017. The unemployment rate that peaked in early 2017 declined substantially throughout the year. The seasonally adjusted unemployment rate stood at 9.9 percent as of the end of 2017. The downtrend continued in the first quarter of 2018 (Chart II.2.3). However, the uptrend in the labor participation rate continues to restrain the decline in unemployment rates despite a strong employment outlook. Employment is being boosted by KGF loans, extended predominantly to small and medium sized firms as the economic activity gained ground and diffused across all the sectors, as well as by employment incentives.

Chart II.2.3: Labor Force
(Seasonally Adjusted, %)



Source: TURKSTAT Latest Data: 02.18

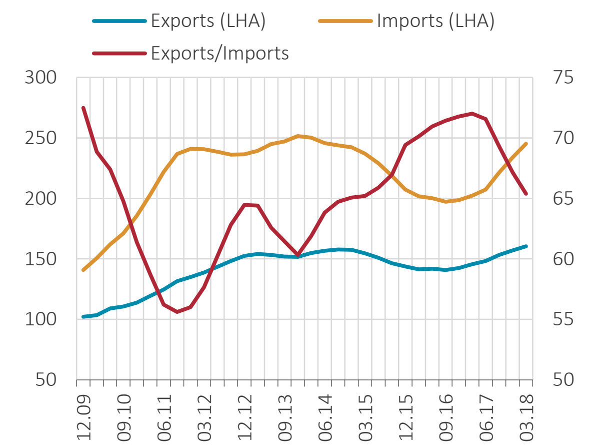
Chart II.2.4: Central Government Budget Balance
(12-Month Cumulative, Billion TL, %)



Source: Undersecretariat of Treasury Latest Data: 12.17

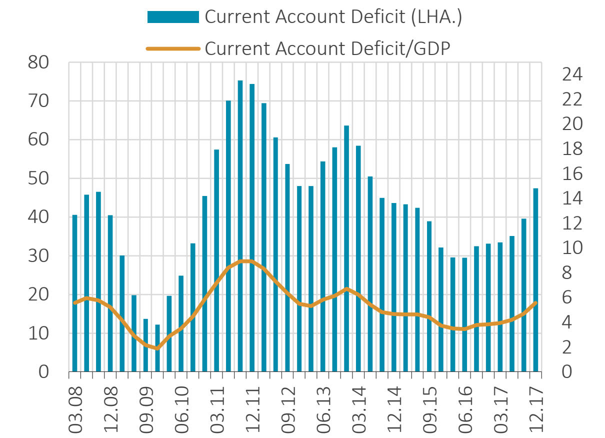
The ratio of central government budget deficit to GDP appeared to be 1.5 percent by the end of 2017. The fiscal policy that aims to support growth dynamics with an investment-oriented approach through direct or indirect instruments manifested its positive effects in the second half of the year. Central government budget deficit, which assumed an upward trend in the first half due to increased public consumption and public sector driven infrastructure-construction projects, started to decline owing to the economic growth that prevailed during the rest of the year. The 12-month cumulative central government budget deficit posted a decrease by 9 billion TL to 47 billion TL by the end of 2017 (Chart II.2.4). This downtrend can also be sustained throughout 2018 with the reflection of growth on tax revenues.

Chart II.2.5: Foreign Trade
(12-Month Cumulative, Billion USD, %)



Source: CBRT Latest Data: 03.18

Chart II.2.6: Current Account Deficit
(12-Month Cumulative, Billion USD, %)

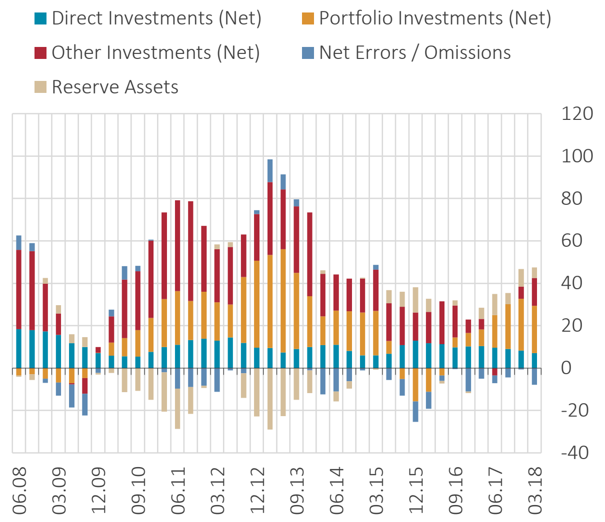


Source: CBRT Latest Data: 12.17

The ratio of imports covered by exports decreased as domestic demand recovered during the last two quarters of 2017 (Chart II.2.5). Imports of goods excluding gold posted a limited increase, whereas gold imports rose slightly. Meanwhile, the persistence of protectionist trends in international trade poses downside risks to direct exports and also to foreign trade due to increased competition in alternative markets. Therefore, it is essential for exporting firms to sustain their productivity and maintain their export markets and shares.

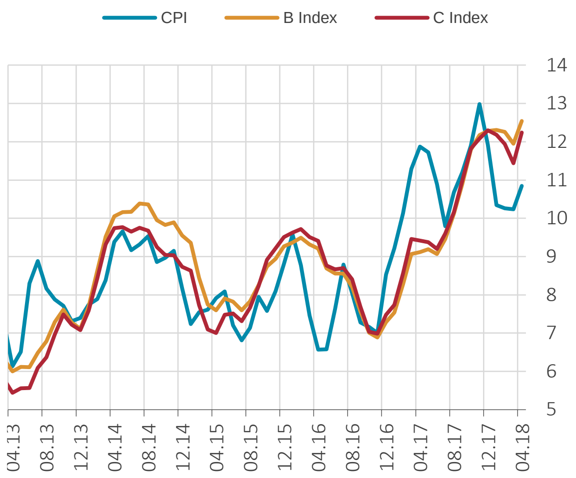
In the last quarter of 2017, the current account deficit widened slightly on the back of price hikes in imports and energy, and its ratio to GDP became 5.6 percent (Chart II.2.6). The growth trend that gained ground in the Euro area and in global economy, along with the fluctuation in exchange rates, bolsters both goods exports and tourism. Leading indicators of the first quarter of 2018 suggest that exports preserved their positive performance as was the case in the last quarter of 2017. These developments are anticipated to bring about a correction in the current account deficit. The 12-month cumulative changes in financing of the current account deficit show that the contribution of direct investments and portfolio investments decreased while that of other investments increased compared to the previous quarter (Chart II.2.7).

Chart II.2.7: Financing Sources of Current Account Deficit (12-Month Cumulative, Billion USD)



Source: CBRT Latest Data: 03.18

Chart II.2.8: Price Indices(Annual % Change)



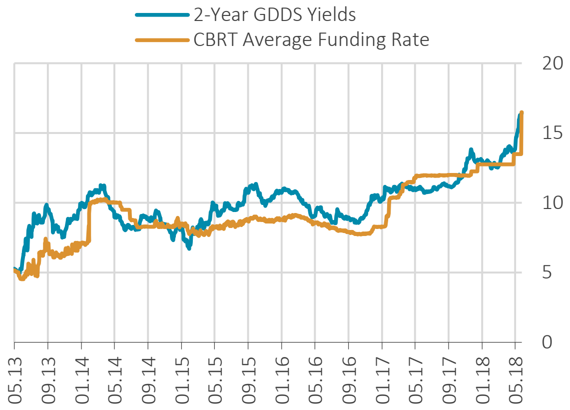
Source: CBRT Latest Data: 04.18

Consumer inflation increased from the second quarter of 2017 through to the end of the year (Chart II.2.8). The depreciation in the Turkish lira as well as price hikes in energy and food were instrumental in this increase. The consumer inflation, in annual terms, was 11.9 percent as of December 2017. The B and C indices reached 12.3 percent. In early 2018, food inflation decelerated driven by unprocessed food prices, yet remained high in other sub-groups due to prevailing cost effects, demand conditions and inflation expectations. The recent upswings in exchange rates are still a source of pressure on inflation, primarily on core goods and energy.

In the second half of 2017, the cautious stance in monetary policy was reinforced gradually due to high levels of domestic demand and inflation. First, all CBRT funding started to be provided through the Late Liquidity Window (LLW) facility. Thus, the CBRT weighted average funding rate materialized at 12.25 percent, the LLW lending rate. Later on, additional monetary tightening was delivered by raising the lending rate to 12.75 percent. In 2018, due to the prevalence of a robust economic activity and risks to pricing behaviors posed by inflation expectations, another proportional tightening was accomplished and the LLW interest rate was raised to 13.5 percent. Moreover, in May, unhealthy price formations observed in financial markets exacerbated risks to pricing behaviors. In this framework, the Monetary Policy Committee decided to implement a strong monetary tightening to support price stability and raised the

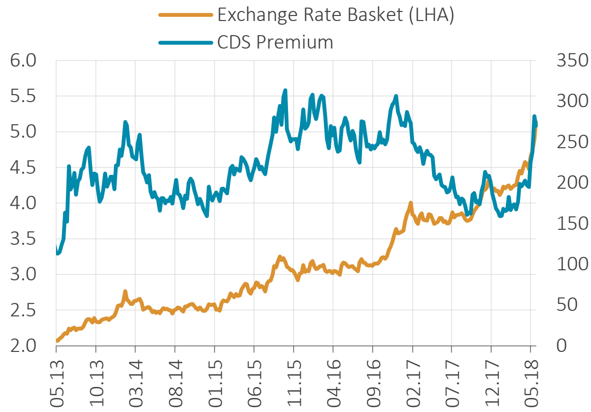
LLW lending rate to 16.5 percent. Finally, the operational framework of the monetary policy was simplified and the policy rate was determined as the one-week repo auction rate (16.5 percent).

Chart II.2.9: Interest Rates (Annual %)



Source: CBRT Latest Data: 05.18

Chart II.2.10: Exchange Rate Basket and CDS (Basis point, TL)



Source: CBRT Latest Data: 05.18

The two-year bond yields that started to soar in the last quarter of 2017 dropped by the end of the year (Chart II.2.9). However, the spread between the two-year bond rate and the CBRT average funding rate started to rewiden in early 2018. This is interpreted as a reflection of the market volatility.

The investor risk perception continued to improve throughout 2017 and CDS premiums maintained a downtrend. CDS premiums posted pricing-driven increases at times of heightened exchange rate volatility in 2018 (Chart II.2.10).