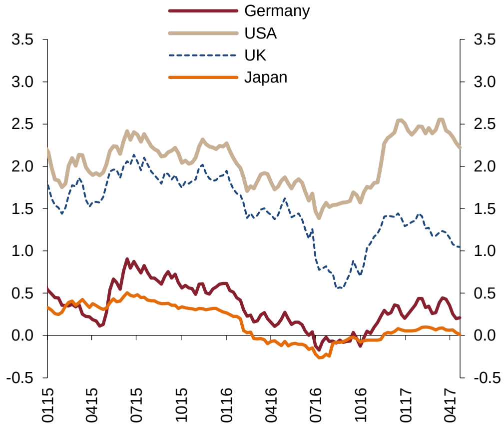
1. Overview

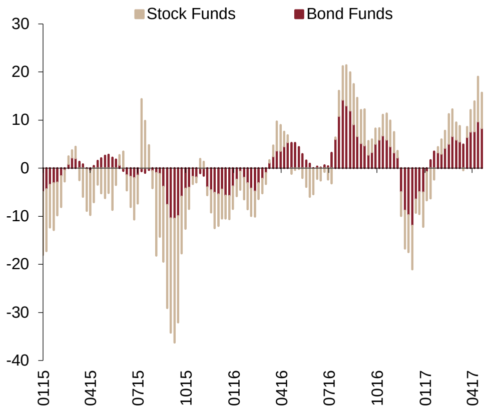
Financial markets have been less volatile since January 2017 amid normalizing post-election expectations for US economic policies, reduced uncertainty about Fed policies and the improving outlook for global economic activity. The sharp upward trend in long-term bond yields of advanced economies observed in the aftermath of the US presidential elections in November came to an end as a result of upbeat global financial markets (Chart 1.1). Accordingly, bond and stock markets in emerging economies have received portfolio inflows since the previous reporting period (Chart 1.2).

Chart 1.1.
10-Year Treasury Bond Yields
(Percent)



Source: Bloomberg.

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



Source: EPFR.

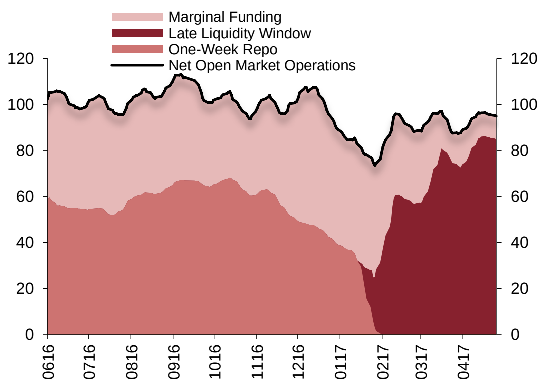
Recently, Turkey also has received more portfolio inflows similar to peer emerging economies. Due to monetary tightening, short-term interest rates continued to edge up, while the slope of the yield curve reversed and the Turkish lira saw appreciation as well as reduced volatility. Meanwhile, loan growth is stronger than in previous years owing to macroprudential policies supportive of the financial system, fiscal incentives and measures. The recent improvement in lending conditions is largely driven by commercial loan conditions that have been easing on the back of public credit guarantees.

The first quarter of 2017 was marked by increasing core inflation indicators as well as steeper cost pressures on producer prices due to rising exchange rates and commodity prices. The relative recovery in demand conditions and the high inflation expectations led to price hikes over this period. As a result, consumer inflation rose to 11.29 percent in the first quarter. After the temporary third-quarter slowdown, economic activity recorded a moderate growth driven by domestic demand in the fourth quarter of 2016. Thanks to the fourth-quarter pickup in exports, net external demand provided a large contribution to quarterly growth, which is likely to strengthen throughout 2017. Indicators for the first quarter suggest that economic recovery lost some momentum compared to the fourth quarter due to the heightened uncertainty amid financial market volatility, the weak outlook in labor markets and the rapidly rising inflation, all of which, however, look poised to display a better outlook in the remainder of the year. Moreover, the upsurge in exports of goods as well as the accommodative incentives and measures are likely to boost economic recovery from the second quarter onwards.

1.1. Monetary Policy and Financial Markets

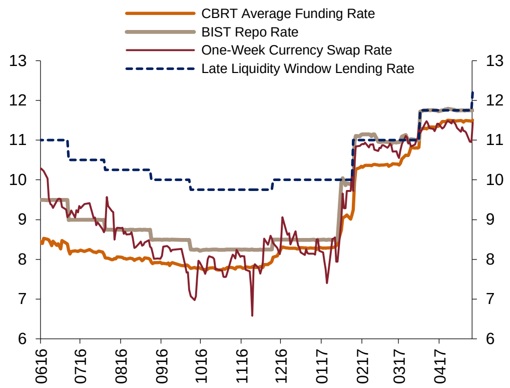
The CBRT delivered a strong monetary tightening in early January 2017 to preserve inflation outlook against repercussions of the severe FX market volatility that seemed inconsistent with economic fundamentals. Accordingly, as of 12 January 2017, the CBRT suspended one-week repo auctions, gradually lowered marginal funding and resorted more heavily to the late liquidity window for funding (Chart 1.1.1). Additionally, the marginal funding rate was raised by 75 basis points at the January MPC meeting, while the late liquidity window lending rate was hiked by a total of 225 basis points in January, March and April meetings, leading to a stronger monetary tightening, which was also transmitted to other money market rates (Chart 1.1.2). The BIST overnight repo rates and the currency swap market rates moved in tandem with the CBRT's weighted average funding cost, while the FX market stabilized relatively, which indicates that the transmission of monetary policy has worked in the intended way.

Chart 1.1.1.
CBRT Funding*
(2-Week Moving Average, Billion TL)



* Marginal funding is overnight funding quoted at the upper band of the interest rate corridor.
Source: CBRT.

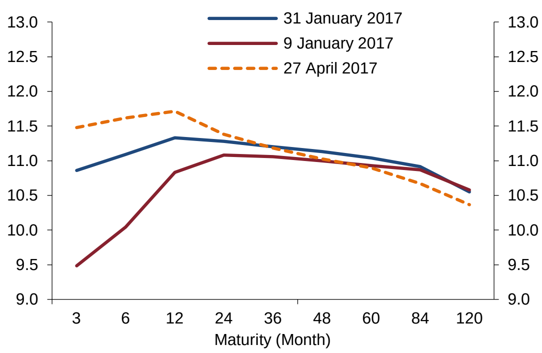
Chart 1.1.2.
Bank's Funding Costs at the Money Markets
(5-Day Moving Average, Percent)



Source: BIST, CBRT.

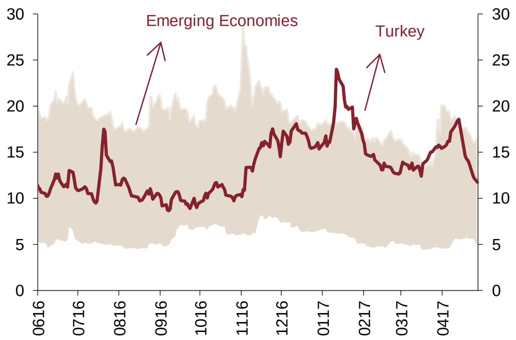
The slope of the yield curve has been reversing since early 2017, which points to the tight monetary policy stance. Short-term currency swap yields continued to climb markedly in the inter-reporting period due to the CBRT's monetary policy actions, whereas long-term currency swap yields hardly changed (Chart 1.1.3). Policy actions had a strong effect on the FX market as well, with the implied volatility of the Turkish lira improving after the steep increase in January (Chart 1.1.4).

Chart 1.1.3.
Yield Curve on Currency Swaps
(Percent)



Source: Bloomberg.

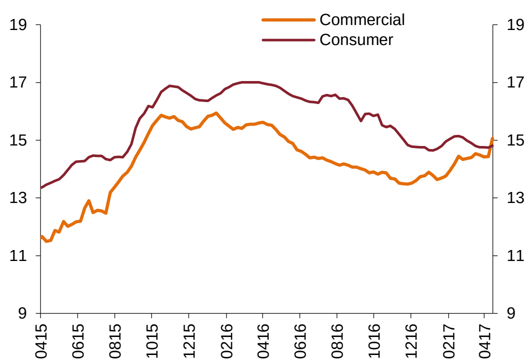
Chart 1.1.4.
Implied FX Volatility*
(1 Month, Percent)



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

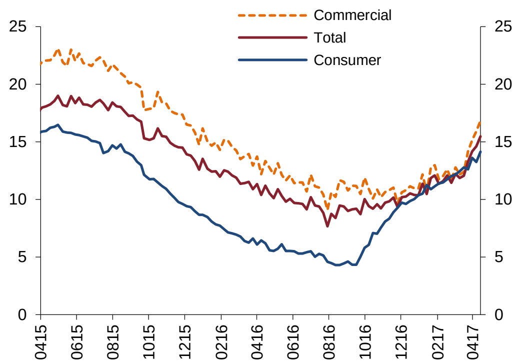
Despite the CBRT's higher funding cost, credit conditions continued to recover in the first quarter of 2017 thanks to macroprudential policies supportive of the financial system, fiscal incentives and public credit guarantees. Due to macroprudential policies and other measures to enhance access to credit, both consumer and commercial loan rates increased at a slower pace than the CBRT's average funding cost in this period (Chart 1.1.5). The growth of TL-denominated commercial loans has accelerated in recent months, in part owing to the rapid increase in the loans supported by the Credit Guarantee Fund (Chart 1.1.6).

Chart 1.1.5.
TL Loan Rates*
(Flow, Annualized, 4-Week Moving Average, Percent)



* Excluding overdraft accounts, credit cards and non-zero interest rate loans.
Source: CBRT.

Chart 1.1.6.
Annual Loan Growth
(Adjusted for Exchange Rate, Percent)

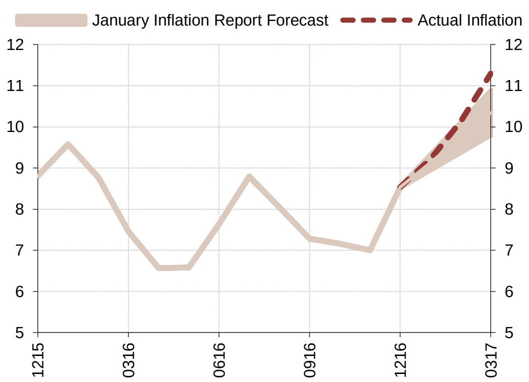


1.2. Macroeconomic Developments and Main Assumptions

Inflation

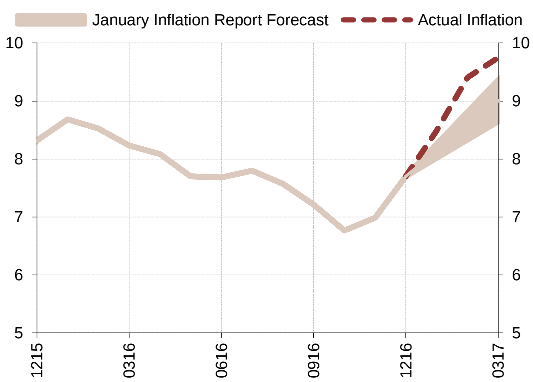
Consumer inflation hit 11.29 percent in March, surpassing the upper band of the January Inflation Report forecast (Chart 1.2.1). The forecast for the consumer inflation excluding unprocessed food, alcoholic beverages and tobacco products showed a similar pattern (Chart 1.2.2). The uptick in inflation was largely due to the Turkish lira depreciation and higher import prices as well as rising food prices. The effects of the Turkish lira depreciation spread across the entire index. Core inflation increased in this period, while non-core items such as unprocessed food, energy, alcoholic beverages and tobacco products provided a significantly larger contribution to inflation (Chart 1.2.3).

Chart 1.2.1.
Inflation Forecasts and Actual Inflation*
(Percent)



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

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



Food inflation rose sharply in the first quarter, especially due to unprocessed food, amid adverse weather conditions, the Turkish lira depreciation, the recovering exports of fruits and vegetables and the low base effect. Negative supply conditions mostly affected prices of fresh fruits and vegetables, while the effects of exchange rates and import prices were evident in other food items. Thus, annual food inflation was slightly higher than the path projected in the January Inflation Report.

Being subject to a faster exchange rate pass-through, energy prices were the first to reflect the effects of the Turkish lira depreciation. In addition to exchange rate effects, increases in oil prices and administered water tariffs drove energy prices remarkably higher in the first quarter. The weak Turkish lira also had an adverse impact on core goods inflation, which rose dramatically due to prevailing exchange rate effects notwithstanding the temporary tax cut on furniture and home appliances. Thus, core goods made the second biggest contribution to higher consumer inflation after food.

Chart 1.2.3.
Contribution of Unprocessed Food, Energy, Alcoholic Beverages and Tobacco Products to CPI Inflation
(Percentage Point)

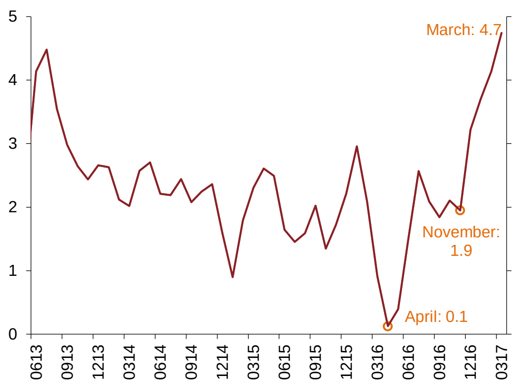
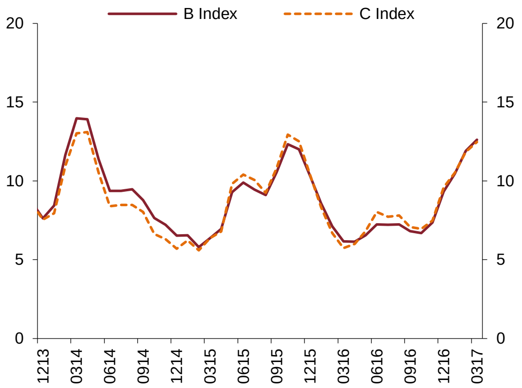


Chart 1.2.4.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



Source: TURKSTAT, CBRT.

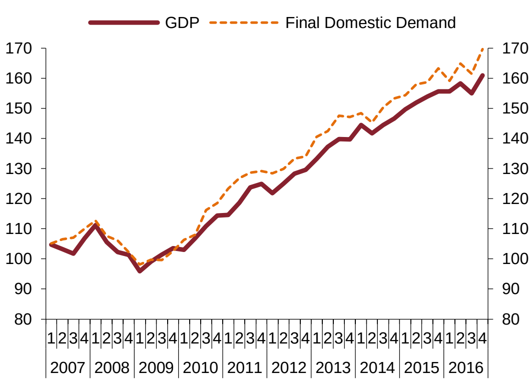
Services inflation was also on the rise in the first quarter, though at a slower pace than core goods. This rise was attributed mostly to the lagged effects of rising fuel prices as well as increases driven by exchange rate sensitive services. Rent inflation remained elevated, primarily in Istanbul. Against this backdrop, the uptrend that started in December 2016 in the underlying trend of core indicators continued more strongly into the first quarter (Chart 1.2.4). Alternative core inflation indicators monitored by the CBRT posted a similar upward pattern.

Supply and Demand

Data for the fourth quarter of 2016 confirmed the conjecture that the third-quarter economic slowdown was transitory. In this period, the GDP expanded by 3.8 percent quarter-on-quarter and 3.5 percent year-on-year (Chart 1.2.5). Excluding the compensation for the workday losses of the third quarter, the fourth quarter was marked by a mild growth. On the other hand, the TURKSTAT's upward revisions to the first three quarters of 2016 showed that the level of economic activity was much higher than the previous reporting period. In effect, the economy grew by 2.9 percent in 2016, down from a year ago.

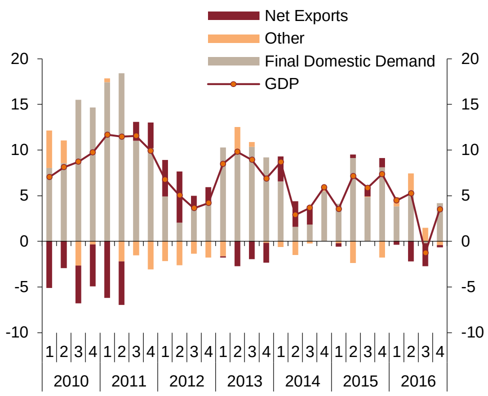
Annual growth was driven by domestic demand in the final quarter (Chart 1.2.6). Private consumption expenditures were up both yearly and quarterly thanks to depreciation of the Turkish lira, demand brought forward by SCT adjustments on automobiles, eased macroprudential measures and improved financial conditions. Investments increased at a slower pace than consumption in this period. Weak machinery and equipment investments contained the recovery in investments. With exports accelerating in the final quarter, net external demand provided a more robust contribution to quarterly growth and a slightly better contribution to annual growth compared to the first nine months of 2016, which owes to exchange rate developments, the restored relations with Russia, the positive implications of market diversification on exports of goods and services and flat imports.

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



Source: CBRT, TURKSTAT.

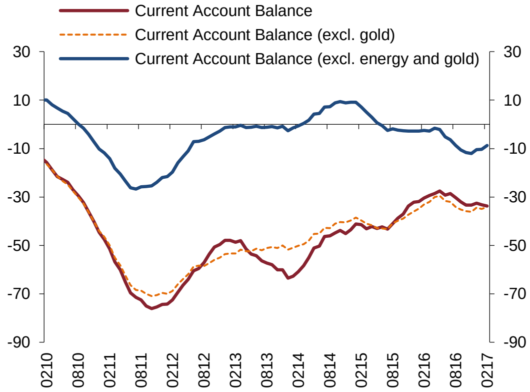
Chart 1.2.6.
Contributions from the Expenditure Side*
(Percentage Points)



* Other includes changes in stocks and statistical discrepancy due to the use of chain linked index.
Source: TURKSTAT.

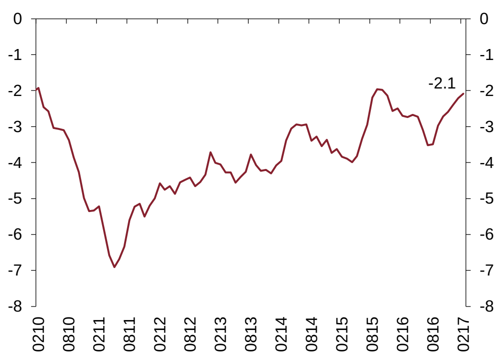
Indicators for the first quarter of 2017 suggest that economic recovery lost some momentum in this period. The rapid depreciation of the Turkish lira in early January, the heightened uncertainty amid financial market volatility and the rapidly rising inflation are expected to dampen consumption and investment expenditure. Even though tax incentives stimulate the demand for houses, furniture and home appliances, weakening total retail sales hint at a domestic demand recovery that fails to spread across all sectors. On the other hand, net external demand is expected to contribute further to growth in line with the robust course of goods exports. Parallel to this change in the composition of growth, the recent trend of the current account balance has improved (Charts 1.2.7 and 1.2.8), which is expected to continue across the year, especially with the support from goods exports.

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



Source: CBRT.

Chart 1.2.8.
Current Account Balance Excluding Gold
(Seasonally Adjusted, 3-Month Moving Average, Billion USD)

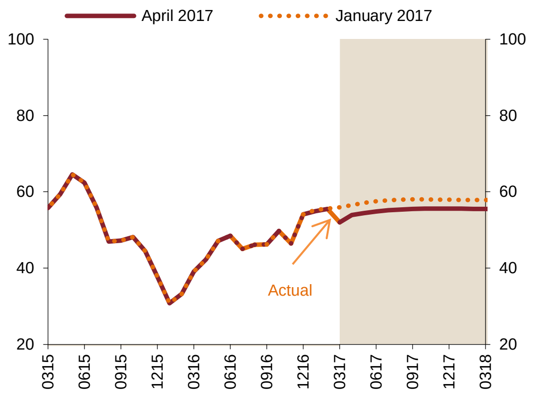


Oil, Import and Food Prices

Assumptions for the average crude oil prices in 2017, which were 57 USD in the January Inflation Report, were set as 55 USD for 2017 in light of the recent developments. Meanwhile, assumptions for USD-denominated import prices were revised considerably upwards for 2017 due to the rising trend in commodity prices (Charts 1.2.9 and 1.2.10).

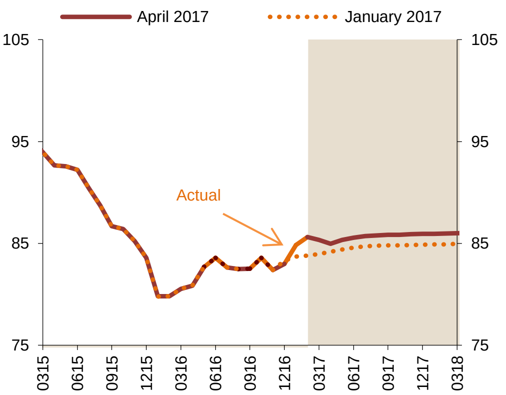
Food inflation in the first quarter of 2017 stood somewhat above January projections with 12.53 percent. This was led by the impact of adverse weather conditions on the food supply coupled with the effects of the depreciated Turkish lira and the recent rebound in the exports of fruits and vegetables. Meanwhile, measures to be taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee (Food Committee) are expected to limit this rise to some extent in the upcoming period. Accordingly, the assumption for food price inflation was kept unchanged at 9 percent for end-2017 and 7 percent for end-2018.

Chart 1.2.9.
Oil Prices
(USD/bbl)



Source: Bloomberg, CBRT.

Chart 1.2.10.
Import Prices
(2010=100)



Source: CBRT, TURKSTAT.

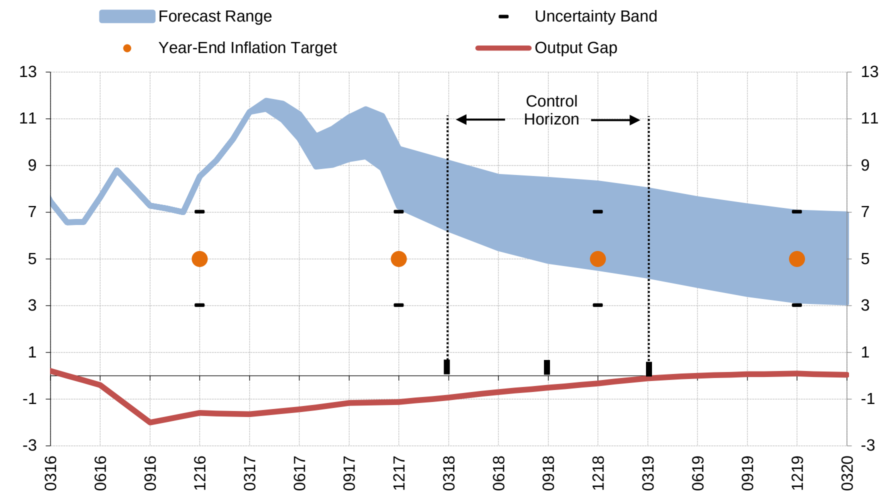
Fiscal Policy and Tax Adjustments

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 increases. Accordingly, it is expected that the effects of tax increases in 2016 on annual inflation will gradually vanish, which will thus support disinflation. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms.

1.3. Inflation and 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 8.5 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 6.4 percent at end-2018. Hence, inflation is expected to be, with 70 percent probability, between 7.3 percent and 9.7 percent (with a mid-point of 8.5 percent) at end-2017 and between 4.6 percent and 8.2 percent (with a mid-point of 6.4 percent) at end-2018 (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts*
(Percent)



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

Year-end inflation forecasts for 2017 and 2018 were revised upwards by 0.5 and 0.4 points, respectively compared to the 2017 January Inflation Report. The upward revision in TL-denominated import prices is estimated to drive the year-end inflation forecast for end-2017 upwards by 0.1 point compared to the previous Report. On the other hand, output gap forecasts, which were revised upwards due to the relative improvement in economic activity, are estimated to push the year-end forecast for 2017 up by 0.2 points. Lastly, the higher-than-projected first-quarter inflation in 2017 compared to the January Inflation Report coupled with the increase in the underlying trend of inflation are estimated to drive the year-end inflation forecast up by 0.2 points.

On the other hand, the consumer inflation forecast for 2018 was also revised upwards from 6 percent to 6.4 percent. This revision was driven by the raise in the year-end inflation forecast for 2017 and the increase in the underlying trend of inflation. The projection of a decline in inflation from 8.5 percent at end-2017 to 6.4 percent by end-2018 is based on the policy stance that focuses on bringing inflation down as well as on an outlook where cumulative exchange rate effects will disappear and economic activity will remain moderate.

1.4. Risks and Monetary Policy

Prospects about post-election US economic policies had alleviated effects on financial markets since early 2017. Compared to the previous reporting period, indicators of economic activity point to stronger global growth in 2017, driven especially by advanced economies. However, uncertainties over the Brexit process and ambiguities regarding post-election economic policies in the US keep downside risks to global growth brisk. The upward trend in advanced economies' long-term bond yields, which started in November came to a halt, and portfolio flows to bond and stock markets of emerging economies resumed thanks to abated ambiguities over the Fed policy accompanied by optimistic expectations in financial markets. Although global financial conditions have improved slightly in the recent period, the direction and volume of portfolio flows to emerging economies will depend on the pace of the Fed's monetary tightening cycle.

Despite the relative improvement in global financial conditions, domestic financial conditions tightened slightly in the first quarter of 2017 due to the partially persistent volatility in the FX market and the tightening in monetary policy. On the other hand, the Turkish lira has recently diverged positively from other emerging market currencies and partly compensated for past losses. Moreover, macroprudential policies supportive of the financial system as well as public incentives and public credit guarantees allowed credit conditions to recover further. The recovery in consumer loans and TL-denominated commercial loans observed in the first quarter of 2017 is monitored closely with regard to its effects on aggregate demand and economic activity.

Downside risks to economic activity have recently abated. The growth outlook for 2017 is expected to be more favorable compared to 2016, which was marked by several concurrent adverse shocks. The relative stability in tourism revenues, the stronger confidence channel, the favorable effect of the cumulative exchange rate depreciation on net exports and the normalization of commercial relations with Russia will all contribute to growth. Moreover, measures and incentives to stimulate consumption and investment expenditures, fading perceptions of uncertainty and the improvement in the tightness of financial conditions will also enhance growth. Accordingly, economic activity is expected to strengthen as of the second quarter of the year. On the other hand, the pace of recovery in tourism revenues, uncertainties regarding monetary policies of advanced economies, the course of capital flows and geopolitical developments will continue to constitute downside risks to growth in 2017.

Consumer inflation has surged since November 2016 and exceeded the upper band of the January Inflation Report forecasts. The upward trend in inflation was largely driven by the depreciation of the Turkish lira and the rise in import prices in addition to the increase in food prices. The rapid depreciation of the Turkish lira spread across the consumer price index, particularly to energy and durable goods items. As also indicated in the previous Report, due to the base effects stemming from the prices of unprocessed food, tobacco products and clothing as well as temporary tax reductions, consumer inflation will fluctuate throughout 2017. Inflation is expected to peak in April and May particularly due to the base effect from unprocessed food and the lagged effects of the exchange rate, and then to fall thereafter as the impact of last year’s price increases in energy, alcoholic beverages, tobacco products and food diminishes gradually. The tight monetary policy stance will support the disinflation process.

Medium-term inflation forecasts are based on an outlook where aggregate demand conditions continue to support disinflation, albeit at a more limited extent in comparison with the January Inflation Report. The upward revision in GDP for 2016 and the acceleration in credits indicate that the recovery in economic activity might be stronger than expected. However, elevated unemployment rates suggest that the demand-side risks on inflation are balanced. The effects of production and employment incentives and measures to boost the credit market on aggregate demand conditions will be closely monitored in the upcoming period.

Risks to food inflation, another major determinant of inflation forecasts, are considered to be on the upside. Due to the recovery in the exports of food products and the impact of the exchange rate developments, food inflation might overshoot current projections, which are based on the assumption that measures taken by the Food Committee will considerably balance the upside risks to food prices.

Although cost pressures are partly contained on the back of the recent rise in the risk appetite, the escalation in inflation poses a risk to the pricing behavior. Thus, the tight stance in monetary policy will be maintained until the inflation outlook displays a significant improvement. The CBRT formulates monetary policy by taking the medium-term inflation outlook into account, thus focusing on the developments in the underlying trend of inflation rather than the anticipated fluctuations in inflation driven by the base effects during the course of the year. Inflation expectations, pricing behavior 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 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. 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 against 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.