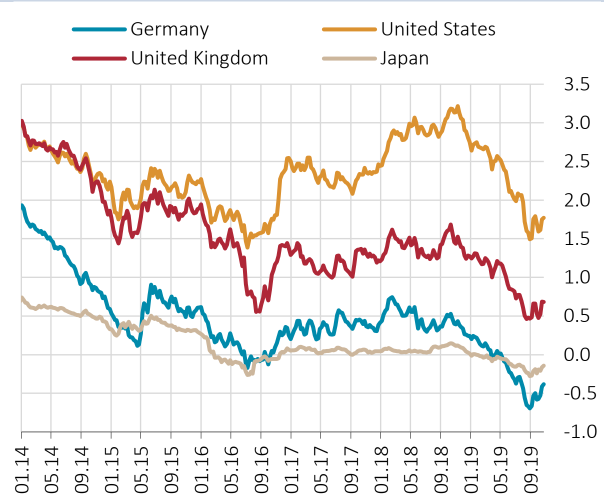
1. Overview

The slowdown in global economic activity became more visible and the uncertainty over global economic policies heightened considerably in the second half of 2019. The global economic outlook, coupled with increased geopolitical uncertainties, presents a weaker course compared to the previous reporting period. These developments depress commodity markets and lead to a mild course in crude oil prices. Accordingly, global inflation rates in 2019 are projected to remain flat depending on the global growth outlook and commodity prices.

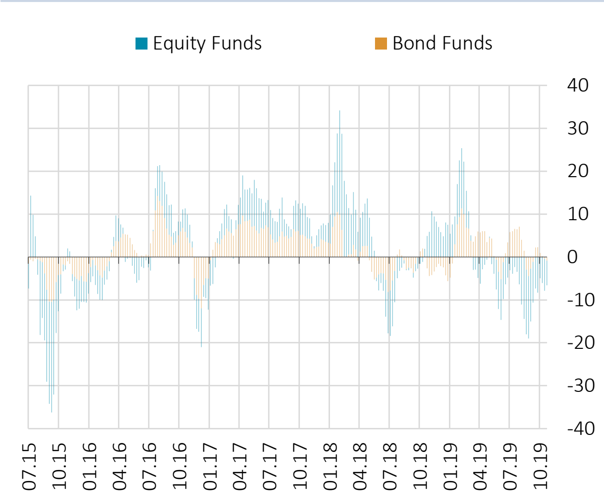
As the weakening in global economic activity and downside risks to inflation became clear, the easing in global monetary policies strengthened compared to the previous reporting period. Both advanced and emerging market economies eased their monetary stance in this period. Against this background, global financial conditions presented a more favorable outlook, and long-term bond yields declined particularly in the US (Chart 1.1). Although this development supported the demand and the risk appetite for emerging market financial assets, protectionist measures and other uncertainties regarding global economic policies suppressed portfolio flows to emerging market economies (EMEs). In the third quarter, while inflows to EME bond markets remained quite limited, EME equity markets posted significant outflows (Chart 1.2). High global uncertainties, lingering geopolitical problems, mounting protectionist tendencies and county-specific fragilities across EMEs will continue to be the determinants of portfolio flows towards those countries in the period ahead.

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.

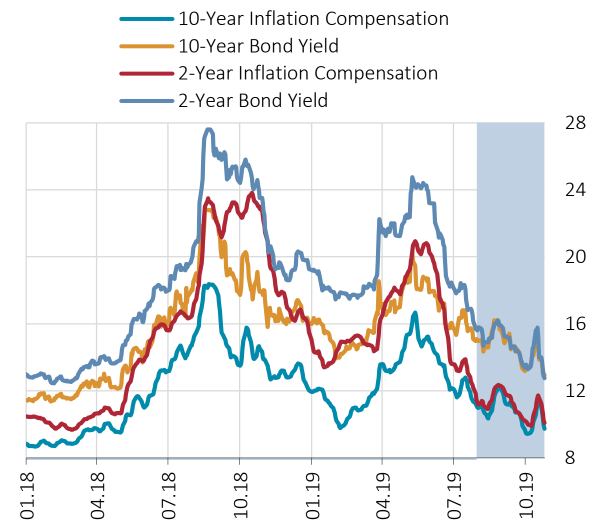
Turkey's risk premium fluctuated amid uncertainties over global economic policies and geopolitical developments in the previous period. In response to the receding global risk appetite in August, Turkey's risk premium increased, as was the case in other emerging economies. After declining once again in September, the country risk premium followed a fluctuating course in October amid geopolitical developments. This situation also had implications for the portfolio flows towards Turkey. Meanwhile, interest rates on credits and deposits decreased significantly on the back of the CBRT's policy rate cuts, the fall in inflation and inflation expectations and the improvement in banking sector liquidity, while credit growth gained momentum driven by both supply and demand. The downward tendency of long-term bond rates continued in this reporting period on the back of the fall in inflation compensation in line with the declining inflation expectations (Figure 1.1.1). The cautious stance of monetary policy, the stable course of exchange rates and the faster disinflation than projections have all contributed to this outcome.

The inflation outlook continued to improve in this period. In the third quarter, consumer inflation fell by 6.46 points compared to the previous quarter to 9.26%. In addition to the high base effect from the previous year, the degree of monetary tightness, domestic demand conditions, the mild course of exchange rates and commodity prices, and the improvement in inflation expectations were influential in the significant slowdown in inflation. In the meantime, economic activity remained on a modest recovery path. Although the improvement continues across sectors, investments remain weak. It is anticipated that, in the period ahead, the contribution of net exports to growth will continue, albeit to a diminished extent, and the economy will maintain its gradual recovery on the back of the disinflation trend and the improvement in financial conditions.

1.1 Monetary Policy and Financial Markets

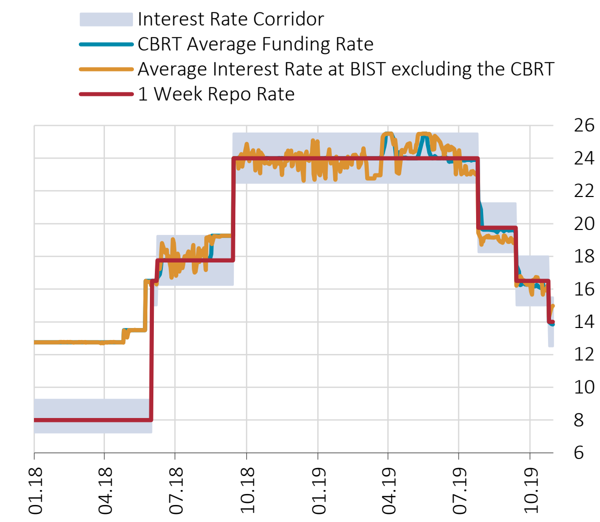
In line with the ongoing improvement in the inflation outlook, the Monetary Policy Committee (MPC) delivered rate cuts in its July, September and October meetings, bringing the one-week repo rate down to 14% (Chart 1.1.2). The funding need of the system has decreased significantly since the previous reporting period due to rediscount credits, CBRT's Turkish Lira currency swaps and the Treasury's TL-exchanged operations with the market. Open market operations have largely been funded by one-week repo auctions and the Primary Dealer repo facility has been used to a limited extent. On the back of the liquidity facility provided to Primary Dealer banks, the BIST overnight repo rates stand at slightly below the policy rate.

Chart 1.1.1: Bond Yields (%) and Inflation Compensation (5-Day Moving Average, %)



Sources: Bloomberg.

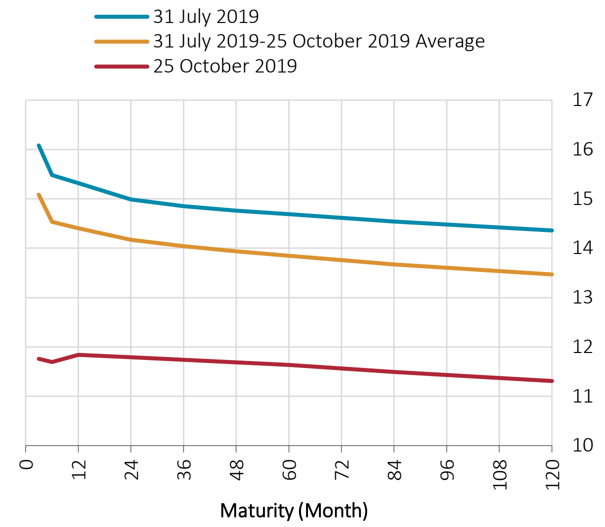
Chart 1.1.2: CBRT Rates and Short-Term Interest Rates (%)



Source: BIST, CBRT.

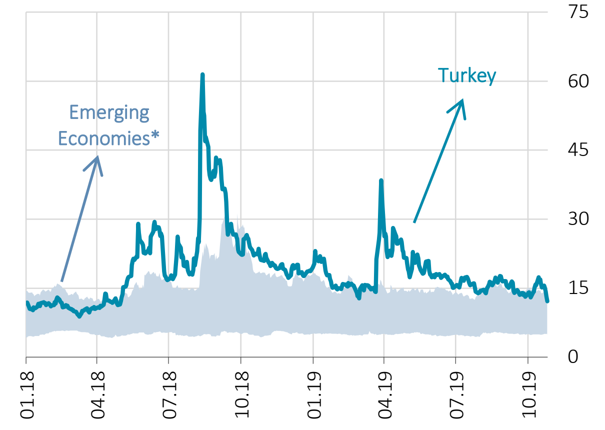
In the current reporting period, currency swap yield curves trended downwards across all maturities compared to the previous reporting period on the back of the interest rate cuts, in addition to the contribution from the decline in inflation expectations (Chart 1.1.3). The implied volatility of the Turkish lira remained flat in the third quarter, although it fluctuated in October due to geopolitical developments (Chart 1.1.4).

Chart 1.1.3: Recent Currency Swap Yield Curve (%)



Source: Bloomberg.

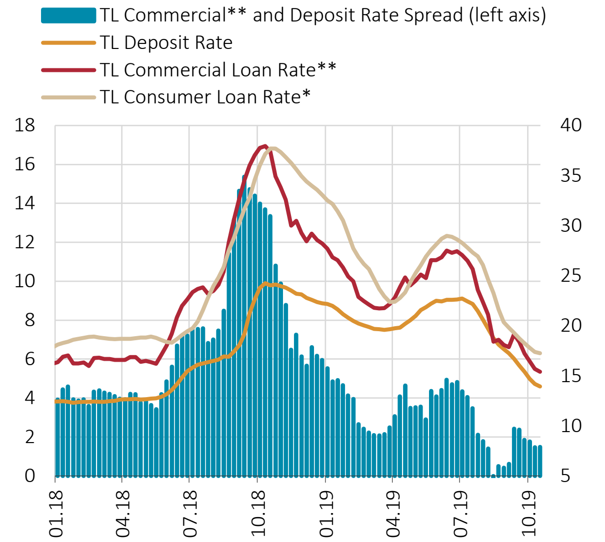
Chart 1.1.4: Implied FX Volatility (1-Month Ahead, %)



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

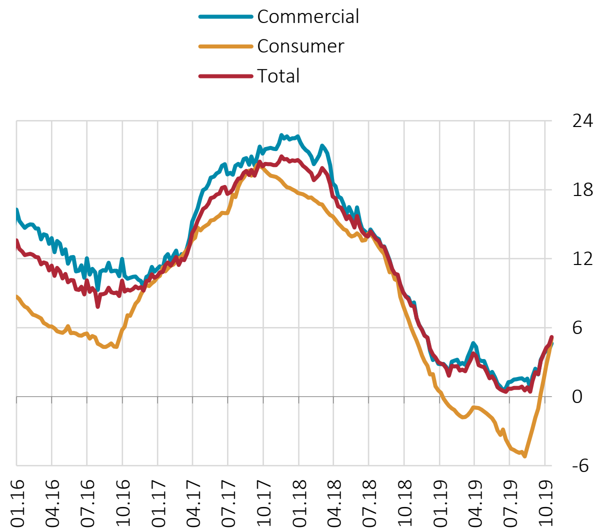
Following the CBRT's interest rate cuts, loan rates declined noticeably across all loan types, and the spread between commercial loan and deposit rates declined below its historic averages (Chart 1.1.5). In this period, the increase in credit demand due to the improvement in financing conditions and the recovery in the domestic demand, led to a significant acceleration in consumer loans from early August on. Commercial loans have also gained pace, though in a more moderate fashion compared to consumer loans (Chart 1.1.6).

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



Source: CBRT.
* TL consumer loan rate series is the average of personal, vehicle and housing loan rates.
** TL commercial loan rate series excludes overdraft accounts, credit cards and zero-rate loans.

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



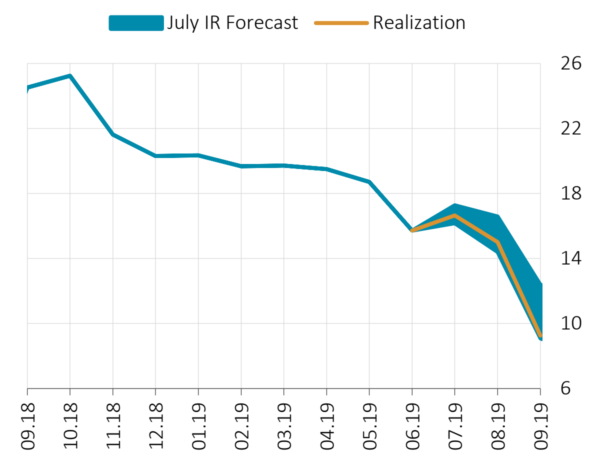
Source: CBRT.

1.2 Macroeconomic Developments and Main Assumptions

Inflation

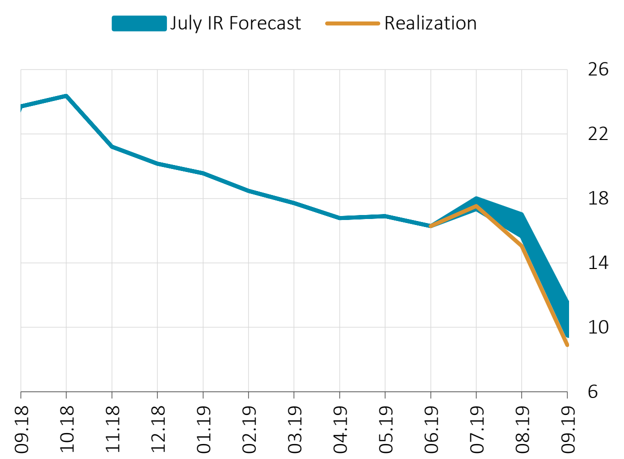
Consumer inflation fell to 9.26% in the third quarter of 2019. The annual inflation of one of the core indicators, the B index, decelerated significantly in this period. Both consumer and core inflation figures stood close to the lower bound of the July Inflation Report forecasts (Chart 1.2.1 and Chart 1.2.2). In this period, the significant slowdown in inflation was driven by the stable course of the Turkish lira in the recent period, improving inflation expectations, and the domestic demand conditions, as well as the high base effect from the previous year. Import prices in dollars also supported the disinflation process.

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



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

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

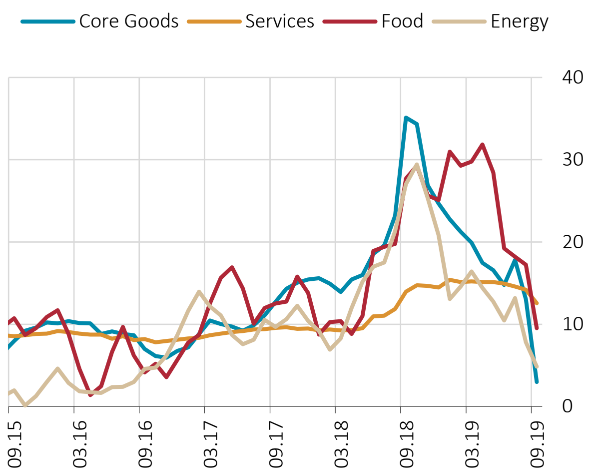


Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

While the downtrend in annual inflation was observed across all major subcategories, the decline was more evident in core goods and food inflation. Although annual core goods inflation temporarily increased in July due to the expiry of tax cuts, it decreased afterwards due to the base effect as well as the exchange rate and the moderate course of domestic demand (Chart 1.2.3). Meanwhile, annual food inflation dropped to 9.52%. In addition to the strong base effect, the boosting effect of favorable weather conditions on the supply of agricultural products – fresh fruits and vegetables in particular, and the moderate increases in processed food prices were the drivers of this decline. Energy prices rose in the third quarter due to price adjustments in electricity and natural gas but annual inflation in this group decreased due to the base effect. Although accumulated cost-driven lagged price hikes and the backward indexation behavior led to upward effects on annual services inflation, it posted a decline due to food prices and domestic demand conditions. On the other hand, price adjustments in tobacco products put a drag on the downtrend in inflation in this period.

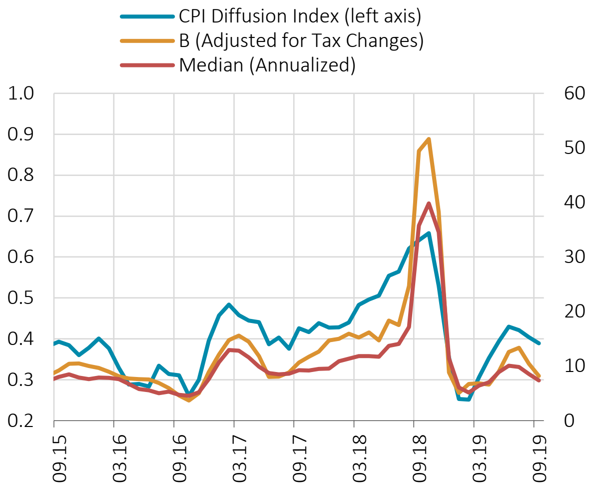
In the third quarter of the year, indicators of pricing behavior suggested a significant improvement in the underlying trend of inflation and a weakened tendency to increase prices (Chart 1.2.4). This was predominantly triggered by the relatively stable course of the Turkish lira as well as the improvement in inflation expectations and mild domestic demand conditions. It is projected that consumer inflation will remain in single digits in October but it will slightly increase in the last two months of the year due to reverse base effect and reach levels that are more consistent with underlying trend indicators. The indirect effects of administered price adjustments such as electricity and natural gas on consumer inflation are closely monitored. In addition, continuation of the improvement in inflation expectations and its alignment with medium-term inflation targets will be an important indicator for the monetary policy stance in the upcoming period.

Chart 1.2.3: CPI Sub-Groups (Annual % Change)



Source: TURKSTAT.

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



Sources: CBRT, TURKSTAT.

*Diffusion Index: Ratio of the number of items with increasing prices minus the number of items with decreasing prices to total number of items within a given month.

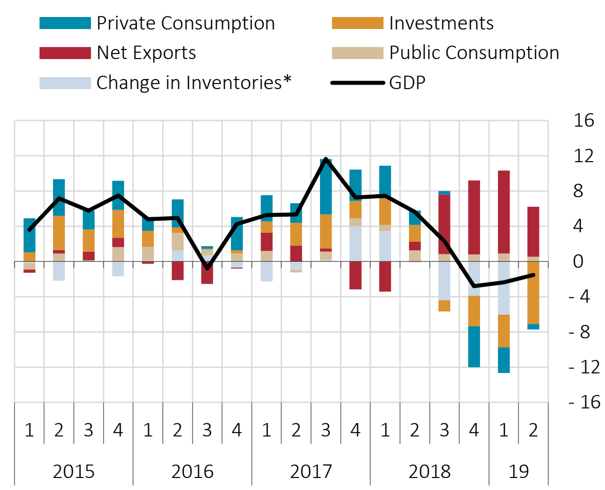
Median: Median monthly inflation of seasonally-adjusted 5-digit sub-price indices.

B Index: Seasonally adjusted, annualized, 3-month moving average, percentage change.

Supply and Demand

Economic activity posted a moderate recovery in the second quarter of 2019 as projected in the July Inflation Report. In this period, gross domestic product (GDP) contracted by 1.5% year-on-year but expanded by 1.2% quarter-on-quarter in seasonally and calendar-adjusted terms. While the contribution of net exports to annual growth hit high levels, domestic demand was weak compared to the previous year. The contribution to the recovery in the first half of the year came both from domestic demand and net exports. The rise in domestic demand was mainly driven by public spending as well as by consumption expenditures that increased due to tax cuts on durable goods, lagged effects of the strong loan growth in the first quarter, and real wage increases. On the other hand, investment expenditures remained weak due to high risk premium and tight financial conditions (Chart 1.2.5).

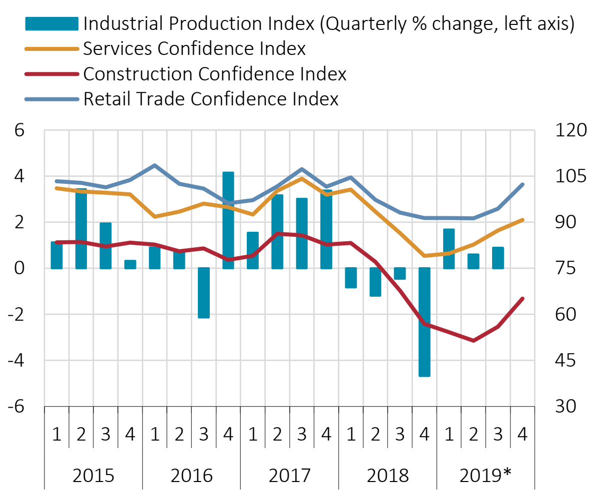
Chart 1.2.5: Contributions to Annual GDP Growth by Expenditures (% Points)



Sources: CBRT, TURKSTAT.

* It includes inventories and statistical discrepancy caused by chain-linking.

Chart 1.2.6: Industrial Production Index and Sectoral Confidence Indices* (Seasonally-Adjusted)



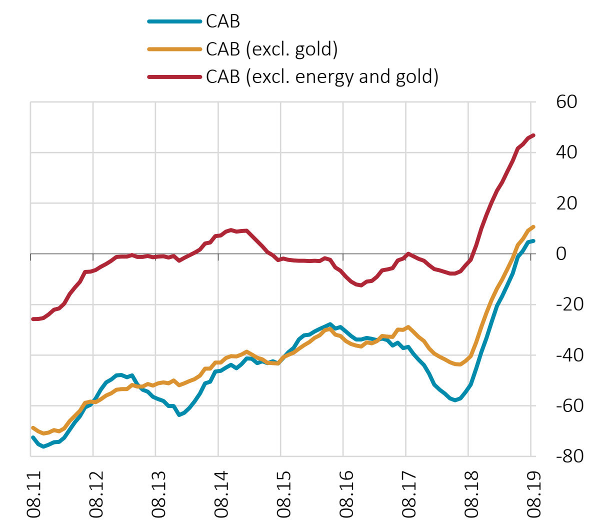
Sources: TURKSTAT.

* Industrial production covers the July-August period, while confidence indices cover October.

The moderate recovery in economic activity and the improvement in its sectoral diffusion continued in the third quarter of the year, as also suggested by industrial production and survey indicators (Chart 1.2.6). The weak employment market outlook and the expiry of tax cuts curbed domestic demand in this period whereas public spending and the partial improvement in financial conditions supported it. Investments remain weak despite showing signs of recovery starting from the third quarter. On the other hand, despite the weakening global growth outlook, particularly for the European Union (EU), exports of goods and services continue to increase due to firms' orientation towards external markets, their flexibility in market diversification and the favorable impact of improved competitiveness. Against this background, notwithstanding the increased import demand due to the moderate recovery in economic activity, the contribution of net exports to growth continued in the third quarter of the year and the improvement in external balance was sustained thanks to robust tourism in particular (Chart 1.2.7). In sum, the moderate recovery in economic activity continued in the third quarter on the back of domestic demand and net exports whereas the labor market outlook remained weak (Chart 1.2.8).

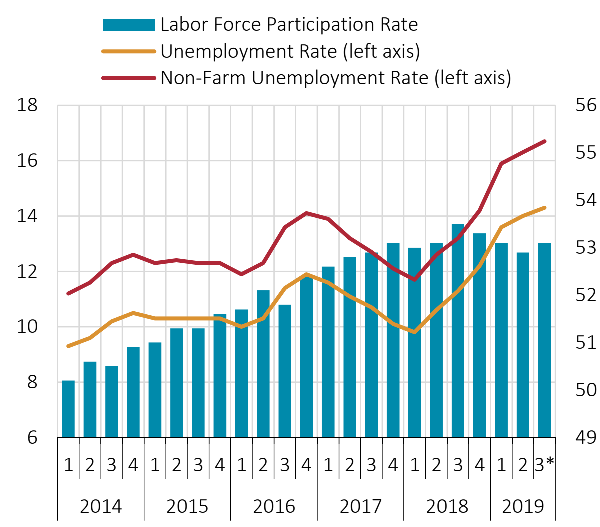
Looking forward, it is projected that domestic demand and economic activity will continue to recover at a moderate pace with the help of the disinflation trend and the improvement in financial conditions. Considering the current levels of output gap, it is estimated that aggregate demand conditions will continue to exert a downward pressure on inflation under the projected recovery trend. While the favorable impact of improved competitiveness prevails due to the diversity of export markets, the weak global growth outlook partly tempers external demand. The current account balance, which has recently recorded significant improvement as a result of the composition of growth, is expected to maintain a moderate course in the upcoming period.

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



Source: CBRT.

Chart 1.2.8: Unemployment Rates (Seasonally-Adjusted, %)



Source: TURKSTAT.

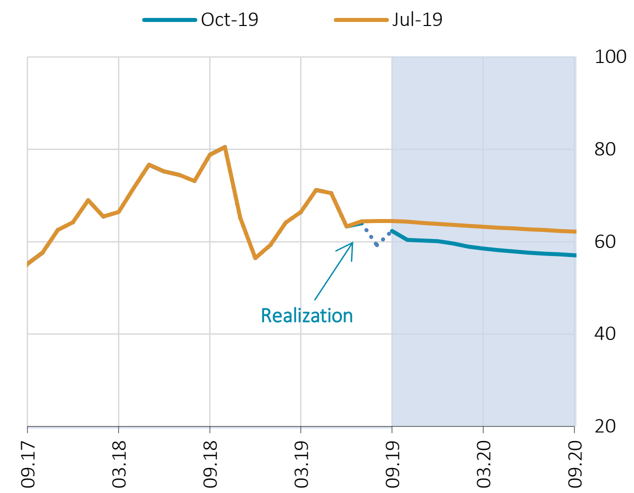
* July period.

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 July Inflation Report. Despite protracted adverse supply-side developments in the meantime, assumptions for crude oil prices have been revised downward amid weakening global trade and growth outlook. The average crude oil price assumption has been lowered to 63.4 USD/bbl for 2019 from 65 USD/bbl in the July Report and to 57.7 USD/bbl for 2020 from 62.6 USD/bbl (Chart 1.2.9). Accordingly, the assumption for the average annual rate of increase in USD-denominated import prices for 2019 and 2020 has also been revised downwards (Chart 1.2.10).

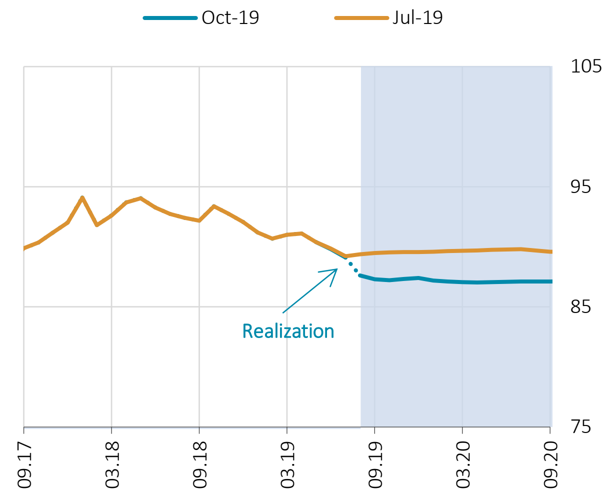
Another exogenous variable on which our medium-term projections are based is unprocessed food prices. Thanks to lower prices of fresh fruits and vegetables amid benign supply conditions, unprocessed food inflation dropped significantly from the July reporting period. Meanwhile, the second-quarter surge in processed food prices lost pace in the third quarter. In light of the favorable outlook for processed and unprocessed food prices, the year-end food inflation forecast has been lowered to 10% for 2019 from 15% in the July Inflation Report, and left unchanged at 11% for 2020.

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

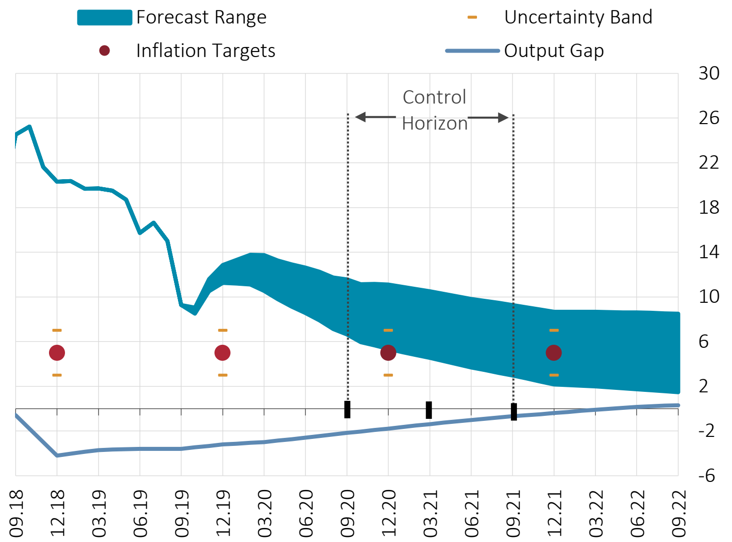
Having supported economic activity in the first half of 2019 through fiscal incentives and measures as well as increased public spending, fiscal policy remained accommodative in the third quarter on the back of non-tax revenues. Our estimates for the upcoming period are built on the assumption that the public sector will provide a moderate and decreasing contribution to economic activity. On the other hand, in the third quarter, alcoholic beverages and tobacco inflation rose at a faster pace than forecast in July due to increased cigarette prices and tax hikes in alcoholic beverages, curbing the downward revision to the end-2019 inflation forecast.

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 and that administered prices and wages will be largely set to support disinflation, as laid out in the New Economy Program (NEP). The robust policy coordination to lower inflation and ensure macroeconomic stabilization is critical for continued improvement in the 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 12.0% 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 11.2% and 12.8% (with a mid-point of 12.0%) at end-2019 and between 5.3% and 11.1% (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 July Inflation Report, inflation declined markedly, coming in closer to the lower end of the forecast band. The significant improvement in the underlying trend of inflation and the downward revisions to import prices and food prices had a positive impact on the year-end inflation forecast compared to the previous reporting period. However, the moderate recovery in the output gap and the tax hikes for alcoholic beverages and tobacco products pushed year-end inflation forecasts upward. Hence, the consumer inflation forecast for end-2019 was lowered to 12% from the July forecast of 13.9%. 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 1.9 points. The third quarter's consumer inflation is expected to be 1.5 points down from the July forecast, and the impending fall in the underlying trend of inflation are estimated to bring the year-end inflation forecast down by 1.1 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 revision to the food inflation forecast for end-2019 led to a 1.2 point decline in the inflation forecast. However, the larger-than-expected hike in tobacco prices drives the end-2019 inflation forecast up by 0.6 points. Furthermore, the slightly narrower-than-expected output gap adds 0.1 point to the consumer inflation forecast.

The inflation forecast for 2020 was kept unchanged at 8.2%. The improved underlying trend of inflation and the revisions to assumptions for oil and import prices are estimated to bring inflation down by 0.3 and 0.2 points, respectively, in 2020. However, being revised upward from the previous reporting period, the output gap drives the end-2020 forecast up by 0.5 points, offsetting these disinflationary effects.

The above-mentioned forecasts are based on a framework in which global financial conditions will follow a moderate course and the recent gradual improvement in perceived uncertainty will continue into the upcoming period. Projections rely on an outlook in which the extent of monetary tightness will be determined in a way to ensure that the ongoing disinflation is consistent with the targeted 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.

The improved outlook for global financial conditions, as well as the third quarter's benign inflation and external balance outcomes, helped reduce the volatility in financial markets. Against this backdrop, while adjustments in reserve requirements and other supportive measures provided a boost to loan supply, the reduction in the degree of monetary tightness stimulated loan demand, which, together, led to the recovery in loan growth. Improved financial conditions support the gradual recovery in domestic demand. Given the state of competitiveness, despite sluggish global growth, net exports are expected to continue contributing to economic growth albeit more moderately than in the previous reporting period. Likewise, aggregate demand conditions will provide a slightly smaller support to disinflation than in July.

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]

- Possible fluctuations in the country risk premium,
- Elevated levels of medium-term inflation expectations,
- Risks to the coordination between monetary and fiscal policies (fiscal stance, administered prices, wage and tax adjustments),
- Risks to the credit market,
- Lingering weakness in global growth outlook,
- Uncertainty over the evolution of capital flows to emerging market economies,
- Volatility in international commodity prices.

Turkey's risk premium still hovers above that of other emerging market economies, and the exchange rate volatility remains high. The country risk premium and exchange rate volatility continue to pose upside risks to the medium-term inflation outlook, considering also the global uncertainties and geopolitical risks. Determining the degree of monetary policy tightness in a way that will keep the disinflation process on track with the target path is of great importance to achieve a sustained improvement in the country risk premium and exchange rate volatility. With a view to enhancing the effectiveness of the monetary policy and minimize potential inflation-growth trade-offs, it is deemed crucial that macro-financial policies are made with a focus on reducing financial volatility and risk premium, and that the predictability of fiscal policy continues to be reinforced.

Despite a decline across all maturities, with more emphasis on the short term, inflation expectations still hover above the medium-term inflation target. Accordingly, elevated levels of inflation expectations may continue to pose an upside risk to the inflation outlook in the upcoming period. Currently, the anchoring of inflation and exchange rate expectations is critical to the effectiveness of monetary policy.

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 reduced with a view to anchoring expectations and alleviating 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, projections rely on an outlook where the budget deficit will be contained parallel to the NEP projections. Moreover, it assumed that the administered price and tax adjustments will support the disinflation process and 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.

[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.

Owing to the CBRT'S notable policy rate cut in the previous quarter, banks' domestic funding conditions were eased, leading them to reflect the reduced TL funding costs to loan rates. Accordingly, TL business and consumer loan rates decreased considerably, and total loans accelerated, with consumer loans in the lead. This increase in total loans was driven by both supply and demand-side developments. Should the recent significant acceleration continue without speeding down, the resulting credit growth's effect on growth and inflation would be higher than envisaged in the baseline scenario. Further, the banks' likely preference of a credit composition more tilted towards consumer loans than in the baseline scenario due to their risk perceptions would have repercussions on the composition of growth, inflation, current account and the risk premium.

Decreasing the degree of monetary policy tightness will likely further underpin the normalization in credit conditions and the credit demand, yet downside risks to the credit market are in place for the upcoming period. Notwithstanding the accommodative stance of the global monetary policies, uncertainties over global economic policies and geopolitical risks are climbing, which keep the risk appetite subsided, restricting the acceleration of capital flows towards emerging economies. This indicates that easing in external financing conditions may prove more limited in the upcoming period, posing a downside risk to banks' loan supply. Moreover, possible impacts of the volume of non-performing loans and Stage 2 loans on the banking sector's loan supply in the short term are monitored closely. Meanwhile, the continuation of the recovery in credit demand recently induced by the fall in the interest rates, will depend on the developments in employment and incomes. The speed, scope and sustainability of the normalization in credit supply and demand remain important to the economic activity outlook.

The downside risks to the global economic activity outlook are still in place due to heightened uncertainties pertaining to global economic policies and persisting geopolitical uncertainties. These risks continue to pose risk to domestic growth via capital flows as well as the foreign trade channel. To this end, the prospective effects of the decline in manufacturing industry in the Euro Area and the developments regarding the trade disputes between the United States and China on the Turkey's growth via the foreign trade channel are closely monitored.

Risks to capital flows to emerging market economies are balanced. While the easing in global monetary policies is expected to support capital flows to these country groups, the strong downside risks to global growth, the elevated level of uncertainties regarding global economic policies, lingering geopolitical problems and vulnerabilities peculiar to emerging market economies are restraining a possible recovery in capital flows and fueling downside risks for the upcoming period.

The downside risks to the future course of crude oil prices persist. Likely supply-side problems stemming from geopolitical issues might pose an upside risk to oil prices; however, heightened uncertainty in global trade and the unfavorable outlook in global economic activity bring downside risks to crude oil prices to the fore. Meanwhile, instabilities in emerging markets, easing in monetary policies of advanced economies and increased economic and geopolitical uncertainties on a global scale make upside risks to precious metal prices more evident. Against this background, the monetary policy response will be determined in a way to keep the likely impact of energy and commodity prices-driven risks on inflation expectations and pricing behavior under control.