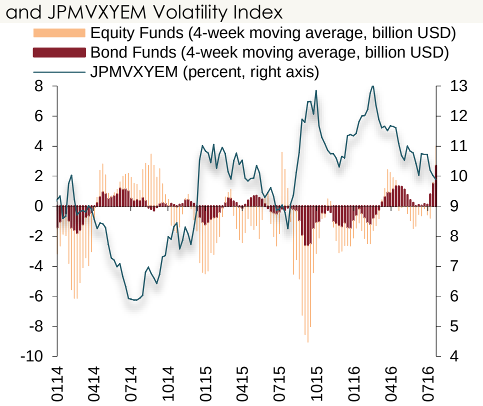
1. Overview

In the second quarter of 2016, changing expectations over the monetary policies of advanced economies and the Brexit referendum that resulted in the UK's decision to leave the EU were the key drivers of volatility in global markets. Global uncertainties and the sluggish growth across emerging economies triggered portfolio outflows from emerging markets, particularly in equity funds (Chart 1.1). Global growth expectations were also revised downward after the Brexit referendum, spurring hopes that major central banks would deliver additional support for the markets, and the growing sentiment that the Fed would postpone the rate hike until next year boosted the global risk appetite.

Prospects of a prolonged period of low policy rates across advanced economies helped bring global volatility indices down again, causing long-term interest rates to plunge (Chart 1.2). In fact, the US 10-year bond yields slid to an all-time low in July, sinking below their mid-2012 level. More recently, long-term interest rates in advanced economies have fallen to historic lows, thereby driving portfolio flows into emerging market bonds. Accordingly, market rates have been declining across emerging economies. Additionally, the recovery in oil prices and the expectation that the Brexit referendum will affect growth and trade in mostly advanced economies have led to eased financial conditions in emerging economies amid partially improved sentiment towards oil-exporting emerging economies. In this regard, the emerging market exchange rate volatility index has also declined.

Chart 1.1.

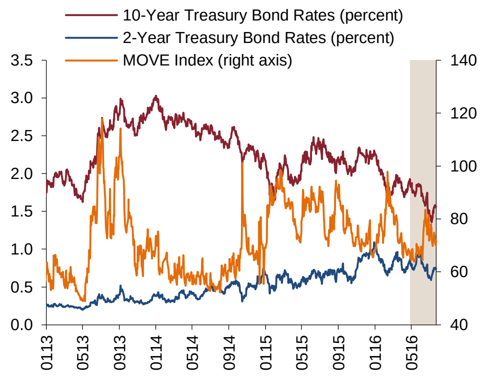
Portfolio Flows to Emerging Economies and JPMVXYEM Volatility Index



Source: EPFR, Bloomberg.

Chart 1.2.

US Treasury Bond Rates and MOVE Index



Source: Bloomberg.

Global uncertainties also spilled over into the Turkish economy in the second quarter; yet, the favorable course of macroeconomic indicators, combined with the new measures adopted in line with the road map of August 2015 as well as the monetary policy simplification helped to tame the uncertainty and risk sentiment over Turkey. Consumer inflation was broadly in line with the forecasts of the April Inflation Report in the second quarter of 2016, while underlying core inflation continued to improve on the back of services prices. In this period, again in line with April Inflation Report projections, the current account deficit continued to narrow, and the economy remained on a moderate and steady growth track. The CBRT maintained its policy stance, which is tight against the inflation outlook, stabilizing for the foreign exchange liquidity and supportive of financial stability, and took further steps towards monetary policy simplification. Accordingly, risk premium and market rates began to fall in the second quarter, while inflation expectations dropped and the Turkish lira appreciated in real terms.

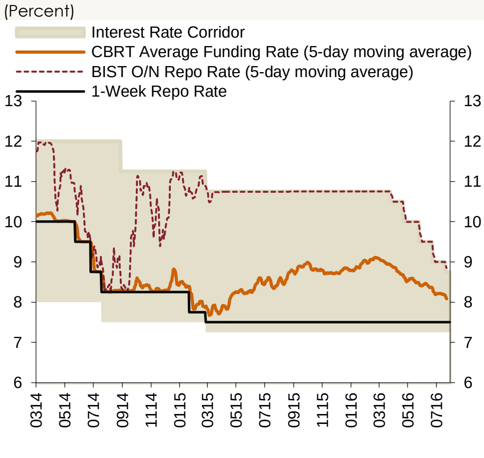
The mid-July market fluctuations caused by domestic developments resulted in renewed increase in risk premium, heightened market rates and a depreciated Turkish lira. Against the possibility that these developments may have an adverse impact on the domestic macroeconomic outlook via the financial conditions channel, the CBRT announced new measures on July 17 to ensure the smooth operation of markets. These measures help financial system to have efficient access to liquidity. The CBRT closely monitors market depth and pricings and will take all measures required to maintain financial stability when necessary. The favorable course of the global risk appetite and the adopted measures are expected to render the spillovers from domestic uncertainty short-lived and limited. Moreover, the implementation of the planned structural reforms will significantly boost the growth potential, thus positively affecting the risk sentiment towards the Turkish economy.

1.1. Monetary Policy and Financial Conditions

In the second quarter of 2016, the CBRT maintained its tight liquidity policy stance on account of inflation expectations, the pricing behavior and other factors affecting inflation. Waning global volatilities, the favorable course of core inflation indicators and the effective use of policy tools described in the road map helped the CBRT to continue with monetary policy simplification. In addition, the liquidity measures adopted on July 17 contained the domestically induced market turmoil. To this end, the CBRT lowered the marginal funding rate to 8.75 percent via two consecutive 50 basis points reductions in May and June followed by a 25 basis points cut in July. The one-week repo auction rate and the overnight borrowing rate were kept unchanged at 7.5 and 7.25 percent, respectively (Chart 1.1.1).

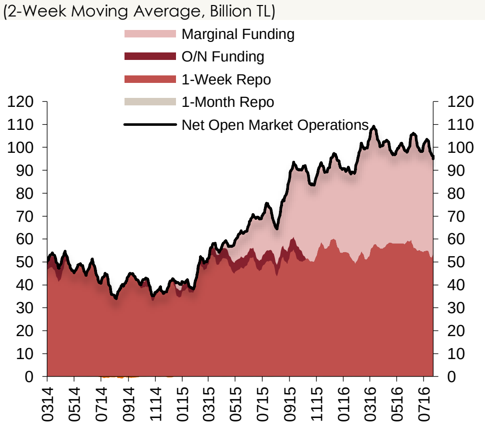
One-week repo auctions continued to be the main funding tool of the CBRT, while the share of the marginal funding remained high (Chart 1.1.2). The weighted average funding rate receded to around 8.2 percent in July. Interbank overnight repo rates dropped in line with the reductions in the upper band of the interest rate corridor. In the upcoming period, the monetary policy stance will continue to depend on the inflation outlook.

Chart 1.1.1.
CBRT Rates and BIST Interbank O/N Repo Rates
(Percent)



Source: BIST, CBRT.

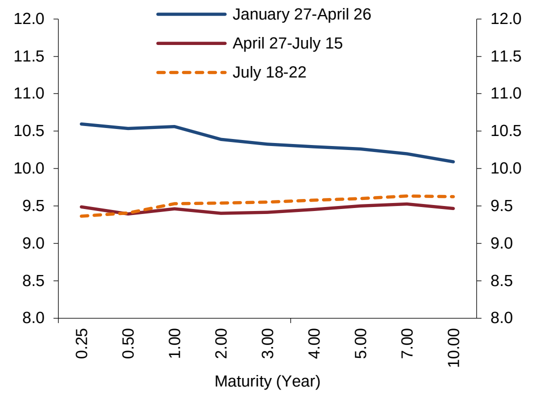
Chart 1.1.2.
CBRT Funding*
(2-Week Moving Average, Billion TL)



* Marginal funding is O/N funding quoted at the upper band of the interest rate corridor.
Source: BIST, CBRT.

Amid continued monetary easing across central banks of advanced economies as well as the favorable course of domestic macroeconomic indicators and monetary policy simplification, the yield curve shifted downwards in all maturities until mid-July (Chart 1.1.3). However, in the subsequent days, the gains in the yield curve were lost partially due to domestic uncertainty.

Chart 1.1.3.
Yield Curve on Cross Currency Swaps
(Percent)



Source: Bloomberg.

The annual growth rate of credits extended to the non-financial sector, which decelerated partly due to the CBRT's tight monetary policy stance and the macroprudential measures introduced by the BRSA regarding non-mortgage consumer credits, fell to 9.5 percent in the second quarter of 2016 (Chart 1.1.4). Commercial credits, which have been growing faster than consumer credits since the start of 2014, continued with this rapid pace in this period as well. These developments in credit growth and composition contribute to the re-balancing process and financial stability. The annualized growth rates in 13-week moving averages show that both commercial and consumer credits have picked up since early 2016 (Chart 1.1.5). Yet, this recovery is mostly prompted by seasonal effects as growth rates are still below the previous year's averages. The risk weight adjustments in consumer credits as well as wage developments and improved financial conditions will support credit growth in the upcoming period.

Chart 1.1.4.
Annual Credit Growth
(Adjusted for Exchange Rate, Percent)

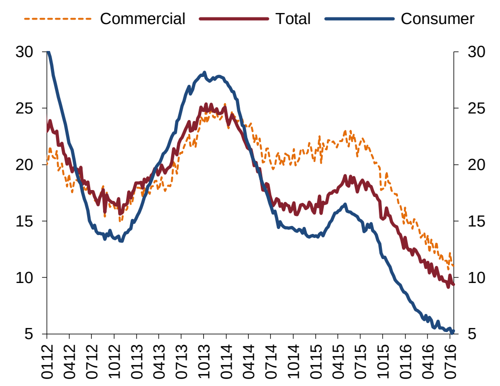
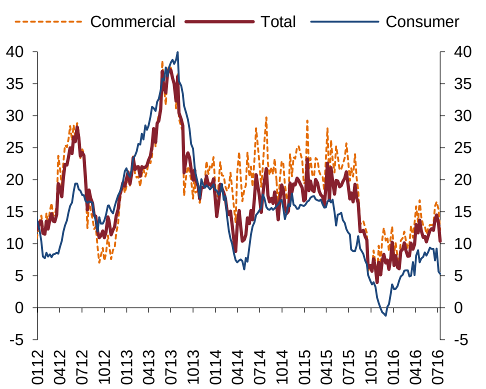


Chart 1.1.5.
Annualized Credit Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Percent)



Source: CBRT.

In terms of economic fundamentals, fragilities were mostly contained by the tight monetary policy, the improvement in the current account balance, macroprudential measures, reasonable credit growth and the outlook of the credit composition favoring price stability and financial stability. Sustaining fiscal discipline was also a major factor enhancing the resilience of the economy in this period. It is important to restrict the repercussions from recent domestic and external developments on financial markets and the economy. Accordingly, maintaining the effective implementation of the measures laid out in the road map and continuing with the tight monetary policy stance are assessed to have reduced the economy's sensitivity to global shocks, thus supporting financial stability. The CBRT closely monitors market developments and will continue to take additional steps to support financial stability, if necessary.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the second quarter of 2016, consumer inflation edged up by 0.18 points quarter-on-quarter and hit 7.64 percent, remaining broadly in line with the April Inflation Report forecast (Chart 1.2.1). The rise in inflation was mostly attributed to unprocessed food and energy prices, whereas annual inflation in core goods and services was down. Thus, inflation excluding unprocessed food and tobacco prices declined as predicted in the April Inflation Report (Chart 1.2.2). In this quarter, cumulative exchange rate effects on annual inflation have been fading, while import prices, particularly oil, have been rising. Therefore, inflation was up in food and energy but down across core items in the second quarter.

Chart 1.2.1.
Inflation Forecasts and Realizations*
(Percent)

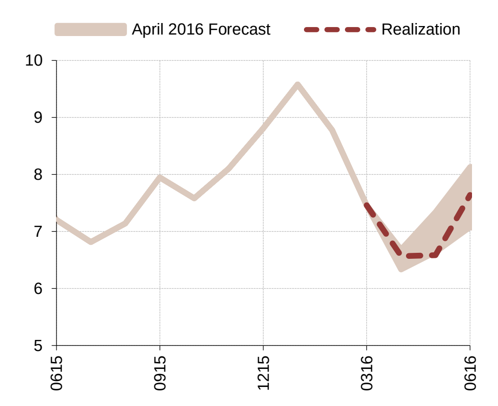
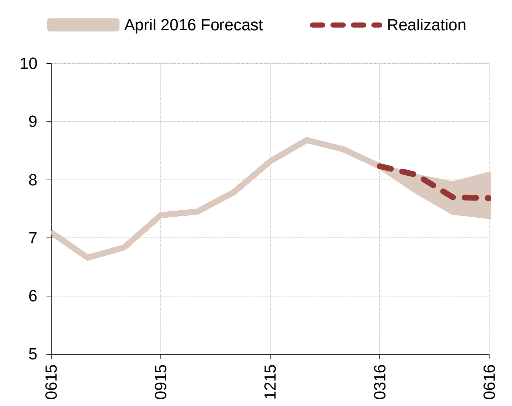


Chart 1.2.2.
Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco*
(Percent)



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

The first quarter's modest outlook for unprocessed food prices deteriorated slightly in the second quarter. Although price hikes in catering services have recently been slow, changes in food prices brought annual food and catering services inflation up to 7.65 percent in the second quarter (Chart 1.2.3). On the other hand, annual inflation excluding food and catering services remained on a steady decline.

Chart 1.2.3.
Food and Non-Food Prices
(Annual Percent Change)

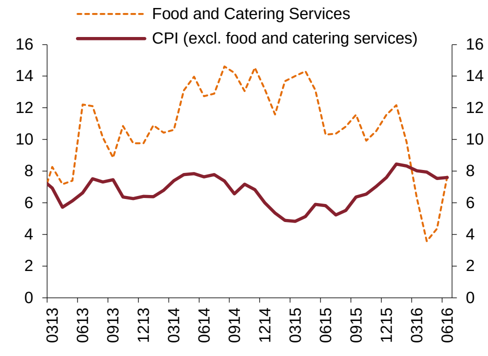
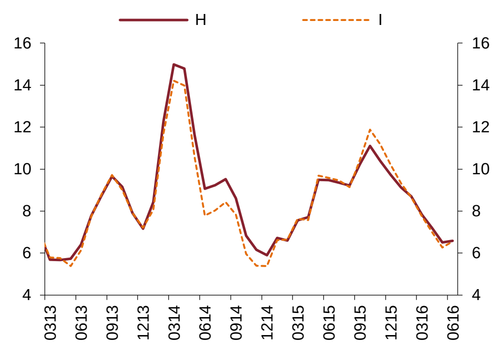


Chart 1.2.4.
Core Inflation Indicators
(Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



Source: TURKSTAT, CBRT.

The underlying services inflation slowed down in the second quarter. This was largely owed to price movements across services such as accommodation, transport and catering driven by the developments in the tourism sector. On the other hand, despite waning cumulative exchange rate effects, the underlying core goods inflation remained broadly unchanged from the previous quarter as the depreciation of the Turkish lira in May passed through to prices of durable goods in particular. Accordingly, the underlying core inflation indicators continued to slow on the back of services prices (Chart 1.2.4). In sum, the food and energy-driven increase in inflation was partially offset by the second-quarter improvement in core items.

Supply and Demand

According to the GDP data of the first quarter of 2016, economic activity was in line with the outlook presented in the April Inflation Report, and GDP grew by 0.8 and 4.8 percent in quarter-on-quarter and year-on-year terms, respectively (Chart 1.2.5). On the production side, the largest contribution to growth came from agricultural and industrial sectors in the first quarter while the value added from construction and services provided relatively less support. On the spending front, final domestic demand was the main driver of annual growth as expected, whereas net exports contributed negatively to growth (Chart 1.2.6). The contribution of final domestic demand to growth has been through consumption spending in this period.

Chart 1.2.5.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, Billion TL)

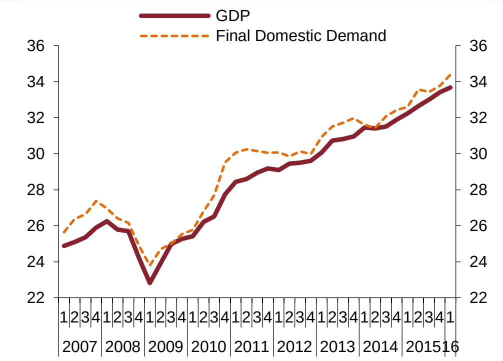
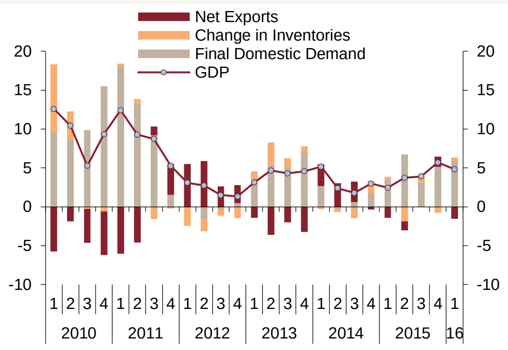


Chart 1.2.6.
Annual GDP Growth and Contributions from the Demand Side (Percentage Points)



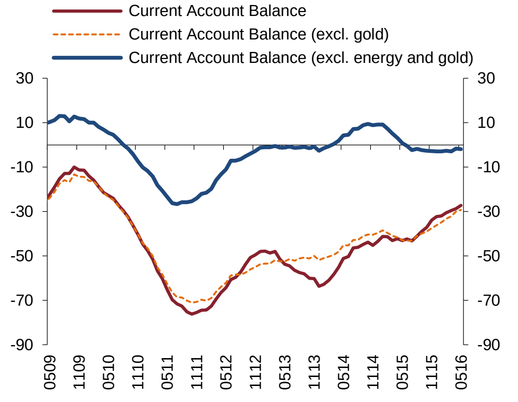
Source: TURKSTAT.

Current indicators for the second quarter of 2016 point to mild economic activity. Industrial production posted a 0.4 percent decline from the previous quarter's average in the April-May period. Domestic demand indicators for sales, production and imports also hint at some quarterly increase for the second quarter, albeit at a slower rate than in the first quarter. In addition, external trade data for the April-May period indicate that foreign demand may make a subdued contribution to growth.

Growth is expected to be driven mainly by domestic demand in 2016. The course of employment, which has been favorable despite substantial wage hikes will continue to support consumption via the income channel. Private investments are expected to edge up in the second half of 2016 on the back of domestic demand conditions and the modest global growth. Yet, domestic demand growth will be spurred mostly by increased consumption spending. The anticipated recovery across Turkey's export markets will continue to support exports in the remainder of the year. On the other hand, the recent domestic developments are expected to pose some downside risks to economic activity and the current account balance via tourism revenues in the short term.

In sum, domestic demand is likely to increase owing mainly to consumption spending and external demand will recover amid the expected mild growth in our export markets in 2016. Despite this outlook on demand composition, the current account balance is expected to improve further in 2016 amid continuing macroprudential measures and the low course of commodity prices (Chart 1.2.7).

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



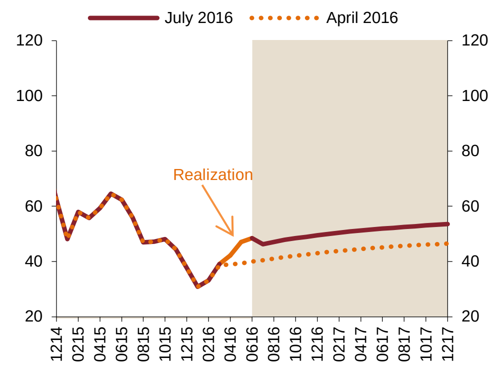
Source: CBRT.

Oil, Import and Food Prices

Oil and import prices edged up in the inter-reporting period. Thus, assumptions for crude oil prices and USD-denominated import prices were revised upwards compared to the April Inflation Report (Charts 1.2.8 and 1.2.9). With regard to annual averages, the crude oil price assumption was increased from 40 USD to 44 USD for 2016. Also, assumptions for annual percentage changes in average import prices were revised upwards by 0.4 points for 2016. Food inflation saw a marked decline due to unprocessed food prices in the first quarter, yet this was reversed in the second quarter. Still, the food inflation path in June proved close to April Inflation Report projections. The recent upside movements in unprocessed food prices will cause food inflation to surge in July, while a downside correction in food prices is likely in the period ahead. Due to the measures taken by the Food and

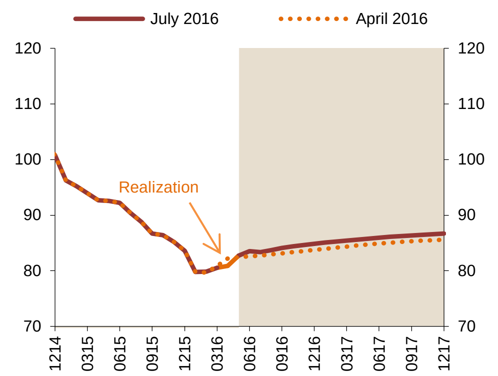
Agricultural Products Markets Monitoring and Evaluation Committee and the seasonal decline in food demand owing to the tourism sector, food price inflation for end-2016 is expected to be lower compared to the previous reporting period. Accordingly, the assumption for food price inflation was revised downwards from 9 percent to 8 percent for 2016, and kept unchanged at 8 percent for 2017.

Chart 1.2.8.
Revisions in Oil Prices
(USD/bbl)



Source: Bloomberg, CBRT.

Chart 1.2.9.
Revisions in Import Prices
(2010=100, USD)



Source: CBRT, TURKSTAT.

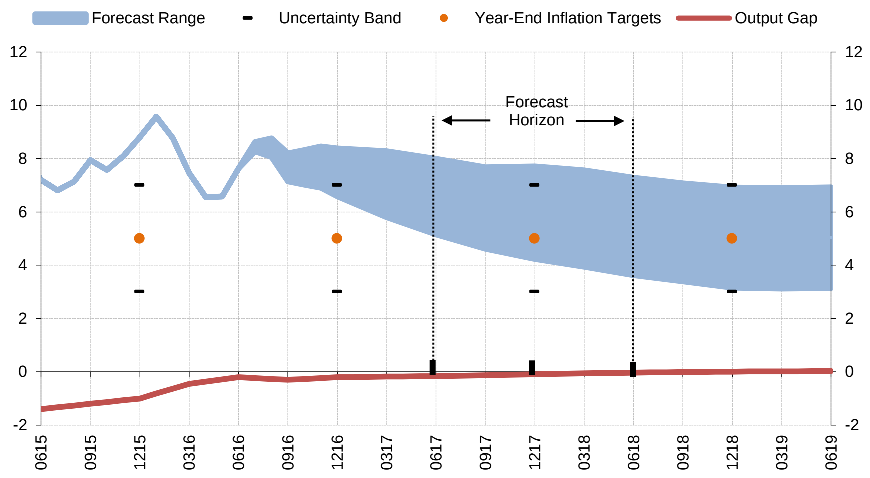
Fiscal Policy and Tax Adjustments

Medium-term forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance depends on the MTP projections covering the 2016-2018 period. The effects of the minimum wage rise in early 2016 on production costs, aggregate demand and inflation are being closely monitored. Exclusive to this period, firms opted for a high-rated price adjustment amid rising costs due to tax adjustments and a limited lump sum tax rise in administered prices of tobacco products in July.

1.3. Inflation and Monetary Policy Outlook

In view of the above economic conditions, policy stance and assumptions, inflation forecasts for the upcoming period are unchanged from the previous Report. Given a decisive policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. Hence, inflation is expected to be, with 70 percent probability, between 6.6 percent and 8.4 percent (with a mid-point of 7.5 percent) at end-2016 and between 4.3 percent and 7.7 percent (with a mid-point of 6 percent) at end-2017 (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.

The Turkish lira followed a fluctuating course following the April Inflation Report, while oil prices inched up and import prices remained close to the projections. Although TL-denominated import prices are estimated to be higher compared to the previous reporting period, the pass-through to inflation will be restricted depending on the moderate course of domestic demand in the second half of the year. The recent upward movement in unprocessed food prices and adjustments in tobacco prices will push inflation significantly upwards in July. On the other hand, food prices are projected to see a downward correction in the upcoming period. In addition, core inflation is likely to hover more modestly across the year compared to the previous reporting period. The rise in tobacco prices is expected to push the end-2016 inflation forecast upwards compared to the April projections, yet the improvement in headline inflation and the course of economic activity are expected to compensate for this increase. Against this background, the year-end consumer inflation forecasts for 2016 and 2017 were unchanged.

1.4. Risks and Monetary Policy

Financial conditions continue to be tight despite the recent rise in the global risk appetite, which eased conditions slightly. Financial conditions are likely to remain tight in the short term owing to domestic developments and weaker capital flows. Accordingly, credit growth rates are not expected to recover notably. The moderate course of credits is driven not only by demand but also by supply-side factors. Recent surveys show that credit standards did not display any easing. Domestic developments have recently led to fluctuations in markets. Liquidity measures taken by MPC have partially limited the volatility in markets. It is projected that the effects of the fluctuations in markets will prove temporary and Turkey will sustain its resilience through its sound economic fundamentals. On the other hand, to balance the short-term effects of the tightness in financial conditions, the CBRT may make downside adjustments to required reserves, if deemed necessary.

Economic activity maintains a moderate and stable course of growth. Consumption spending fuels domestic demand, while investments remain relatively sluggish. Despite the adverse effects of geopolitical developments on external demand, exports of goods to EU countries remain strong. Restored relations with Russia may support external demand in the last quarter. Accordingly, exports are expected to provide further support to growth in the upcoming period. Meanwhile, the steady increase in employment and wage developments boost domestic demand through the income channel. In this respect, economic activity is expected to grow moderately across the year.

Recent terrorist attacks and domestic developments pose a downside risk to economic activity especially through the tourism sector. Thus, the economy may witness a slowdown in the second and third quarters in which tourism revenues register a high share within economic activity. In fact, leading indicators of the second quarter point to a quarter-on-quarter deceleration, which may also continue through the third quarter. On the other hand, the economy is expected to maintain a steady course of growth amid structural arrangements and investment incentives. Against this background, risks to economic activity are likely to be balanced in the medium term.

The current account deficit may widen slightly in the short term even though external balances continue to recover. The current account balance is being positively affected by the lagged effects of the decline in energy prices. Moreover, the moderate course of credits and the increasing share of commercial credits in credit composition also support the improvement in the current account balance. However, the fact that the current economic growth is fueled by domestic demand and that the tourism sector is experiencing a slowdown signals a possible deceleration in the recovery of the current account balance in the upcoming period. Yet, the current account deficit is estimated to hover at reasonable and predictable levels across the year.

Even though inflation is projected to rise in the short term, core inflation is expected to settle on a milder track across the year. The recent hikes in unprocessed food prices and the tobacco price adjustments will cause an upsurge in July inflation. Yet, food prices may see a downward correction in the upcoming periods. Owing to the measures taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee accompanied by the seasonal decline in food demand caused by the tourism sector, the year-end food price inflation is expected to prove lower compared to the previous reporting period. In addition, owing to the expected deceleration in economic activity in the short term, core inflation is anticipated to exhibit a milder course compared to the previous reporting period across the year. Meanwhile, the minimum wage hike is estimated to have a limited effect on core inflation on the back of state support. Accordingly, inflation forecasts for the baseline scenario were unchanged.

Inflation forecasts accommodate both upside and downside risks. Recent exchange rate developments pose an upside risk to inflation through the cost channel. Moreover, the possible adjustments to administered prices and taxes to compensate for the effect of the recent rise in budget expenditures on fiscal balances may push inflation upwards towards the end of the year. On the other hand, the latest domestic developments constitute downside risks to demand and inflation through the confidence channel and the tourism sector. The CBRT will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.

Despite experiencing significant external shocks in recent years, the adopted policy framework was successful in containing the deterioration in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience with the inflation targeting regime showed that combatting inflation requires joint efforts. Thus, in order to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties by taking structural factors into account. In this respect, actions taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee set an invaluable precedent. In the upcoming period, the CBRT will contribute to these efforts by undertaking extensive studies to examine structural issues in inflation dynamics.

Global financial markets and capital flows remain highly volatile. Despite the recent slight rise in the risk appetite, persisting concerns over global growth and uncertainties in global monetary policies feed into volatility. The tight monetary policy stance, the cautious macroprudential policy and the effective use of the policy tools announced in the road map of August 2015 enhanced the resilience of the economy against external shocks to a certain extent. However, adverse domestic developments may cause fluctuations in markets if accompanied by global volatilities and this may place extra pressure on financial conditions. In such circumstances, the CBRT will closely monitor the developments in both global and domestic markets and take necessary stabilizing measures by utilizing its large variety of tools.

The recent monetary policy decisions of the CBRT should be evaluated under the scope of the simplification process. The ultimate aim of the simplification is to achieve a narrow and symmetrical corridor and provide funding via a single rate. The simplification is believed to contribute to the effectiveness of the transmission mechanism. Therefore, simplification of the monetary policy will be finalized within a reasonable schedule. The pace and timing of simplification will depend on the developments regarding inflation and financial stability.

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, sustained fiscal discipline has become essential in reducing the sensitivity of the Turkish economy against external shocks. In the current environment of highly uncertain global markets, the gains from maintaining and further advancing these achievements are significant. Any measure to provide permanent fiscal discipline and reduction in the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping the interest rates of long-term government securities at low levels.