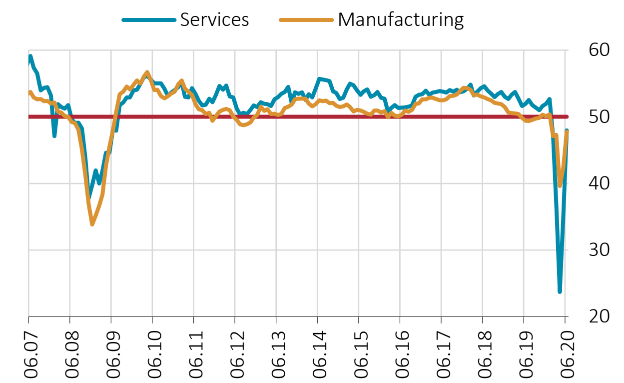
1. Overview

In the second quarter of the year, developments regarding the spread of the coronavirus (Covid-19) further deepened the weakening of global growth that started in the first quarter. Global economic activity has shown signs of partial recovery in the third quarter due to the easing of measures to contain the pandemic and the gradual normalization steps. Indeed, PMI data registered a rapid improvement and converged to the critical level of 50 in June, following the start of normalization in many countries as of May and early June (Chart 1.1). While the recovery in global growth is expected to continue in the second half of the year, uncertainties surrounding recovery remain high.

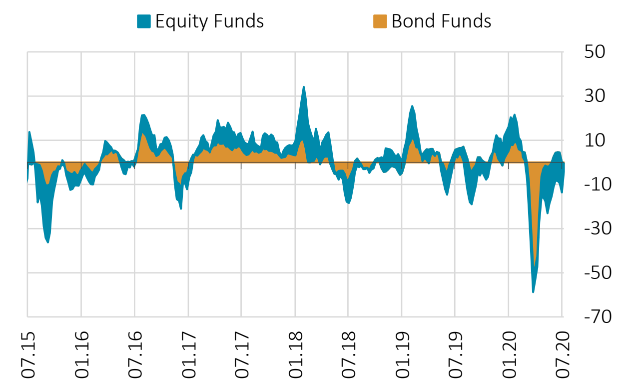
Despite rising food prices during the pandemic, headline inflation in advanced and emerging economies decreased in the second quarter on the back of the weakened global growth outlook and declining crude oil prices. Notwithstanding the supply-side effects driven by the pandemic, demand-induced downward pressure on global core inflation is expected to continue.

Chart 1.1: Global PMI (Seasonally Adjusted, Level)



Source: IHS Markit.

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

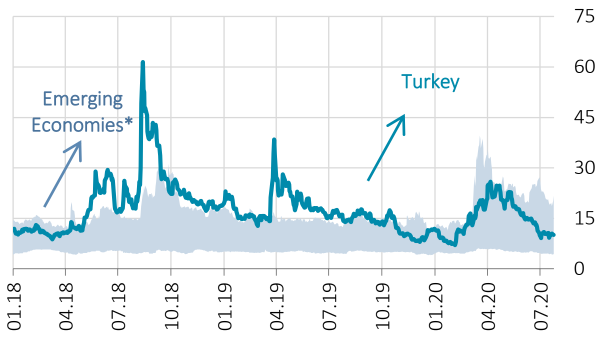


Source: EPFR.

Following the expansionary measures to alleviate the impact of the pandemic on global financial markets and economic activity, policy rates have rapidly converged to the zero lower bound in advanced economies and rate cuts have consequently stopped. Meanwhile, rate cuts have lost pace in emerging economies. These countries continued to register large amounts of portfolio outflows in the second quarter, albeit at a decelerated rate compared to the first quarter (Chart 1.2). Due to measures introduced by the central banks of advanced economies and the post-pandemic normalization phase, portfolio flows followed a relatively more positive course in July. On the back of continued expansionary monetary and fiscal policy steps, capital flows to emerging economies are expected to post some recovery in the second half of 2020.

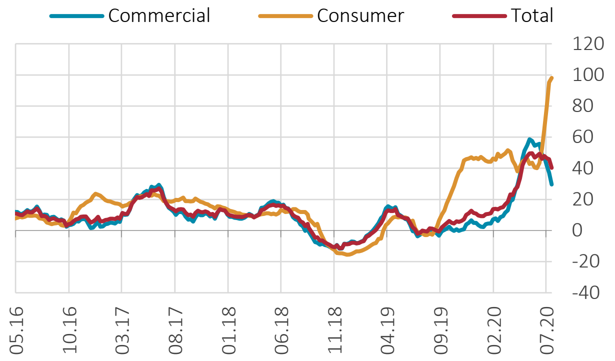
The pressure on the currencies of emerging economies has somewhat eased due to the increase in global risk appetite while the normalization steps have partially alleviated the negative effects of global developments on Turkey's risk premium and exchange rate volatility (Chart 1.3). In the period prior to the onset of the pandemic, financial conditions improved noticeably owing to the disinflation process and the rate cuts, and credit growth started to increase in the third quarter of 2019 (Chart 1.4). In the post-pandemic period, credit growth has further accelerated on the back of monetary and fiscal measures introduced to maintain the healthy functioning of the credit channel and firms' cash flows. The growth in commercial loans remains strong though it has somewhat lost pace recently. On the other hand, the growth rate of consumer loans significantly increased in the period after June due to the credit packages offered by state banks for housing and vehicle loans.

Chart 1.3: Implied FX Volatility (1-Month)



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

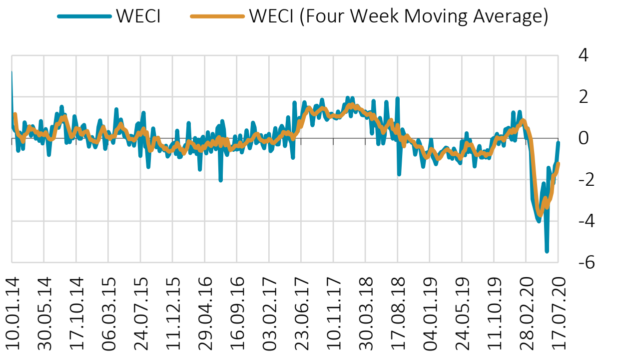
Chart 1.4: Loan Growth (13-Week Annualized Moving Average, Adjusted for Exchange Rates, %)



Source: CBRT.

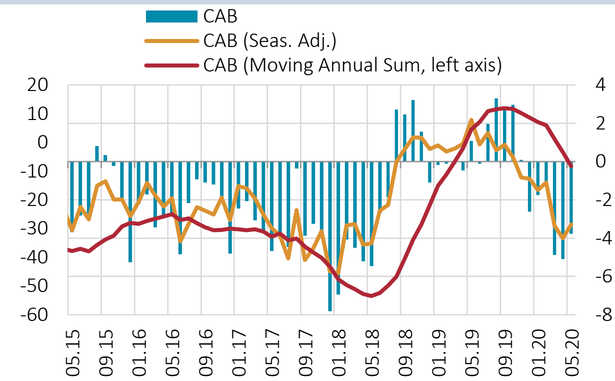
The pandemic-led weakening of economic activity that started in the second half of March became more pronounced in April. Recovery in economic activity started in May following the gradual steps towards normalization, and gained pace in June and July (Chart 1.5). May figures and provisional foreign trade data for June indicate that the foreign trade volume, most visibly exports, posted a recovery and the foreign trade deficit started to decline following the gradual easing of measures in Turkey and abroad. The easing of travel restrictions is expected to contribute to a partial improvement in tourism revenues in the period ahead. The recovery in exports of goods and low levels of commodity prices will support the current account balance in the upcoming period (Chart 1.6). Due to the impact of the pandemic on activity, unemployment rates rose while the sharp decline in the participation rate limited this rise. Leading indicators and high-frequency data suggest that the labor market remains weak despite the positive impact of the measures and the recent recovery in economic activity.

Chart 1.5: Weekly Economic Conditions Index (WECI)[1]



Source: CBRT.

Chart 1.6: Current Account Balance (CAB) (USD Billion)

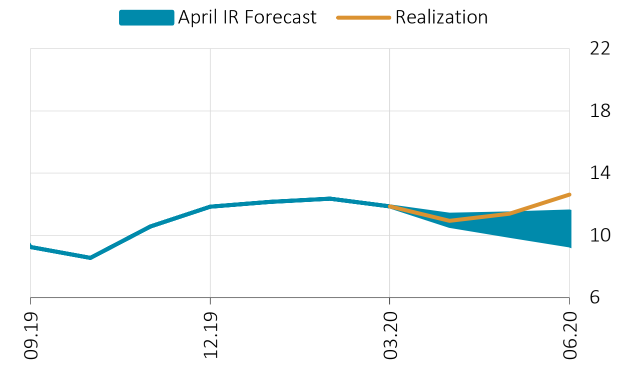


Source: CBRT.

In the second quarter of 2020, consumer inflation increased by 0.76 points to 12.62% and stood above the upper bound of the forecast range in the April Inflation Report (Chart 1.7). In the same period, annual inflation of the B index, one of the core inflation indicators, was also higher than projected (Chart 1.8). Core goods and food constituted the main groups, in the respective order, that contributed to the increase in inflation compared to the first quarter. In this period, the pandemic-related rise in unit costs, cumulative exchange rate developments, the recovery in international oil prices, and the increasing food prices driven by seasonal and pandemic-related factors were influential in the rise in consumer inflation. Against this background, annual inflation and the trends of core indicators increased.

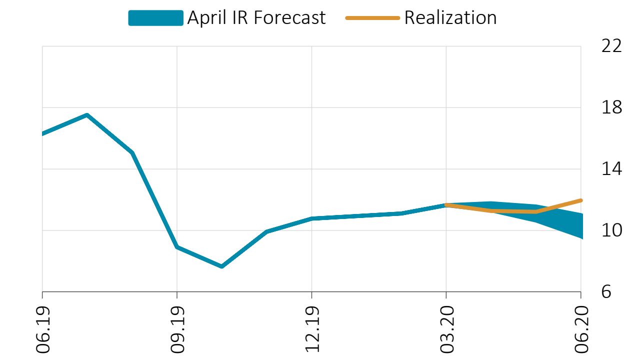
[1] A detailed explanation of the index is provided in Box 4.1.

Chart 1.7: April Inflation Forecast and Actual Inflation* (%)



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

Chart 1.8: April Forecast and Actual Rates for Inflation Excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold (B Index)* (%)

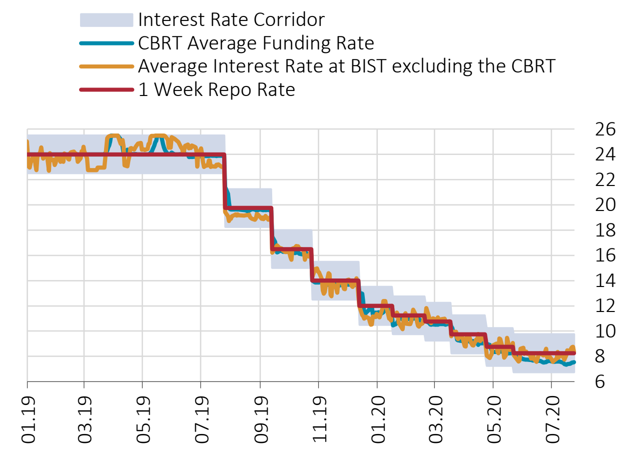


Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

Compared with the April Inflation Report projections, the effect of supply-side factors on inflation was somewhat stronger. This was mainly due to supply chain disruptions as well as capacity constraints imposed in certain sectors under gradual normalization. Leading indicators for July suggest a deceleration in monthly price increases in the said services items. As the normalization continues, supply-side factors, which have prevailed recently due to pandemic-related restrictions, will phase out. Accordingly, demand-driven disinflationary effects will become more prevalent in the second half of the year.

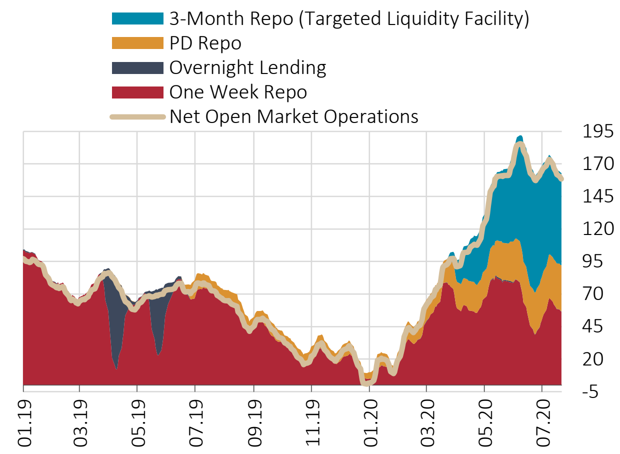
Based on the assessment that aggregate demand conditions, which weakened due to the pandemic, had an increased disinflationary effect, 250 basis points of policy rate cuts were delivered in March, April and May in total. In view of all factors affecting the inflation outlook, the policy rate was kept constant at 8.25% in June and July (Chart 1.9). In the current reporting period, a significant portion of the funding need of the system was met via the TL currency swap transactions at the CBRT and the BIST. Meanwhile, due to new facilities taking effect after the pandemic, the composition of the funding provided through open market operations (OMO) changed. Accordingly, the proportions of OMO funding taken up by three-month repo auctions under the targeted additional liquidity facilities and by funding provided to primary dealer banks both increased (Chart 1.10).

Chart 1.9: CBRT Rates and Short-Term Rates (%)



Sources: BIST, CBRT.

Chart 1.10: CBRT Open Market Operations (2-week Moving Average, TRY Billion)



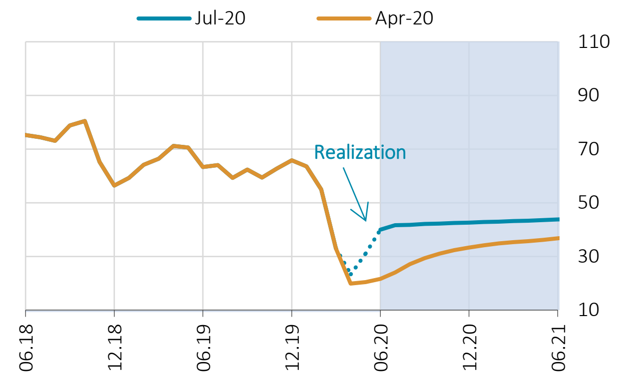
Source: CBRT.

1.1 Inflation and the Monetary Policy Outlook

Main Assumptions Regarding Exogenous Variables

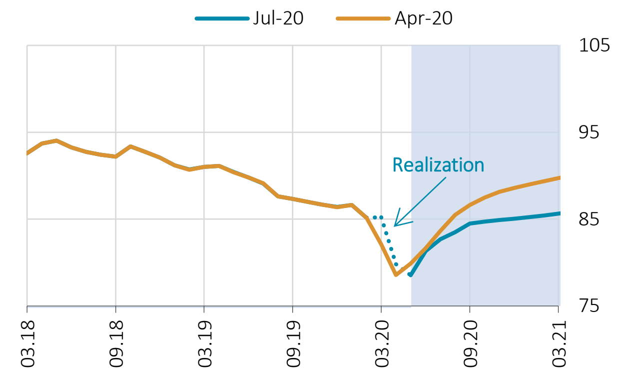
Medium-term projections are based on the macroeconomic background summarized above, as well as on the assumptions for exogenous factors such as import prices, food prices and fiscal policy. Accordingly, on the back of the agreement between OPEC+ countries over oil production cuts and the partial recovery in global demand outlook, the crude oil price assumption of the April Inflation Report was revised upwards from USD 32.6 to USD 41.6 on average for 2020, and from USD 36.8 to USD 43.8 for 2021 (Chart 1.1.1). On the other hand, the assumptions for USD-denominated import prices for 2020 and 2021 were revised downwards due to the weak course of other non-oil commodity prices such as aluminum and agricultural commodities (Chart 1.1.2). Additionally, the food inflation forecast, which was set at 9.5% for 2020 in the April Inflation Report, was revised upwards to 10.5% in view of the recent trends in unprocessed food prices. The food inflation forecast for 2021 was also revised to 8% from 7%. Medium-term projections are based on an outlook where the fiscal policy actions along with other monetary and financial measures will support the potential output of the economy during the pandemic and contribute to the recovery in the post-pandemic period. Moreover, it is assumed that adjustments in administered prices and taxes will be set broadly in line with the disinflation path.

Chart 1.1.1: Revisions to Oil Price Assumptions* (USD/bbl)



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

Chart 1.1.2: Revisions to Import Price Assumptions* (Index, 2010=100)

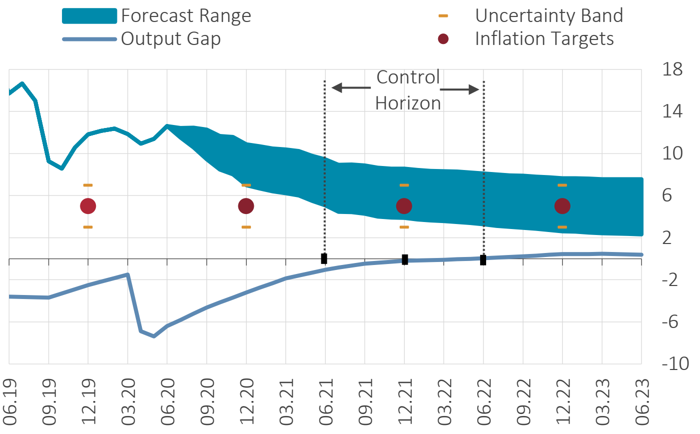


Sources: CBRT, TURKSTAT.
* Shaded area denotes the forecast period.

Medium Term Projections

Under the current monetary policy stance and strong policy coordination, inflation is projected to converge gradually to the targets. Accordingly, inflation is projected to be 8.9% at the end of 2020 and fall to 6.2% at the end of 2021, before stabilizing around 5% over the medium term. With a 70% probability, inflation is expected to be between 6.9% and 10.9% (with a mid-point of 8.9%) at end-2020 and between 3.9% and 8.5% (with a mid-point of 6.2%) at end-2021 (Chart 1.1.3).

Chart 1.1.3: Inflation and Output Gap Forecasts*



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

In the inter-reporting period, inflation rose and materialized above the forecast range on the back of the increase in unit costs driven by the pandemic despite weak aggregate demand conditions. Turkish lira import prices were slightly higher than expected mostly due to recovering oil prices, while food inflation surged due to seasonal and pandemic-related effects. In addition to ongoing capacity constraints in some sectors throughout the gradual normalization, the stronger credit impulse caused the disinflationary effect of aggregate demand conditions to become relatively limited compared to the projections in the April Inflation Report. Thus, supply and demand-side factors led to an upward revision in output gap forecasts from the second quarter of 2020 onwards. Supply-side factors, which prevailed due to pandemic-related restrictions in the short run, are expected to phase out as normalization continues, and demand-driven disinflationary effects may become more prevalent in the second half of the year, as suggested by negative output gap forecasts. Nevertheless, in light of recent inflation figures and all factors affecting the inflation outlook, inflation forecasts for end-2020 and end-2021 are revised upward.

The inflation forecast for end-2020 was revised upward by 1.5 points from 7.4% to 8.9%. Upward revisions to the assumption of oil prices for the rest of the year due to rising international oil prices brought the consumer inflation forecast up by 0.5 points compared to the previous Report, and the increase in the food inflation forecast for end-2020 pushed the inflation forecast up by 0.2 points. The upward revision in the output gap, as a result of capacity constraints easing at a slower-than-expected pace with normalization being gradual and the accelerating credit growth, brought the inflation forecast up by 0.3 points.[2] Meanwhile, supply-side factors, which prevailed due to pandemic-related restrictions in the short run, caused unit costs to rise, driving the year-end inflation forecast 0.2 points higher.[3] Moreover, the forecast error for the second quarter and the rise in underlying inflation are judged to add 0.3 points to the year-end inflation forecast.

The inflation forecast for end-2021, on the other hand, was changed from 5.4% to 6.2%. Of this upward revision of 0.8 points from the April Inflation Report, the oil price-driven rise in the assumption for Turkish lira import prices accounted for 0.1 points and the rise in the food inflation assumption from 7% to 8% accounted for 0.2 points. Meanwhile, the upward output gap revision as a result of the stronger-than-envisaged recovery in aggregate demand conditions increased the year-end forecast by 0.2 points. Lastly, the most recent realizations in inflation drove the forecast for underlying inflation up by 0.3 points.

The above-mentioned projections are based on the assumption that there will be no second wave of pandemic that will require another round of restrictions on mobility and that the global economy will continue to recover in the second half of the year. Despite expansionary monetary and fiscal measures in

[2] The impact of pandemic-led capacity constraints on output gap estimations through potential output is discussed in detail in Box 7.1.
[3] Box 3.1 analyzes how the pandemic-driven increase in unit costs affects inflation, with emphasis on unit labor costs.

advanced and emerging economies, the country risk premium is assumed to improve gradually due to the ongoing uncertainty over the effectiveness of such measures and the recovery. Global uncertainties regarding the course of the pandemic and its economic impact significantly elevate the uncertainty associated with the assumptions and forecasts.

Economic activity strengthens as normalization extends to a broader scale. Assuming that there will be no second wave of pandemic, the economy will likely continue to recover in the second half of 2020, but the pace of recovery will depend on the course of normalization both in Turkey and abroad. Within a framework in which the monetary stance will be determined based on indicators for the underlying trend and in a way to ensure that the ongoing disinflation is consistent with the medium-term inflation target, it is expected that supply-side factors, which prevailed due to pandemic-related restrictions in the short run, will phase out as normalization continues and the declining trend in inflation will resume starting from July.

1.2 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 downside and upside macroeconomic risks that may lead to a change in the baseline projections and the associated monetary policy stance are as follows:[4]

- Uncertainties regarding the course of the pandemic and the steps towards normalization;
- Risks to the global growth outlook;
- Uncertainties regarding demand composition, growth and the labor market outlook;
- Risks to credit supply and composition;
- Risks to the course of food prices;
- Risks to inflation expectations and pricing behavior;
- Uncertainties regarding capital flows towards emerging markets and volatilities in country risk premium;
- Volatilities in crude oil and import prices;
- Risks to the coordination between monetary and fiscal policies (fiscal stance, administered prices, wage and tax adjustments);

Measures to counter the pandemic have been eased in many countries and the global economy showed signs of a partial recovery in the third quarter on the back of the steps towards normalization. The current forecasts are based on a framework in which health measures will not be tightened again either in Turkey or abroad, and the recovery in global activity will continue in a gradual manner. However, due to the continued spread of the pandemic primarily in the southern hemisphere and the likelihood of a second wave, uncertainties over global economic recovery remain high. In addition to the uncertainties regarding the course of the pandemic, uncertainties also remain over the effectiveness of economic policies, the magnitude of the effect on supply chains and global trade, the implications of increased indebtedness on the pace of recovery, and how consumption habits and general spending behavior will change. In any case, a prolonged normalization phase could translate into a much weaker global and domestic growth outlook, calling for additional policy measures.

The impact of the pandemic-related developments on domestic growth, particularly on services, exports, tourism and other related sectors, and on the labor market are closely monitored. Effects of the pandemic-driven business closures, capacity constraints and the slowing economic activity on the labor

[4] Evaluations of how and through which channel these risks may affect the inflation forecasts cited in the previous section are summarized in Table 7.2.3. in Chapter 7.

market have become evident since February. Unemployment increased and the labor force participation rate decreased noticeably. Subsidies provided through the unemployment insurance fund and current transfers, short-time work allowance in particular, limit the income loss of households and contribute to preserving employment. The economic recovery is expected to improve employment conditions in the upcoming period. Nevertheless, demand conditions may pull inflation further down due to a weaker economic recovery or a weaker-than-envisaged impact of recovery on the labor market arising from pandemic-related uncertainties.

Unit labor costs increased due to the declines in production and sales driven by measures such as travel restrictions, lockdowns and social isolation. Despite restraining effects of aggregate demand conditions, the rise in unit costs led to an increase in the trends of core inflation indicators. During the normalization process, the impact of unit costs on inflation is expected to weaken as the supply-side capacity constraints will subside. Thus, the demand-driven disinflationary effects will become more prevalent in the second half of the year. However, the difficulty in decomposing the fluctuation in growth into its demand and supply components creates significant levels of uncertainty over the estimation of the output gap. Pricing behavior in sectors sensitive to consumer loans and the course of supply constraints may affect inflation. The fact that year-end and medium-term inflation expectations hover above targets necessitates the close monitoring of the pricing behavior.

The pandemic has taken a significant toll on firms’ cash flows and balance sheets as well as household incomes both in Turkey and abroad concurrently and in an unprecedented manner. However, the monetary, financial and fiscal measures introduced, as well as the expansion of loan supply mostly by state-owned banks, make significant contribution to the uninterrupted flow of credit to the real sector and the economic recovery process. Meanwhile, in the recent period, consumer loans in particular have picked up significantly. Although this acceleration has been driven partially by pent-up demand, effects of loan growth and composition on inflation, economic activity, current account deficit and risk premium are monitored closely.

Food prices rose in the second quarter due to seasonal and pandemic-related developments. Although the weak course in tourism is expected to put a cap on the increase of food prices, particularly the recent high course in unprocessed food prices and the developments in wheat prices keep the upside risks to food price forecasts alive. In the meantime, oil prices have posted a recovery thanks to abating conflicts among oil exporting countries regarding the oil output and expectations that the worst on the demand side is over. Still, the downside risks to the prices of crude oil and other commodities remain due to the uncertainties over global economic activity.

Accommodative policy measures and steps towards normalization have driven the risk appetite slightly higher, slowing down portfolio outflows from emerging markets. Following the normalization steps, and thanks to recent monetary and financial measures, the adverse effects of global developments on Turkey’s risk premium and exchange rate volatility somewhat eased. However, the ongoing uncertainties over the global economic outlook and effectiveness of policy measures might lead to fluctuations in the global risk appetite and portfolio flows to emerging economies. As uncertainty still reigns, the pandemic disease is closely monitored for its evolving global impact on capital flows, financial conditions, international trade, and commodity prices.

Fiscal policy actions, along with other monetary and financial measures taken during the pandemic, have supported the potential output of the economy by limiting the pandemic-related economic risks and significantly contributed to the start of a recovery in economic activity. Sustaining the coordination between monetary and fiscal policies during the recovery process, and determining the macro policy mix in a way that will ensure the continuation of the disinflation process while supporting the current account balance are crucial for maintaining healthy and stable growth. In the upcoming period, temporary and targeted fiscal and quasi-fiscal policy actions will be critical to support the sectors in which the recovery might take longer due to pandemic-related effects.