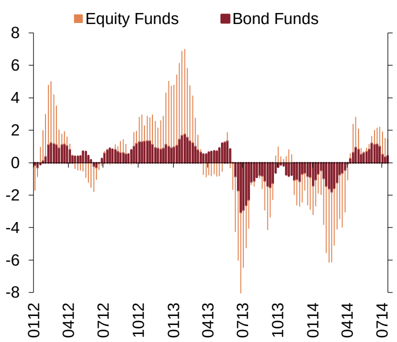
1. Overview

Following the protracted global uncertainty, financial volatilities subsided and liquidity conditions improved in the second quarter of 2014. In this period, conditions for the global risk appetite remained favorable while the sluggish course of capital flows to emerging economies reversed (Chart 1.1). More recently, the Fed's decision to continue with an accommodative policy for an extended period of time and to lower its long-term interest rate projections, as well as the ECB's policy rate cut and announcement of a new quantitative easing program have been the key factors improving global liquidity conditions. This moderate global growth outlook and favorable conditions for risk appetite are expected to continue to support capital flows into emerging economies over the upcoming period.

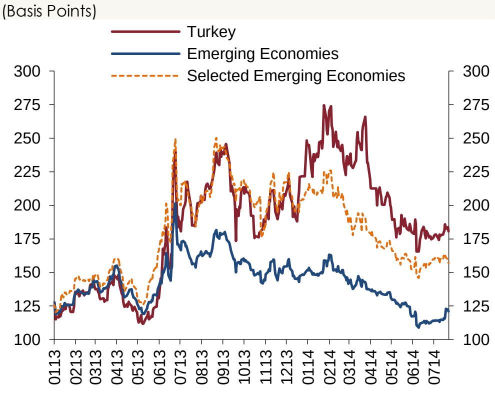
The deteriorating risk sentiment towards Turkey shifted into reverse gear following the strong and front-loaded monetary tightening in January and risk premium indicators recorded a notable improvement in the second quarter due to reduced domestic and external uncertainty (Chart 1.2). In the first half of the year, economic activity continued to expand moderately, while growth of net exports contributed positively to economic growth. Thus, the current account deficit showed a marked improvement. The effect of exchange rate developments on inflation began to decline by the second quarter and underlying trend of inflation improved. These improvements in macroeconomic balances are expected to continue into the second half of the year on the back of a tight monetary policy stance, macroprudential measures and a recovering external demand.

Chart 1.1.
Portfolio Flows to Emerging Economies
(4-Week Moving Average, Billion USD)



Source: EPFR.

Chart 1.2.
CDS for Emerging Economies and Turkey*
(Basis Points)



* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile. Selected emerging economies are Brazil, Indonesia and South Africa.
Source: CBRT, Bloomberg.

1.1. Monetary Policy and Financial Conditions

Due to heightened domestic and external market uncertainties during late 2013 and early 2014, Turkey's risk premium indicators rose. Meanwhile, the Turkish lira diverged slightly from other emerging market currencies by depreciating at a faster rate (Charts 1.2 and 1.1.5). In order to contain the deterioration in inflation expectations and the pricing behavior and also to maintain macroeconomic and financial stability, the CBRT delivered a strong and front-loaded monetary tightening at its interim

MPC meeting on January 28 (Chart 1.1.1). Moreover, the operational framework was simplified and the CBRT funding was henceforth provided primarily from the one-week repo rate (Chart 1.1.2).

Since the publication of the April Inflation Report, conditions that necessitated the strong and front-loaded monetary tightening of January 28 have improved to a large extent. This improvement is due mostly to the reduced domestic and external uncertainty as well as to the Fed's and ECB's latest decisions. In June, the Fed announced that it would continue with its low rate policy over the medium run. Additionally, the FOMC members revised down their long-term interest rate projections from 4 to 3.75 percent. Meanwhile, the ECB set a negative borrowing rate and announced a new quantitative easing program due in September. These developments helped global liquidity conditions to improve, providing some push for capital flows into emerging markets. Moreover, in addition to improved financial indicators, the deterioration in inflation during the first quarter stopped, leading to a notable decline in non-food inflation in recent months.

Owing to the strong and front-loaded monetary tightening on January 28, the resulting decrease in risk premiums, the improving global liquidity conditions, the slowing trend of inflation and the waning cumulative effects of exchange rate depreciation on inflation, the CBRT recently decided to deliver measured rate cuts. Firstly, in April, the late liquidity window lending rate was lowered from 15 to 13.5 percent. Then, the one-week repo rate was cut by 50, 75 and 50 basis points in May, June and July, respectively. (Chart 1.1.1).

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

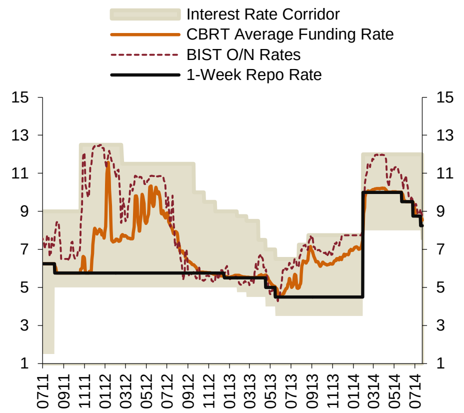
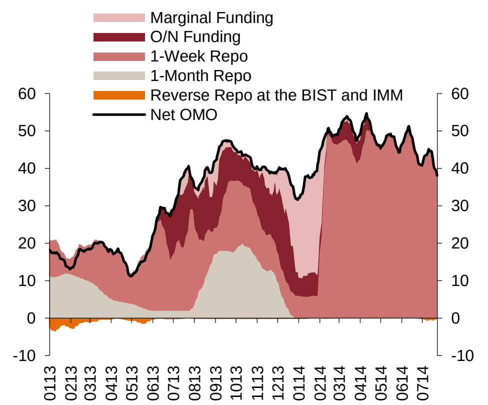


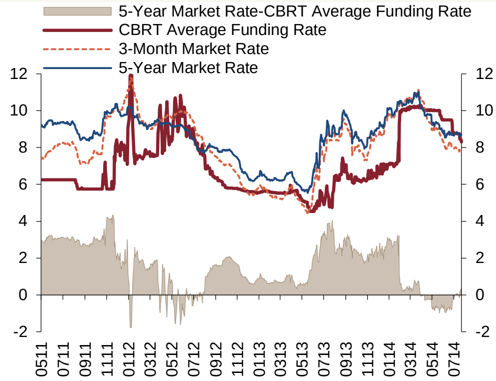
Chart 1.1.2.
CBRT Funding*
(2-Week Moving Average, Billion TL)



Source: BIST, CBRT.

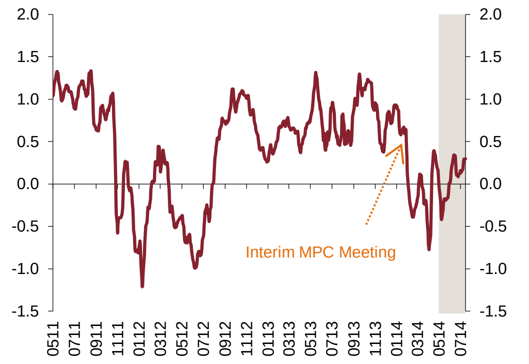
Despite the rate cuts, the monetary stance remains tight. Long-term interest rates have recently fallen on improved risk indicators and increased global liquidity. The spread between long-term rates and the CBRT funding rate remains close to zero (Chart 1.1.3). Similarly, the spread between long-term and short-term market rates is well below the average of past years (Chart 1.1.4). Currently at this state, these indicators reflect a tight monetary policy stance.

Chart 1.1.3.
Money Market and the CBRT Funding Rates
(Percent)



Source: BIST, CBRT.

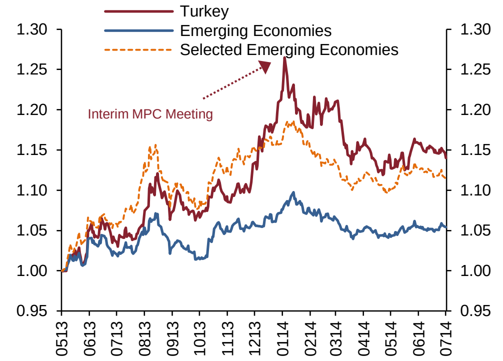
Chart 1.1.4.
Interest Rate Spread*
(Percent)



* Spread between 4-year and 6-month yields derived from the ENS yield curve, 5-day moving average.
Source: BIST.

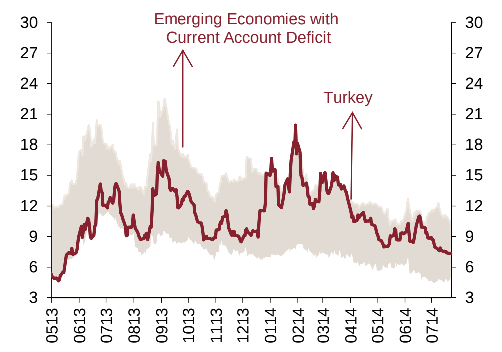
During increased global financial uncertainty from May 2013 to early 2014, Turkey, along with other emerging economies, experienced marked currency depreciation and a surge in implied exchange rate volatility. After the strong monetary tightening at end-January 2014, the risk sentiment improved; the Turkish lira appreciated, thereby weakening the recent divergence of the Turkish lira from the peer currencies; and the implied volatility declined. Due to decreased domestic and external uncertainty, announcements of extended accommodative monetary policy from central banks in advanced economies and the tight monetary policy stance, the Turkish lira volatility appears to have recently fallen more, compared to similar countries (Charts 1.1.5 and 1.1.6).

Chart 1.1.5.
TL and Emerging Market Currencies vs USD*
(22.05.2013=1)



* Emerging economies include Brazil, Czech Republic, Indonesia, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile. Selected emerging economies are Brazil, India, Indonesia and South Africa.
Source: CBRT, Bloomberg.

Chart 1.1.6.
Implied FX Volatility*
(1 month)



* Emerging economies with currency account deficit include Brazil, Czech Republic, Indonesia, India, South Africa, Colombia, Hungary, Mexico, Poland, Romania and Chile.
Source: CBRT, Bloomberg.

The banking sector's funding costs decreased amid recent improvements in market conditions, which passed to both consumer and commercial loan rates. Yet, lower loan rates notwithstanding, the growth rates of consumer loans and credit card debts continued to hover significantly below the average of previous years amid the adoption of macroprudential measures by the BRSA (Chart 1.1.7). The growth rate of commercial loans displayed a slight slowdown in previous years, which, however, is markedly limited compared to the deceleration in consumer loans (Chart 1.1.8). The fact that consumer loan growth decreases to reasonable levels while commercial loan growth remains steady is expected to support financial stability, the balancing process and the disinflation.

Chart 1.1.7.
Consumer Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)

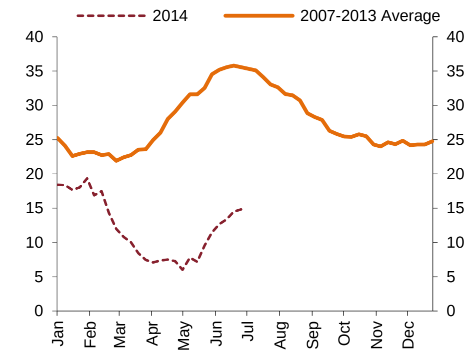
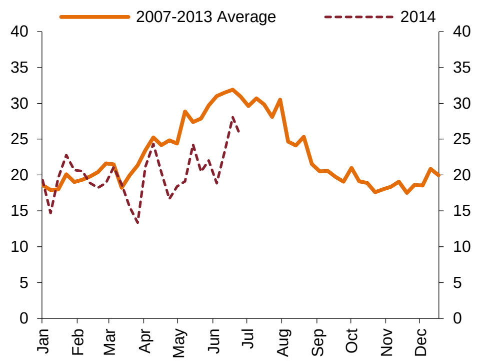


Chart 1.1.8.
Commercial Loan Growth
(Adjusted for Exchange Rate Effect, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

In light of these developments, the FCI estimated by the CBRT for the second quarter of 2014 was in line with the forecast given in the April Inflation Report, with financial conditions becoming less tight (Chart 1.1.9). More specifically, the recovery in capital flows and the stock market affects financial conditions favorably (Chart 1.1.10).

Chart 1.1.9
Financial Conditions and Credit Growth

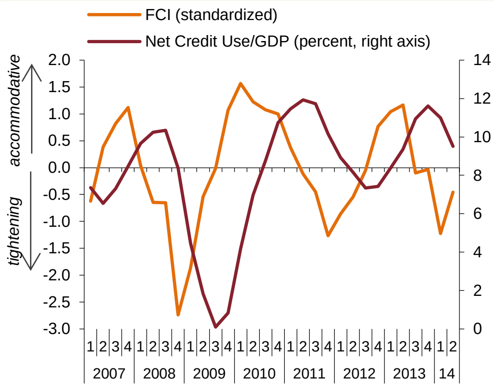
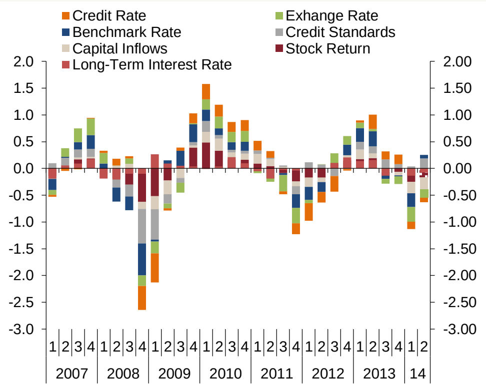


Chart 1.1.10
Financial Conditions Index and Contributions



* For further details on measuring FCI, see the CBT Research Notes in Economics No. 12/31.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

Annual consumer inflation rose by 0.8 points quarter-on-quarter to 9.16 percent in the second quarter of 2014, while inflation excluding unprocessed food and tobacco at 9.09 percent was consistent with the April Inflation Report (Charts 1.2.1 and 1.2.2). This second-quarter rise in inflation was mainly attributed to prices of food and core goods. Food prices, in particular, had the worst second quarter in the history of the index due to supply shocks. In the core goods category, prices of durable goods fell in this quarter but prices of sub-items, which is subject to the lagged effects of the exchange rate depreciation remained on the rise. In the services category, the underlying trend was steady at its relatively high level. The impact of the Turkish lira depreciation after the second half of 2013 on annual inflation peaked in this quarter. Thus, the rise in the annual inflation of core inflation indicators halted.

Chart 1.2.1.
April 2014 Inflation Forecasts and Realizations
(Percent)

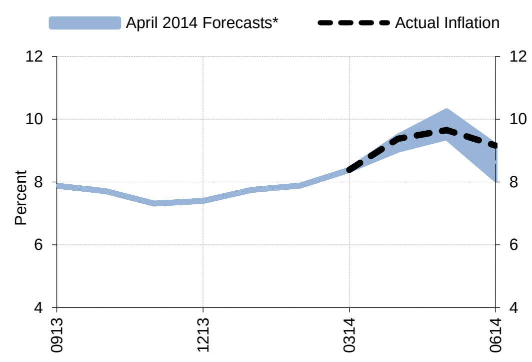
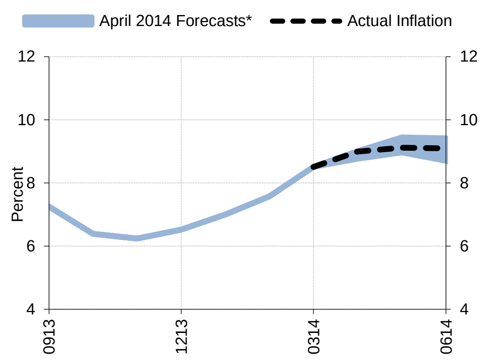


Chart 1.2.2.
April 2014 Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco
(Percent)



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: TurkStat, CBRT.

The uptrend in core inflation indicators slowed in the second quarter and diffusion indices declined. In this period, USD-denominated import prices remained flat, while cost factors excluding food products followed a moderate course on the back of the Turkish lira appreciation. Therefore, indicators for both the underlying inflation and the pricing behavior improved from the first quarter.

The inflation outlook is expected to be governed mainly by the course of economic activity, exchange rates and food prices. Consumer inflation is expected to trend downward in the upcoming period. Both the partially improved pricing behavior and the moderate course of final domestic demand will support the fall in consumer inflation. Moreover, inflation expectations are likely to remain anchored due to the tight monetary policy stance.

The elevated level of food prices has recently been the main factor slowing down the decline in inflation. Negative supply shocks and the exchange rate pass-through caused food prices to surge significantly. In this context, the annual CPI inflation has been diverging notably from the annual non-food CPI inflation since mid-2013 (Chart 1.2.3). This divergence is more significant considering the seasonally adjusted inflation in recent months driven by supply-side factors (Chart 1.2.4). Thus, the course of food prices, which essentially falls outside the domain of monetary policy, is likely to be influential on the inflation outlook over the forthcoming period.

Recent realizations on domestic food prices diverged markedly from those on international food prices. After climbing amid the first-quarter's negative supply-side developments, international food prices slumped to a one-and-a-half-year low. Domestic prices, on the other hand, rose on par with international prices in the first quarter, but continued to climb in the second quarter although international prices were markedly down (Charts 3.2.5 and 3.2.6). Many products whose prices are rising domestically are subject to high external trade taxes. Therefore, an active external trade policy to be imposed on certain agricultural products might be effective in curbing the upside risks on food prices.

Chart 1.2.3.
Food Prices and CPI
(Annual Percent Change)

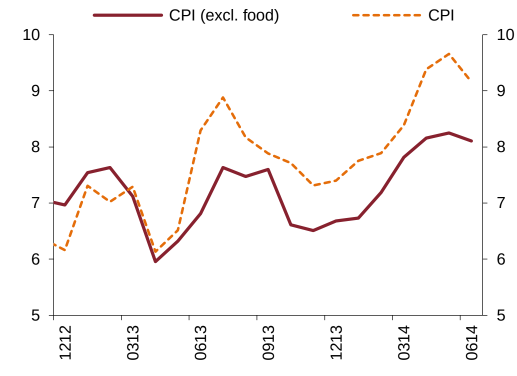
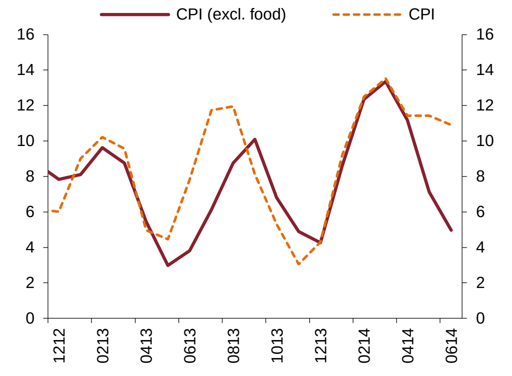


Chart 1.2.4.
Food Prices and CPI
(Seasonally Adjusted, 3-Month Moving Average, Annualized)

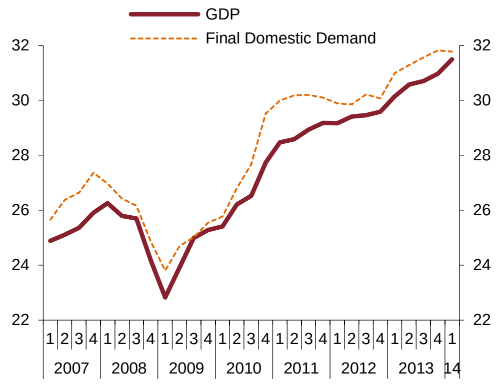


Source: TurkStat, CBRT.

Supply and Demand

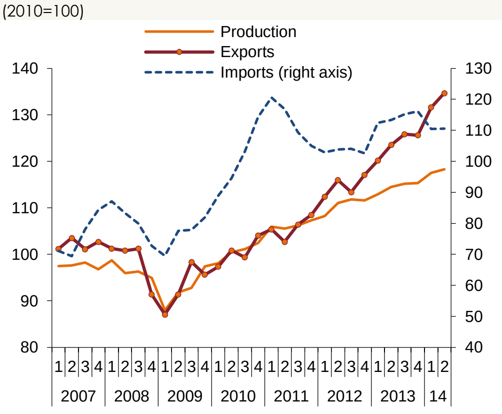
According to the GDP data of the first quarter of 2014, demand developments proved largely consistent with the outlook presented in the April Inflation Report. Expenditures on durable goods and the private sector machinery and equipment investments, which are relatively more sensitive to the exchange rate, financing conditions and expectations posted a quarterly decline, while expenditures on non-durable consumption goods and private sector construction investments recorded a quarter-on-quarter increase. In this period, public expenditures remained on the increase and net exports contributed significantly to growth. Thus, the GDP increased, while final domestic demand followed a flat course (Chart 1.2.5).

Chart 1.2.5.
GDP and Final Domestic Demand
(Seasonally Adjusted, Billion TL, 1998 Prices)



Source: TurkStat, CBRT.

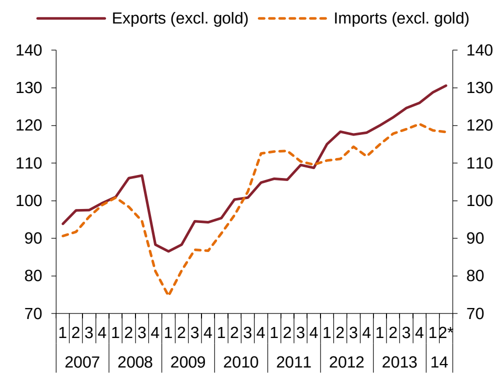
Chart 1.2.6.
Production, Export and Imports of Consumption Goods*
(2010=100)



* Estimate for April and May.
Source: TurkStat, CBRT.

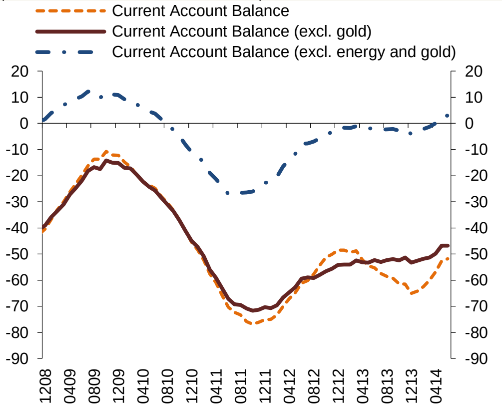
Second-quarter data on the expenditure side suggest a mild increase in private consumption, private construction investments and public expenditures, but a sustained weak course in the private sector machinery and equipment investments. The mild uptick in the production of consumption goods driven by the high uptrend in exports continues, yet imports follow a rather flat course (Chart 1.2.6). Export-driven production increase is apparent all over the economy. In fact, external trade has witnessed a continuation of uptrend in exports excluding gold in contrast to the decline in imports excluding gold for the last two quarters (Chart 1.2.7). Thus, external trade developments continue to support growth and the current account balance has exhibited a notable improvement since the start of the year (Chart 1.2.8). Accordingly, the current account deficit is expected to become apparently narrower in the second quarter and economic activity is estimated to record a moderate increase.

Chart 1.2.7.
Export and Import Quantity Indices
(Seasonally Adjusted 2010=100)



* Estimate for June.
Source: TurkStat, CBRT.

Chart 1.2.8.
Current Account Balance
(12-Month Cumulative, Billion USD)



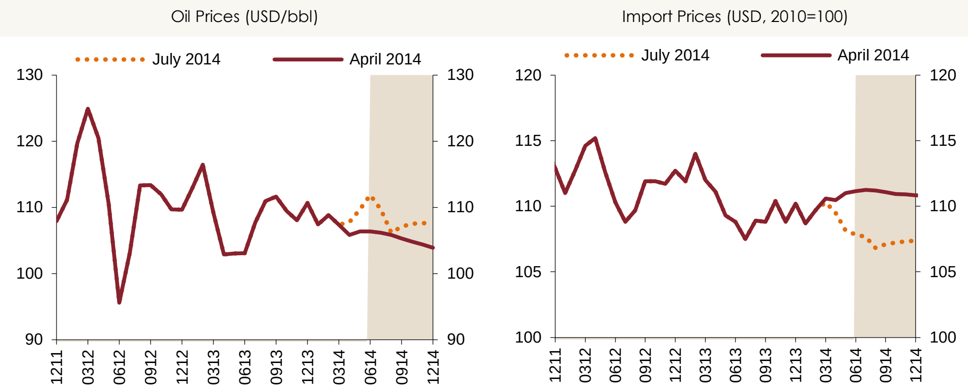
Source: CBRT.

Alleviation of domestic and external uncertainties, the quarter-on-quarter improvement in consumer confidence in the second quarter and the global economic recovery are projected to support the recovery in economic activity in the second half of the year. As a result of the tight monetary policy stance coupled with macroprudential measures, the recovery is expected to be gradual and mild. Accordingly, domestic demand conditions are expected to support disinflation and the current account deficit is envisaged to improve further. Recent geopolitical developments, on the other hand, may pose downside risks to growth and the balancing process directly due to the trade channel as well as the oil price channel.

Energy, Import and Food Prices

In the second quarter of the year, oil prices remained slightly above the path presented in the April Inflation Report, while import prices lagged behind projections (Chart 1.2.9). Nevertheless, the average oil price assumption for 2014 was revised upwards, while exports were revised downwards (Table 7.1.1). The current outlook suggests that the developments in oil and import prices largely balance each other in the inflation outlook. Accordingly, year-end inflation forecasts were not subject to any revision due to external prices. The assumption for year-end food price inflation is maintained at 9 percent (Table 7.1.1). However, food inflation hovers around remarkably high levels at the end of the second quarter. An active external trade policy in agricultural products, the domestic prices of which increased more notably than international prices, is assessed to curb the upside risks to food prices.

Chart 1.2.9. Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.

Source: CBRT, TurkStat.

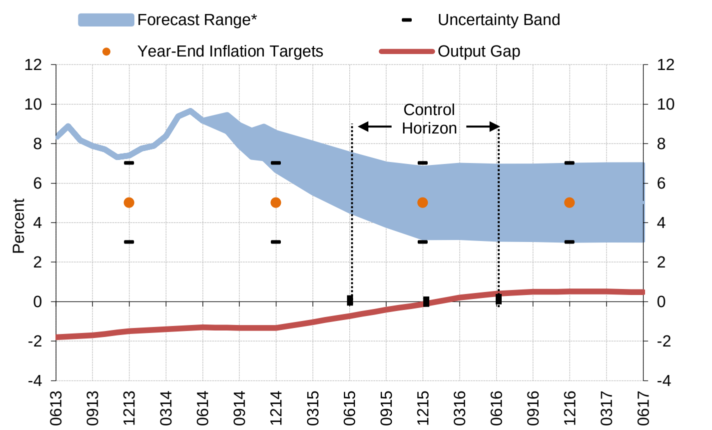
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with the inflation targets and automatic pricing mechanisms. Thus, the end-2014 inflation forecast was not subject to any revision stemming from the fiscal policy. The medium-term fiscal policy stance is based on the MTP projections covering the 2014-2016 period. Accordingly, it is assumed that the cautious fiscal stance will be preserved and primary expenditures will be kept under control.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the assumption that the tight monetary policy stance will be maintained by keeping a flat yield curve until there is a significant improvement in the inflation outlook and the improvement in the global liquidity conditions is sustained. A further assumption is that the annual loan growth rate will stabilize around 15 percent by the end of 2014 on the back of the macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.7 percent and 8.5 percent (with a mid-point of 7.6 percent) at end-2014 and between 3.3 percent and 6.7 percent (with a mid-point of 5 percent) at end-2015. Inflation is projected to stabilize around 5 percent in the medium term(Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts



* Shaded region indicates the 70 percent confidence interval for the forecast.
Source: CBRT.

Due to high food prices and the lagged effects of exchange rate depreciation, annual inflation is expected to considerably exceed the 5-percent target at the year-end. On the back of the mild course of import prices, the gradual elimination of the lagged effects of the exchange rate and the moderate course of private domestic demand conditions, inflation is envisaged to drop to 7.6 percent at the year-end (Chart 1.3.1).

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

Loan growth continues at reasonable levels in response to the tight monetary policy stance and macroprudential measures. In the first half of the year, consumer loan growth fell well below its average of recent years, while commercial loan growth was relatively more robust. This favorable growth composition of loans both contribute to disinflation and support balancing by curbing final domestic demand.

In line with these developments, final domestic demand displays a modest outlook. Meanwhile, with the help of the recovery in external demand, exports contribute positively to economic growth. Under the current outlook of demand components, aggregate demand conditions are estimated to curb inflationary pressures and the current account deficit is expected to exhibit a significant improvement in 2014. Recent geopolitical developments on the other hand, may pose downside risks to growth and the balancing process directly due to the trade channel as well as the oil price channel. In addition, a rise in oil prices may bear adverse effects on inflation.

The adverse impact of exchange rate developments since mid-2013 on annual inflation is gradually tapering off. Indeed, the underlying trend of core inflation indicators has recently displayed a decline amid the alleviation of inflationary pressures led by the exchange rate particularly on durable goods. However, the high course of food prices due to supply-side developments has recently limited the pace of decline in inflation. Should the year-end food inflation stay above the assumed level and food prices remain high, consumer price inflation will exceed the figures presented in the Inflation Report. Given the falling prices in foreign agricultural products in the second quarter, an active external trade policy for these products is assessed to curb upside risks to food prices.

Inflation hovering above the target in the recent future necessitates close monitoring of the negative effects on the pricing behavior. Accordingly, the CBRT will closely monitor inflation expectations, pricing behavior and other factors that affect inflation, and maintain a tight monetary policy stance by keeping a flat yield curve until there is a significant improvement in the inflation outlook.

Recently, the Fed has stated that accommodative policies will be maintained for a long time and lowered the long-term interest rate forecasts which had a positive effect on the markets. In addition, the ECB reduced the policy rates and announced a new quantitative easing program, boosting the global risk appetite. These developments led to expansionary effects on global liquidity conditions and capital inflows towards emerging economies saw a recovery. The mild global growth outlook and the favorable conditions for risk appetite are expected to further support capital flows to emerging economies in the upcoming period. Accordingly, should capital inflows accelerate, the CBRT may take steps to strengthen foreign exchange reserves.

The CBRT closely monitors developments on fiscal policy and tax adjustments 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 on administered prices in the forthcoming period. A revision of the monetary policy stance may be considered should the fiscal stance deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improving social welfare by keeping the interest rates of long-term government securities at low levels. In this respect, implementing the structural reforms required by the MTP remains to be of utmost importance.