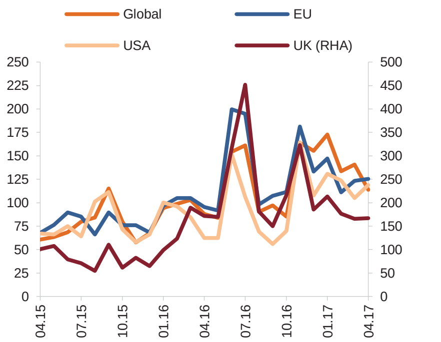
I. Macroeconomic Outlook

The uncertainty in global financial markets following the US presidential elections has partly abated since the last report period. During this period, the decline in global uncertainties and the recovery signals of global growth have led to strong performance of stock market indices, especially in advanced economies. On the back of the decline in inflation expectations, demand in bond markets has recently increased and long-term interest rates have assumed a downtrend again. Since the beginning of 2017, emerging economies have enjoyed portfolio inflows thanks to the increase in global risk appetite and investors seeking higher yields. The Emerging Market Currency Index has appreciated against the US dollar owing to portfolio inflows. While it remains weak, global growth has continued to recover. Moreover, despite the recent pick-up, growth rates in emerging economies, excluding China and India, are still below those of advanced economies.

Economic activity showed a moderate recovery in the last quarter of 2016, driven by increased private consumption expenditures and strong goods exports supported by measures and incentives introduced. Meanwhile, developments in exchange rates and oil prices, and the rise in food prices caused a rise in consumer inflation. Foreign trade continued to make a positive contribution to the current account balance, despite the decline in the share of tourism in export revenues. Exports of goods and services are anticipated to increase in the upcoming period owing to the net income effect of the global economic recovery on our export partners and the market diversification performance of our exporters. The central government budget deficit slightly increased in the second half of 2016 and the first quarter of 2017, when fiscal policy supported economic growth. This increase is expected to be temporary and fiscal discipline will continue to be the main anchor of the Turkish economy. As a result of all these developments, risk perceptions for Turkey's assets have been on a positive trend since the second half of 2016.

In the first quarter of 2017, economic policy uncertainty decreased.

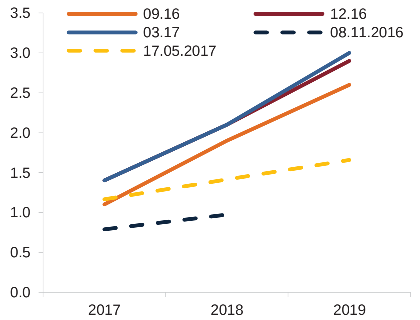
Chart I.1.1
Economic Policy Uncertainty Indices
(Index, 2012=100)



Note: Indices are not comparable among themselves in terms of level.
Source: Bloomberg (Latest Data: 04.17)

Market participants foresee a softer path in the Fed's policy rate.

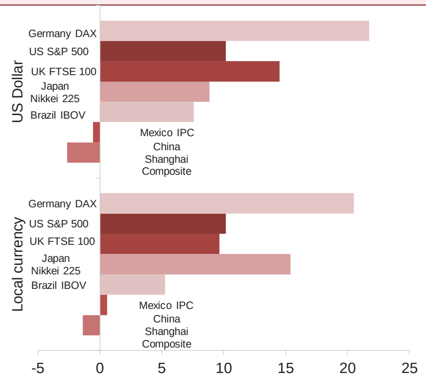
Chart I.1.2
FOMC Members' Median Policy Interest Forecasts (Straight Lines) and Market Expectations (Intermittent Lines)



Note: Intermittent lines indicate 30-day Fed fund futures rates.
Source: Bloomberg (Latest Data: 17.05.2017)

After the US presidential election, particularly the advanced economy stock market indices have shown a strong performance.

Chart I.1.3
Stock Market Indices
(Percentage Change, 08.11.2016-17.05.2017)



Source: Bloomberg (Latest Data: 17.05.17)

I.1 International Developments

The uncertainty experienced in the global financial markets following the US presidential election has somewhat decreased since the last reporting period (Chart I.1.1). The limited progress made by the new administration regarding expansionary fiscal and protectionist trade policy objectives (Box I.1.1) and a clearer picture of normalization in the monetary policy have played a role in this decrease.

The convergence of the US inflation to the 2-percent target of the US Federal Reserve (Fed) supports the normalization process in monetary policy. The rise in inflation and the recovery in leading economic activity indicators have increased the likelihood that the Fed will go for two Fed rate hikes in the rest of the year. On the other hand, there exists a divergence between the long-term Fed rate expectations of the members of the Federal Open Market Committee (FOMC) and those of market participants (Chart 1.1.2). More precisely, while FOMC members predict that the policy rate will approach 3 percent in the period up to 2019, market participants are more cautious in assessing the recovery in the economy and expect a more moderate increase in Fed rates. In addition, the issues related to the downsizing of the balance sheet of the Fed remain on the agenda.

While stock market indices show a strong performance, particularly in advanced economies, in the aftermath of the US presidential election, there has also recently been an increase in demand in bond markets due to the decline in inflation expectations (Chart I.1.3 and Chart I.1.4). In almost all emerging markets, treasury bond yields that increased following the US election started to decline after January (Chart I.1.5).

Chart I.1.4
10-Year Treasury Bond Yields in US, Germany and Japan (Percent)

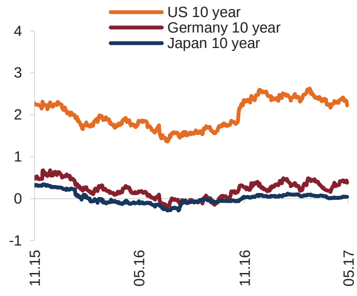
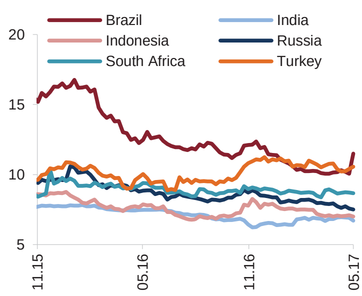


Chart I.1.5
10-Year Treasury Bond Rate in Emerging Economies (Percent)



Source: Bloomberg (Latest Data: 19.05.17)

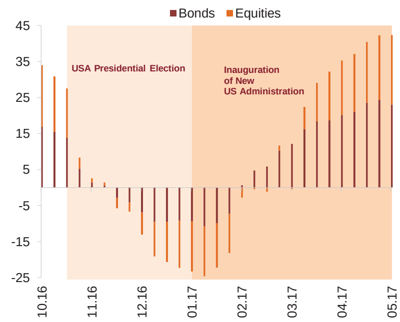
With respect to the monetary policy stance, it is observed that the decoupling in the policies of the central banks of advanced economies has continued. At the March meeting, the Fed made the first interest rate increase in 2017 and gave the early signal of starting the balance sheet reduction. It is foreseen that the expansionary monetary policies will continue in Japan where the inflation rate is expected to fall short of converging to the target in the mid-term, and in the EU where concerns over the financial system persist.

Since the beginning of 2017, portfolio inflows to emerging economies have increased due to the global risk appetite and the search for high yield (Chart I.1.6). The demand for high-yield debt instruments has increased due to the leading indicators of the global economic outlook and the developments in the aftermath of the US presidential elections. Likewise, there have been significant inflows to global capital markets. In line with the increasing risk appetite, portfolio inflows as well as risk premiums have improved (Chart I.1.7).

The depreciation of the emerging market currency index against the US dollar since November 2016 was offset as of April by intensive portfolio inflows particularly to bond markets in the emerging economies after the new administration in the US took over the office (Chart I.1.8). The US dollar strengthened against major currencies first, and then depreciated as a result of political developments. On the other hand, after the elections in the Netherlands and France, the euro appreciated against the US dollar as the political uncertainties in the EU declined.

Since the beginning of 2017, portfolio flows towards emerging economies have gained momentum.

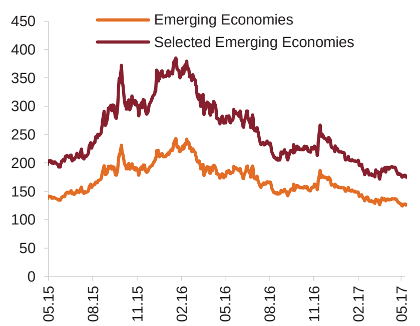
Chart I.1.6
Weekly Capital Flows to Emerging Economies (Billion US Dollar, 13-Week Cumulative)



Source: EPFR (Latest Data: 10.05.17)

With increased risk appetite, credit default swap premiums in emerging economies improved.

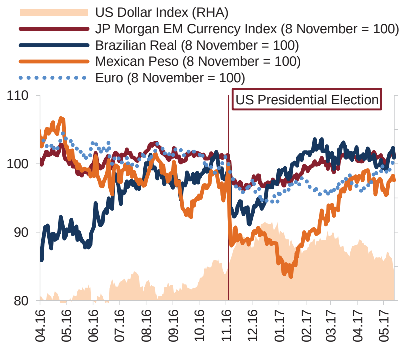
Chart I.1.7
CDS Premiums in Emerging Economies (Basis Points)



Note: Emerging economies include Brazil, Czech Republic, Indonesia, S. Africa, Colombia, Hungary, Poland, Romania, Turkey and Chile. Brazil, Indonesia and South Africa CDS premiums are used for the calculation of the average of selected emerging economies.

Source: Bloomberg (Latest Data: 17.05.17)

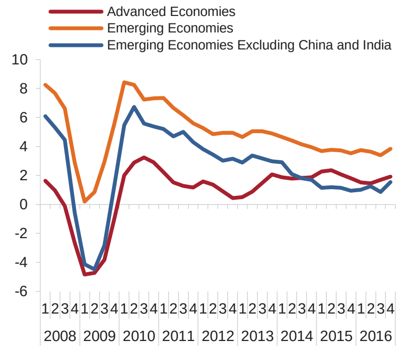
Chart I.1.8
Exchange Rate Indices



Source: Bloomberg (Latest Data: 17.05.17)

Global growth continues to recover, albeit with a weak outlook.

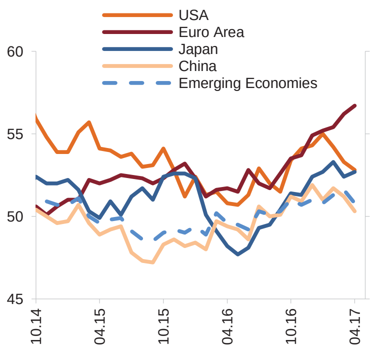
Chart I.1.9
Growth of Advanced and Emerging Economies
(Percentage Change, Annual)



Note: Advanced Economies: USA, Euro Area, Japan, UK, Canada, S.Korea, Switzerland, Sweden, Norway, Denmark, Israel. Emerging Economies: China, Brazil, India, Mexico, Russia, Turkey, Poland, Indonesia, S.Africa, Argentina, Thailand, Malaysia, Czech Republic, Colombia, Hungary, Romania, Philippines, Ukraine, Chile, Peru, Morocco.

Source: Bloomberg, CBRT (Latest Data: 12.16)

Chart I.1.10
Manufacturing Industry PMI Indices



Source: Bloomberg, CBRT (Latest Data: 04.17)

The global growth, though maintaining a weak outlook, continues to recover (Chart I.1.9). Leading growth indicators support this judgment for advanced economies, in particular for the EU (Chart I.1.10). While it is expected that the expansionary fiscal policies anticipated to be applied in the US in the upcoming term will support the global growth, protectionist trade policies and political uncertainties in Europe stand out as downside risks.

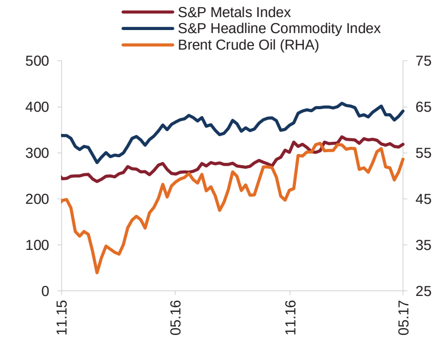
Growth rates in emerging economies, except China and India, have recently recovered, but still remain below the growth rates of advanced economies. There is no improvement in the momentum of China's growth that was lost during the transition from the growth model based on investment and exports to the growth model based on consumption. In addition, the shadow banking and high indebtedness in China continue to be viewed as financial vulnerability concerns.

The upward trend observed in the commodity prices since 2016 continues (Chart I.1.11). The relative recovery in the Chinese economy and the positive signals from the US and the global growth played a role in the rise in the general commodity index. Oil prices have increased slightly due to the partial implementation of the oil production restriction imposed by OPEC member countries. In addition, the US shale oil production and the increase in general oil stocks also played a role in this limited rise in oil prices.

Several elections took place around the world over the last year and their outcomes indicate that vulnerabilities resulting from political uncertainties will be somewhat decreasing in the forthcoming period. However, the early election in the United Kingdom, elections in Germany and the EU-UK negotiations are considered the political uncertainties that are expected to affect financial markets. It is thought that the steps towards reducing the Fed balance sheet, the inflation trends in advanced economies and the developments in the banking sector will play a role in the formation of monetary policies. It is also expected that with the finalization of the global financial reform agenda, uncertainties regarding the regulations will disappear and reforms will be in effect. The absence of any deterioration or reversal of reforms and regulations, particularly in the United States, is a precondition for an open and integrated global financial system.

The global economic growth and the political and financial conditions in advanced economies are among the factors that can affect capital flows towards emerging economies. In this framework, macroeconomic measures to increase the resilience of the financial systems of emerging economies as well as policies focusing on structural problems gain importance.

Chart I.1.11
Commodity Prices
(Indices, US Dollar)



Source: Bloomberg (Latest Data: 19.05.2017)

Box I.1.I Protectionist Policies in International Trade and Possible Effects

The ever-increasing phenomenon of globalization since the beginning of the 1980s has brought about liberal policy implementations that support global and regional integration. Developments in information technology, transportation and communications have contributed to the growth of global capital flows and trade volume. With the influence of liberal trade policies, countries have become a part of "global value chains", and a structural transformation has occurred in their production activities. Throughout this time, the sensitivity of the change in international trade volume to global growth and demand conditions has increased[1]. Along with the political and economic formations such as the EU, multilateral trade agreements like NAFTA (North American Free Trade Agreement) and developments such as China's membership of the World Trade Organization (WTO) have contributed to the increase in global trade flows. However, when addressed in terms of the effects on employment, income distribution and development, there are differences in the influences of pro-globalization trade policies on countries.

In the aftermath of the global financial crisis, the influences of globalization on growth and employment have become more visible due to the impacts of weak economic growth and declining investments, and protectionist trade policies have been resorted to more. According to the WTO report[2], the number of trade measures implemented across the G20 reached its highest level since 2009, with a monthly average of 21 between October 2015 and May 2016. In this period, 89 of 145 trade measures consisted of countervailing measures and anti-dumping practices.

In recent years, protectionist policies in developed countries have started to be voiced due to the negative developments in growth and employment, as well as increased migration movements. In this period, the start of the Brexit process, referring to the departure of the UK from the EU, resulted in an increase in political and economic uncertainty, and contributed to the spread of anti-integration policies. In addition, the implementation of protectionist trade policies was among the promises of the new administration in the US presidential campaign. Also, the uncertainty in the period after the US presidential election about the implementation of these policies is considered as a downside risk for global trade flows and economic growth that are already slowing down after the global financial crisis[3]. Therefore, the possible effects of protectionist trade policies envisaged to be implemented by the new administration are important for the global economic outlook.

It is assessed that the composition of the US foreign trade deficit is the determinant factor for the rise of protectionist trade policies. By 2016, the US had the largest foreign trade deficit with China, followed by Japan, Germany and Mexico, respectively (Chart I.1.I). On a regional basis, it is likely that the Asian economies in which the US trade deficit intensifies will be among the countries most vulnerable to possible protectionist policies.

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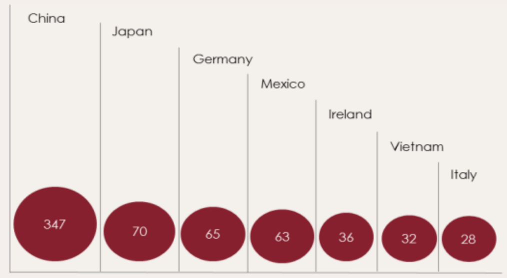
[1] Domit, S. and T. Shakir (2010). "Interpreting the World Trade Collapse", Bank of England Quarterly Bulletin.

[2] "Report on G20 Trade Measures", WTO OMC, June 2016.

[3] IMF Global Financial Stability Report, April 2017.

Chart I.1.I.1
US Trade Deficit Composition
(Billion US Dollar)



Source: US Bureau of Census (Latest Data: 2016)

The revision of free trade agreements, the renegotiation of NAFTA, the introduction of customs duty with the rates of 35 and 45 percent for imports from China and Mexico, respectively, have been raised among the possible protectionist trade policies that can be put into practice by the US[4]. On the other hand, in the post-election period, it was decided in the first place not to put the Trans-Pacific Partnership (TPP) agreement into effect. One reason for this is the possibility that the TPP is able to contribute more to the high-skilled workforce, but is likely to increase inequality in income distribution. In addition, the removal of the paragraph related to the prevention of protectionist policies from the G20 Communique on the recommendation of the US at the G20 Finance Ministers and Central Bank Governors meeting held in Germany on March 2017 has been a significant development echoed in international markets. However, it has also been seen that there are some legal and political obstacles to the protectionist trade policies brought forward by the US administration. Delaying the draft law amending the health reform can be considered as an example of political obstacles.

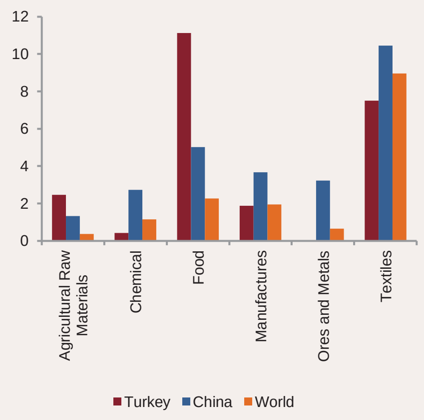
Table I.1.I.1
Turkey's Exports to the US
(Billion US Dollar)

	2010	2011	2012	2013	2014	2015	2016
Total Exports	3.76	4.58	5.60	5.64	6.34	6.40	6.62
Trade Deficit	8.55	11.45	8.53	6.96	6.38	4.74	4.24
Share of Exports in Total (%)	3.3	3.4	3.7	3.7	4	4.4	4.6
Export Growth (%, Annual)	16.1	21.8	22.3	0.6	12.4	0.9	3.6

Source: TURKSTAT(Latest Data: 2016)

[4] "Here's Donald Trump's Presidential Announcement Speech," 16 June 2015, time.com/3923128/donald-trump-announcement-speech (date of access 2 May 2017); "Trump calls NAFTA a 'disaster,'" 25 September 2015, www.cbsnews.com/videos/trump-calls-nafta-a-disaster (date of access: 2 May2017).

Chart I.1.I.2
Weighted Average Effective Tariff Rates Applied by the US
(2015, %)



Note: Sectoral division is based on SITC REV2.
Source: World Integrated Trade Solution (WITS).

Protectionist trade policies continue to be seen as a downside risk factor for global economic activities in reports published by international organizations, in particular by the IMF. In the event that these measures are put into practice, it is estimated that there will be some negative reflections on the US and developing countries, but the direct effects on the Turkish economy are assessed to be limited. Turkey's exports to the US are on an upward trend and constituted 4.6 percent of Turkey's total exports by 2016 (Table I.1.I). Although the annual growth rate of exports to the US fluctuated between 2010 and 2016, there was a decrease in the foreign trade deficit. Moreover, the average tariff rates applied by the US on imports from Turkey are already above the world averages in food and agricultural raw materials sectors (Chart I.1.2). In this respect, if the US imposes unilateral tariff increases on China in certain sectors, the competitive power of Turkey in the US market will increase relative to China. In addition, according to empirical findings[5], the high income elasticity of Turkey's exports to developed countries also supports the expectation that the effects of possible US protectionist policies will be limited. However, the effects of these policies on the global economic outlook should be closely monitored in a multifaceted way.

[5] Çulha and Kalafatcılar, CBRT Research Notes in Economics, 2014-05.

Box I.1.II Financial Instruments International Financial Reporting Standards 9: Expected Credit Loss

High loan losses of banks and other credit institutions during the 2008 global financial crisis provided a basis for a review of the "incurred credit loss" approach that caused these losses to be represented in financial statements with a time lag and to a lesser extent than they should be. After the global financial crisis, upon the invitation of G20 leaders, legal authorities of countries and regulatory bodies, the International Accounting Standards Board finalized its studies and published the "IFRS - International Financial Reporting Standards – 9" document in 2014. The document comprises new regulations on the classification and risk measurement of financial instruments, expected credit loss, and hedge accounting. This box presents information on the "expected credit loss approach", an element of IFRS 9 accounting standards that will be implemented in 2018, which enables a more prudent loan provision mechanism.

Expected Credit Loss

Unlike the backward-looking approach of the IAS (International Accounting Standards) 39, the IFRS 9 adopts the approach of "utilizing full range of current and previous information that may have effect on future cash flows estimation for the credit". The expected credit loss (ECL) is a probability-weighted estimate of lifetime credit losses of a financial instrument. In other words, it is the present value of all cash shortfalls. A cash shortfall is defined as "the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive." ECL calculations employ any reasonable and supportable information obtained from past events, current economic conditions and forecasts of future economic conditions.

Although the ECL approach of IFRS 9 and the expected loss calculation of Basel III look alike, the expected loss is calculated for a time window of 12 months in Basel III. On the other hand, the "probability of default (PD)" and the "loss given default (LGD)" elements used in ECL calculations are estimated marginally for each period in the remaining maturity of a financial asset. Meanwhile, the exposure at default (EAD) is estimated according to lifetime cash flows of the asset. The present value of the expected loss is adjusted with the discount factor (DF). The ECL may be formulized briefly as:

$$ECL = PD*LGD*EAD*DF$$

The ECL is reflected in financial statements through two approaches:

12-month ECL: This refers to the portion of lifetime expected credit losses that represents the expected credit losses resulting from probable default events[1] regarding a financial instrument within 12 months after the reporting date (or remaining maturity if the expected lifetime of the financial asset is less than 12 months).[2] The 12-month ECL is not an estimation of the cash shortfalls in 12 months but an estimation of loss calculated by weighting the expected lifetime (as long as the asset is shown in

[1] If there is no reasonable and grounded information revealing default, action is taken based on the presumption that the default will take place in maximum 90 days.

[2] TFRS 9 (2017 Version) Financial Instruments, APPENDIX A Defined Terms

balance sheet) cash shortfalls with the probability of default for 12 months.

Lifetime ECL: This refers to expected credit losses originating from all possible default events over the expected lifetime of a financial instrument.[3]

The IFRS 9 has designed a three-stage model for the recognition of impairment based on changes in the credit quality.[4]

Table I.1.II.1
Conditions for Impairment and Stages

Stages	Stage 1	Stage 2	Stage 3
Recognition of Expected Credit Losses	12-Month Expected Credit Loss	Lifetime Expected Credit Loss	
Interest Revenue	Gross Carrying Amount		Net Carrying Amount

Stage 1: This stage includes financial instruments that do not show a significant increase in the credit risk or that have low credit risk on the date of initial recognition.[5] For these financial instruments, the 12-month ECL method is used to determine the loan loss provision to be set aside. The interest revenue of these assets is calculated based on the gross carrying amount of the financial asset.

Stage 2: The transition to stage 2 is linked to a significant increase in the credit risk. Financial instruments that have had a significant increase in the credit risk since the date of initial recognition, or in other words, instruments that are not classified as having low credit risk are included in this stage. The ECL for these assets is accounted with the lifetime expected credit loss method. Similar to the interest revenue of assets in stage 1, the interest revenue of these assets is also calculated based on the gross carrying amount.

Stage 3: In addition to the conditions set out in stage 2, this stage includes financial instruments that become credit-impaired or that are in default. For these financial instruments, the lifetime ECL method is used to determine the loan loss provision to be set aside. However, the interest revenue of these assets is calculated based on the net carrying amount which is the net of loss allowance, instead of the gross carrying amount.

Example: At the beginning of January 2018, a TL 100-thousand unsecured loan is extended with a maturity of 4 years at an annual interest rate of 10 percent and with a principal payment at maturity. The LGD is assumed to be 100 percent since the loan is unsecured, and the gross amount of the loan is considered to be TL 100 thousand for all periods as the principal payment will be made at maturity.

[3] TFRS 9 (Version 2017) Financial Instruments, APPENDIX A Defined Terms

[4] Snapshot: Financial Instruments: Expected Credit Losses (2013), IFRS.

[5] TFRS 9 (Version 2017) Financial Instruments, B5.5.22

1) December 31, 2018: The credit is in stage 1. The PD for the next 12-month period is estimated to be 1 percent based on the bank model.

2) December 31, 2019: Credit risk has increased significantly as it is expected that the customer will have cash flow problems due to the deterioration in economic conditions. This loan is transferred to stage 2. The PD for the remaining life of the loan is estimated to be 35 percent.

3) December 31, 2020: Since the loan has not been paid back, it is transferred to stage 3. The PD for the remaining life of the loan is estimated to be 60 percent. As this loan was in stage 2 throughout 2020, the interest revenue will be calculated based on the gross carrying amount of the loan.

4) December 31, 2021: Throughout 2021, the interest revenue will be calculated based on the net carrying amount of the loan (net of loss allowance).

Table I.1.II.2
Example: Calculation of Expected Credit Loss

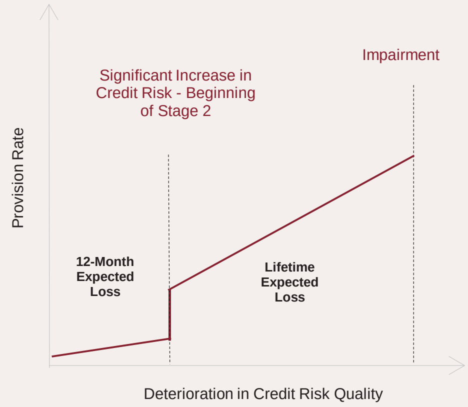
Reporting Date	Stages	Gross Carrying Amount	LGD	PD	ECL	Net Carrying Amount	Interest Revenue
31.12.2018	1	100,000 TL	100%	1%	100,000*1% = TL 1,000	TL 99,000	100,000*10% = TL 10,000
31.12.2019	2	100,000 TL	100%	35%	100,000*35% = TL 35,000	TL 65,000	100,000*10% = TL 10,000
31.12.2020	3	100,000 TL	100%	60%	100,000*60% = TL 60,000	TL 40,000	100,000*10% = TL 10,000
31.12.2021	3	100,000 TL	100%	60%	100,000*60% = TL 60,000	TL 40,000	40,000*10% = TL 4,000

IFRS 9 Turkey Implementation: Transition Process of the Banking Sector

The "*Regulation on the Procedures and Principles Regarding the Classification of Loans and the Provisions to be Set Aside*", which regulates the provisions to be set aside by the Turkish banking sector in the scope of the TFRS (Turkey Financial Reporting Standards) 9, will come into force on 01.01.2018. In this regulation, the distinction between general and specific provisions is maintained. Consistent with the IFRS 9, provisions which are set aside by the approaches of the 12-month ECL and the lifetime ECL driven by a significant increase in credit risk are considered as *general provisions*. On the other hand, provisions which are set aside through the approach of expected credit loss due to the default of the borrower are called *specific provisions*.

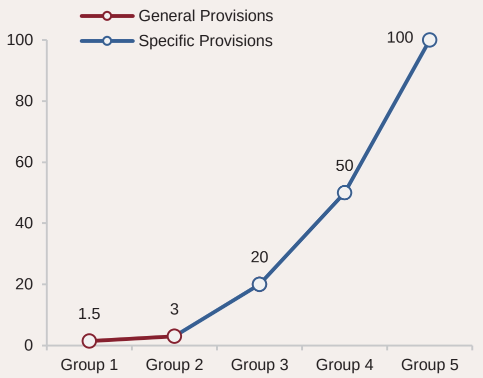
From 2018 onwards when the new regulation will become effective, banks applying the TFRS 9 will recognize general provisions at an amount as much as the 12-month ECL for the loans that do not witness a significant increase in the credit risk. When there is a significant increase in the credit risk of the loan, the provision will be set aside to the extent of the lifetime ECL and the rate of provision will also increase in proportion to the deterioration in the loan quality (Chart I.1.II.1). According to the regulation, the relevant authority may decide to give some additional time to banks for the transition to the adoption of the TFRS 9. In this case, banks which are not eligible to apply the TFRS 9, will set aside a minimum general provision of 1.5 percent and 3 percent for their standard loans and loans under close monitoring, respectively. The specific provision ratios for banks are set at the minimum levels of 20, 50 and 100 percent for the loans under third, fourth and fifth groups, respectively (I.1.II.2).

Chart I.1.II.1
Provisions for Banks Conforming to the TFRS 9



Source: IASB

Chart I.1.II.2
Provisions for Banks Not Conforming to the TFRS 9
(Percent)



Source: BRSA

The expected credit loss approach, which allows for a more prudent provision mechanism in new accounting standards, is anticipated to strengthen banks' credit risk management. Determining expected credit losses according to future risks instead of realizations could mitigate the impact of possible shocks by reducing the cyclicality of the financial system. In addition, earlier recognition of credit losses for financial assets will enable banks to make sound capital adequacy assessments. In this context, it is important that the risks likely to arise in the future are evaluated in a comprehensive manner. The validation and regular review of banks' internal models will increase the effectiveness of the ECL implementation.

I.2 Domestic Developments

In the final quarter of 2016, the Turkish economy grew with the support of the final domestic demand (Chart I.2.1). The rise in the final domestic demand was mainly driven by the balancing effect of macroprudential measures on private consumption expenditures. In the final quarter of 2016, the negative impact of net exports to growth remained minimal. On the back of these developments, the negative impacts of the geopolitical risks and the developments detrimental to net exports were significantly reduced.

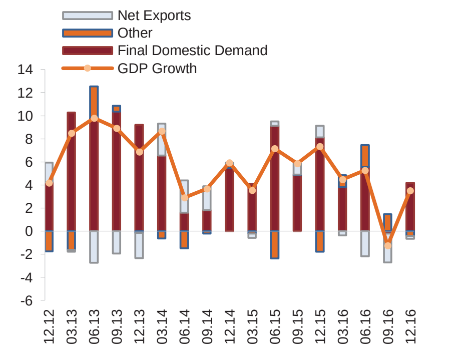
Despite the economic contraction in the third quarter of 2016, economic activity recovered in the final quarter of the year. Seasonally and calendar adjusted industrial production index, which increased by 0.4 percent year-on-year, partly compensated for the previous quarter's loss (Chart I.2.2).

The positive outcomes of the growth-supportive measures that were taken against the slowdown in economic activity in the third quarter of 2016 started to be observed in the final quarter of 2016. Led by the recently announced investment stimulus package, the growth-supportive loan implementations helped lower unemployment and increase production capacity. It can be asserted that the mentioned steps were in tandem with the accommodative fiscal policies that emerging economies have been implementing to mitigate the effects of heightened global uncertainties.

In the second half of 2016, employment tendency weakened and job losses increased, resulting in a rise in the unemployment rate (Chart I.2.3). The climb in unemployment was mainly driven by the slowdown in economic activity and the decline in employment in industry and construction sectors stemming from the weakening in new employment opportunities. Since May 2017, the leading indicators have been pointing to an improvement in the economic activity and consequently better employment data with the contribution of the employment campaign.

In the final quarter of 2016, there was an economic recovery, quarter-on-quarter.

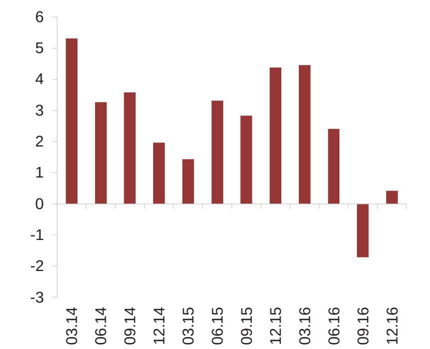
Chart I.2.1
Contribution to Growth from the Expenditure Side
(Percentage Point)



Source: TURKSTAT (Latest Data: 12.16)

Seasonally and calendar adjusted industrial production index points to an economic recovery in the last quarter of 2016.

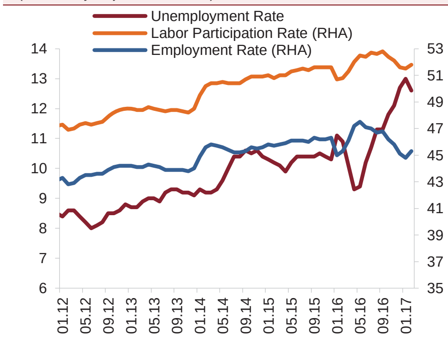
Chart I.2.2
Industrial Production Index
(Seasonally and Calender Adjusted Annual Percentage Change)



Source: TURKSTAT (Latest Data: 12.16)

Unemployment rate increased in the second half of 2016.

Chart I.2.3
Labor Force
(Seasonally Adjusted, Percent)

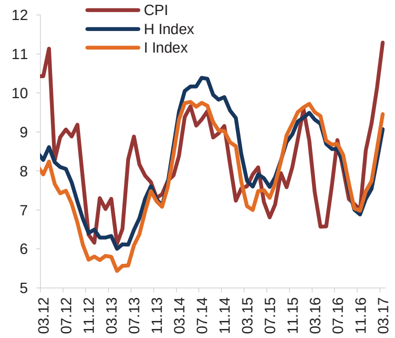


Source: TURKSTAT (Latest Data: 02.17)

Consumer inflation has been on the rise since the third quarter of 2016 (Chart I.2.4). The rise in consumer inflation was driven by the rise in costs and oil prices, the escalation in food prices and low base effects. While rising import prices affected consumer prices via the cost channel, adverse weather conditions observed as of December were the main reason for climbing fresh fruit and vegetable prices. The services sector inflation rose due to the price increases in FX-dependent sectors which was triggered by the climbing oil prices stemming from currency depreciation.

As of the final last quarter of 2016, consumer inflation has increased owing to the developments in FX and oil prices along with the rise in food prices.

Chart I.2.4
Price Indices
(Annual Percentage Change)



Source: CBRT (Latest Data: 03.17)

Although the current account deficit slightly increased in the final quarter of 2016, foreign trade contributed positively to current account balance thanks to the significant increase in exports of goods and despite the declining share of tourism in exports (Chart I.2.5 and I.2.6). Another favorable development for foreign trade in the first quarter of 2017 was the regional and sectoral rise of exports, specifically to the EU countries. In the first couple of months of 2017, due to domestic demand conditions and FX movements, the contribution of foreign trade to growth is expected to be positive in net terms. Another positive contribution to current account deficit would be the likely recovery in global economic activity.

Improvement in net exports has narrowed current account deficit.

Chart I.2.5
Current Account
(12 Month Cumulative Billion USD)

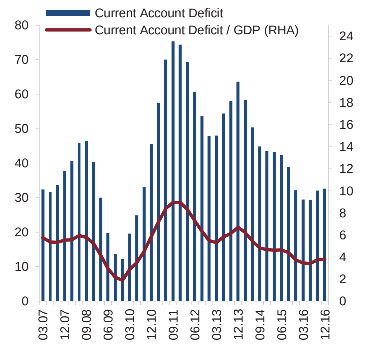
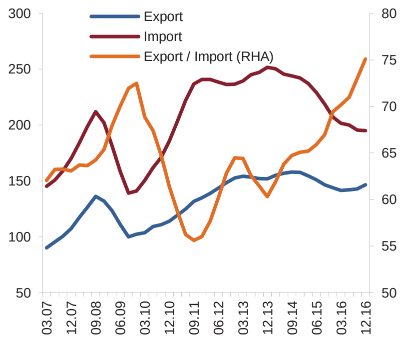


Chart I.2.6
Foreign Trade
(12 Month Cumulative, Billion USD, Percent)

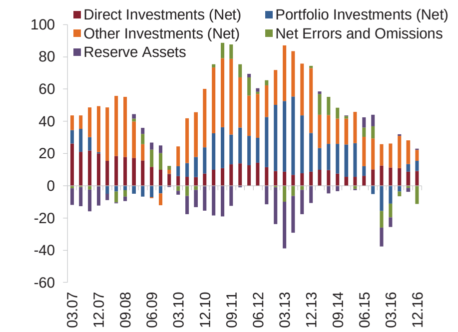


Source: CBRT(Latest Data: 12.16)

Exports of goods are expected to rise in the upcoming periods, depending on several factors including the outlook in the EU economies and overall global economy, the wealth effects of possible oil price increases on our foreign trade partners and Turkish traders' market diversification performance. However, lingering uncertainties surrounding the global economic activity such as monetary policies in advanced economies, the trend of capital flows and geopolitical developments are likely to affect the general performance of exports within the year. On the other hand, the rise of protectionist policies poses downward risks to the foreign trade channel. Lastly, it could be argued that commodity prices can gradually rise and create an upward pressure on the current account balance in 2017.

The financing of current account deficit continues to improve.

Chart I.2.7
Current Account Deficit Financing Items
(12 Month Cumulative Billion USD)

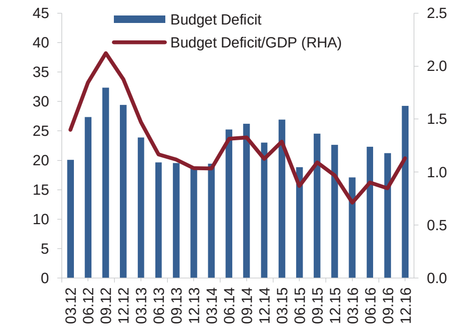


Source: CBRT (Latest Data: 12.16)

In the last quarter of 2016, the contribution of foreign direct investments in current account financing remained unchanged compared to the previous quarter. While the share of portfolio inflows in current account financing increased, that of the reserves maintained previous period's share (Chart I.2.7).

There is a modest rise in central government budget deficit.

Chart I.2.8
Central Government Budget Balance
(12 Month Cumulative, Billion USD, Percent)



Source: Undersecretariat of Treasury (Latest Data: 12.16)

While the second half of 2016 was marked by a slowdown in economic growth, fiscal policy supported growth especially through public consumption expenditures. Growth responded positively to the consumption and investment stimuli and positive annual growth was achieved again. In this framework, the central government budget deficit has risen and the central government budget deficit/GDP ratio has increased after a long period of decline (Chart I.2.8). The decline in tax revenues stemming from the deceleration in growth was partly compensated by the indirect positive impact of the stimulus packages on tax revenues.

Chart I.2.9
Exchange Rate Basket and CDS
(Basis points, TL)

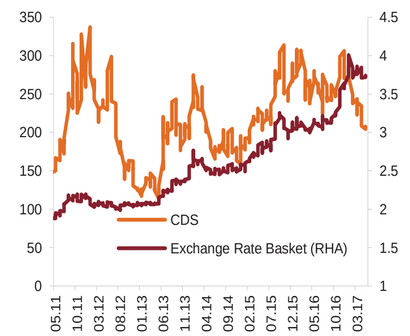
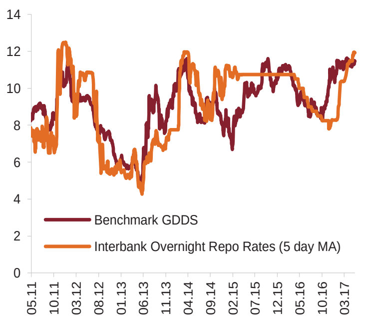


Chart I.2.10
Interest Rates
(Percent)



Note: Exchange rate basket is the arithmetic average of the dollar and euro.

Source: CBRT and Bloomberg (Latest Data: 12.05.17)

Since the second half of 2016, there has been a positive trend in risk perceptions for the Turkish financial assets. Five-year CDS spreads kept declining due to the improved risk perception (Chart I.2.9). Despite fluctuations in the global markets after the US elections and the global uncertainties, the recent decline in CDS premiums has had a positive impact on the borrowing costs of the private sector. Moreover, as of the second half of 2016, the upward movement in the exchange rates was reversed with the support of the positive atmosphere after the Turkish referendum amending the Constitution. As a result of the tight monetary policy stance that the CBRT adopted in the face of fluctuations in FX markets, the average funding rate and GDDS yields have increased (Chart I.2.10).