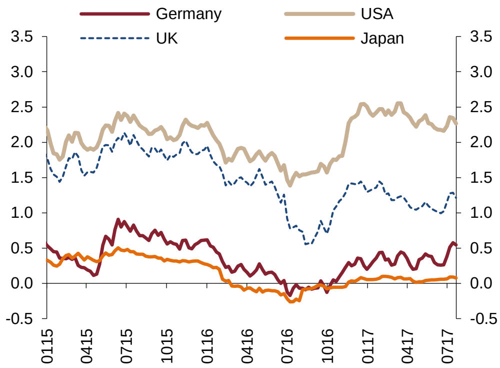
1. Overview

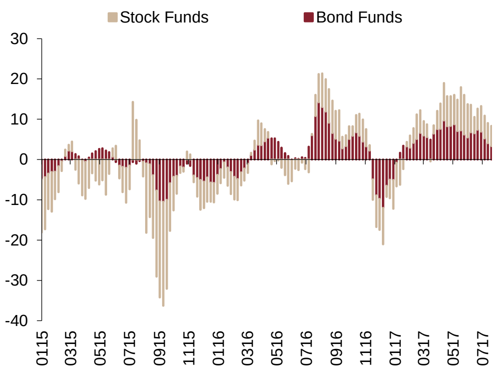
Global risk appetite was buoyant in the second quarter of 2017. Despite an apparently more upbeat global economic outlook, currently low inflation rates across the globe have stimulated the risk appetite. Although statements from major central banks have led to short-term fluctuations across markets, expectations were maintained that the global monetary policy normalization would be moderate. Thanks to the global risk appetite that rallied on the renewed optimism in global financial markets, market fluctuations were rather subdued and long-term bond yields remained almost flat in advanced economies (Chart 1.1). Accordingly, bond and stock markets in emerging economies continued to receive strong portfolio flows in the inter-reporting period (Chart 1.2).

Chart 1.1.
10-Year Bond Rates
(Percent)



Source: Bloomberg.

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



Source: EPFR.

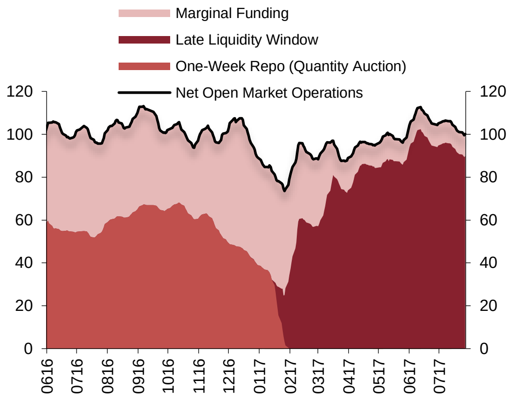
Similar to other emerging economies, Turkey has recently been receiving portfolio flows. Since end-January, exchange rate volatility and risk premium indicators in Turkey performed better than other emerging market economies, in part due to the tight monetary policy stance. The marked acceleration in loan utilization in the second quarter of the year, which is triggered by macroprudential policies as well as public measures and incentives, assumed a more stable path as of the end of the quarter. Thus, financial conditions have lately been more conducive to economic activity.

After a steady uptrend since December 2016, consumer inflation edged down to 10.9 percent in the second quarter of 2017. This partial improvement was largely driven by falling oil prices and the recent appreciation of the Turkish lira, but the support of demand conditions to disinflation diminished in the second quarter. Economic activity continued to recover in the first quarter of 2017. Leading indicators suggest that the economic recovery remained robust in the second quarter as well. Moreover, there are signs that the economic recovery is spreading to a wider range of sectors. Domestic demand has improved and the growing EU demand continues to have a positive impact on exports. Economic activity is expected to remain strong due to the adoption of supportive incentives and measures.

1.1. Monetary Policy and Financial Markets

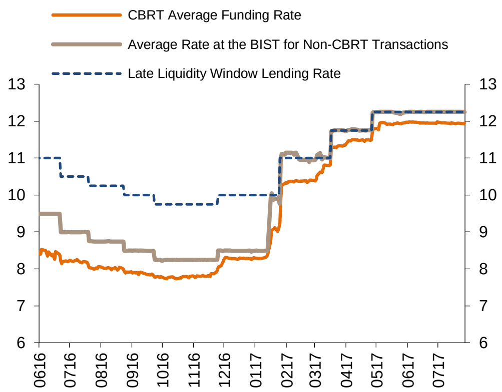
In the beginning of the second quarter, global financial conditions were relatively more favorable while exchange rates remained somewhat volatile. Noting that the increased inflation which has been driven mostly by the lagged spillovers of the Turkish lira depreciation, rising import prices and higher food prices might pose a risk to the pricing behavior, the MPC decided to tighten the monetary policy further at its April meeting and raise the late liquidity window lending rate from 11.75 to 12.25 percent. Moreover, the CBRT continued to provide the greater portion of its funding from the late liquidity window (Chart 1.1.1). In June and July, the risk appetite was bolstered by upward growth revisions in the global economic growth and waning volatilities; nevertheless, the CBRT maintained a tight monetary policy stance to contain the risks to the pricing behavior (Chart 1.1.2).

Chart 1.1.1.
CBRT Funding*
(2-Week Moving Average, Billion TL)



* Marginal funding is overnight funding quoted at the upper band of the interest rate corridor.
Source: CBRT.

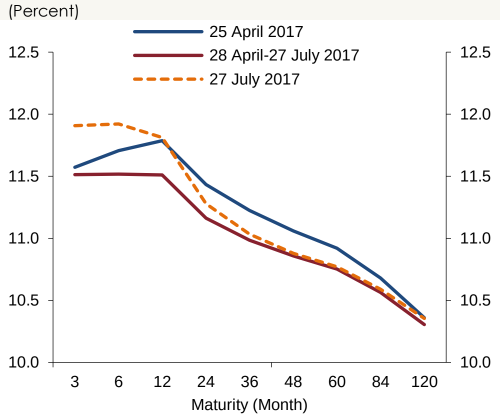
Chart 1.1.2.
Short-Term Interest Rates
(5-Day Moving Average, Percent)



Source: BIST, CBRT.

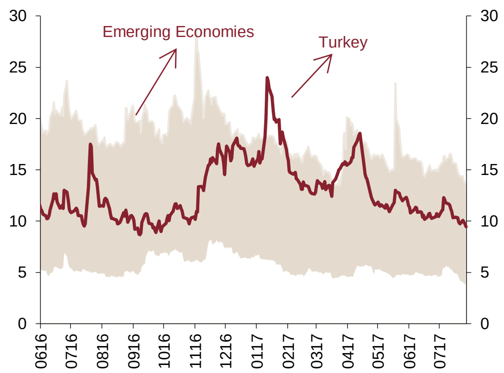
With the global risk appetite growing, medium and long-term currency swap yields inched down since the previous Report (Chart 1.1.3). Turkey's implied FX volatility against the US dollar has continued to fall in part due to the tight monetary policy stance, nearing the average of other emerging economies (Chart 1.1.4).

Chart 1.1.3.
Yield Curve on Currency Swaps
(Percent)



Source: Bloomberg.

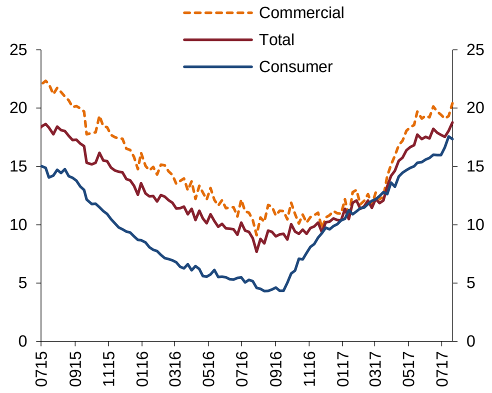
Chart 1.1.4.
Implied FX Volatility*
(1-Month-Ahead, Percent)



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

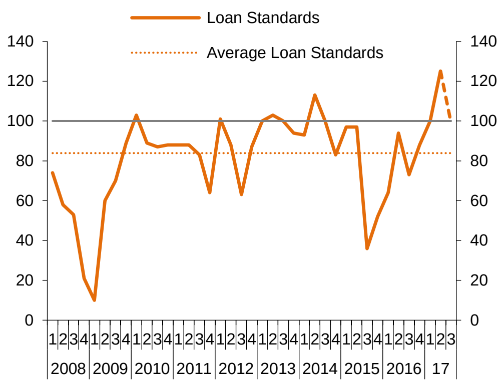
Consumer loans remained on the rise in the second quarter of 2017 amid rekindled consumer confidence and accommodative macroprudential policies. Additionally, incentives such as SMEDO loans and the Treasury-backed Credit Guarantee Fund helped commercial loans accelerate further (Chart 1.1.5). Thanks to these measures on credits, banks' standards for commercial loans eased in the second quarter of 2017 both on a quarterly basis and compared to historical averages, while no further easing is expected in the third quarter (Chart 1.1.6).

Chart 1.1.5.
Annual Loan Growth
(Adjusted for Exchange Rate, Percent)



Source: CBRT.

Chart 1.1.6.
Commercial Loan Standards*



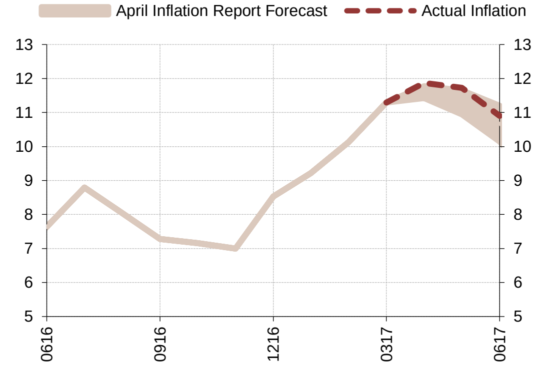
* Index values above 100 indicate easing in loan standards. The third-quarter data for 2017 is forecast.
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

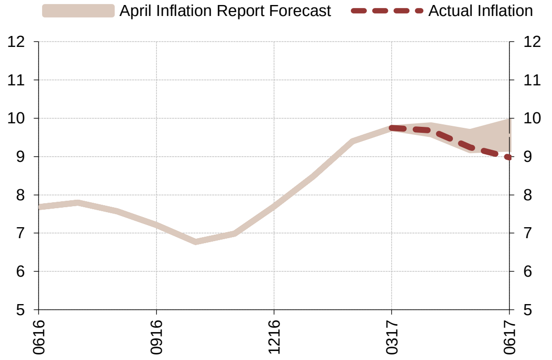
Consumer inflation was in line with the April Inflation Report forecast at 10.9 percent in June (Chart 1.2.1). The consumer inflation excluding unprocessed food, alcoholic beverages and tobacco products was slightly below the previous forecast (Chart 1.2.2), largely due to lower-than-anticipated energy prices backed by falling oil prices. Consumer inflation stood near the upper bound of the forecast, which resulted from soaring unprocessed food prices.

Chart 1.2.1.
Inflation Forecasts and Actual Inflation*
(Percent)



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

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

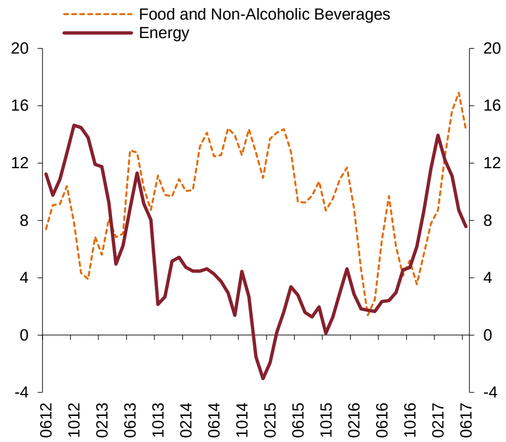


* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: TURKSTAT, CBRT.

Consumer inflation has trended upwards since December mainly due to the Turkish lira depreciation of almost 25 percent against the currency basket, food price spikes led by supply conditions, rising oil prices and earlier tax adjustments. After nearing 12 percent in April, consumer inflation slowed slightly over the following two months (Chart 1.2.1). More recently, oil prices have fallen while the Turkish lira has appreciated somewhat after the steep decline in early 2017. Accordingly, energy inflation has been on the decline since March. This exchange rate outlook also helped price hikes to subside across items such as durable goods. On the other hand, the lagged effects of the cumulative Turkish lira depreciation weighed on inflation through core goods excluding clothing and durables.

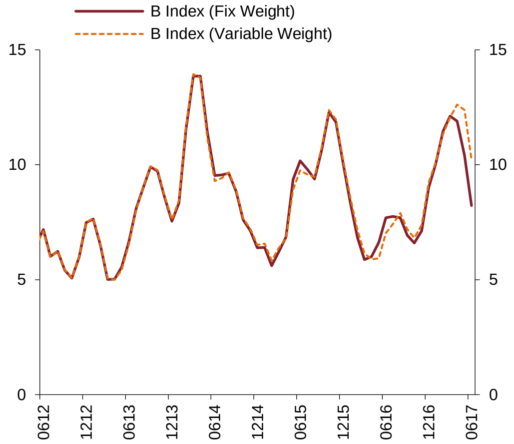
Another key driver of high inflation in the second quarter was food prices (Chart 1.2.3). Food inflation, particularly in prices of fresh fruits and vegetables, has shown a negative pattern due also to the low base effect from the previous year. In addition, surging red meat prices put upward pressure on consumer inflation both directly and through catering services. Consequently, annual food inflation surpassed the path projected in April due to widespread price increases across subcategories.

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



Source: TURKSTAT, CBRT.

Chart 1.2.4.
Core Inflation Indicator B Index with Fix Weight vs Variable Weight* (Seasonally Adjusted, 3-Month Moving Average, Annualized, Percent)



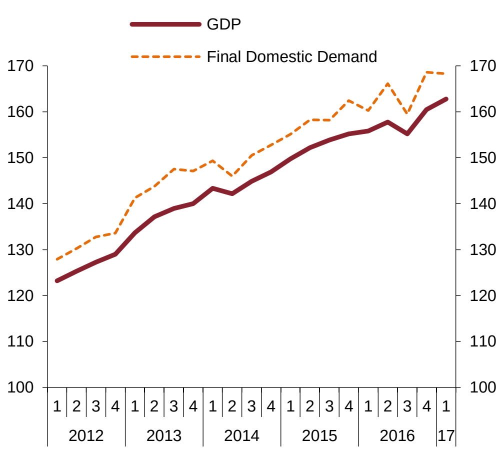
* In January 2017, the weighting system used to incorporate clothing and footwear products in the CPI was changed from the variable-weight method to the fixed-weight method. For a detailed analysis, see the article titled "Impact of the Change in the Weight Structure of Clothing and Footwear Group on the Underlying Trend of Inflation" published in the CBRT blog.
Source: TURKSTAT, CBRT.

Although pressures driven by producer prices waned to some degree in the second quarter, the cumulative effects from earlier periods remained strong. With economic activity recovering at a more robust pace, the disinflationary impact of demand conditions diminished in the second quarter. After deteriorating for some time, medium-term inflation expectations now seem to follow a relatively flat pattern. Against this backdrop, the diffusion index and core inflation indicators signaled an improvement in underlying inflation, which, however, mostly reflected the temporary effects of the methodological change in the weighting system of clothing prices. Adjusted for this change, core inflation posted a rather modest improvement (Chart 1.2.4). In sum, despite the recent slowdown, underlying inflation remained elevated.

Supply and Demand

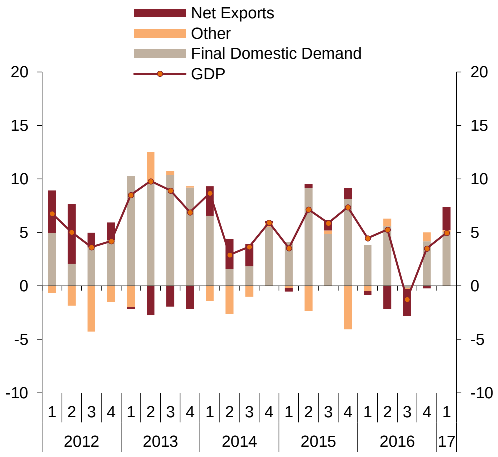
Economic activity in the first quarter proved to be stronger compared to the outlook envisaged in April Inflation Report. GDP grew by an annual 5 percent and a quarterly 1.4 percent in the first quarter of 2017. Thus, economic activity continued to recover (Chart 1.2.5). The main drivers of quarterly GDP growth were exports, construction investments and public spending. Machinery and equipment investments remained sluggish, while private consumption slowed owing to demand being brought forward due to tax incentives. The high contribution from net exports to growth indicates a growth composition in favor of the current account balance (Chart 1.2.6).

Chart 1.2.5.
GDP and Final Domestic Demand
(Real, Seasonally Adjusted, 2009=100)



Source: TURKSTAT, CBRT.

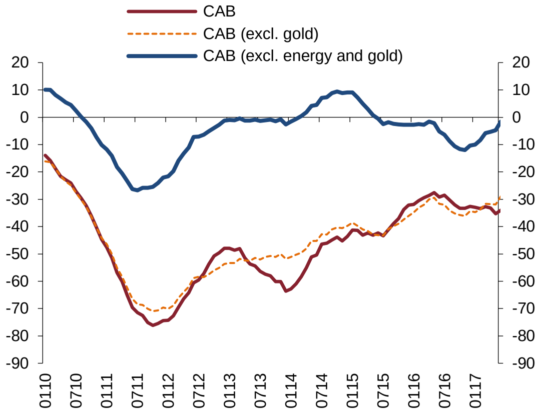
Chart 1.2.6.
Contributions from the Expenditures Side*
(Percentage Point)



* Other includes changes in stocks and statistical discrepancy due to the use of chain-linked index.
Source: TURKSTAT.

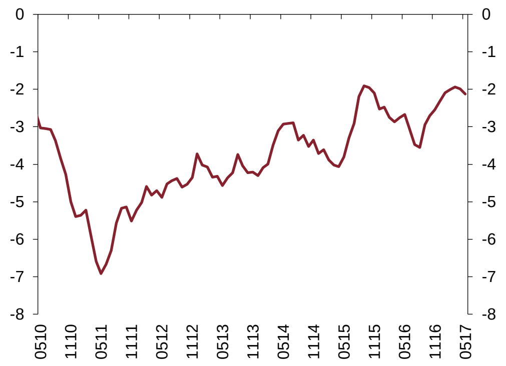
Recent data suggest that economic recovery gained momentum in the second quarter and spread across a wider range of sectors compared to the previous reporting period. The fiscal policy helped bolster growth through new measures and incentives as well as public investment and consumption spending. Macroprudential policies and public incentives stimulated consumer loans and helped rekindle consumer confidence, suggesting that consumer demand is on the rebound. In the first half of 2017, net exports made a larger contribution to growth amid robust external demand conditions, particularly in the EU countries. Increases in exports of goods restricted the deterioration of the current account deficit and led to an improvement in core indicators (Charts 1.2.7 and 1.2.8). The strong performance of exports will continue to have a favorable impact on the current account balance.

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



Source: CBRT.

Chart 1.2.8.
Current Account Balance Excluding Gold
(Seasonally Adjusted, 3-Month Moving Average, Billion USD)



Source: CBRT.

Economic recovery was partly transmitted to the labor market in the first quarter but had a more sizeable impact in the second quarter, pulling down unemployment rates at an accelerated pace. Leading indicators hint at a continued economy-wide employment growth for the third quarter. With a more solid economic rebound, unemployment rates are expected to decline further in the upcoming period. Accordingly, after spending relatively more on durable goods in the first half of the year, consumers are expected to shift their demand in the second half towards other categories of goods as well.

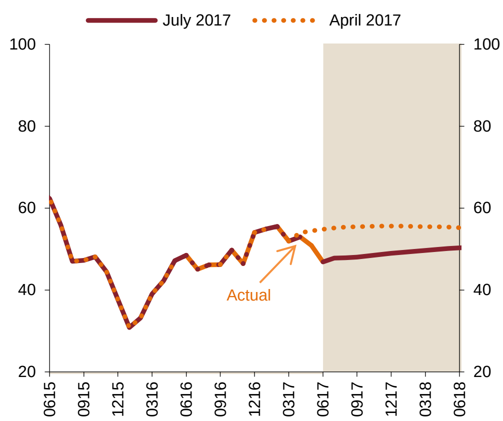
On the other hand, in the medium term, the growth outlook, which was shaped by exports and consumption in the first half of the year, is more likely to be determined by investments, which may generate employment opportunities. Accordingly, abated domestic uncertainties have spurred the investment demand and growth recently, while uncertainties regarding monetary policies of advanced economies, the course of capital flows and geopolitical developments continue to constitute downside risks to growth in 2017.

Oil, Import and Food Prices

Assumptions for the average crude oil prices in 2017, which were 55 USD in the April Inflation Report, were set as 50 USD for 2017 in light of the recent developments. Meanwhile, assumptions for USD-denominated import prices were revised upwards for 2017 (Charts 1.2.9 and 1.2.10).

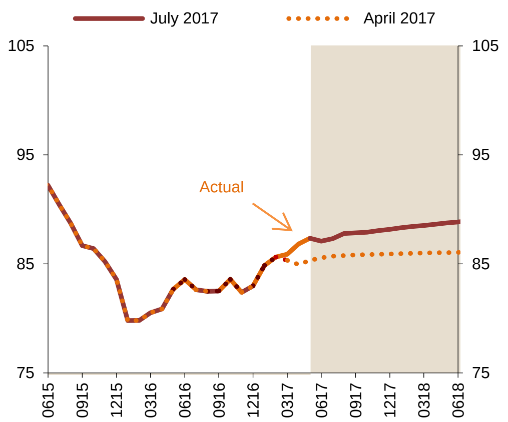
Food inflation in the first quarter of 2017 stood somewhat above April projections at 14.34 percent, which was led mostly by the unprocessed food prices. The current state of food inflation and food inflation realizations of the July-December period in past years indicate the necessity to make an upward revision to the year-end food inflation stated in the April Inflation Report. Meanwhile, measures to be taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee are expected to put a gradual limit on this rise in the upcoming period. Accordingly, the assumption for food price inflation was set as 10 percent for end-2017 and kept unchanged at 7 percent for 2018.

Chart 1.2.9.
Revisions in Oil Prices*
(USD/bbl)



* Shaded area denotes forecast.
Source: Bloomberg, CBRT.

Chart 1.2.10.
Revisions in Import Prices*
(2010=100)



* Shaded area denotes forecast.
Source: CBRT, TURKSTAT.

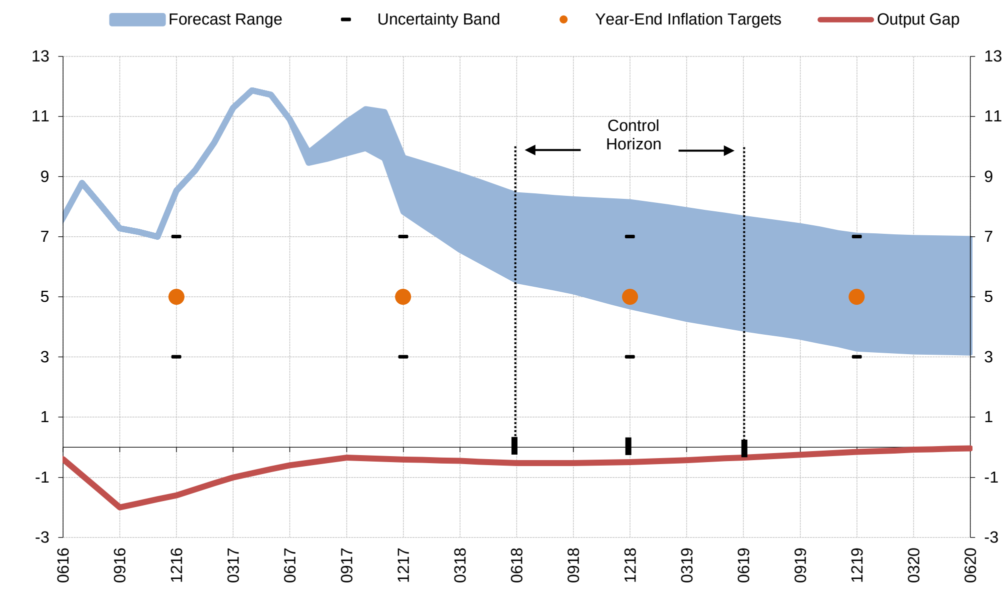
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that fiscal discipline will be maintained and administered prices and taxes will not be subject to any unanticipated increase. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. As per the Council of Ministers Decree adopted in July 2017, the projected hike in the lump-sum SCT taxes on cigarettes and other tobacco products under the automatic mechanism was withheld, which was reflected onto the forecasts of the July Inflation Report.

1.3. Inflation and the Monetary Policy Outlook

Given a tight policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to be 8.7 percent at end-2017, and stabilize around 5 percent in the medium term after falling to 6.4 percent in 2018. Hence, inflation is expected to be, with 70 percent probability, between 7.8 percent and 9.6 percent (with a mid-point of 8.7 percent) at end-2017 and between 4.7 percent and 8.1 percent (with a mid-point of 6.4 percent) at end-2018 (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 year-end inflation forecast was revised upwards by 0.2 points for 2017 compared to the April Inflation Report, while the year-end inflation forecast for 2018 was kept unchanged. The upward revision in the output gap on back of the recovery in economic activity drove the year-end inflation forecast for 2017 upwards by 0.2 points. Another factor affecting the forecasts was the revision of 2017 food inflation forecast from 9 to 10 percent. This revision pushed the year-end forecast for 2017 up by 0.2 points compared to the previous Report. On the other hand, the Turkish lira has followed a stable course and oil prices have registered a sizeable fall recently. Thus, despite the upward revision in assumptions for USD-denominated import prices, TL-denominated import prices pulled the year-end forecast for 2017 down by 0.1 point. Moreover, the automatic tax increase in tobacco products was withheld, which caused alcoholic beverages and tobacco products to decrease the year-end consumer inflation by 0.1 point compared to the previous Report. Accordingly, the year-end consumer inflation forecast for 2017, which was announced as 8.5 percent in the April Inflation Report, was raised to 8.7 percent.

On the other hand, the consumer inflation forecast for 2018 was kept as 6.4 percent. The narrowing output gap is expected to weigh on end-2018 inflation by 0.1 point, which is likely to be counterbalanced by the revision in TL-denominated import prices.

1.4. Risks and the Monetary Policy

The mild recovery in global economic activity became more pronounced, due particularly to advanced economies in the first quarter of 2017. The considerable fall in volatility in global financial markets and the increased risk appetite cause global financial conditions to have an intensified support on economic activity. Moreover, the optimistic outlook in the consumer and the real sector confidence indices as well as the favorable course of some commodity prices, especially oil, also improve expectations regarding global economic activity. The favorable global growth outlook and the resulting fall in unemployment notwithstanding, the normalization of monetary policy in advanced economies is believed to prove mild due to the absence of an apparent wage-driven pressure on inflation. These factors support portfolio flows to emerging economies including Turkey.

Despite the current favorable outlook in global economic activity, downside risks to global economy are also present. In particular, the high risk appetite and low volatility cycle in financial markets may reverse should the Fed's policy rate hike and the balance sheet downsizing prove faster than envisioned. This may generate volatility in security prices in advanced economies, which may decelerate growth. Moreover, lower risk appetite may cause fluctuations in portfolio flows to emerging economies as well. In addition, the course of Brexit and effects of the blurred global economic policies such as foreign trade protectionism that is on the agenda of many countries, particularly the US, are also being monitored closely.

In line with the positive course of the global financial markets, domestic financial conditions also proved more accommodative in the second quarter. This was driven by macroprudential policies, public measures and incentives as well as acceleration of credits backed by the Credit Guarantee Fund, for which the limits were raised and terms of use were eased as of March. On the other hand, owing to strong capital inflows to especially the government bond markets as of March, the share of foreign investors within the domestic debt stock increased, and the Treasury raised external borrowing against strong foreign demand, which provided domestic banks with considerable room on the supply side. As the upper limit defined for credits secured by the Credit Guarantee Fund is near and as the supply-side effects have recently stepped in for the banking sector; credit growth, which lost pace starting from June, is expected to stabilize as of the second half of the year. The improvement in credits in the first half of the year is monitored closely with regard to its impact on the aggregate demand and economic activity.

Recently released indicators confirm the previous assessments that downside risks to economic activity have abated and the economic recovery will prove more robust as of the second quarter of the year. Compared to previous periods, the pickup in economic activity spilled over to a wider range of sectors via exports, which signals stable recovery in growth. The gradual improvement in tourism revenues, the strengthened confidence channel, the positive effect of the cumulative depreciation on net exports and the restored commercial relations with Russia support growth. Moreover, the measures and incentive packages to boost consumption and investment expenditures as well as reduced uncertainty and improved financial conditions will continue to spur growth. The improvement in employment and the fall in the unemployment on the back of the ongoing recovery constitute a ground for a sustained favorable outlook and increased contribution of domestic demand to growth. Investment is envisaged to exhibit a gradual improvement as uncertainties wane and the climate of confidence grows stronger. On the other hand, having posed a downside risk to growth recently, the pace of recovery in tourism revenues, uncertainties regarding monetary policies of advanced economies, the course of capital flows and geopolitical developments continue to be downside risk factors on growth in 2017 as well.

The monetary tightening has started to have visible favorable effects on inflation. Consumer inflation receded on the back of falling oil prices as well as the recent stable course of the Turkish lira, and remained broadly consistent with the forecasts in the April Inflation Report. The medium-term inflation outlook seems to have improved since the previous reporting period and the recovery in underlying inflation is expected to continue gradually. However, considering that the rigidity in expectations and the pricing behavior remains to a great extent, the improvement in the core inflation outlook is deemed to be insufficient and requires a tight monetary policy stance.

Even though the inflation peak is presumably over in 2017, inflation is still likely to follow a fluctuating course in the second half. The correction in food prices is yet to be completed, thereby necessitating a cautious stance regarding the persistence of the recent decline in the food inflation driven by base effects. Furthermore, temporary tax reductions in white goods and furniture to be taken back in October as well as the methodological changes in clothing may lead to short-term fluctuations in inflation and temporary increases in core inflation. The inflation outlook is projected to witness a recovery as of year-end, which is expected to be more pronounced in early 2018.

Against this background, the CBRT decided to maintain the tight monetary policy stance in June and July. The tight stance in monetary policy will be maintained until the inflation outlook displays a significant improvement. The CBRT formulates monetary policy by taking the medium-term inflation outlook into account, thus focusing on the developments in underlying inflation rather than the anticipated fluctuations driven by the base effects during the year. Inflation expectation, pricing behavior and other factors affecting inflation will be closely monitored, and further monetary tightening will be delivered if needed.

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, sustaining fiscal discipline has been one of the key factors in lowering the sensitivity of the Turkish economy against external shocks. The room provided by fiscal discipline facilitated the implementation of an expansionary fiscal policy in the recent period. Structural measures to provide room for countercyclical fiscal policies will enhance the coordination of monetary and fiscal policy, and improve macroeconomic stability.