

inflation report

2012-III



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1. Overview

Developments in the Euro Area continued to shape the global economic outlook in the second quarter of 2012. In this respect, there have been major events affecting risk perceptions since the publication of the April Inflation Report. Greek election results in May reduced the probability of an exit from the monetary union and led to a partial recovery in risk perceptions. Nevertheless, recent deepening of interdependent problems regarding sovereign debt and the banking sector in Spain limited the improvement in risk appetite. Although the measures taken and the supportive announcements by leading central banks have led to an improvement in global risk perceptions since June, problems regarding the Euro Area remain as a major risk for the global economy in the medium and long term.

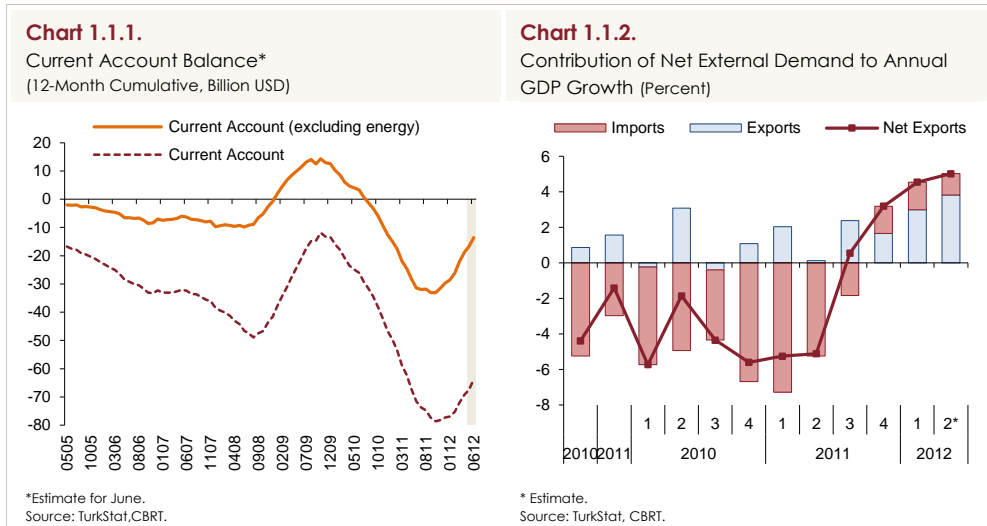
The instability in the global economy coupled with ongoing imbalances has an adverse impact on the global economic outlook. In fact, economic activity has lost momentum in the last quarter both in the US and in China. Accordingly, growth forecasts for advanced and emerging countries have been revised downwards. While inflationary risks have waned in line with the weak outlook for global economic activity, concerns over growth and financial stability remain brisk. Against this background, central banks continue to implement expansionary monetary policies.

Ongoing fragilities and imbalances regarding the global economy keep the risk appetite highly volatile. Four years after the outbreak of the global crisis, advanced economies are still going through deleveraging. Problems in the Euro Area, uncertainties regarding the US economy and China as well as supply-side risks on energy prices still exist. This, coupled with the extraordinarily low cost liquidity facilities provided by central banks, brings about considerable volatility in short-term capital flows to emerging economies. Such an environment leads central banks of emerging economies to give priority to measures aimed at containing the adverse effects of excessive volatility in short-term capital flows. All these confirm the importance of adopting a flexible monetary policy framework.

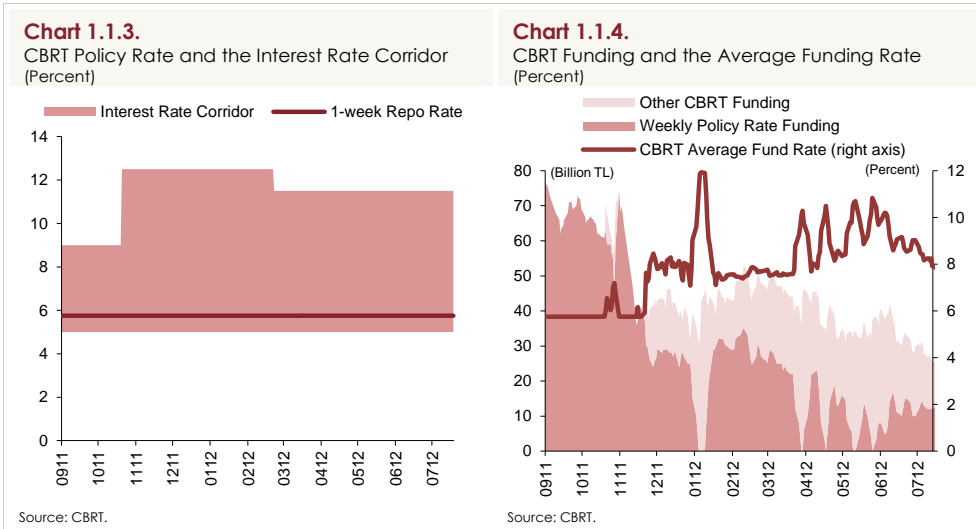
1.1. Monetary Policy Implementation and Monetary Conditions

As of the end of 2010, the Central Bank of the Republic of Turkey (CBRT) has designed and implemented a new policy framework which takes into account macro financial risks. In this respect, the general framework of the inflation targeting regime was modified and additional policy instruments were developed to support the adoption of financial stability as a complementary objective. Policies implemented in this period aimed at managing macro financial risks without prejudice to the price stability objective. To this end, credit growth was brought under control and exchange rate was aligned closer with economic fundamentals.

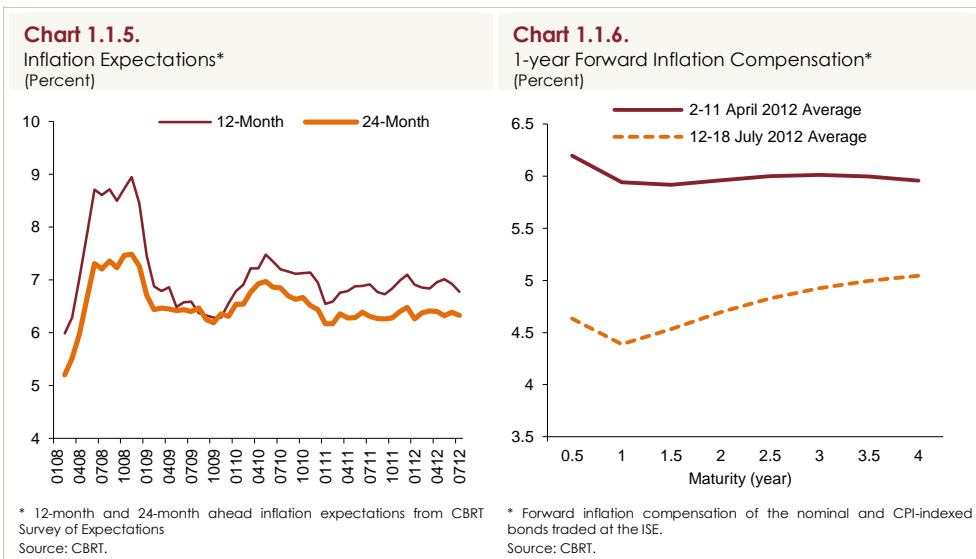
Data released for the first half of the year have shown that policies pursued were successful in delivering the intended results. The composition of growth has displayed a healthier outlook, while the balancing process became more significant. In fact, during this period, current account has continued to improve (Chart 1.1.1) and the contribution of net exports to growth has increased markedly (Chart 1.1.2).



Having started to attain the desired outcomes regarding macro financial risks, monetary policy shifted the emphasis to price stability as of October 2011. In this respect, the CBRT implemented a strong monetary tightening by widening the interest rate corridor upwards and effectively using liquidity operations (Chart 1.1.3). As a consequence, the average funding rate stayed above the policy rate following last October (Chart 1.1.4).



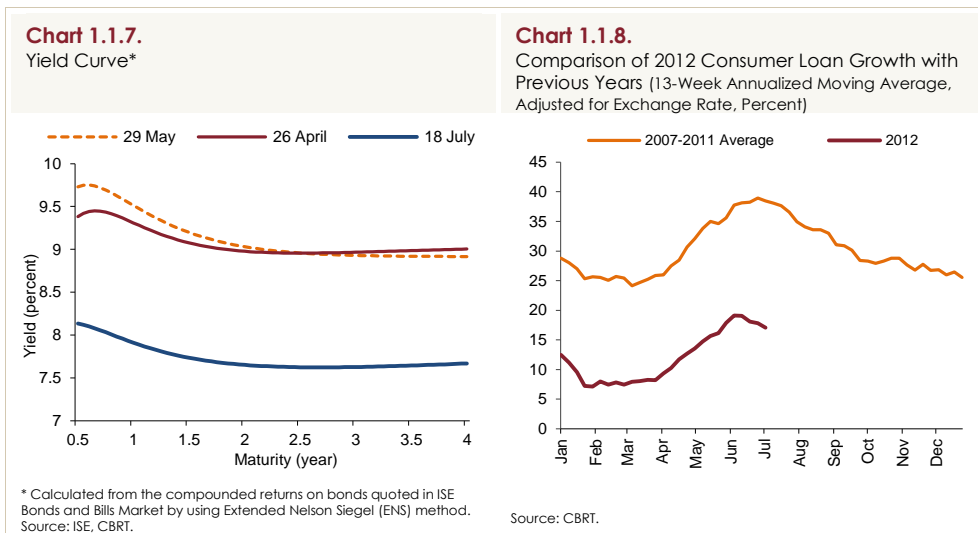
In line with the improvement in global risk appetite, the Monetary Policy Committee (the Committee) kept short-term interest rates relatively stable during the early months of the year. Additional monetary tightening was implemented in April and May with an aim to contain the adverse effects of temporary factors on inflation outlook and limit the risks regarding the pricing behavior. Implementation of more frequent additional tightening not only helped contain credit growth but also reduced inflation uncertainty by curbing exchange rate volatility. These policies, in turn, have prevented a possible deterioration in inflation expectations, amid a period of intensified supply side pressures and double digit inflation (Charts 1.1.5 and 1.1.6).



The resurgence in capital flows to emerging markets and the sharp fall in commodity prices have reduced inflation risks in June. Moreover, risk appetite towards Turkey has improved with the better-than-expected outturns in inflation and current account. Consequently, the CBRT has reduced its average funding rate gradually since early June (Chart 1.1.4). Yet, the Committee preserved its cautious stance in July meeting, highlighting the risks related to pricing behavior as inflation will stay at high levels for some time. Moreover, the Committee has stated that it would be appropriate to preserve the flexibility in monetary policy amid the prevailing uncertainties regarding the global economy. In this respect, it was reiterated that the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be closely monitored and the funding amount will be adjusted in either direction, as needed.

The yield curve was more negatively sloped during May due to more frequent implementation of the additional monetary tightening. Yields have shifted down across all maturities in June with easing inflation expectations and declining risk premium (Chart 1.1.7).

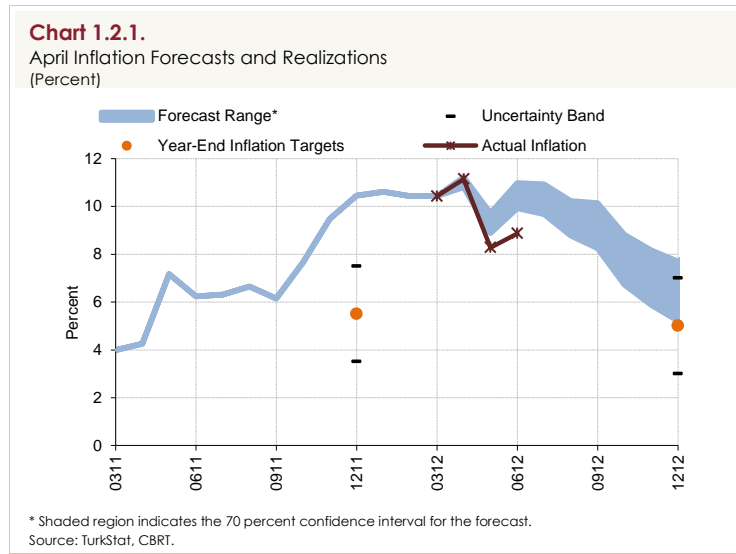
On the other hand, credit conditions have been relatively tighter. The pick-up in credit growth in the second quarter can be attributed to seasonal factors rather than an acceleration in the course of growth. In this period, the pace of growth in credit was much slower compared to the average growth observed during the same periods of past years, especially for consumer credit (Chart 1.1.8). Credit growth is expected to follow a plausible and robust course in the forthcoming period, in line with the projection of a moderate increase in domestic demand.



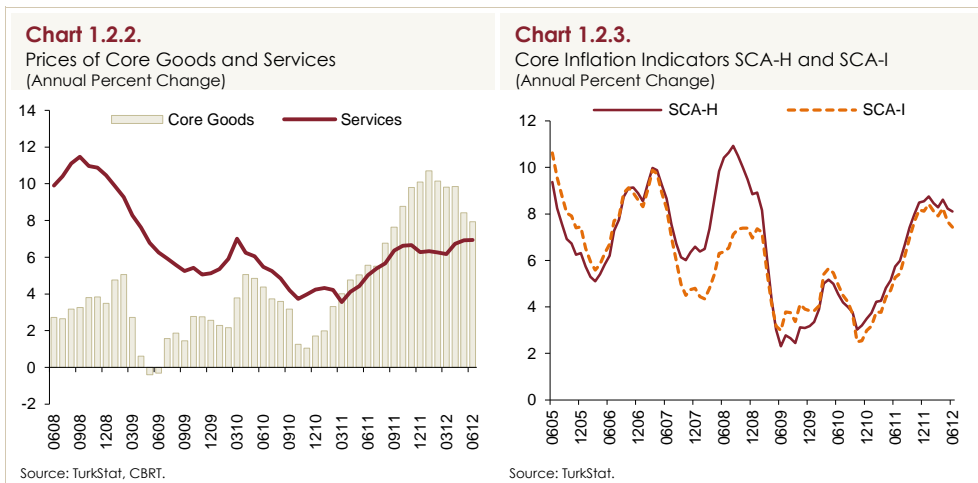
1.2. Macroeconomic Developments and Main Assumptions

Inflation

Inflation declined to 8.9 percent by the end of June, remaining well below the forecasts presented in the April Inflation Report for the second quarter of the year owing to the better-than-projected course of oil and unprocessed food prices (Chart 1.2.1).

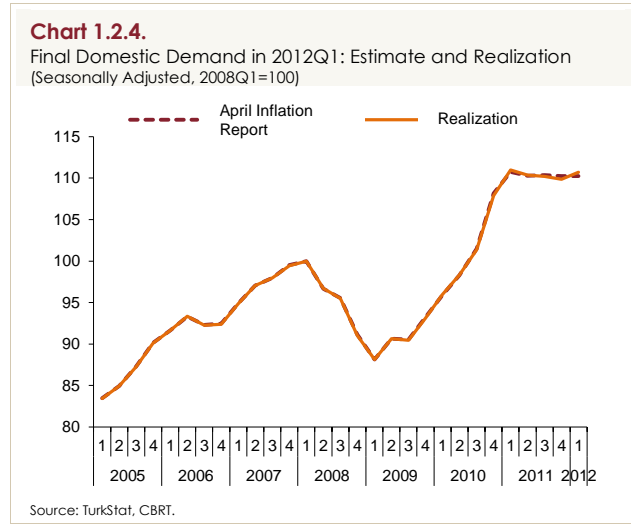


As the cumulative pass-through effect of exchange rate movements in 2011 faded, the core inflation has continued to fall. After a slight pick-up, prices of services followed a mild course (Chart 1.2.2). Against these developments, core inflation indicators maintained a downward trend (Chart 1.2.3).



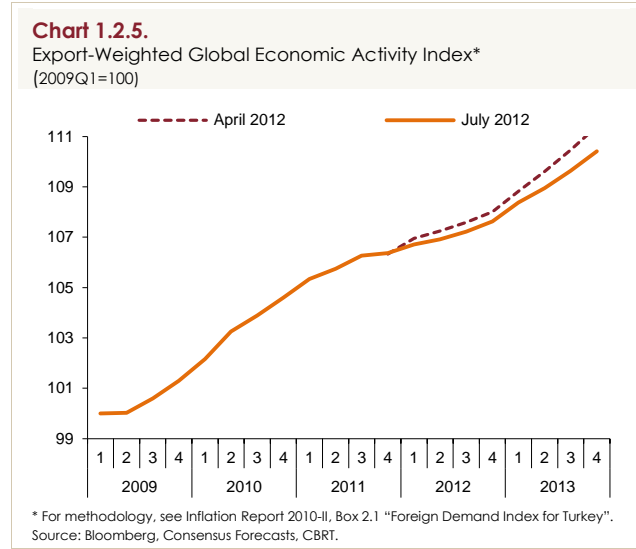
Supply and Demand

National accounts data regarding the first quarter of 2012 indicate that demand conditions have been broadly in line with the outlook presented in the April Inflation Report (Chart 1.2.4). Final domestic demand remained weak, while net exports continued to have positive contribution to annual growth rate (Chart 1.1.2).



Recently released data point that final domestic demand is growing at a moderate rate, exports maintain an upward trend and the balancing of the demand composition continue in the second quarter. Economic activity is expected to post a relatively higher increase on a quarterly basis in the second quarter. Nevertheless, this can be largely attributed to the low base at the beginning of the year, hence the recovery in economic activity is considered to be mild in this period.

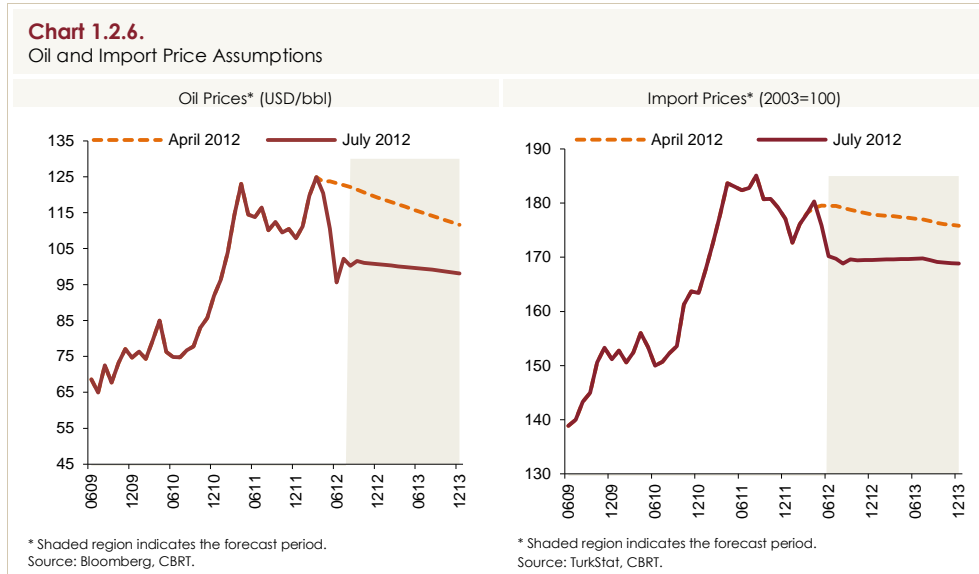
Forecasts are based on the assumption that external demand would follow a weaker course in the second half of the year compared to the first half due to problems in the global economy, which would restrain aggregate demand. In fact, growth rates in both advanced and emerging economies were revised downwards in the last quarter (Chart 1.2.5), while the Euro Area growth outlook especially remained weak.



In sum, output gap forecasts for the first half of the year remained broadly unchanged as domestic economic activity has been in line with the projections laid out in the previous Report. As for the second half, the contribution of aggregate demand conditions to disinflation is assumed to be slightly higher compared to the previous reporting period due to the weakening in the outlook for global economic activity. This update did not have a significant effect on the inflation forecast for 2012.

Energy, Imports and Food Prices

Oil prices remained below projections in the inter-reporting period (Chart 1.2.6). Accordingly, taking into account the recent futures prices, the assumption for average oil price was reduced from USD 120 to USD 110 for 2012, and from USD 115 to USD 100 for 2013. In line with the overall fall in the prices of commodities, projections for import prices were also revised downwards (Chart 1.2.6). Although, fluctuations in the Turkish lira in the second quarter partially offset the favorable impact of the fall in import prices on domestic prices, the combined effect of these developments on the inflation forecast for end-2012 was 0.15 percentage points on the downside.



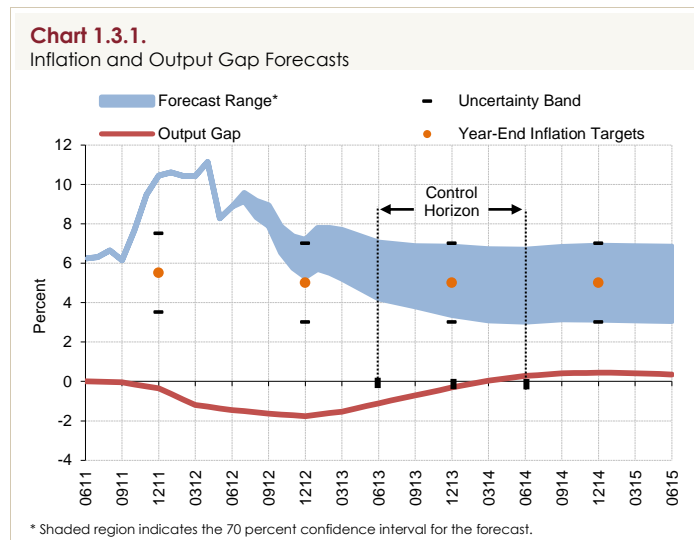
The assumption for food price inflation for end-2012 was slightly revised downwards. Due to the favorable course of unprocessed food prices in the first half of the year, food prices increased at considerably lower rates compared to historical averages. Nevertheless, forecasts were based on a cautious stance which entailed the assumption that the favorable course of food prices in the first half would be largely reversed in the second half. Accordingly, the assumption for the annual rate of increase in food prices, which was 7.5 percent in the previous Report, was revised downwards by only 0.5 percentage points to 7 percent in the current Report. The contribution of this revision to the inflation forecast for end-2012 was around 0.15 percentage points on the downside.

Fiscal Policy and Tax Adjustments

Regarding the fiscal outlook, medium-term inflation forecasts take the revised projections of the MTP as given. Accordingly, the ratio of primary expenditures (accumulated over 12-months) to GDP is assumed to remain largely unchanged in the second half of the year. As per the arrangements introduced to taxes imposed on tobacco products in the last quarter of 2011, tobacco prices are envisaged to remain unchanged throughout 2012, and increase at the beginning of 2013 at rates implied by the tax adjustments announced in October 2011. Furthermore, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and the automatic pricing mechanisms.

1.3. Inflation and Monetary Policy Outlook

Forecasts are based on the assumption that monetary policy will maintain its cautious and flexible stance, and annual loan growth rate will be around 14 percent by the end of the year as in the previous report. Accordingly, inflation is expected to be, with 70 percent probability, between 5.3 and 7.1 percent (with a mid-point of 6.2 percent) at the end of 2012, and between 3.4 and 6.8 percent (with a mid-point of 5.1 percent) at the end of 2013. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).



Overall, the year-end inflation forecast is lowered by 0.3 percentage points to 6.2 percent, mainly owing to the downward revisions in energy and food prices (Chart 1.3.1). Revised forecasts indicate that inflation will resume a downward trend following a slight increase in July. The fall in inflation will become more evident in the last quarter of the year as the base effect stemming from tax adjustments in administered products will be removed. As for the core inflation indicators, the downward trend is expected to continue in the rest of the year.

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

Ongoing uncertainty regarding the global economy requires the maintenance of a flexible approach in monetary policy. The perception that leading central banks will keep interest rates at low levels for a prolonged period encourages the search for yield. On the other hand, despite the steps taken for the resolution of problems regarding the Euro Area, risk appetite remains highly sensitive to news due to ongoing fragilities in the financial system, elevated levels of sovereign borrowing costs and weakening growth outlook. Therefore, it is highly likely that short term capital inflows will continue to be volatile in the forthcoming period. Under these conditions, it is important to preserve the flexibility of monetary policy in either direction.

A further weakening in global economic outlook may prompt central banks of emerging economies to implement additional monetary easing. Such an event would feed into macro financial risks for emerging economies like Turkey. A resurgence in short-term capital inflows may slow down the balancing process through rapid credit growth and appreciation pressures on domestic currency. Should such a risk materialize, the CBRT may keep short-term rates at low levels while tightening through reserve requirements, including the mechanism it has developed for reserve requirements by increasing the coefficients which define the amount of foreign exchange to be held per unit of Turkish lira reserve requirements.

It is also likely that problems in the Euro Area may further intensify, given the ongoing deleveraging process in banking, household and public sector balance sheets and possible delays in the institutional mechanisms to resolve the related problems. Should such a risk materialize, the immediate reaction could be to implement an active liquidity policy via the interest rate corridor to be followed by measures to relieve the tension in the banking system through the use of reserve requirements as well as other liquidity instruments.

On the other hand, aggregate demand and commodity prices may increase faster than expected should the measures taken towards the solution of problems regarding the global economy are completed sooner and more decisively than envisaged. Materialization of such a risk would possibly require a tightening using all policy instruments, as it would mean increased pressures on the medium-term inflation outlook.

Another risk for the forthcoming period is the uncertainty regarding the commodity prices. Although weak global outlook dampens the upside pressures on commodity prices, prevailing geopolitical and supply-side problems pose upside risks regarding energy prices in the short term. Moreover, the recent rapid increase in agricultural commodity prices pose risks regarding processed food prices. Should such risks materialize, the CBRT will not respond to temporary price movements, yet will not tolerate any permanent deterioration in expectations and pricing behavior.

Unprocessed food prices pose downside risks on the inflation outlook in 2012, as indicated in the April Inflation Report. We have adopted a rather cautious approach in the current Report, assuming a reversal in the favorable trend observed during the first half of the year. Year-end inflation may be lower than projected in the baseline scenario should unprocessed food prices display a more favorable course than expected.

Inflation will continue to stay above the target for some time, necessitating a cautious stance regarding the pricing behavior. Although the monetary tightening implemented since last October as well as the moderate aggregate demand outlook reduce the likelihood of second round effects, pricing behavior will be monitored closely in the forthcoming period.

The CBRT monitors fiscal policy developments closely while formulating monetary policy. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. In this respect, it is assumed that there will be no additional deterioration in the budget balance in the second half of the year as well as no unforeseen hikes in administered prices. A revision in the monetary policy stance may be considered should the fiscal stance deviate significantly from this framework, and have a consequent adverse effect on the medium-term inflation outlook.

Maintaining the prudent fiscal policy implemented in recent years is crucial for preserving the resilience of our economy against existing global uncertainties. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving deficit would support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. This will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities at low levels. In this respect,

steps towards implementation of the structural reforms envisaged by the MTP remain to be of utmost importance.

2. International Economic Developments

Economic and political developments in the Euro Area have shaped the global economic outlook in the last quarter. Growth rates in emerging and advanced economies decreased in general and risk appetite was highly volatile in this period. Expectations for the forthcoming period point that the economic activity will continue to slow down.

Following the evaluation period of the April Inflation Report, results of the Greek elections attenuated the perceptions of exit from the EU. On the other hand, public borrowing rates that went even beyond 7 percent in Spain as well as aggravating problems in the banking sector reinforced the need of Spain for an EU and IMF-based financial support. However, the amount of the probable support to be higher than the other countries raises concerns over the sufficiency of the currently available resources. Meanwhile, public borrowing rates in Italy have also reached distressing levels that can challenge debt rollover in the same period, which became another factor to elevate risks in the region. In line with these developments, economic activity continued to lose momentum across the Euro Area in the last quarter, and expectations for the second half of the year deteriorated. Steps taken by policymakers and the ECB against adverse economic developments were perceived as insufficient by market players, signaling that downside risks on the EU economy will remain brisk for an extended period.

Last-quarter-data on the US economy indicate a slowdown in the recovery of the economic activity. However much the US economy grew compared to other advanced economies in the first quarter, labor market data point that the fall in unemployment rates halted and the rise in employment lost pace. On the other hand, expectations regarding economic activity did not suggest a marked recovery. Thus, the Fed decided to continue with its swap policy to exchange short-term Treasuries for long-term bonds in its June meeting. At the same time, given the developments in the economic activity, the possibility of a third expansionary package was also kept on the agenda.

In the said period, economic activities of emerging economies also decelerated in line with the advanced economies. For example, having attained two-digit figures since 2010, growth rate of the Chinese economy recorded the lowest level in the second quarter of 2012 following the global

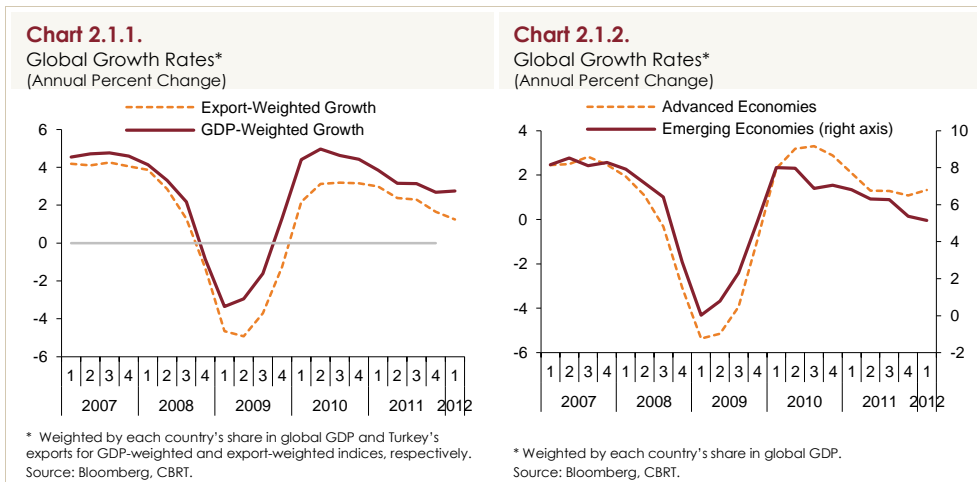
economic crisis. Parallel to the low quarterly growth rates across advanced and emerging economies, year-end growth expectations were revised downwards.

Inflation has recently trended downwards across advanced and emerging economies and risks on growth follow a downside path, which facilitated the central banks to pursue monetary policies with a focus on growth. In this respect, central banks of some advanced and emerging economies opted for policy rate cuts in order to bolster economic activity. It is expected that the slackening of the monetary policy stance will continue through the rest of the year.

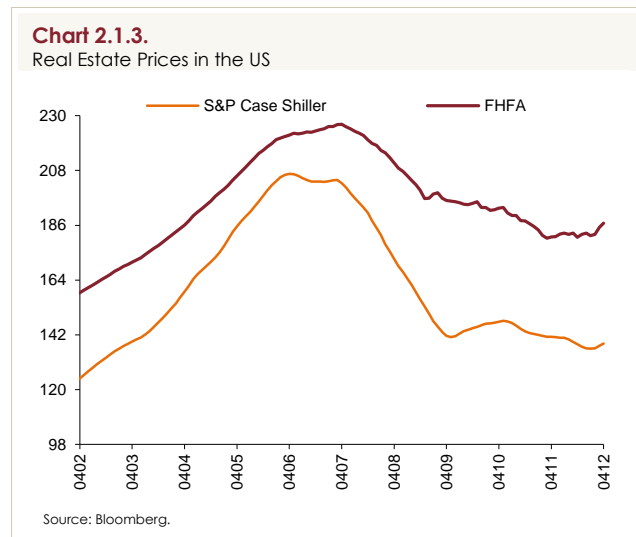
Due to the slowdown in global economic activity, commodity prices saw plunges in the second quarter. Nevertheless, energy prices have recently trended upwards owing to supply-side developments. Furthermore, due to the drought in America, the recent rise in agricultural commodity prices is likely to pose an upside risk on processed food prices in the forthcoming period.

2.1. Global Growth

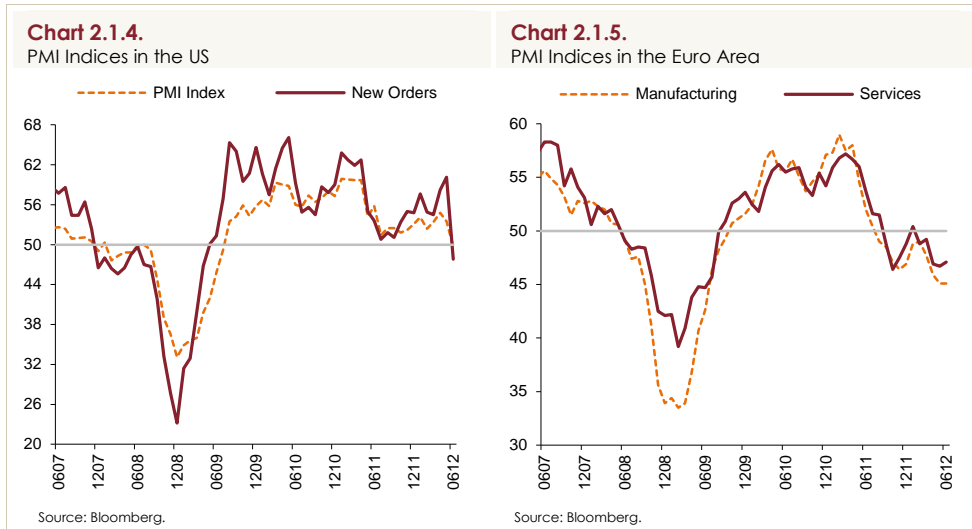
Second liquidity operation of 3-year maturity by the ECB besides the aversion of Greek default and the improvement in perceptions regarding the debt crisis of the Euro Area led to a temporary optimism in markets in the first quarter of the year. As a result, GDP-weighted global growth index moved slightly upwards, while the change in world trade remained limited (Chart 2.1.1). However, amid the aggravated debt crisis in the Euro Area due to the stronger need of Spanish banking sector for financing in the second quarter, the global growth outlook for the forthcoming period is weaker than the previous reporting period.



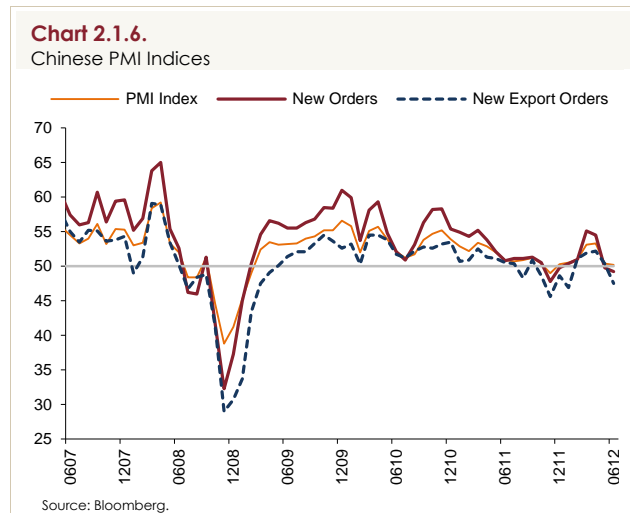
Aggregated indices suggest that advanced economies saw a slight increase, while emerging economies experienced a decline in economic activity in the first quarter of 2012 (Chart 2.1.2). The US and Japan contributed positively to growth in advanced economies. However, having recorded rather low rates in the first quarter, the Euro Area and the UK pulled the said growth rate down. As for the emerging economies, the deceleration in Chinese and Indian economies has been the main driver of the slowdown in the economic activity of this group.



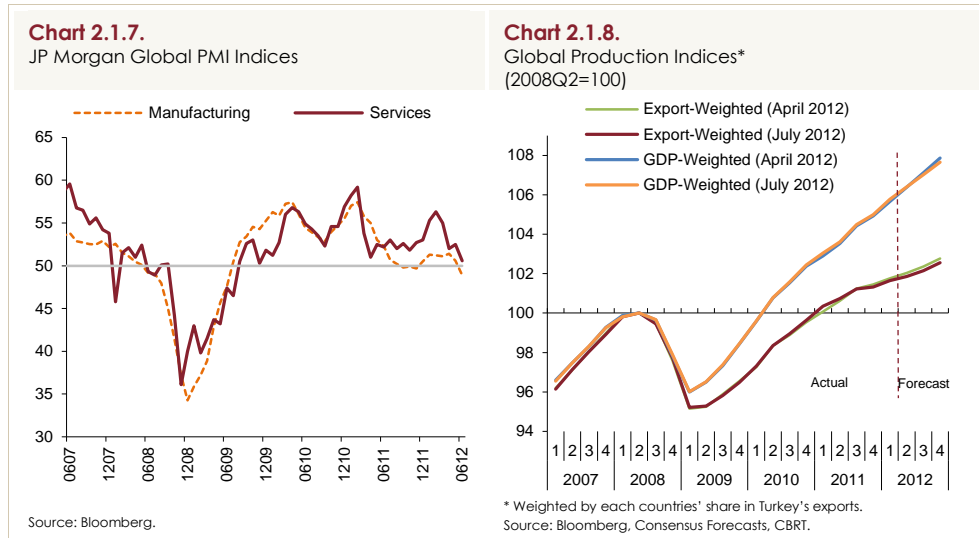
In the first quarter of 2012, GDP growth in the US posted a quarterly increase by 1.9 percent in annualized terms and the data regarding the housing market proved favorable in the same period, thus contributing positively to the US economic outlook by increasing the consumer and investor confidence. However, despite signals for recovery in the housing sector, (Chart 2.1.3 and Box 2.1) labor force did not see any improvement and the worsening Euro Area debt crisis continued to pose uncertainty on global growth, constituting a notable downside risk on the US growth for the forthcoming period. In fact, the decline in PMI figures of the second quarter is noticeable (Chart 2.1.4). For the Euro Area, which continued to record a quarterly contraction in the first quarter of 2012, growth is projected to remain limited in the second quarter of the year parallel to the intensifying problems (Chart 2.1.5).



In the recovery process following the global crisis, Chinese growth rate, which provided the largest contribution to growth in emerging economies, continued to fall in the second quarter and GDP grew by 7.6 percent annually. Mainly driven by consumption, growth was slightly supported by external demand. PMI indicators suggest that growth will remain limited in the forthcoming period (Chart 2.1.6).



The data released in the inter-reporting period point that the global growth outlook for the forthcoming period has worsened. Global PMI figures suggest that production industry and services sub-indices edged up at the start of the year, while this trend has reversed since March and indices have recorded a decline (Chart 2.1.7).



Year-end global growth forecasts suggest that projections presented in the July Consensus Forecasts Bulletin indicate a weaker growth outlook compared to the outlook presented in the April Inflation Report. In July, year-end growth forecasts for the US economy were slightly reduced and forecasts for the Euro Area were revised downwards due to developments in Italy, Spain and Greece (Table 2.1.1). GDP and export-weighted global production indices, which were reduced by July Consensus Forecasts, were also revised downwards in the inter-reporting period. In line with the outlook presented above, this confirms that a noticeable recovery is not expected in external economies, and therefore global problems will continue to exert pressure on external demand (Chart 2.1.8).

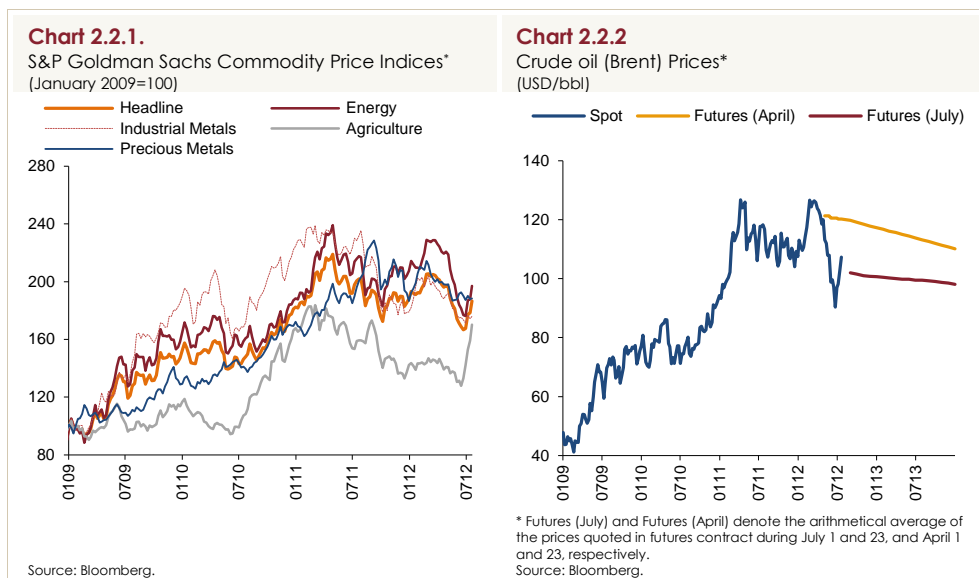
Table 2.1.1.
Growth Forecasts for end-2012
(Annual Percent Change)

	April	July
World	2.6	2.5
<i>Advanced Economies</i>		
USA	2.3	2.1
Euro Area	-0.4	-0.5
Germany	0.7	0.9
France	0.3	0.2
Italy	-1.5	-2.0
Spain	-1.6	-1.7
Greece	-5.4	-6.8
Japan	2.0	2.5
UK	0.7	0.1
<i>Emerging Economies</i>		
Asia-Pacific	5.0	4.9
China	8.4	8.1
India	7.2	6.3
Latin America	3.7	3.3
Brazil	3.3	1.9
Eastern Europe	2.8	2.7

Source: Consensus Forecasts.

2.2. Commodity Prices

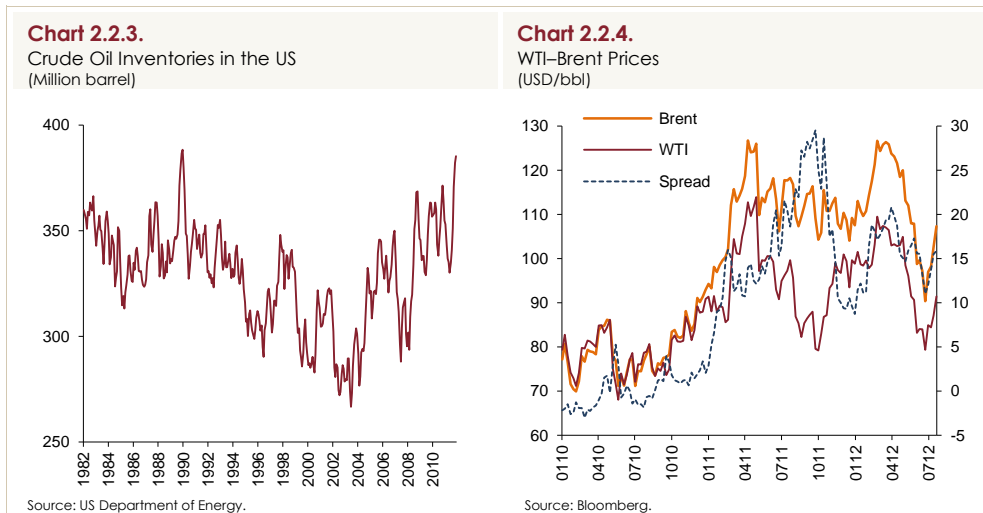
In the second quarter of 2012, the headline commodity index hit the 6-quarter low, but trended upwards again mainly due to supply-side problems. Energy prices decreased amid adverse global growth outlook, and increased as of early July owing to the geopolitical problems in the Middle East. Having halted owing to the supply-side problems led by the drought in the US that were manifested as of midst June, declining agricultural product prices were replaced by sharp increases. Concerns over global economic activity dominated industrial metal prices, thus causing further modest decline. On the other hand, upon the release of unfavorable data regarding the Euro Area, China and especially the US, a new round of monetary expansion has been considered in these economies, thus determining the course of precious metal prices (Charts 2.2.1 and 2.2.2).



In this period, demand-side developments have played a great role in the downward movement of oil prices. Unfavorable US employment figures, the poor course of industrial production in China that has intense commodity use and the aggravating concerns over the Italian and Spanish economies in the Euro Area following Greece affected the global growth outlook adversely, and oil prices hit the 18-months low at the end of the second quarter. Although a favorable outlook emerged following the meeting of the Euro Area leaders in late June besides the decision for a rate cut by the ECB, persisting concerns over the region exert a downward pressure on oil prices.

On the other hand, the downward trend of oil prices was also driven by supply-side developments. Despite the deterioration in global growth outlook, Saudi Arabia sustained crude oil production at record levels, which stood out as a positive development for the crude oil market. Moreover, due to the rise in crude oil production with unconventional methods in the US and Canada, crude oil stocks in the US have hit the top level since 1990 (Chart 2.2.3).

Following the unfruitful negotiations with Iran to overcome the nuclear crisis, the decision to lay embargo taken by Europe in January was enforced on July 1, 2012. With this decision, oil exports from Iran not only to Europe but also to other countries are deprived of insurance services in crude oil trade. Against this background, recurring conflict between Iran and the US over the Strait of Hormuz, which is of great importance for seaborne crude oil trade shipment, has elevated political risks in the region. Growing political tension in Syria and deepening domestic problems in Iraq are among other geopolitical developments leading to a rise in oil prices. Furthermore, the suspension of oil production in Norway, which is the world's fifth largest crude oil exporter, following the disagreement among employees and employer unions in the crude oil industry pose an upside risk on oil prices in the short term. Although the intervention by the government to prevent a cutback in production was considered to be a positive development, the problem is yet to be solved, which stands as a risk factor especially on Brent crude oil prices (Chart 2.2.4).



Following the Latin America and Russia, supply-side problems in agricultural problems have become more noticeable due to the recent drought in the US. Cereal production in the US, which is expected to record high

levels due to the rise in cultivated areas, is highly likely to remain far below the projected level due to the excessively hot weather conditions in the country, resulting in an upside risk on agricultural product prices (Table 2.2.1).

As a result, languish global growth alleviated the pressure on commodity prices, while supply-side problems regarding crude oil and agricultural products stand out as a risk factor. Moreover, gradually aggravating geopolitical problems in the Middle East keep upside risks on oil prices brisk in the short and medium term through the supply channel.

Table 2.2.1.

Production, Consumption and Inventory Forecasts for Agricultural Commodities*

	2010/2011	2011/2012	2012/2013	
			May Forecasts**	July Forecasts
WHEAT(million tons)				
Initial Inventory	200.6	197.2	197.0	197.2
Production	651.1	694.7	677.6	665.3
Consumption	654.5	694.7	686.5	680.1
Period-end Inventory	197.2	197.2	188.1	182.4
CORN (million tons)				
Initial Inventory	144.1	124.3	127.6	129.4
Production	829.1	873.7	945.8	905.2
Consumption	848.9	868.6	921.0	900.5
Period-end Inventory	124.3	129.4	152.3	134.1
COTTON (million bales)				
Initial Inventory	47.8	49.5	66.9	66.7
Production	116.4	122.7	16.7	113.8
Consumption	114.7	106.6	110.0	109.0
Period-end Inventory	49.5	66.7	73.8	72.4

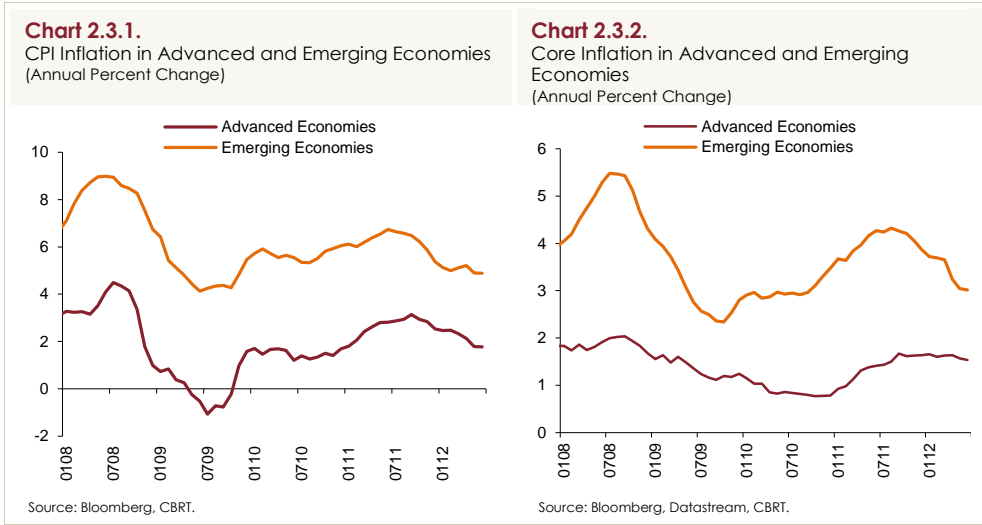
* The figures may be inconsistent due to discrepancies among countries in terms of exports and imports data, as well as the loss and damage in the marketing network.

** Preliminary forecasts for 2012/2013 were released in May.

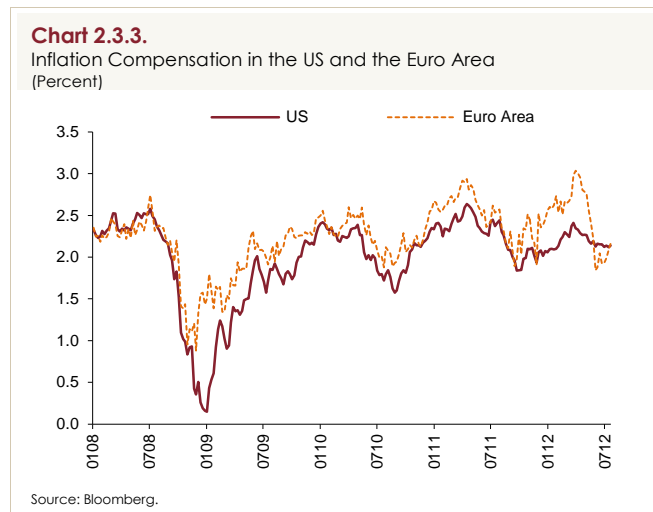
Source: US Department of Agriculture.

2.3. Global Inflation

In the second quarter of 2012, annual consumer inflation rates continued to trend downwards both in advanced and emerging economies (Chart 2.3.1). The fall in commodity prices in this period was the largest contributor to disinflation. Meanwhile, annual core inflation rates fell sharply in emerging economies, but remained flat in advanced ones (Chart 2.3.2).



In the second quarter of 2012, adverse economic developments in the Euro Area, especially the financing need of the banking sector in Spain, were influential in the aggravation of concerns over the growth outlook of the region and the plunge in inflation compensation (Chart 2.3.3). In the same period, the fall in inflation compensation for the US remained limited.



Global inflation forecasts for 2012 and 2013 edged down compared to the previous reporting period (Table 2.3.1). Nevertheless, hikes in agricultural product prices as of June are considered to be an upside risk factor on global inflation rates in the forthcoming period. Additionally, the latest decisions taken by the ECB to bolster Euro Area economy may raise inflation rates across the region. Furthermore, the probable pause of the recent downtrend in energy prices may fuel the said upside risks.

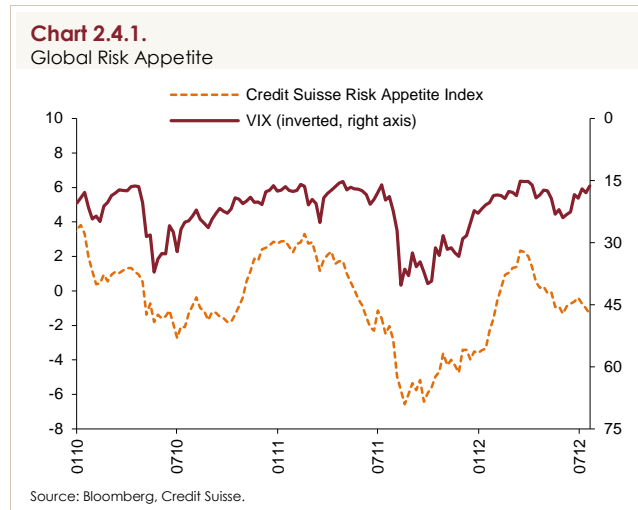
Table 2.3.1.
Inflation Forecasts for end-2012
(Annual Percent Change)

	2012		2013	
	April	July	April	July
World	3.0	2.9	2.9	2.8
<i>Advanced Economies</i>				
USA	2.3	2.0	2.1	1.9
Euro Area	2.3	2.3	1.7	1.7
Germany	2.0	2.0	1.8	1.8
France	2.1	2.0	1.8	1.6
Italy	3.0	3.0	2.4	2.0
Spain	1.8	1.8	1.6	1.5
Greece	0.9	0.6	0.5	1.9
Japan	-0.2	0.1	0.0	0.0
UK	2.8	2.7	2.0	2.0
<i>Emerging Economies</i>				
Asia-Pacific	3.8	3.8	4.0	4.0
China	3.3	3.0	3.6	3.5
India*	7.0	8.4	6.6	7.6
Latin America	6.0	5.9	6.3	6.4
Brazil	5.1	4.9	5.4	5.4
Eastern Europe	6.4	6.4	5.3	5.3

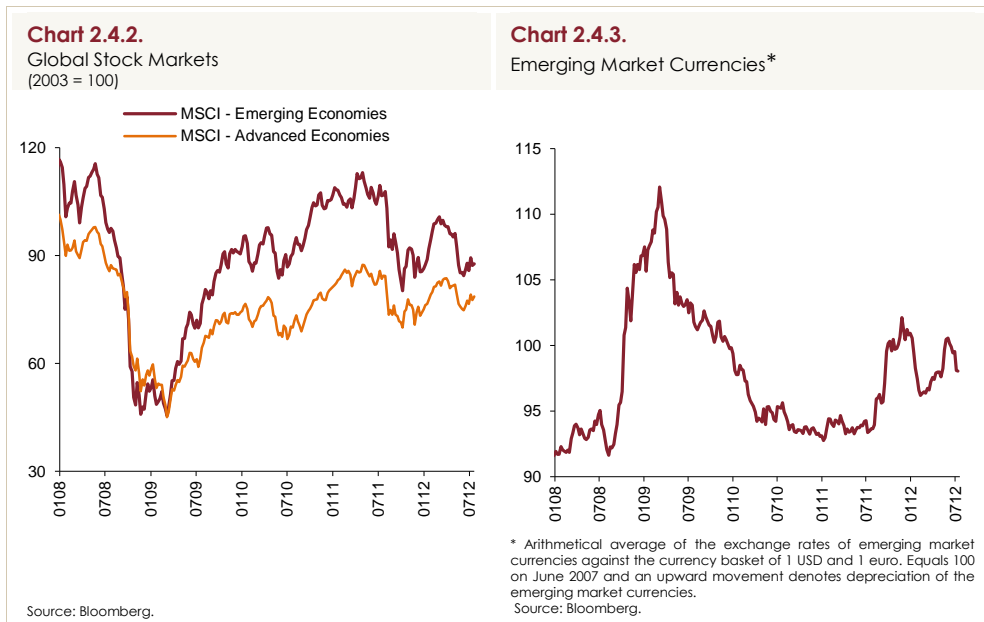
* As of the fiscal year starting in April.
Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

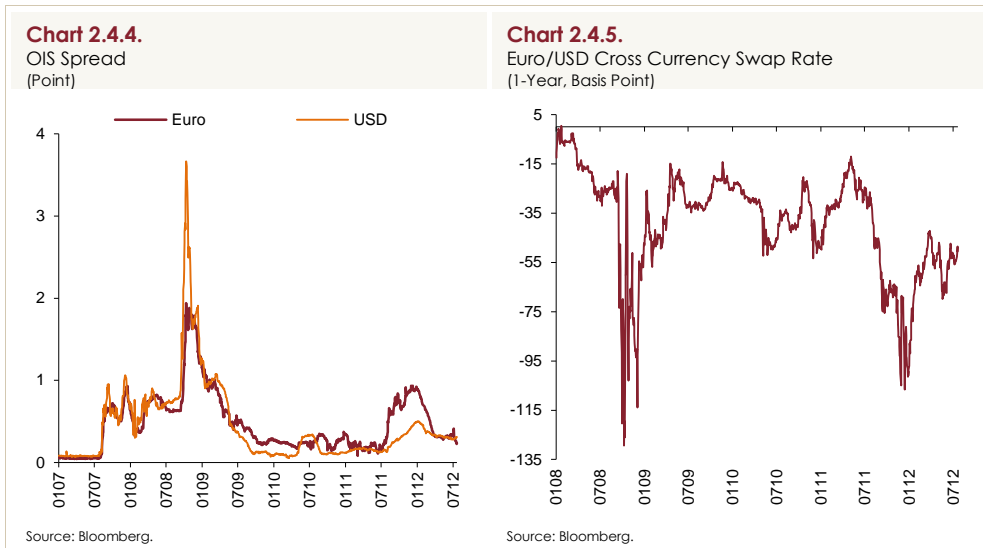
In the last quarter, intensifying concerns over Spain due to the problems in the banking sector and the political unrest in Greece were among the primary factors that kept the Euro Area debt crisis alive. Besides the problems in the Euro Area, the data for economic activity undershot the forecasts especially in the Chinese and US economies, resulting in an attenuated global risk appetite in April and May. Ensuring external support to re-capitalize the Spanish banking sector and welcoming of the election results in Greece have prevented deterioration in risk appetite since June. Despite the decisions for aid to the Spanish banking sector and resorting to the banking union in the Euro Area in the EU summit on June 28–29, risk appetite did not record a remarkable recovery as there are uncertainties yet to be solved regarding practice and scope. Yields have climbed to levels that can trigger concerns over debt sustainability in Spain since mid-July and perceptions strengthened that Greece has challenges in implementing the current stability program, which continued to inhibit the risk appetite (Chart 2.4.1).



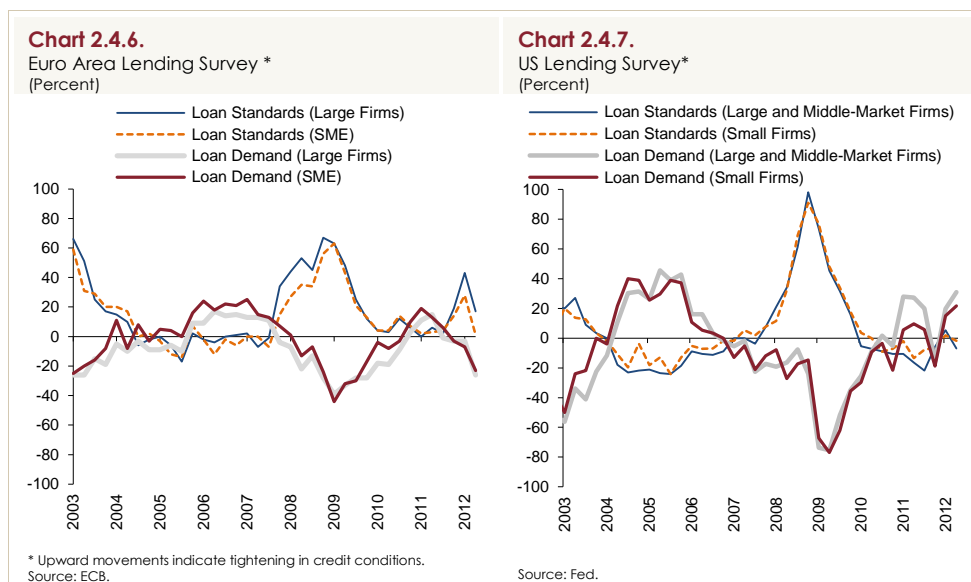
In line with the developments in the global risk appetite, a partial recovery was seen in stocks market subsequent to notable losses of value. Similarly, exchange rates of emerging economies which experienced devaluations partially compensated for their losses thanks to the recovery in the risk appetite (Charts 2.4.2 and 2.4.3).



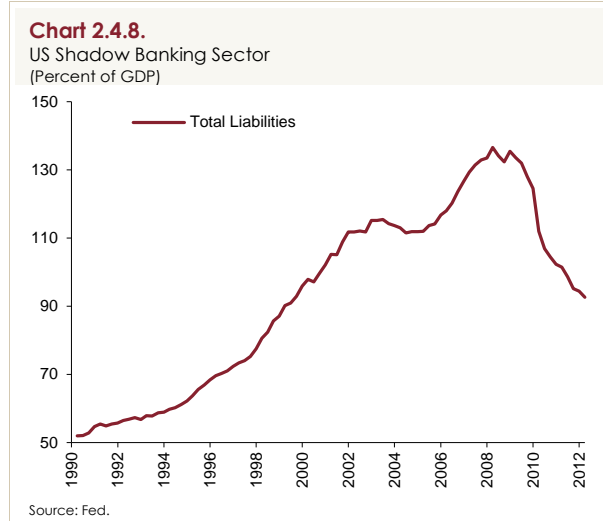
As for the money markets, OIS spread remained broadly unchanged in the last quarter. Notwithstanding the loose policies of the central banks, the counterparty risk remains brisk in the sector (Chart 2.4.4). Owing to the problems driven by the Spanish banking sector, the euro/USD cross currency swap rates remained high against the euro in the last quarter (Chart 2.4.5).



The Euro Area debt crisis still affects credit markets adversely. The last loan tendency survey released by the ECB suggests that despite the significant fall in the tightening of lending conditions in early 2012, the credit demand declined more remarkably (Chart 2.4.6). On the other hand, the latest loan tendency survey released by the Fed points that the US banking sector slightly eased lending conditions; and the credit demand improved following the fall in the last quarter of 2011 and reached the highest levels following the global financial crisis (Chart 2.4.7).



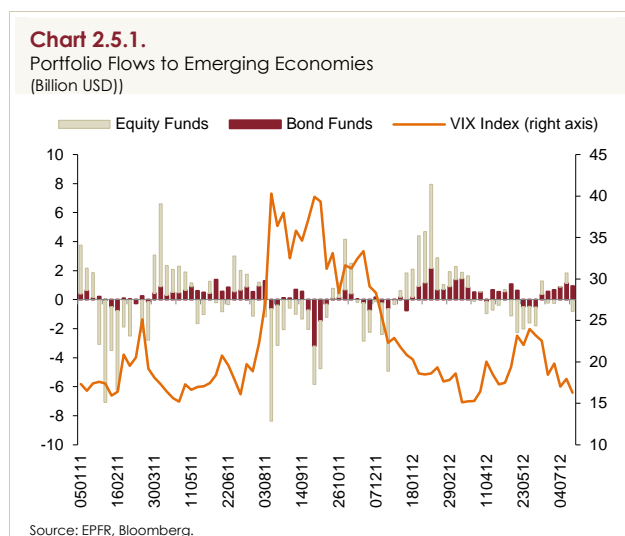
Having expanded enormously in the pre-crisis period, and thus being criticized for generating asset bubbles primarily in the real estate sector, weakening in activities in the shadow banking sector persists (Chart 2.4.8).



Experiences in global markets in the last quarter signal that fragilities are still vibrant and developments in the Euro Area debt crisis will continue to set the agenda items. Whether the disagreements on the implementation of the decisions taken in the summit of June 28–29 can be removed or not is of great importance in this context. Those in the Spanish banking sector being the leading ones, developments to affect borrowing costs of Italy and Spain are expected to remain as the determinant factors in global markets.

2.5. Capital Flows

The deteriorating trend in the global risk appetite in the second quarter of 2012 brought about capital outflows from emerging economies, which drew notable amounts of portfolio investments in the first quarter (Chart 2.5.1). Emerging Asian countries experienced the highest amount of fund outflows, while the relatively best performers in portfolio investments were Latin American countries. As for the emerging European countries, outflows from equity markets were largely compensated by inflows towards bond funds markets.



On a quarterly basis, funding outflows were mostly seen in stock markets; however, these outflows remained limited to less than 40 percent of the equity fund flows to emerging economies in the first quarter of the year (Table 2.5.1). Meanwhile, investments in bond funds continued, albeit at a slower pace.

Table 2.5.1.
Portfolio Flows to Emerging Economies*
(Billion USD)

	Total	Equity Funds	Bond Funds
2012Q1	32.9	22.7	10.2
2012Q2	-4.7	-8.7	4.0

Source: EPFR

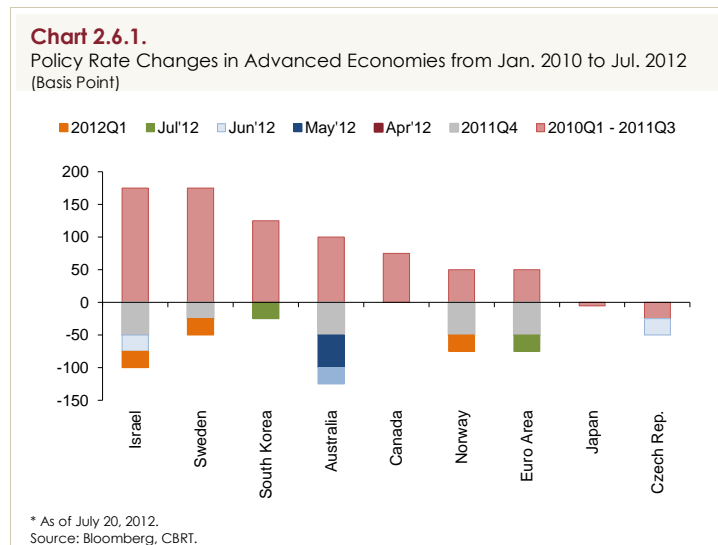
Uncertainties regarding the Euro Area in the forthcoming period are considered to be the leading risk factor that can restrict capital inflows towards emerging economies by affecting the risk appetite of investors adversely.

2.6. Global Monetary Policy Developments

Monetary policy decisions were largely shaped by the global growth outlook in the second quarter of 2012. Accordingly, monetary policy was eased remarkably both in advanced and emerging economies parallel to the global growth outlook that displays a rather negative outlook compared to the previous quarter.

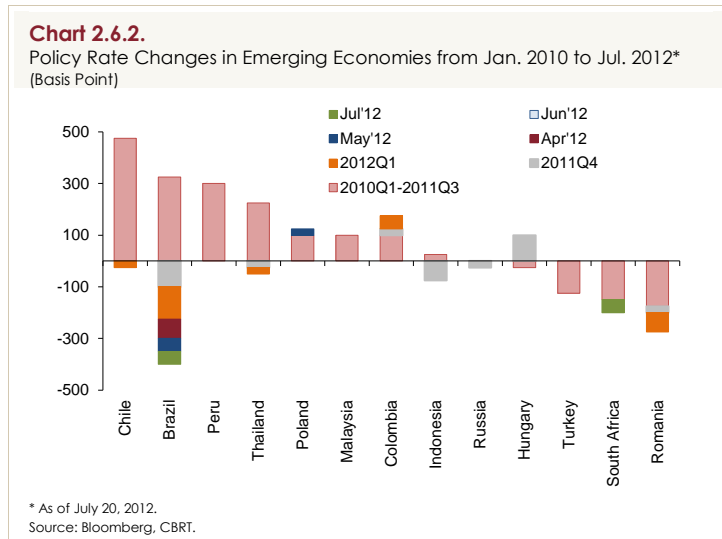
Some advanced economies opted for easing in monetary policies by reducing policy rates in the second quarter. Despite the gradual expansion of the package of measures to solve the problems in the Euro Area and more

common use of ECB funds, Euro Area growth forecasts deteriorated. Accordingly, as expected, the ECB cut the policy rate by 25 basis points in July. Meanwhile, the policy-rate-cut of 25 basis points by the Bank of Korea in July surprised the market. The Czech National Bank, the Reserve Bank of Australia and the Bank of Israel also opted for monetary easing by reducing policy rates in the second quarter (Chart 2.6.1).

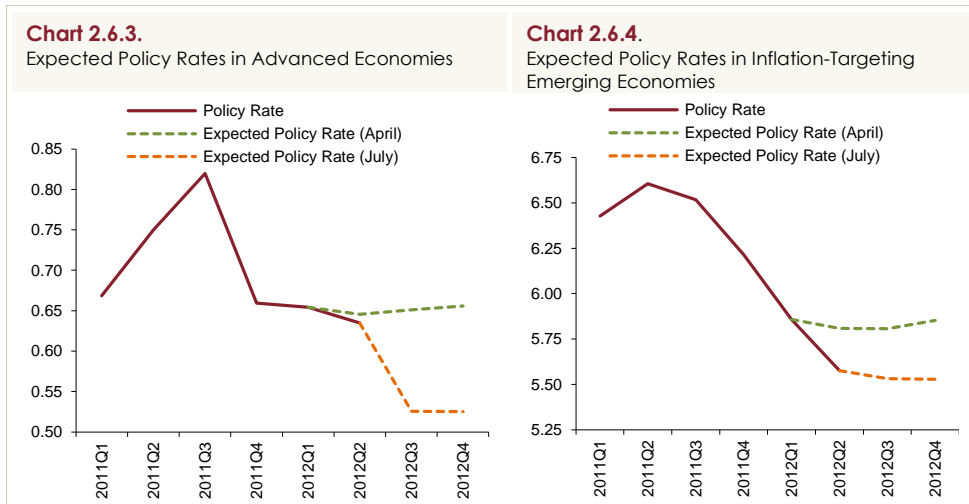


In the second quarter, the Fed and the Bank of England eased their monetary policy stances through the use of quantitative easing tools. For example, following the meeting on June 19 – 20, the Fed announced that it extended the implementation of Operation Twist until the year-end, which was expected to end in early July. Pointing to both medium-term employment forecasts and risks in global financial markets to account for this extension, the Fed signaled for another monetary easing should growth undershoot their forecasts and inflation lags behind their medium-term forecasts. The Bank of England announced in its July meeting that the asset purchasing program was raised by GBP 50 billion.

The second quarter saw reductions in policy rates also in some emerging economies. Banco do Brasil maintained its rate-cut trend in the previous quarter as well. The Reserve Bank of South Africa opted for rate cuts twice as of late 2010, which totaled 50 basis points. Meanwhile, the cuts implemented by the Bank of China and Bank of India by 56 and 50 basis points, respectively point to their concerns over the falling GDP growth rates (Chart 2.6.2).



Due to strong perceptions that the adverse impact of the Euro Area crisis on the global growth outlook will be heavier than expected, in the second quarter of the year, global monetary policy was eased far above the projections presented in the April Inflation Report. Additionally, in the previous reporting period, policy rates were expected to follow a flat course for a while and trend upwards at the year-end both in advanced and emerging economies. The Report also suggested that the downward trend in rates would also continue in the second quarter of the year. When compared to emerging economies, year-end rate expectations in advanced economies were subject to a more sizeable downward revision than envisaged in the April Inflation Report. This is mostly attributed to the strong perception that the ECB will introduce another rate reduction (Charts 2.6.3 and 2.6.4).



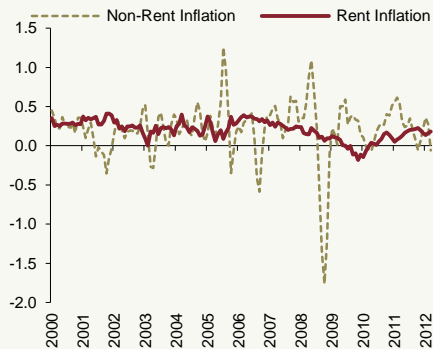
Box
2.1

US Housing Market Dynamics

Falling prices in the US housing market in the post-2007 period increased the default rates in housing loans and decreased new housing constructions. Due to rising housing prices, the number of housing constructions will increase and will ease the process of exit from crisis. Accordingly, by using interest rates, this Box analyzes the US housing market in terms of the relative course of rent and mortgage in the short and long term, and also discusses the possible effects of the high levels of housing stock.

Since 2007, the onset of the crisis, rent inflation remained lower than non-rent inflation rate in the US economy. Given the long-term relative price movements, rent inflation is supposed to be higher than non-rent inflation in a robust housing market (Arslan and Kanik, 2012). Rent inflation has recently approached its long-term level, which is perceived as the first signal that the US housing market is getting normalized (Chart 1).

Chart 1. US Inflation Rates
(Seasonally Adjusted Rent and Non-Rent CPI-Quarterly Moving Average)



Source: Bureau of Labor Statistics.

Chart 2. Case-Shiller and Gordon Housing Price Indices
(Jan. 2000=100)



Source: S&P., Arslan and Kanik (2012).

In the housing market, mortgage rates are significant besides rent. As interest rates affect cost of loans, they also affect the demand for loans, and so the housing demand. Rates on mortgage with 30-year maturity, which is mostly preferred by consumers, have exhibited a downtrend from 1986 to this date, and went down to 6 percent as a result of the accommodative monetary policy implemented by the Fed in 2001. Thanks to the considerably low interest rate and asset-backed mortgage policies implemented by the Fed to alleviate the effects of the economic crisis since 2007, mortgage rates with 30-year maturity went down to 5 percent, and even further down to 4 percent in recent months.¹ Rates on housing loans, which hover around historically low levels, stand out as a factor to bolster recovery in the housing market.

¹ Housing loan rates with different maturities follow a similar course.

Analysis of the effects of rent and interest rates is also possible by using the Gordon growth model, which is a type of discounted cash flows model. Gordon pricing formula is depicted in the equation below:

$$P = \frac{K}{r - g}$$

Where P is the Gordon price, K is the housing rents in the subsequent period, g is the growth rate of housing rents (fixed rent inflation), r is the housing loan rate. Under the assumption that the housing is financed through loan, the equation estimates that Gordon prices will go up in line with the decreasing interest rates and increasing rent inflation.

Gordon Housing Price Index (HPI) obtained from the Gordon pricing formula is illustrated in Chart 2 together with the Case-Shiller HPI. Gordon HPI exhibits a similar trend to the real estate market prices in the long term. Nonetheless, Gordon HPI has recently diverged from the Case-Shiller HPI to a remarkable extent and in April 2012, the ratio of Gordon HPI to Case-Shiller HPI rose to 2.36, which leads one to think that Case-Shiller HPI is considerably lower than Gordon HPI and has a potential to increase.

In sum, these analyses point that interest rates and rent dynamics will contribute to the recovery in the US housing market in the forthcoming period. Nevertheless, there are still notable downside risks pending on the recovery. In fact, the increase in the number of housing stock ready to be sold in the post-crisis period, the limited number of consumers that could avail themselves of the low interest rates and the likelihood of an aggravated Euro Area debt crisis are highlighted as the downside risks in terms of the forecasts in the analysis. On the other hand, the Gordon pricing formula does not include significant factors like risk and expectation, which is considered to be another important factor to affect forecasts.

REFERENCES

Arslan, Y. and B. Kanık, 2012, ABD Kira Enflasyonu ve Konut Fiyat Dinamikleri (in Turkish), CBRT Economic Notes No.12/03.

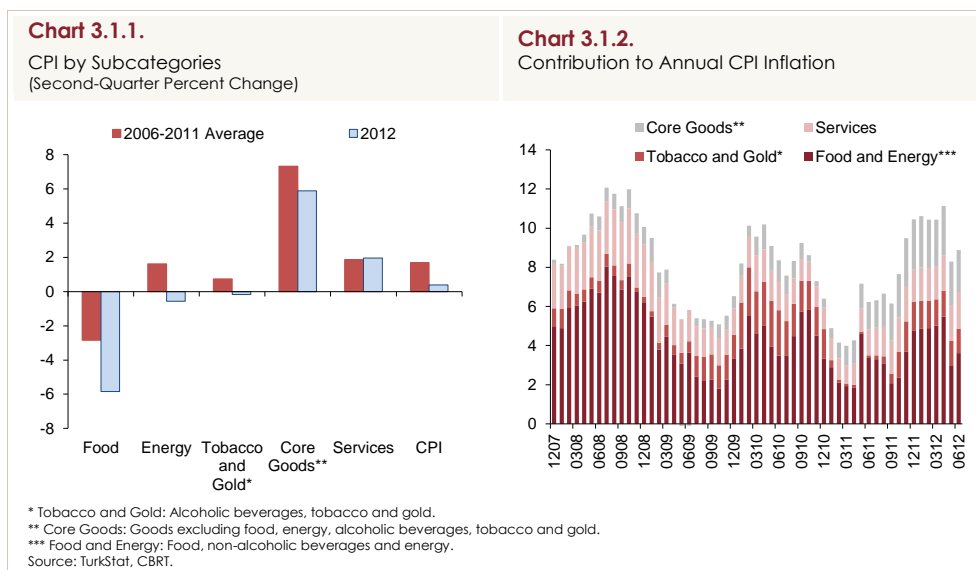
3. Inflation Developments

3.1. Inflation

In the second quarter of 2012, annual consumer inflation went down by 1.6 percentage points to 8.87 percent on a quarterly basis. This was driven by the decline in oil prices parallel to the favorable course of unprocessed food prices and international commodity prices. Annual inflation in core goods continued to trend downwards in this period, while services inflation edged up. Meanwhile, decelerating economic activity bolstered the inflation outlook and core inflation indicators trended downwards in line with the alleviation of cost-side pressures. Hence, in the second quarter of the year, inflation undershot the forecast presented in the April Inflation Report upon the higher-than-anticipated decline in unprocessed food and energy prices.

Across subcategories, quarterly price changes in main expenditure groups except for services were below historical averages in the second quarter (Chart 3.1.1). The decline in annual inflation in this period is attributable to plummeting food prices. The contribution of food group to inflation, which posted a year-on-year decline by 3.87 percentage points in the second quarter, went down by 1.08 percentage points on a quarterly basis (Chart 3.1.2). Despite the high-rated adjustments in electricity and natural gas tariffs in April, the contribution of energy group to inflation fell by 0.33 percentage points amid the decline in fuel prices. Meanwhile, the contribution of services to inflation rose by 0.22 percentage points in tandem with the rise in catering and communication services inflation.

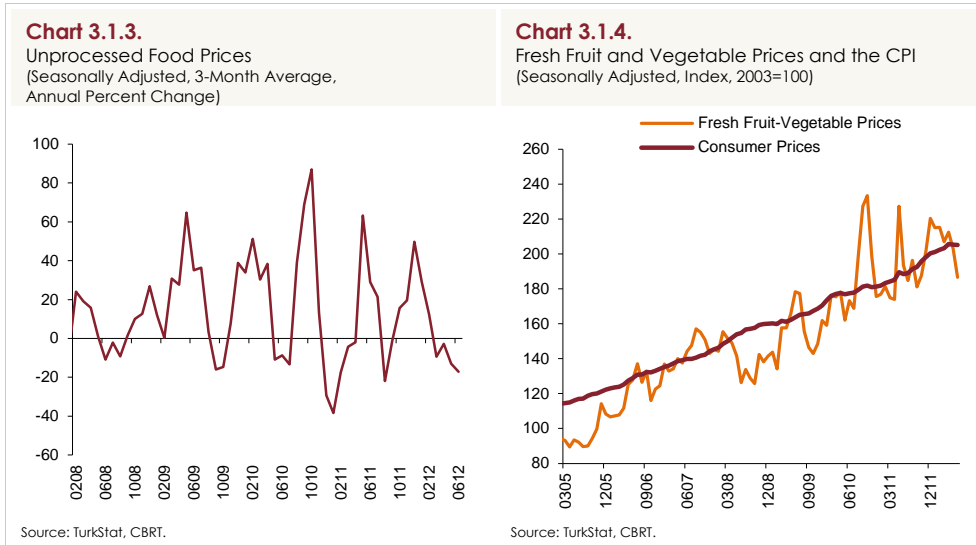
As a result, the course of unprocessed food and oil prices were instrumental in the recent deceleration in consumer inflation. Unprocessed food prices are expected to remain modest throughout the year. On the other hand, processed food prices bear an upside risk depending on the developments in bread prices besides the recent international food commodity prices. Moreover, following low levels, the upward trend in oil prices in late June keep upside risks on the short-term inflation outlook brisk.



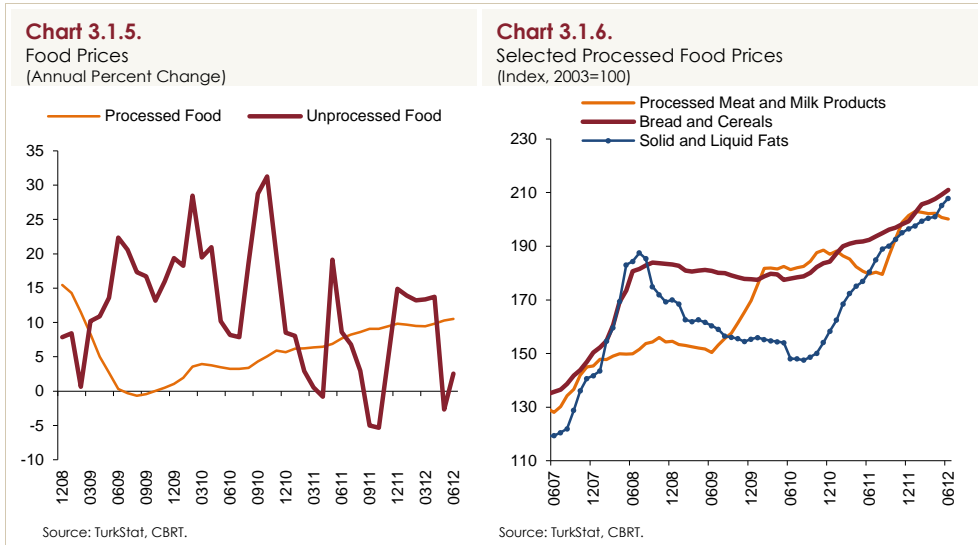
The unprocessed food prices continued to trend upwards in the second quarter (Chart 3.1.3). Due to seasonal effects, prices plummeted by 14.76 percent in the second quarter, which is the largest quarterly decline in the index history. This period saw falling vegetable prices close to historical averages, driven by the decline in fruit prices contrary to the seasonal trend of increase. Therefore, prices of fruits and vegetables recorded a notable decline in comparison with the overall consumer prices (Chart 3.1.4). Analysis of price increases in fruits suggests that the rate of increase in the second quarter displayed a less volatile course compared to previous years. This is also attributable to the adjustment made in the inclusion of new seasonal products under the coverage of the index.¹ The Box 3.1 discusses the impact of CPI volatility led by the strong seasonality in prices of fresh fruits and vegetables.

Upon the decline in prices of unprocessed food items excluding fruit and vegetable as well, unprocessed food group prices followed a more favorable course than envisaged in the April Inflation Report. Thus, annual inflation in unprocessed food excluding fruit and vegetable went down to 2.55 percent by end-June (Chart 3.1.5).

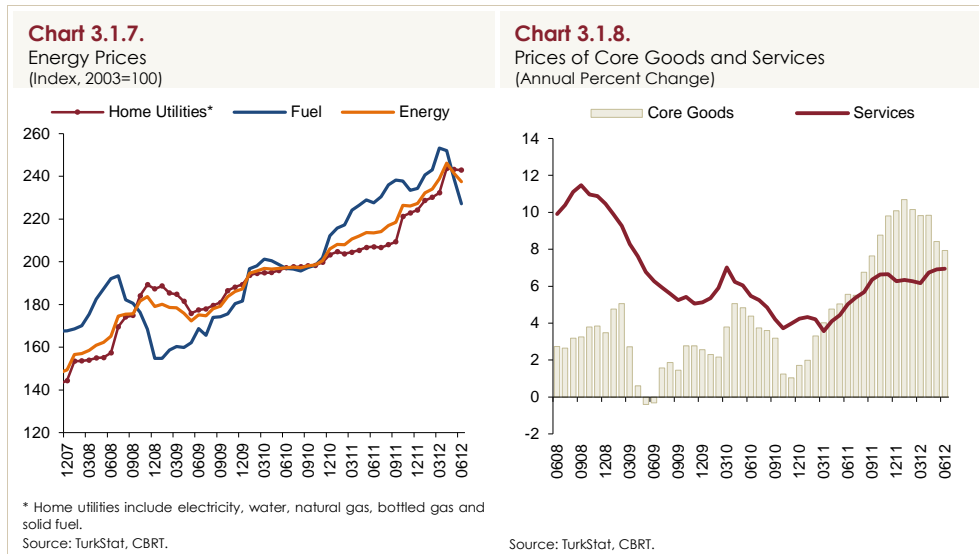
¹ For example, some products, which were included in indices in May 2011 considering the consumption patterns of past years and led to an upsurge in fruit and consumer inflation due to troubles in supply, were included in the index in June 2012. Thus, excessive and short-term price movements to stem from probable supply-side problems and that are adjusted by consumption amounts were partly prevented to reflect on the CPI.



Contrary to this favorable outlook of unprocessed food prices, processed food prices surged above projections. Accordingly, annual inflation in processed food prices rose by around 1 percentage point to 10.51 percent on a quarterly basis (Chart 3.1.5). In this period, prices of bread and cereals continued to trend upwards (Chart 3.1.6). Cumulative increase in the first six months especially in bread prices neared 8 percent, which was driven by the arrangements on weight in grams introduced by the Communique on Bread and Bread Varieties of the Turkish Food Codex. Thus, bread prices may rise further in the third quarter, which constitutes a notable upside risk on processed food prices in the second half of the year. Moreover, prices of fats and oils, which accelerated upon domestic and international developments as of the last quarter of 2010, maintained a negative outlook in this quarter with a sharp increase (Chart 3.1.6). Meanwhile, prices of processed meat and dairy products, which accelerated in the second half of 2011, recorded a decline in this period and put a cap on the rise in processed food prices. As a result, annual food inflation fell approximately by 4 percentage points to 7.38 percent, and remained below the level projected in the April Inflation Report amid the ongoing favorable outlook in unprocessed food prices.



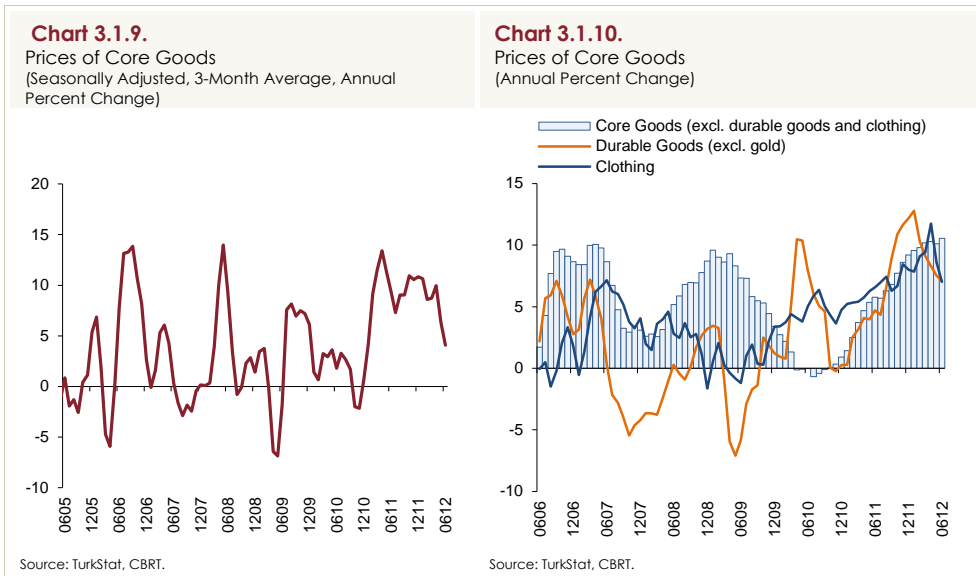
In the second quarter of the year, energy prices went down by 0.57 percent notwithstanding the high-rated adjustments in electricity and natural gas tariffs (Table 3.1.1). Parallel to the plunge in international oil prices in this period, fuel prices fell by 10.27 percent and went back to June 2011 levels (Chart 3.1.7). On the other hand, upon the developments in oil prices within the housing group, all items saw price hikes in the second quarter, excluding bottled gas that plummeted by 8.63 percent. Price increases in water tariffs persisted, albeit at a slower pace compared to the first quarter, and electricity and natural gas tariffs soared in April by 9.28 and 16.24 percent, respectively. Thus, annual energy inflation posted a quarter-on-quarter decline by 2.16 percentage points to 11.23 percent. The contribution of energy group to annual inflation went down to 1.65 percentage points in this period, all of which stemmed from prices of home utilities. Although energy inflation lost momentum in the second quarter, it is still high and is among the primary subcategories directing consumer inflation towards a relatively high course (Box 3.2). Following the second quarter, international oil prices trended upwards in late June, still keeping the upside risks on consumer prices brisk.

**Table 3.1.1.**Prices of Goods and Services
(Quarterly and Annual Percent Change)

	2011					2012	
	I	II	III	IV	Annual	I	II
CPI	1.57	1.83	1.07	5.66	10.45	1.55	0.39
1. Goods	1.53	2.05	0.73	7.29	11.97	1.54	-0.19
Energy	2.27	1.37	2.34	4.03	10.36	5.08	-0.57
Food and Non-Alcoholic Beverages	3.77	-2.46	1.18	9.57	12.21	2.89	-5.85
Unprocessed Food	5.08	-5.79	-1.00	17.23	14.89	3.66	-14.76
Processed Food	2.61	0.57	3.03	3.30	9.82	2.25	1.55
Goods (excl. energy and food)	-0.68	6.32	-0.36	6.93	12.51	-1.14	4.78
Core Goods	-1.08	7.73	-1.55	4.92	10.09	-1.32	5.88
Durable Goods (excl. gold)	4.26	1.85	3.69	1.90	12.19	1.41	-0.05
Alcoholic Beverages, Tobacco and Gold	0.81	1.05	4.38	14.46	21.70	-0.33	-0.17
2. Services	1.67	1.22	2.02	1.22	6.27	1.57	1.96
Rent	1.08	0.99	1.35	1.21	4.71	0.89	1.27
Restaurants and Hotels	1.65	1.80	2.37	2.14	8.20	1.99	2.62
Transport	2.28	2.10	3.07	1.73	9.49	2.12	1.79
Communication	1.96	-1.71	0.35	0.47	1.04	0.06	2.07
Other Services*	1.61	2.14	2.56	0.65	7.12	2.24	2.00

* Services excluding rents, restaurants, hotels, transport and communication.
Source: TurkStat, CBRT.

Having trended downwards since February, annual core goods inflation, went down by 1.89 percentage points to 7.93 percent in the second quarter (Chart 3.1.8). This decline was driven by the decrease in commodity prices besides the appreciation in the Turkish lira. Seasonally adjusted data also indicate that the underlying trend of core goods inflation has plummeted by the end of the second quarter (Chart 3.1.9). Across subcategories, the decline in annual core goods inflation was attributed to the fall in durable goods inflation (Chart 3.1.10). Clothing prices was another factor that supported this outlook by decelerating both on an annual basis and in seasonally adjusted terms. Core goods prices excluding clothing and durable goods continued to soar in the second quarter (Table 3.1.2).

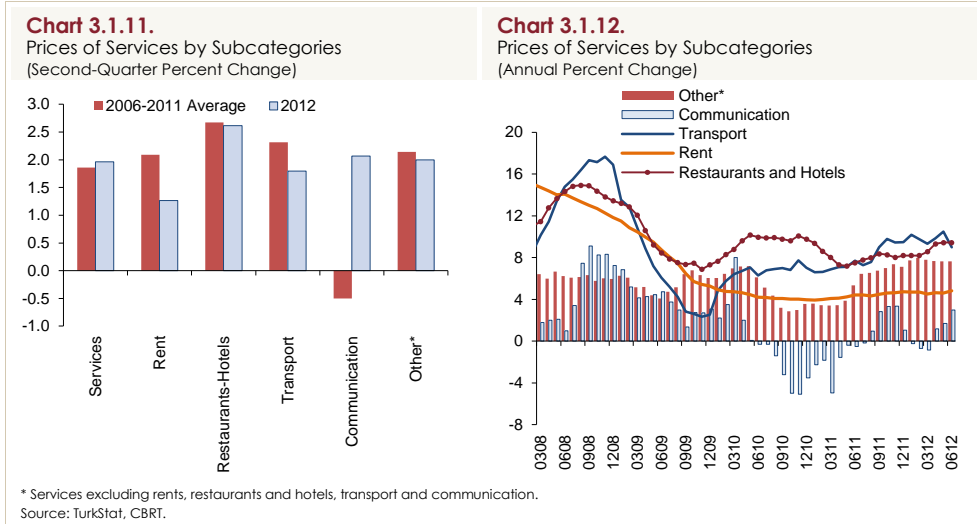

Table 3.1.2.

 Prices of Core Goods
(Quarterly and Annual Percent Change)

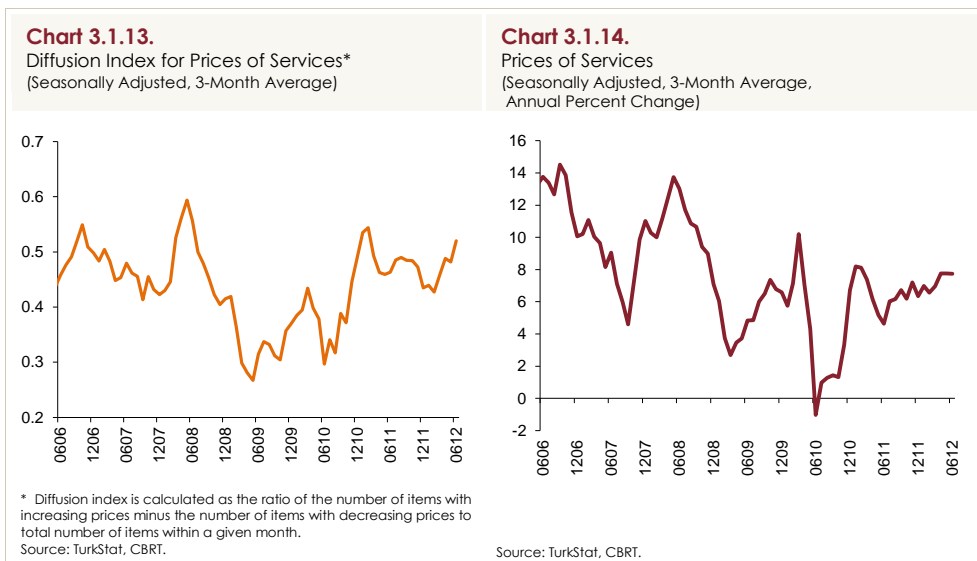
	2011					2012	
	I	II	III	IV	Annual	I	II
Core Goods	-1.08	7.73	-1.55	4.92	10.09	-1.32	5.88
Clothing and Shoes	-12.04	25.08	-12.13	11.72	8.01	-10.90	22.34
Durable Goods (excl. gold)	4.26	1.85	3.69	1.90	12.19	1.41	-0.05
Furniture	0.75	5.04	2.88	4.01	13.25	3.19	1.76
Electrical and Non-Electrical Appliances	2.87	-1.26	0.34	3.29	5.27	0.94	-2.75
Automobile	6.31	2.29	5.68	0.52	15.52	1.09	0.42
Other Durable Goods	2.15	2.71	1.85	3.00	10.06	1.22	3.13
Other	1.82	2.09	1.54	3.44	9.18	2.76	2.42

Source: TurkStat, CBRT.

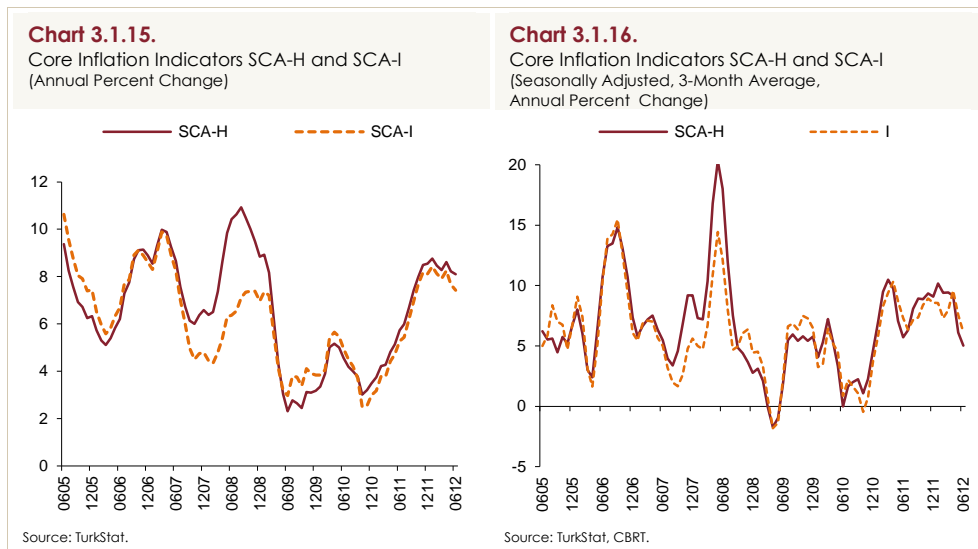
Having recorded a quarterly rise by 0.78 percentage points, annual services inflation gradually increased to 6.94 percent in the second quarter of 2012 (Chart 3.1.8). Therefore, the second-quarter-rise in prices of services was slightly above the averages of past years (Chart 3.1.11). In April and May, prices of services went up mainly upon the increases in transport and catering services (Chart 3.1.12). This was driven by cumulative increases in fuel prices recorded in previous years besides the hikes in processed food prices. In the last month of the quarter, rents and prices of communication services, in particular fixed line communication fees, were influential on the rise in annual inflation. In sum, prices of services reflected the recent developments in input costs. In line with this outlook, the upward trend in the prices of services dispersed into the group as a whole in the second quarter more than the other periods (Chart 3.1.13).



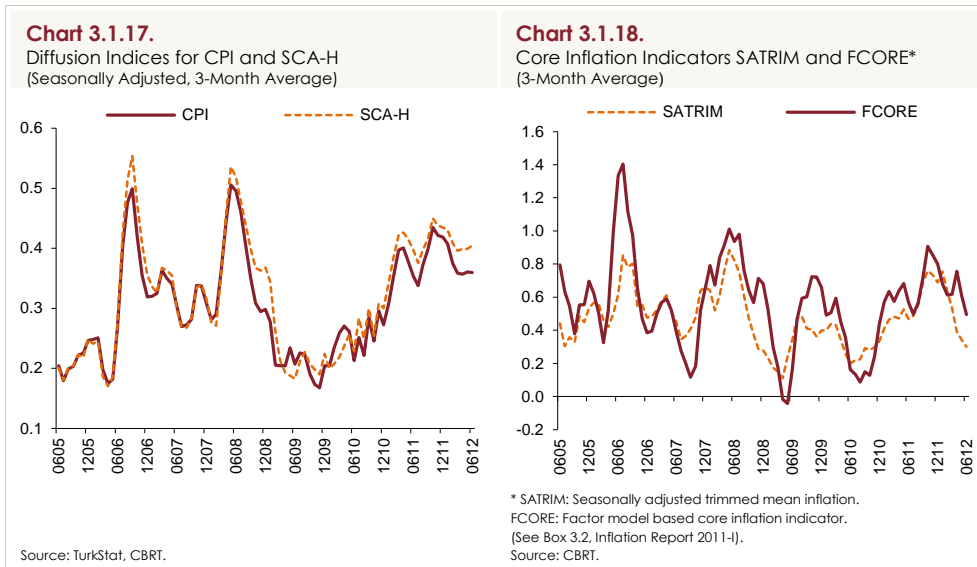
In seasonally adjusted terms, having remained flat in the first quarter of 2012, services inflation edged up in early second quarter, and remained unchanged during the period (Chart 3.1.14). The inflation trend implied by seasonally adjusted prices of services, which remained below the averages of the post-crisis recovery period, is considered to be mild. The upsurge in TL-denominated import prices throughout 2011 accompanied by the lagged effects of robust economic activity pushed inflation upwards; but reflections of this on the prices of services were limited. In fact, in the first half of the year, consumer inflation hovered around 10 percent due to said reasons and services added less to annual inflation than food, energy and core goods.



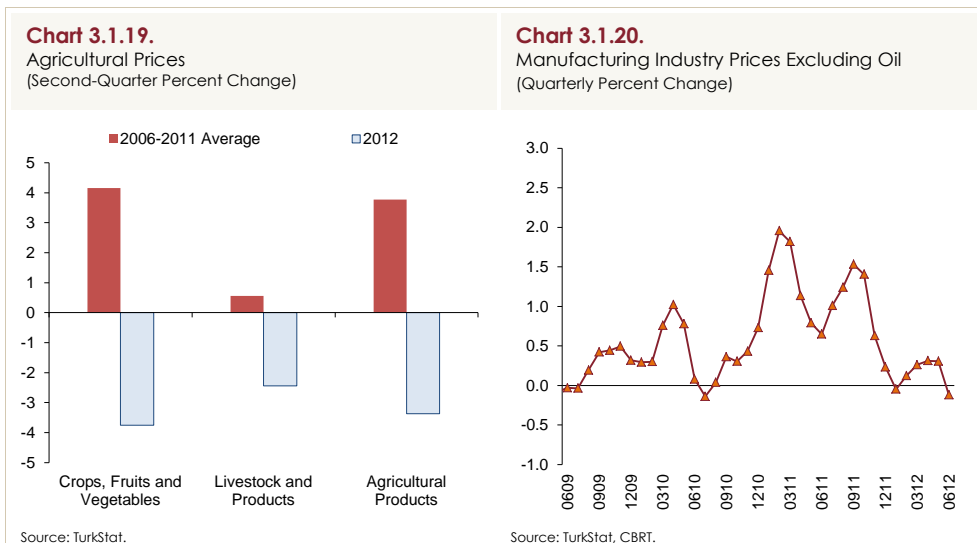
Annual inflation in core indicators SCA-H and SCA-I went down to 8.10 and 7.43 percent, respectively, in the second quarter (Chart 3.1.15). In this period marked by high annual inflation in services, the deceleration in core goods inflation was influential on the said decline. Seasonally adjusted data show that the underlying trend of both indicators decelerated in the second quarter (Chart 3.1.16). The second-quarter-rise especially in clothing prices, which remained below seasonal averages, played a great role in this slowdown; however, prices excluding clothing maintained the same trend.



Diffusion indices for CPI and SCA-H remained flat in the second quarter (Chart 3.1.17). On the other hand, alternative core inflation indicators monitored by the CBRT also declined parallel to the seasonally adjusted underlying trend of SCA-H and SCA-I (Chart 3.1.18). In this period marked by a lower trend in seasonally adjusted price increases, flat courses in diffusion indices were seen, which can be regarded as price raising trend persists in the economy, while the size of increases is going down. In fact, diffusion indices hovered above historical averages; whereas core inflation indicators remained below those averages.



Due to the decline in agricultural and manufacturing industry prices, producer prices fell by 0.89 percent in the second quarter, and annual producer price inflation went down by 1.78 percentage points to 6.44 percent (Table 3.1.3). Upon the fall in livestock and animal product prices besides prices of fresh fruits-vegetables being relatively more evident, quarterly change in agricultural prices lagged far behind the averages of the past quarters (Chart 3.1.19). This downward trend, which is maintained also in seasonally adjusted terms, also reflected into consumer food prices and played a significant role on the slowdown in consumer inflation.



Manufacturing industry prices stayed modest in the second quarter of 2012 (Chart 3.1.20). Notwithstanding the effect of the robust course of the Turkish lira, role of the fall in international commodity prices was more influential in this outlook (Chart 3.1.21). Manufacturing industry prices fell by 0.83 percent in the said period mainly upon the decline in oil and base metal prices (Table 3.1.3). Accordingly, manufacturing prices of intermediate goods also went down in the second quarter. Manufacturing industry prices excluding oil and base metal remained unchanged in this period, while group prices saw a decline for the first time since March 2005, albeit at a limited rate. In the said period, the rate of increase in producer prices of durable goods tumbled compared to the previous quarters. Price increases in sunflower, which is among inputs of manufacturing industry bolstered the upward trend in processed food inflation, while the inflation in manufacturing of food products realized close to seasonal averages without any major changes. Meanwhile, prices of textile products decreased amid the plunge in cotton prices, which has been persisting since last year. Therefore, domestic cost pressures on consumer prices of the clothing group were partially eased. Overall, producer price developments in the second quarter showed that cost effects on consumer prices followed a weak course in this period.

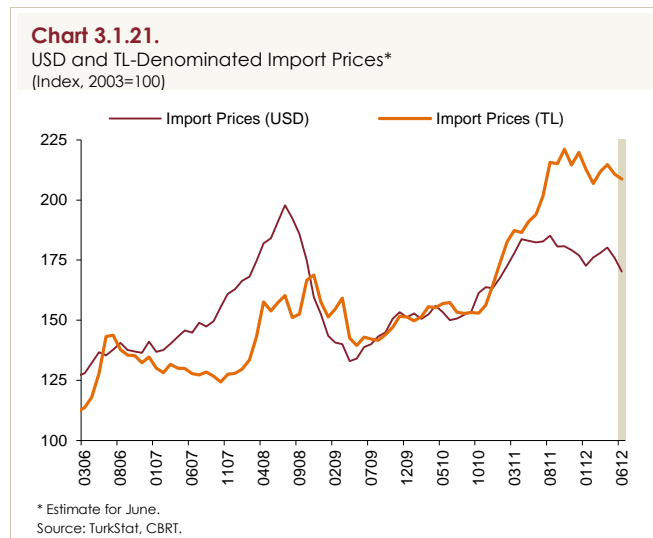


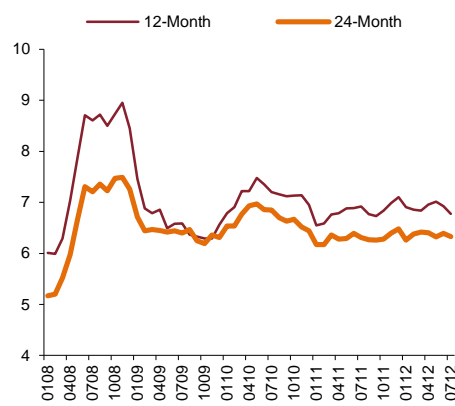
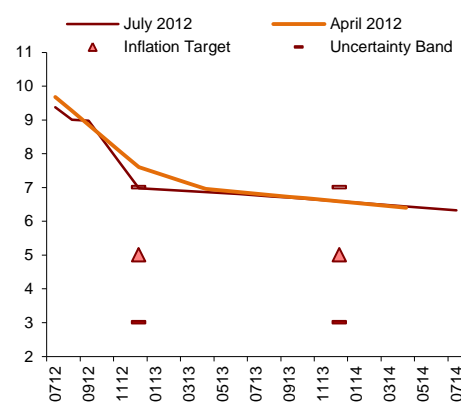
Table 3.1.3.PPI and Subcategories
(Quarterly and Annual Percent Change)

	2011					2012	
	I	II	III	IV	Annual	I	II
PPI	5.40	0.77	3.31	3.28	13.33	0.65	-0.89
Agriculture	5.84	-1.73	-6.03	13.09	10.53	1.65	-3.36
Crops, Fruits and Vegetables	6.81	-2.67	-9.84	17.18	9.83	0.76	-3.75
Livestock and Animal Products	-1.26	-0.39	2.68	5.51	6.56	-0.28	-2.44
Industry	5.31	1.30	5.24	1.48	13.92	0.45	-0.37
Mining	9.70	1.08	4.94	2.93	19.76	0.90	2.24
Manufacturing	6.27	1.98	4.98	0.72	14.59	1.06	-0.83
Manufacturing (excl. oil)	5.55	1.95	4.67	0.70	13.42	0.79	-0.36
Manufacturing (excl. oil and base metals)	4.85	1.53	4.12	1.39	12.38	0.93	-0.09
Electricity, Gas and Water	-4.08	-4.73	7.89	7.91	6.38	-4.64	2.57

Source: TurkStat, CBRT.

3.2. Expectations

Inflation expectations continued to remain flat in the second quarter (Chart 3.2.1). On the other hand, upon the stabilization of the downward trend of core inflation indicators, medium-term expectations posted a slight quarterly decline in the early third quarter. Compared by maturities, inflation expectations for April and July suggest that short-term expectations were slightly revised downwards, while long-term expectations remained broadly unchanged (Chart 3.2.2).

Chart 3.2.1.12- and 24-Month Ahead CPI Expectations*
(Annual Percent Change)* CBRT Survey of Expectations, second survey period results.
Source: CBRT.**Chart 3.2.2.**Inflation Expectations Curve*
(Annual Percent Change)* Calculated by linear interpolation of expectations for different time spans using the CBRT Survey of Expectations, second survey period results.
Source: CBRT.

The distribution of survey respondents for 12-month ahead inflation expectations remained virtually unchanged, while the distribution of survey respondents for 24-month ahead inflation expectations diverged compared to April figures (Charts 3.2.3 and 3.2.4).

Chart 3.2.3.
Distribution of 12-Month Ahead Inflation Expectations*

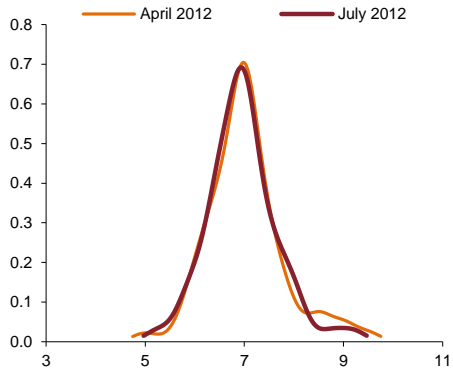
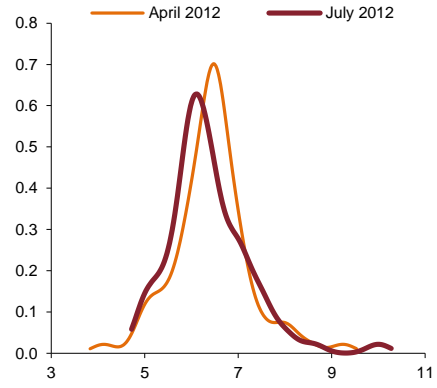


Chart 3.2.4.
Distribution of 24-Month Ahead Inflation Expectations*



* Horizontal axis depicts inflation rates, while the vertical axis indicates the Kernel forecast. CBRT Survey of Expectations, second survey period results. Source: CBRT.

Box
3.1

Seasonal Products in CPI and Unpredicted Volatility

This Box discusses the sources and the size of volatility caused by seasonal products in the consumer price index. First, strong seasonality, the fundamental feature which differentiates the prices of seasonal products from other prices is displayed. Consequently, the heterogeneous structure of the effect of strong seasonality across products to unpredicted volatility is presented along with the effect of seasonal irregularities to the measurement quality of the living cost. Lastly, the volatility caused by strong seasonality is discussed with respect to its monetary policy implications in the context of inflation-targeting regime.²

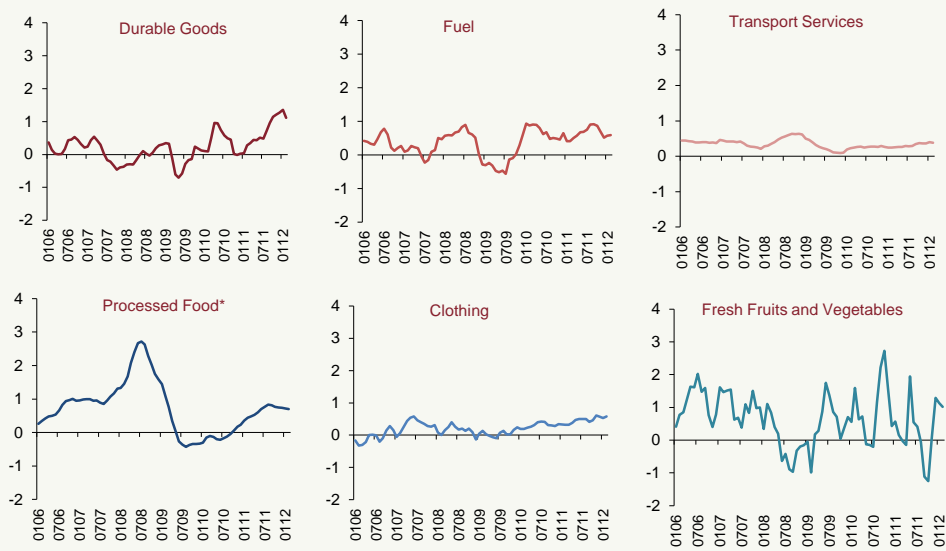
Prices of many products may not display strong seasonality. The price changes in these products are mostly determined by cost factors independent from seasonal effects. Hence, price volatility in these products is higher only in times of cost shocks and prices are stable at other times. On the other hand, the effect of seasonality on price volatility is more apparent and regular in some products. These products which are available only in certain times of the year, with their prices thus being determined according to seasonal conditions, feature strong seasonality. For example, tomato which is available throughout the year has a seasonal price pattern, whereas peach which is available only in summer is classified as a product featuring strong seasonality. Therefore, products with strong seasonality may be included in price indices only in certain months of the year.

A structural difference exists between products with strong seasonality and others in terms of price volatility. Price shocks to products with non-seasonal pattern are caused by changes in input prices or demand, while prices of products with strong seasonality are affected mostly by weather conditions. Price changes in other products are less frequent while products with strong seasonality are subject to sudden price increases or decreases which are reversed in few weeks (Özmen and Sevinç, 2011). However, this should not be interpreted that prices of products with strong seasonality are not determined by supply and demand conditions. On contrary, an additional volatility other than implied by fundamental economic behavior is created when these products are included in the price index by ignoring their structural features. Hence, taking into account of the irregular price movements in products with strong seasonality is critical in order for an accurate analysis of price movements. In this respect, it should be underlined that rather than analyzing prices which exhibit seasonal patterns, this study tackles with a special form of seasonality which causes excessive price volatility and hence measurement bias.

² The analysis is based on Atuk, Özmen and Sevinç (2012).

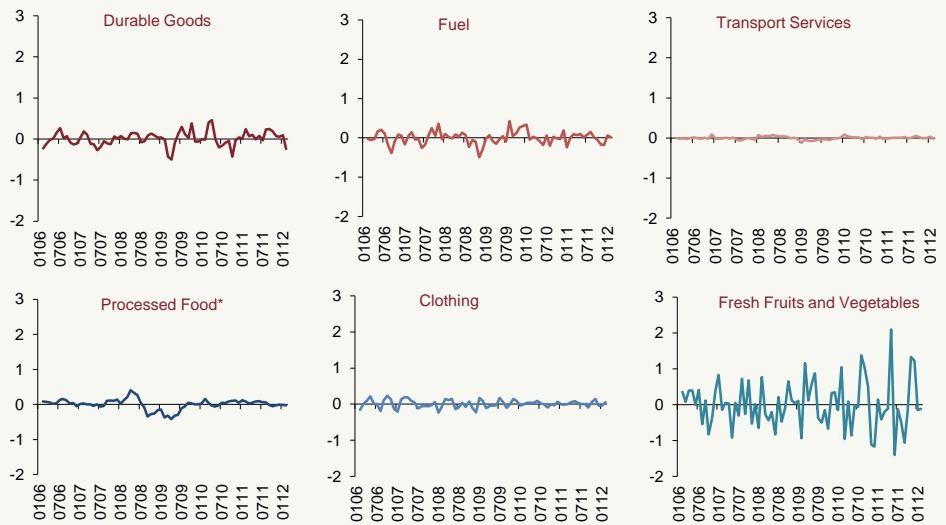
This study concentrates on the prices of clothing as well as fresh fruits and vegetables, which are strongly seasonal products. In order to evaluate the size and the course of price volatility caused by strong seasonality rather than other factors; durable goods, fuel, transport services and processed food which are comparable to strongly seasonal products in terms of their weights in the consumption basket are selected for comparison. Comparisons are based on the contributions to annual inflation. Accordingly, periodic and net monthly contributions of the selected groups to annual inflation are displayed in Charts 1 and 2.

Chart 1. Contributions of the Selected Groups to Annual Inflation (Percentage Point)



* Processed food includes bread, cereals, fats and oils.
Source: TurkStat, CBRT.

Chart 2. Net Monthly Contributions of the Selected Groups to Annual Inflation (Percentage Point)



* Processed food includes bread, cereals, fats and oils.
Source: TurkStat, CBRT.

Chart 1 displays that contributions to annual inflation change over time depending on sectoral characteristics. Durable goods and fuels, products with no strong seasonality, have both high imported input content, whereas processed food, despite having low import dependence, may be subject to international price shocks (Başkaya, Gürgür and Öğünç, 2008). Thus, the time-varying nature of the contributions of these groups to annual inflation can be attributed to international price changes and exchange rate developments. On the other hand, the relatively competitive transport services, with a low input price to final price ratio, may occasionally be affected adversely from fuel price hikes, yet provide the most stable contribution to annual inflation among selected groups.³

As for the products with strong seasonality, there is a notable difference in terms of their contribution to annual inflation. The contribution of clothing, which has highly volatile prices due to strong seasonality, to annual inflation is low. On the other hand, fresh fruits and vegetables have the most volatile contribution to inflation. This difference points to the fact that strong seasonality may not solely suffice to explain excessive variation in inflation.

The differing of product groups with strong seasonality is caused by sectoral differences in market structures. The high number of firms in the clothing sector as well as pre-season production enables accumulation of inventories, and thus making it possible to counterbalance potential demand shocks by supply. On the other hand, fresh fruits and vegetables are produced seasonally, thus causing a possible supply shock to drive prices higher. Hence, due to this sectoral structure, strong seasonality may lead to excessive inflation volatility only in fresh fruits and vegetables sector.⁴

Compared to other groups, the contribution of fresh fruits and vegetables to annual inflation is relatively high in terms of both the size and the volatility. The structural difference of the price volatility in fresh fruits and vegetables is remarkable in terms of the changes in contributions. The monthly change in contributions to annual inflation may be interpreted as the net contribution in the relevant month (Atuk and Sevinç, 2012). The analysis of the net monthly contributions displays that the contributions to annual inflation is limited except for fresh fruits and vegetables. On the other hand, the contribution of fresh fruit and vegetable prices to annual inflation may change by 2 percentage points from one month to the other.

³ For details on the definition of contributions, see Atuk, Özmen and Sevinç (2012).

⁴ For further discussion, see Atuk, Özmen and Sevinç (2012).

This fundamental analysis sheds light on how the structure and the extent of consumer price volatility differ by various product groups. Strong seasonality affects consumer prices depending on the sectoral structure. Hence, fresh fruit and vegetable prices exert a notable and unpredictable volatility on the CPI even beyond the seasonal pattern.

Strongly seasonal products like clothing do not affect annual consumer inflation adversely when their prices display a predictable seasonal pattern (prices change at similar rates in the same period of each year). Thus, a stable monthly course of prices points to a stable path for consumption weights, indicating that past weights might be valid also in the future. On the other hand, when the strong seasonality displays an irregular pattern like in fresh fruits and vegetables (especially in the month of entry to the index), the assumption of constant weight for consumption of such products is highly unrealistic. The assumption of constant consumption weight at the current year of the high price level leads to dispersing of high price volatility to CPI when weight is measured according to previous year prices. Thus, consumption weight measured by historical seasonal averages, like variable weights, ignores the fact that consumers may adjust their consumption against short-lived and excessive price changes. Under current circumstances, due to the absence of real-time data on the consumer prices reflecting information on both quantity as well as the price, assumptions on consumption weights are critical in indexing strongly seasonal products for a better measurement of the cost of living.

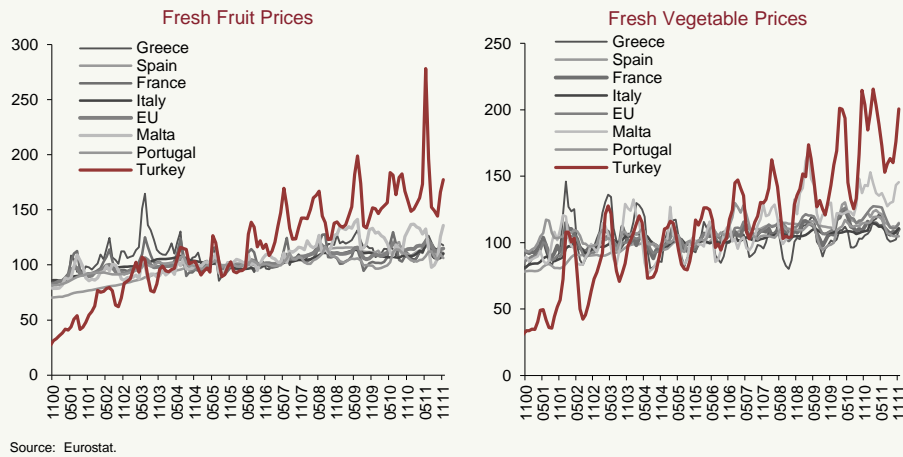
Inflation reflects the movements of the general price level in the economy. Regular and high volatility due to strong seasonality in the prices of fresh fruit and vegetables directly affects the information content of the price index regarding the general price level. The unpredictable nature of this volatility has some monetary policy implications. First, more frequent emphasis on core indicators is needed for communicating the monetary policy. Second, the unpredictable nature of seasonal irregularities caused by random weather conditions constitutes a high risk for an inflation-targeting central bank, thus necessitating a wider band of uncertainty around the inflation target. Third is the uncertainty created by intertemporal differences in adjustments to contracts due to indexation in the economy.

The country-specific nature of these risks may place an even heavier burden on the monetary policy as well as its communication. Chart 3 depicts that fresh fruit and vegetable prices in Turkey differ not only from the EU countries in general, but also from the Mediterranean countries with similar weather conditions.⁵

⁵ This finding is previously presented in Öğünç (2010).

Monetary policy stance against shocks like exchange rate and commodity price movements, which notably affect inflation volatility and are also felt across peer countries, can be more effectively communicated. However, given its low sensitivity to monetary policy, the relatively higher incidence of the country-specific food price shock in Turkey may adversely affect expectations by implying a higher uncertainty of inflation relative to other countries.

Chart 3. Fresh Fruit and Vegetable Prices in EU
(Harmonized Index of Consumer Prices, 2005=100)



Source: Eurostat.

In sum, the analysis of the prices in clothing as well as fresh fruits and vegetables depicts that strong seasonality does not solely determine the excessive volatility of annual inflation. When sectoral features are considered, strong seasonality leads to high volatility of inflation only through fresh fruits and vegetables prices. The different nature of fresh fruits and vegetables prices in Turkey compared to even similar countries signifies the need to account for this apparent difference in price volatility while developing methods for inclusion of seasonal products to the consumer price index.

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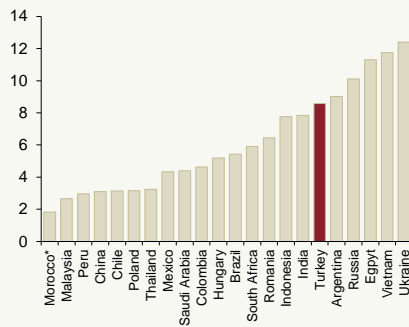
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Box
3.2

High Course of Inflation in Turkey by Prominent Subcategories

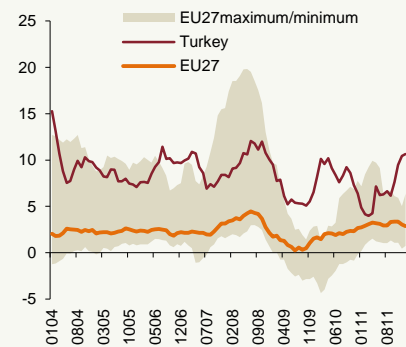
Despite having reached single-digits in 2000s, Turkey's inflation is still high compared to emerging countries. Annual inflation in selected emerging countries averaged 6 percent during 2004-2011, while average annual inflation in Turkey was 8.6 percent in the same period (Chart 1). As for the convergence of Turkey to EU, the comparison of consumer inflation in Turkey to EU countries over time reveals that Turkey's inflation hovered near or above the highest inflation rate in EU (Chart 2). This Box analyses the high course of inflation in Turkey by subcategories and presents findings on some factors that cause this high course.⁶

Chart 1. Average Inflation in Emerging Countries during 2004-2011*
(Annual Percent Change)



* The average inflation for Morocco is measured between 2004 and 2010.
Source: Bloomberg.

Chart 2. Inflation in Turkey and EU-27*
(Annual Percent Change)



* The lowest and the highest monthly frequency of inflation in EU27.
Source: Eurostat.

Both domestic as well as international relative price movements (with respect to EU) are analyzed in order to determine the subcategories of inflation that cause a high course in headline inflation (Chart 3). The reason for analyzing international relative price movements is the possibility that subcategories with a domestic price hike may in fact follow a similar course internationally. In that case, rather than being structural, a domestic price change in a subcategory may be due to an external factor. The ratio of the price of a subcategory to the general price index denotes the domestic relative price, while the ratio of the price of a subcategory to the EU price of the relevant subcategory shows the international relative price. In order to avoid possible divergences with respect to measurement and subcategory definitions, comparisons are based on Harmonized Index of Consumer Prices (HICP) instead of CPI. A subcategory is placed on the upper right hand corner in Chart 3 as its price increases relatively higher

⁶ For further analysis and discussion, see Başer, Kösem and Öğünç (2012).

compared to both general prices as well as the relevant international prices, hence indicating that this sector, also depending on its share of consumption, may be effective on the high course of inflation in Turkey.

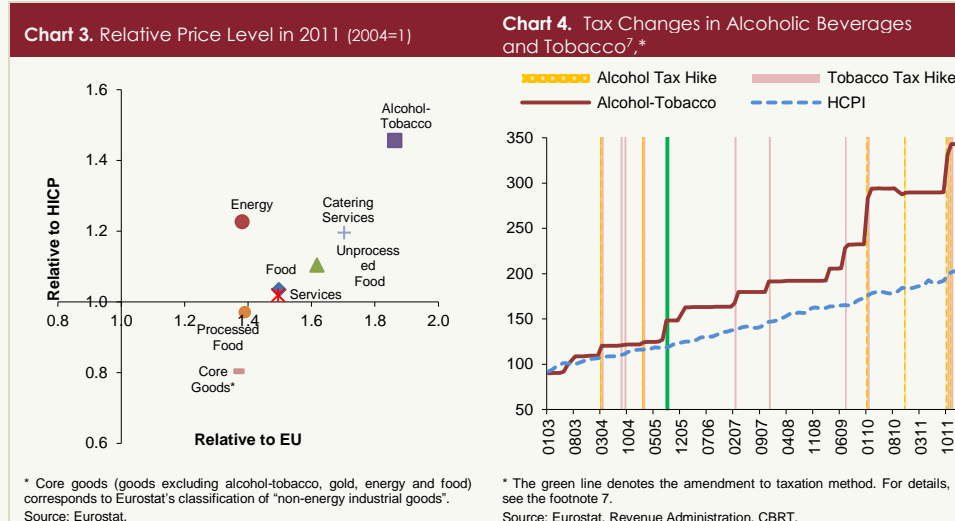


Chart 3 displays that the fastest price hikes relative to HICP inflation occurred in alcoholic beverages and tobacco, energy and catering services as of 2011. Meanwhile, the prices of food and services have not notably diverged from the general price index and increases in core goods prices have been lower relative to general prices. Prices increased faster than EU across all subcategories in the said period, while price increases in energy, processed food and core goods have lagged behind the other sectors. A detailed analysis of subcategories depicts a heterogeneous structure in the subcategories of services, with the prices of catering services increasing rapidly relative to both the general price level and the EU. In this respect, subcategories with remarkable price increases compared to the domestic general prices as well as international sectoral prices are **alcoholic beverages and tobacco products, unprocessed food and catering services**. The first two of these subcategories draws the attention to administered prices, whereas the other two signifies the role of agriculture and livestock policies, thus demonstrating the importance of developing public policies with a medium to long-term perspective.

⁷ Proportional and fixed SCT rates were amended by the decision of the Council of Ministers No. 2004/7674 of August 9, 2004. Accordingly, the proportional SCT rate was lowered from 55.3 percent to 28 percent and fixed tax on cigarettes was determined according to oriental tobacco content. However, this regulation was abolished on July 28, 2005 by the decision of the Council of Ministers No. 2005/9145 of July 25, 2005 and fixed tax was introduced per unit. The proportional SCT rate was raised from 28 percent to 58 percent in this period and payment of proportional tax was decided upon, which is to be calculated over 58 percent provided that it will not be less than the fixed tax per pack. This amendment, which was put into effect as of July 28, 2005 and is currently in effect, is denoted by the vertical green line in Chart 4.

Observations and Evaluations on the Leading Subcategories

(i) Prices of Alcoholic Beverages and Tobacco Products: Tax rates in Turkey vary frequently for alcoholic beverages and tobacco. Hence, this subcategory is crucial for analyzing the fiscal policy and inflation relationship. In recent years, adopted measures to raise tax revenues are led by SCT rate adjustments to alcoholic beverages and tobacco products, which adversely affected the consumer inflation (Chart 4). More specifically, alcoholic beverages and tobacco products added 1.31 and 1.09 points to inflation in 2010 and 2011, respectively; with these contributions comprising a nearly 20 percent of the inflation target in the relevant year. In this respect, a tax adjustment especially to tobacco products is critical in terms of its inflationary effects.

(ii) Energy Prices: The international dependence of Turkey especially on oil and natural gas causes sensitivity to international prices and exchange rate developments as well. The raising USD-denominated prices of oil and natural gas and the high pass-through from exchange rate to domestic energy prices in the context of automatic pricing mechanism stand out as a factor to account for the high course of inflation in the analyzed period.

The energy group is also a significant revenue source for the budget. Taxes in Turkey comprise an important share of fuel prices with tax rates being adjusted upwards in general.⁸ In fact, in international comparisons, Turkey ranks among the highest with Norway in the USD-denominated price of fuel per liter (IEA, 2012).⁹ However, it is noteworthy that as of the last quarter of 2011, Turkey also ranks the highest in the before-tax price of fuel (unleaded gasoline) per liter (IEA, 2012). This points to the significance of the tax burden on fuel in addition to the steps in supply chain and the pricing behavior.¹⁰

Lastly, another factor to explain the energy price developments is the sectoral competitiveness. The completion of planned privatization in energy sector, which is dominated by public enterprises, and thus to bring in relative sectoral competitiveness is crucial with respect to enhancing the domestic energy production and its effectiveness.

⁸ Turkey ranks among the middle among OECD countries in terms of the proportion of taxes in electricity and natural gas prices for household consumers (IEA, 2012).

⁹ Comparisons are based on regular unleaded gasoline prices for Australia, Canada, South Korea, Japan, Mexico, New Zealand and US, while for other OECD countries, 95-octane grading unleaded gasoline prices are used.

¹⁰ IEA (2010) states that the distribution margin measured as the spread between non-tax fuel price and CIF (cost, insurance and freight) import price is twice the EU average in Turkey.

iii) Food Prices: Another significant sector causing high course of inflation is the food sector with the developments in unprocessed food prices, fresh fruits and vegetables standing out in particular. IMF (2011) mentions that Turkey's imports of unprocessed food products are limited compared to its exports, and hence Turkey does not benefit from international trade in smoothing out domestic prices. The study also criticizes the protection of farmers by levying high import duties and strict quotas. In addition to import protection, OECD (2011) also mentions low agricultural productivity and slow increases in productivity. According to WTO (2012), prices of agricultural products in Turkey hover above world prices due to these mentioned effects. In general, all of the above-mentioned studies conclude that domestic competitiveness should be enhanced in agriculture and food sectors.

(iv) Prices of Catering Services: Parallel to the rising per capita income, the share of catering services in the consumer price index increased from 2.8 percent in 1994 to 3.3 percent in 2003 and 5.3 percent during 2007-2012. This fact also gives rises to the possibility that price increases may also be related to changes in consumption.

The analysis of input-output table for 2002 in catering services for understanding the cost structure shows that the share of food and agricultural products is the highest among inputs with 52 percent. In this respect, food price increases are heavily felt also in the prices of catering services. Minimum wage developments stand out as another factor to affect the course of prices given the 15 percent share of payments to employees as well as the structure of the labor force employed in the sector. Other important cost factors are electricity, energy, rent and payments to financial intermediaries. This signifies the role of structural regulations, some of which are also mentioned above, in sectors which are input to catering services.

In sum, country-specific structural factors are significant for the high course of inflation in Turkey. Taxing policies in the alcoholic beverages and tobacco products, international dependence and the competitiveness of the energy sector in addition to taxing, production and distribution chain of the fuel products as well as the competitiveness and low productivity of agricultural products and food stand out.

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4. Supply and Demand Developments

National accounts data for the first quarter of 2012 remained broadly consistent with the outlook presented in the April Inflation Report. Domestic demand increased modestly, while net external demand provided a higher-than-envisaged contribution to annual growth, indicating that the economy was balanced further at a robust pace. Despite the quarterly decline in national income, this contraction does not reflect the underlying trend of economic activity due to temporary factors like external uncertainties and adverse weather conditions.

In fact, indicators for the second quarter of 2012 confirmed our projections that the unfavorable course in the first quarter did not tend to be permanent and economy would revert back into a mild growth path in the subsequent period. The quarterly robust increase in industrial production in the April-May period pointed to a fast rebound in economic activity following the contraction in the first quarter. This recovery is believed to also include the compensation for the negative first quarter, therefore the underlying trend of economic activity is mild despite the robust rebound (Box 4.1).

In the inter-reporting period, problems in the European economies, especially in Greece and Spain, weighed on perceptions about uncertainty and economic activity, while the labor market and the economic activity in China and the US remained weak with respect to the global growth outlook. Signals for a slowdown in economic activity spilled over globally especially in May and June, constituting a downside risk on the external demand outlook for the second quarter of the year.

Despite these mentioned problems, exports have exhibited a stronger underlying trend since the second quarter of 2011 compared to the pre-crisis period. This indicates that cumulative effects of the balancing policies have been manifested and also the market diversification is on a successful path. In fact, the economy was balanced further in the second quarter at a stronger pace, which in turn bolstered macroeconomic fundamentals and perceptions regarding the Turkish economy. Notwithstanding the recent worsening in expectations for orders in the manufacturing industry and sales in the retail sector, indicators of medium to long-term expectations like employment and

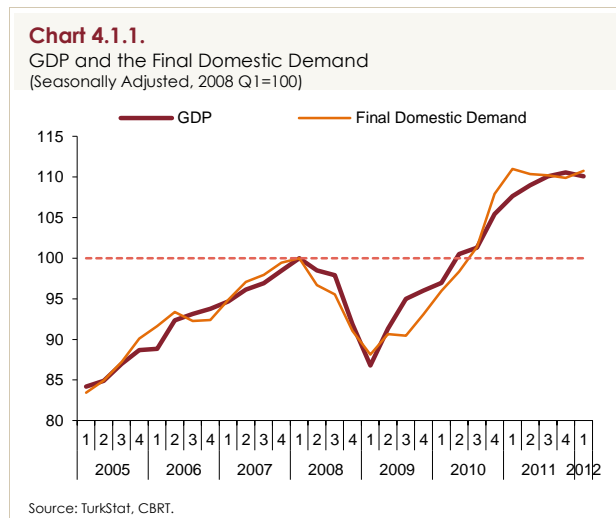
investment plans and consumer confidence did not record a significant deterioration signaling for an improvement of growth in the forthcoming period.

Accordingly, it is projected that the mild course of growth will be maintained in the second quarter of 2012 and aggregate demand will continue to support disinflation. Meanwhile, the improvement in the current account balance is expected to continue, albeit at a slower pace.

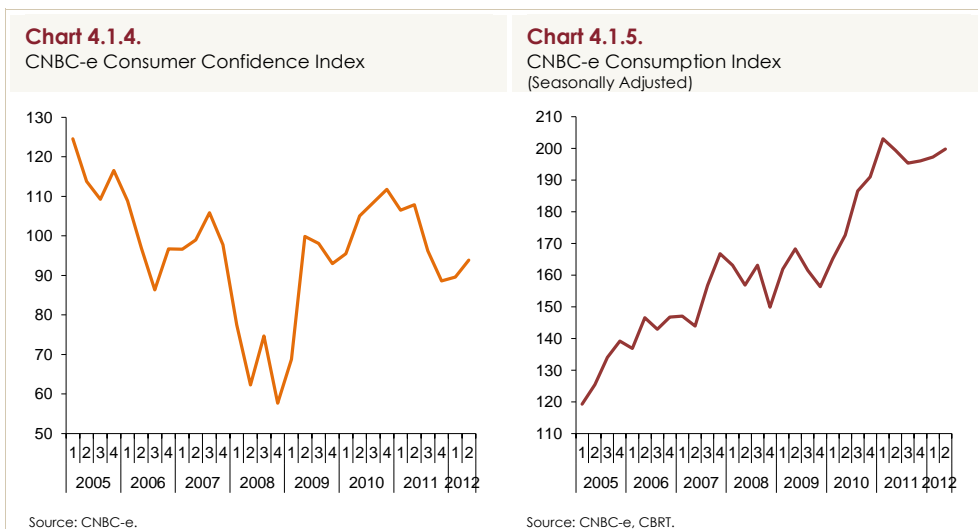
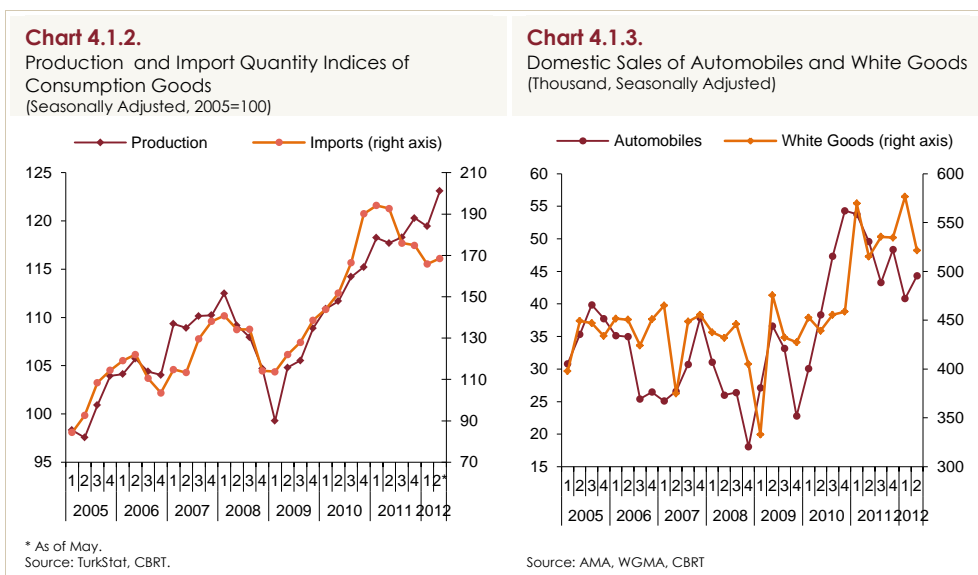
4.1. Gross Domestic Product Developments and Domestic Demand

National accounts data released by TurkStat indicate that GDP posted a year-on-year increase by 3.2 percent in the first quarter of 2012. Demand components were balanced further in the last quarter, with the net external demand providing a larger contribution to annual growth. The main drivers of domestic demand were public consumption and private investment.

Seasonally adjusted data indicate that the GDP recorded a quarterly decrease by 0.4 percent in the first quarter. Thus, having risen in the process of exit from the crisis, the GDP posted a decline on a quarterly basis for the first time since the first quarter of 2009. Demand components remained consistent with the outlook presented in the April Inflation Report. Quarterly growth was mainly fuelled by public expenditures and private investments, while the domestic demand recorded a slight increase (Chart 4.1.1).

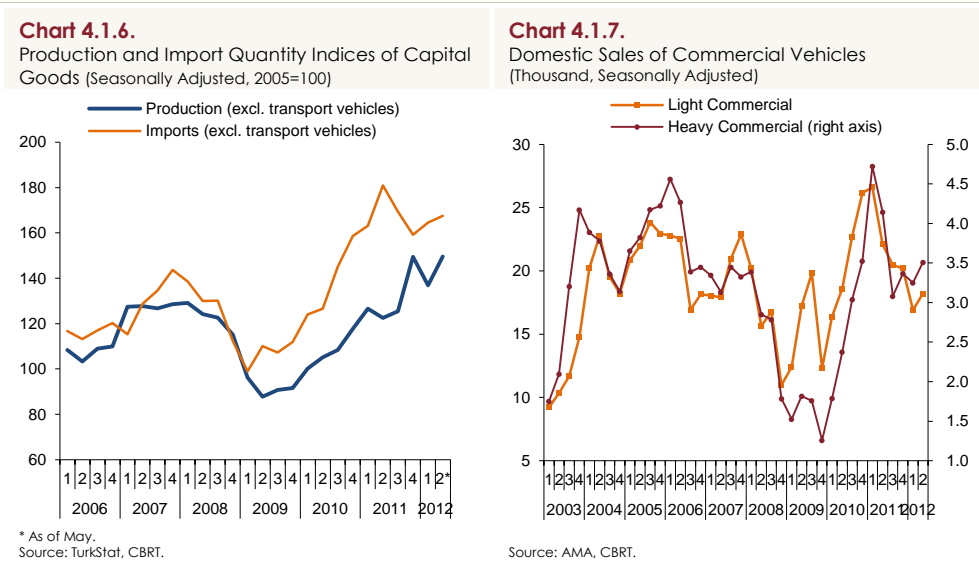


Second-quarter data point that the mild increase in final domestic demand will be sustained. Production of consumption goods, indicative of the private consumption demand, went up in the April-May period (Chart 4.1.2). Despite an increase in the second quarter, domestic sales of automobiles still fall short of the figures in the last quarter of 2011. Meanwhile, sales of white goods saw a decline (Chart 4.1.3). Although lagging behind 2011 levels, consumption and consumer confidence indices posted a quarterly rise in the second quarter (Charts 4.1.4 and 4.1.5).

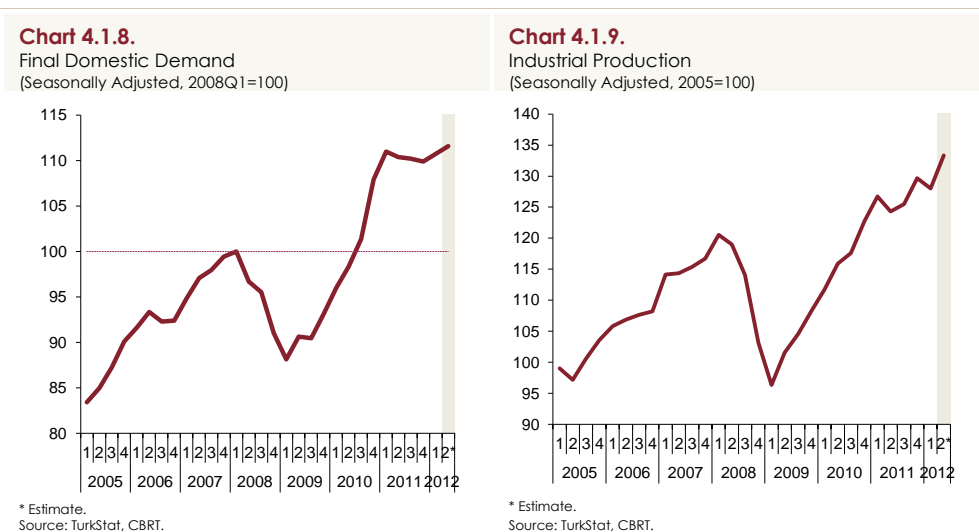


Recent indicators display an increase in investment demand as well as consumption demand in the second quarter. Both production and imports of

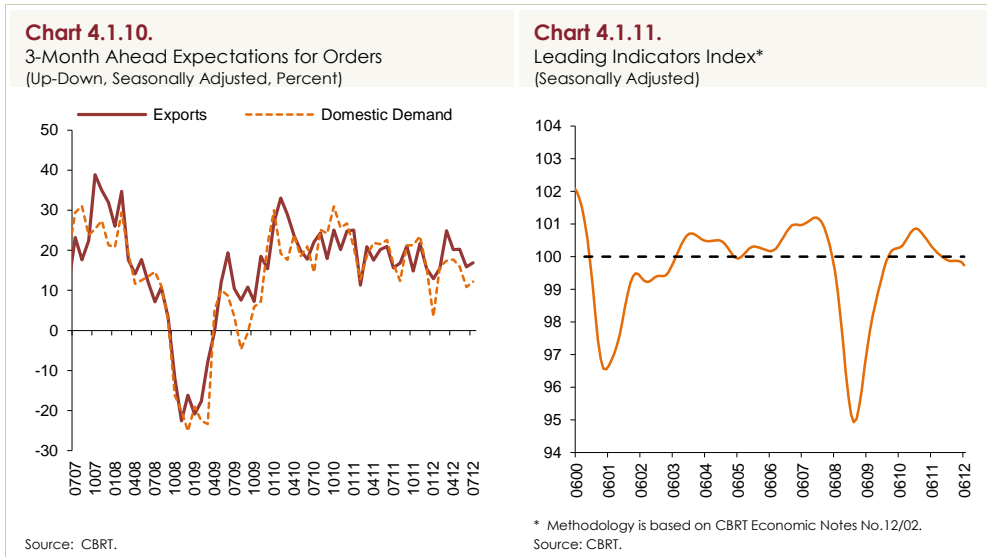
capital goods trended upwards in the April-May period (Chart 4.1.6). Similarly, domestic sales of light and heavy commercial vehicles accelerated in the second quarter (Chart 4.1.7).



In sum, the second-quarter indicators show that domestic demand continues to increase modestly (Chart 4.1.8). The course of recovery in the economy is also supported by production indicators. In fact, following the slump in January amid adverse weather conditions and external uncertainties, industrial production has increased in four consecutive months by May. This stable upward course reflects the mild course of the economic activity and also entails the compensation for the first quarter (Chart 4.1.9).

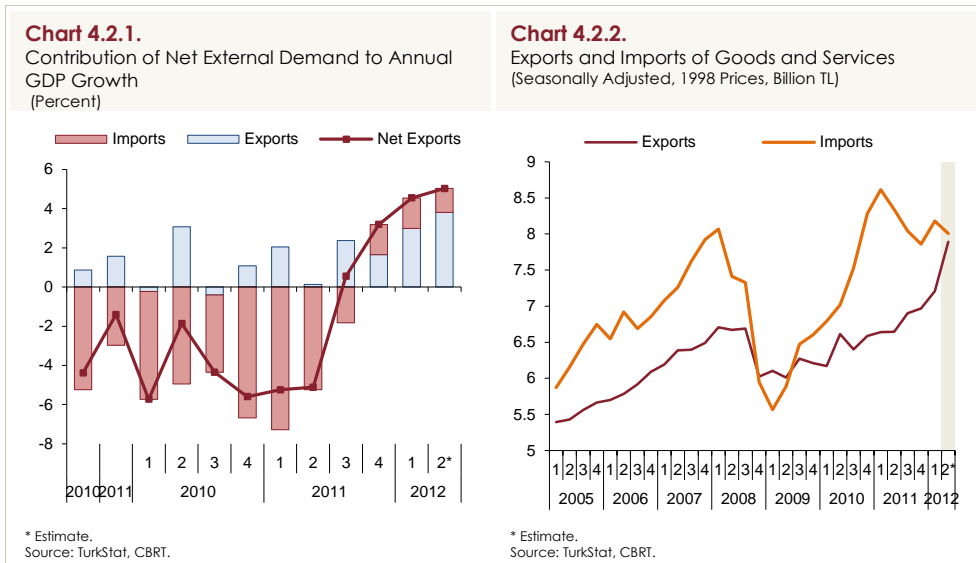


Indicators suggest a rise in the economic activity in the second quarter, while recently-elevated uncertainties regarding the global economy and the financial markets deteriorated expectations as suggested by the surveys. 3-month ahead expectations for orders on domestic and foreign market released by the BTS attenuated in the May-June period, but edged up in July (Chart 4.1.10). Meanwhile, expectations for orders for the next quarter improved and the composite leading indicators, which went up in the first quarter, decreased in the second quarter, implying elevated uncertainties regarding the growth outlook in the second quarter (Chart 4.1.11).



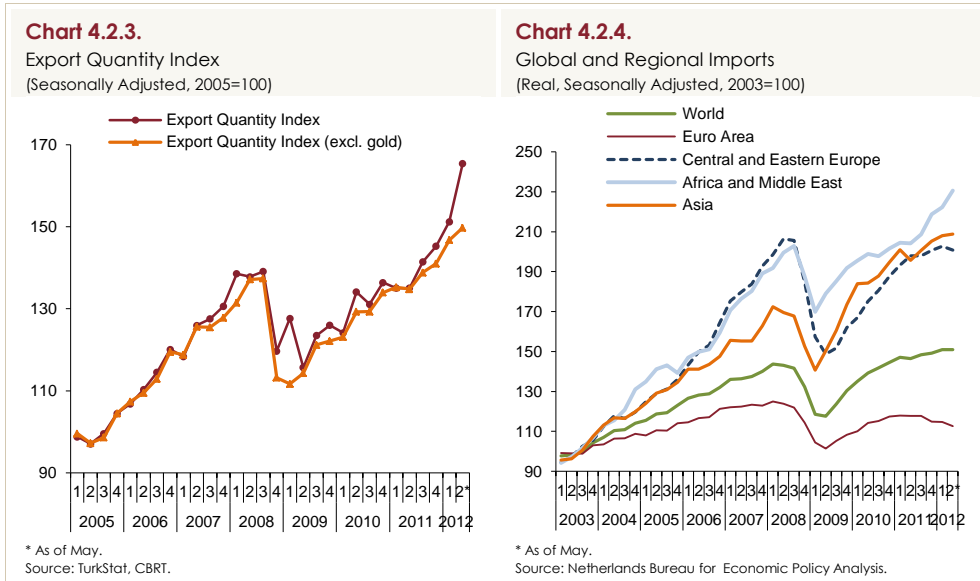
4.2. External Demand

National accounts data for the first quarter of 2012 point to a stronger balancing in demand components. Exports of goods and services posted a year-on-year increase by 13.2 percent, while imports contracted by 5.0 percent in the first quarter. Thus, net external demand provided the largest contribution to growth due to the positive contribution of both exports and imports (Chart 4.2.1). Seasonally adjusted data on the exports of goods and services have gained a remarkable momentum for the last three quarters despite the lingering problems at a global scale. As for the imports, an increase was recorded in the first quarter of 2012 following a consecutive decline for three quarters (Chart 4.2.2).

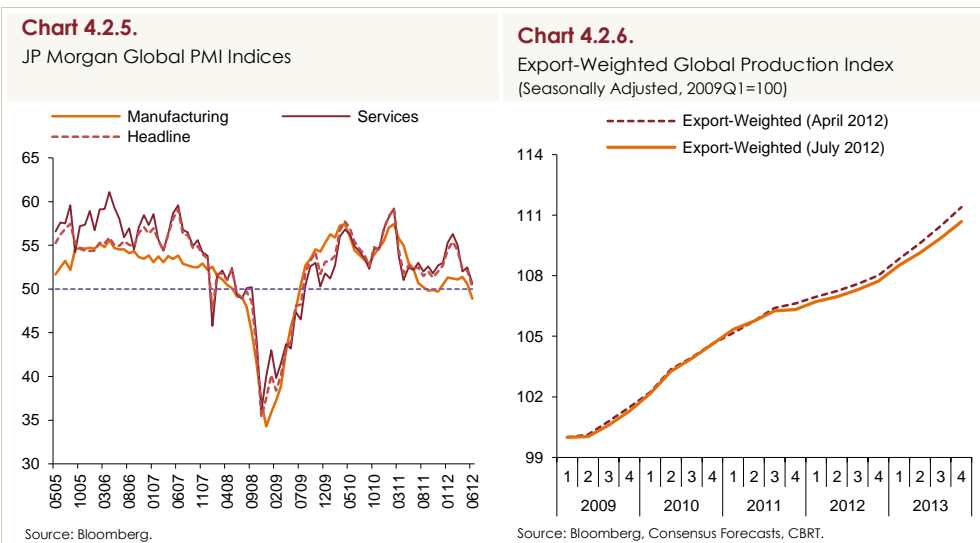


Despite aggravating global problems, the favorable course of exports is noteworthy. In fact, due to the accelerated exports of gold, the exports quantity index, which entails exports of goods, surged by 9.4 percent quarter-on-quarter in the April-May period converging to levels implied by the pre-crisis trend (Chart 4.2.3). Across 2011, gold exports, which realized as USD 1.5 billion, went beyond USD 4 billion in the first five months of 2012. This was believed to be temporary, necessitating the exclusion of gold exports to track the underlying trend of exports. The core index excluding gold exports posted a limited increase compared to exports overall. Accordingly, the underlying trend of exports exhibits a mild growth path.

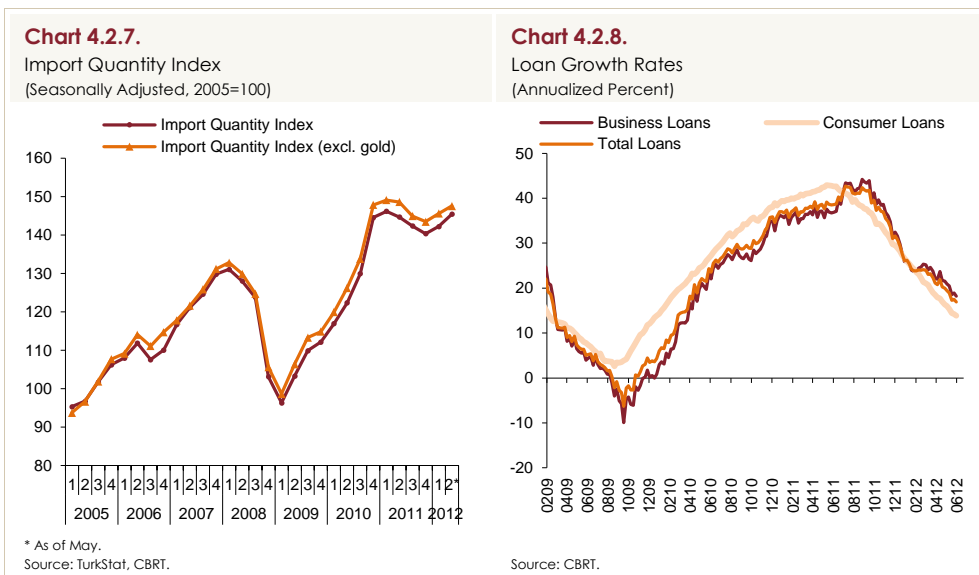
The course of global import demand continues to constitute a significant risk factor on exports. Across regions, the import demand of the Euro Area, one of our major trading partners, remains weak. The almost flat course of demand from Asia, which was on the increase in the previous quarter as well as the weakening import demand in the Central and Eastern Europe are worth noting. On the other hand, the improvement in Africa and the Middle East continues to support export demand (Chart 4.2.4, Box 4.2).



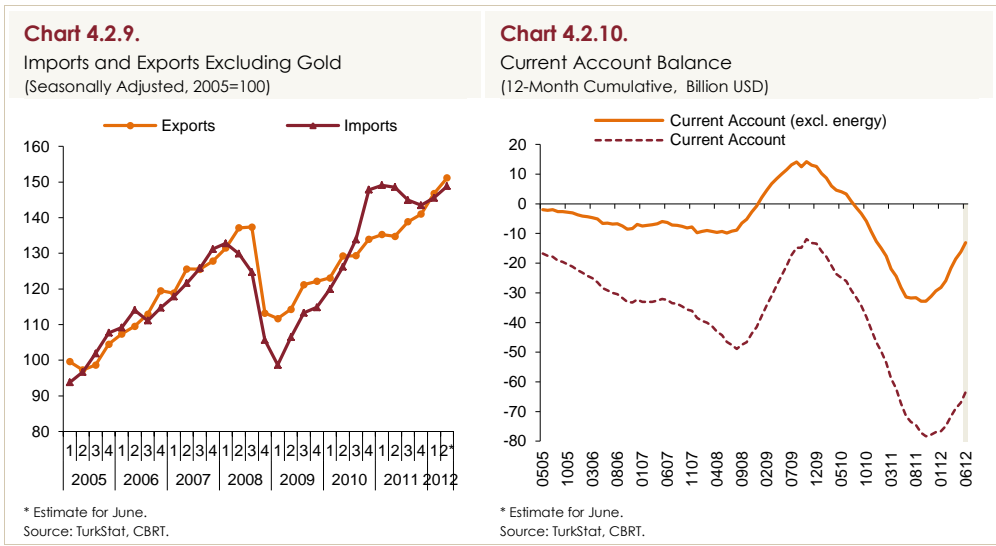
Other short and medium-term indicators of exports point to an adverse outlook in external markets. Global PMI for the manufacturing industry went below 50 in June, recording the lowest level for the last 3 years. On the other hand, services index has almost become neutral (Chart 4.2.5). Emerging economies, which are the drivers of the exit from the crisis, signaled for a slowdown, depicting a worse outlook for external demand. In fact, export-weighted global production index exhibits a weaker growth path compared to the previous reporting period (Chart 4.2.6).



Following the first quarter of 2012, import quantity index displayed a modest increase in the April-May period. Nevertheless, quantity of imports remained below the peak value in the first quarter of 2011. The recent surge in gold exports and coverage of a great part of exports by imports leads to a rise in gold imports. The index that excludes gold to better interpret the underlying trend of imports posted a milder increase in the April-May period compared to aggregate imports (Chart 4.2.7). In addition to the modest course of domestic demand, the deceleration in loans also continues to restrict imports (Chart 4.2.8).

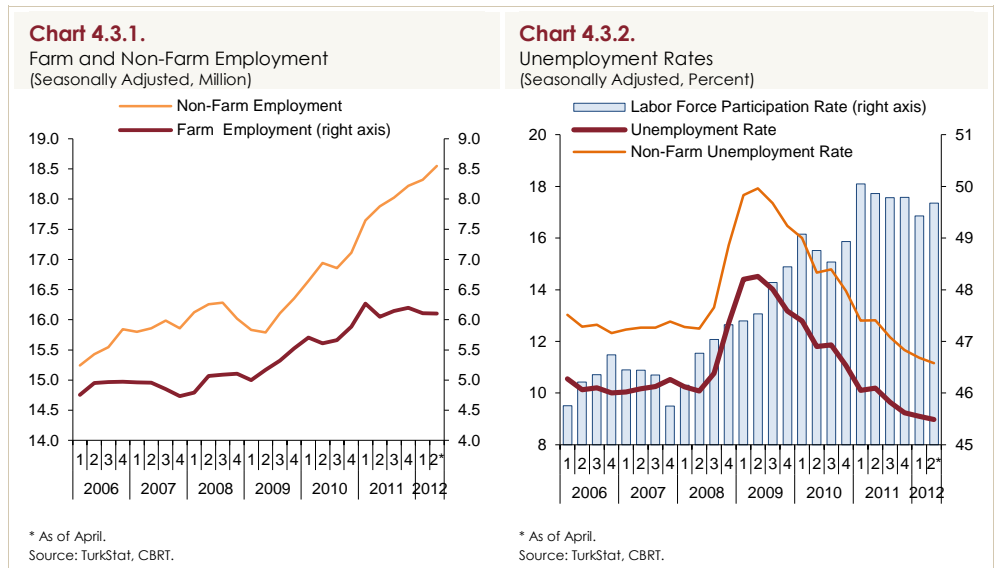


In sum, recent indicators suggest that net external demand continued to fuel annual growth in the second quarter (Chart 4.2.1). Although quantity indices excluding gold point that the real balancing process lost pace in this period (Chart 4.2.9), forecasts on exports and imports value added of aggregate goods and services suggest that the balancing is going on (Chart 4.2.2). Accordingly, the correction in the 12-month cumulative current account deficit still continues (Chart 4.2.10). In order to bring current account deficit to desired levels in the long term, domestic savings need to be increased, and structural measures need to be taken accordingly.

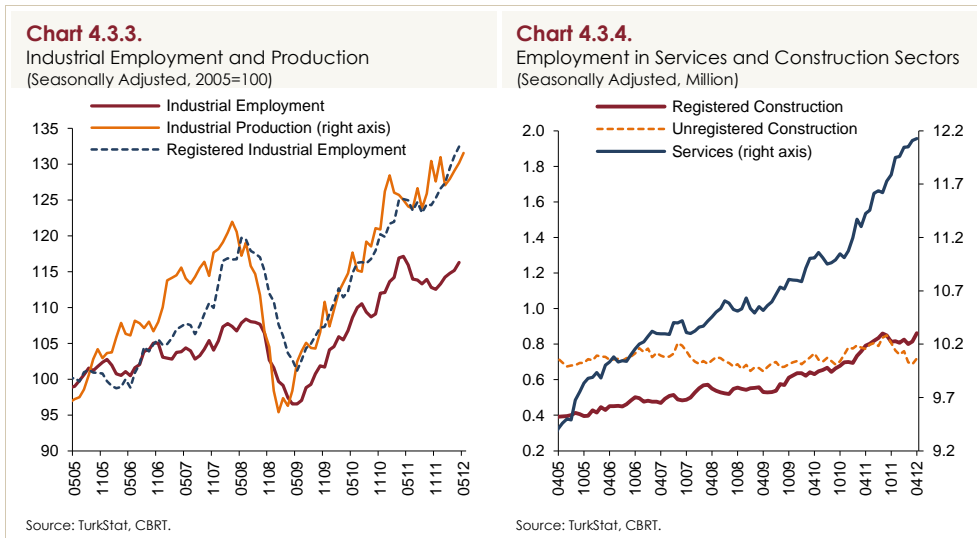


4.3. Labor Market

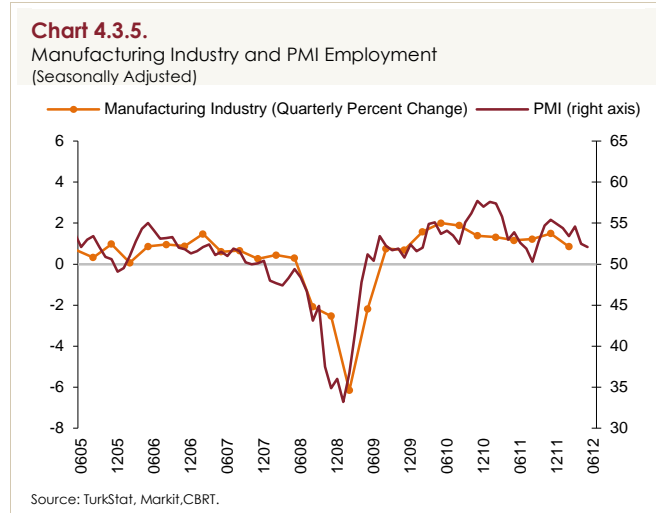
Due to the weak course of labor force participation, unemployment rate went slightly downwards in the first quarter of 2012. In April 2012, being fuelled by all sectors, non-farm employment trended upwards. In this period, farm employment and labor participation rates edged up, while seasonally adjusted total and non-farm unemployment rates posted quarterly decreases by 0.1 and 0,2 percentage points and stood at 9 and 11.2 percent, respectively (Charts 4.3.1 and 4.3.2).



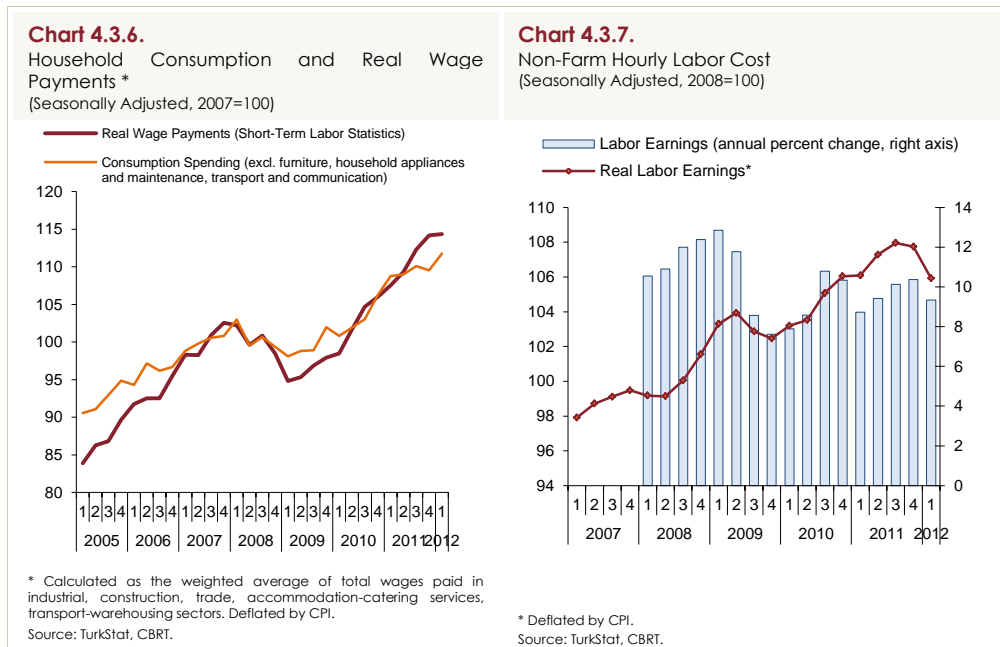
In the first quarter of 2012, industrial employment rose by 2 percent on a quarterly basis (Chart 4.3.3), whereas the construction sector experienced losses in employment. However employment in the construction sector, which has been weak since September 2011, edged up in March, and surged in April, boosting optimism in expectations for the forthcoming period. As for the services sector, employment lost pace in this quarter. Even lower rates of increase in employment were seen in April (Chart 4.3.4). Accordingly, in the first quarter of 2012, seasonally adjusted non-farm employment was positively contributed by all sectors except for construction.



Notwithstanding the quarterly decline in industrial production in the first quarter of 2012, the level of index has maintained a mild increase for the last four months (Chart 4.3.3). Registered industrial employment continued to increase parallel to production developments, while unregistered employment decreased in April. Although declining slightly on a quarterly basis in the second quarter of 2012, PMI employment indicator does not suggest a negative outlook for the said period (Chart 4.3.5). In this respect, industrial employment is expected to edge up also in the second quarter; however, uncertainties regarding the global economic outlook may curb the improvement in production and employment conditions.

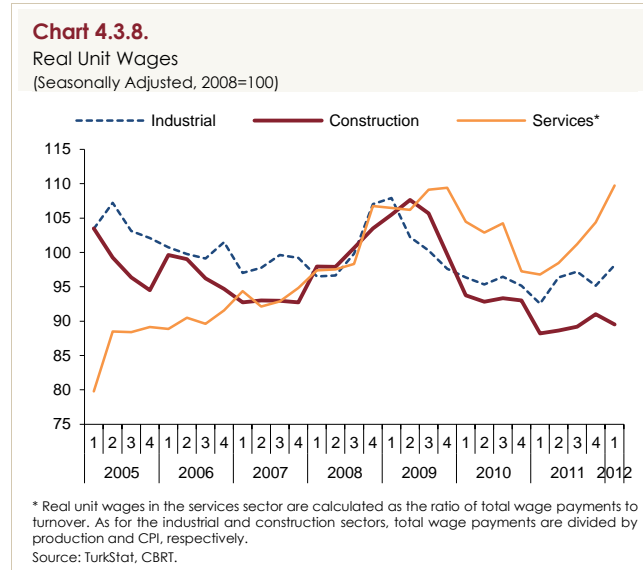


As per the domestic demand outlook, the labor market saw quarterly deceleration in real wage payments in the first quarter of 2012, yet spending especially on those groups sensitive to current income are still in place (Chart 4.3.6). Considering wages as a cost factor, in the first quarter of 2012, non-farm hourly real earnings index, which is released under Labor Cost Indices, displays a quarter-on-quarter decline (Chart 4.3.7).



Real unit wages that also include productivity increases posted a rise in the first quarter of 2012, excluding the construction sector (Chart 4.3.8). The slowdown in economic growth rate in this period gave way to productivity

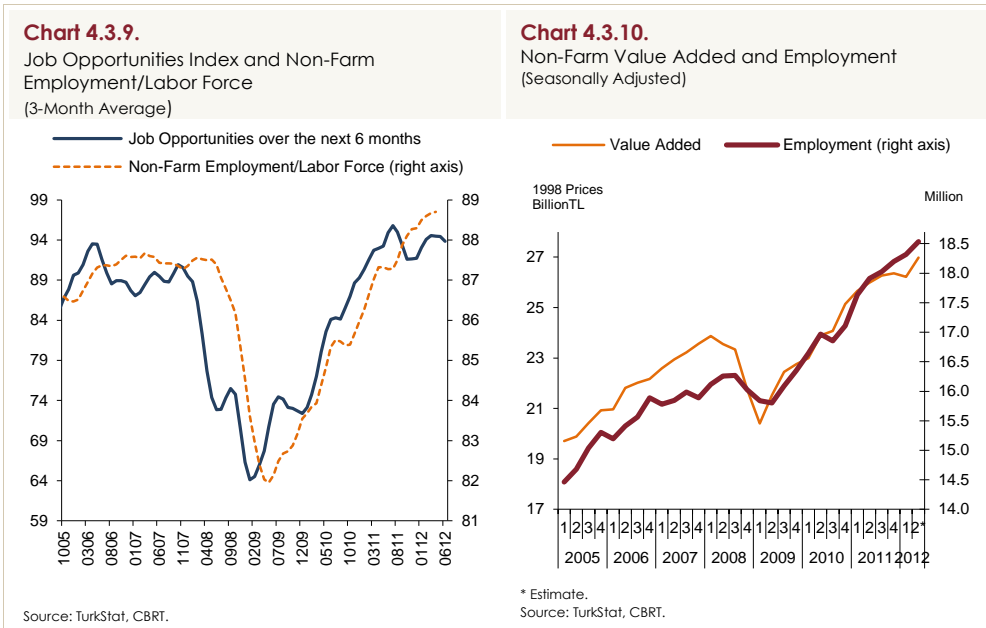
losses in non-farm sectors. Furthermore, in the first quarter, real wages per hour worked remained unchanged on a quarterly basis. Due to the mentioned reasons, real unit wages saw a noticeable increase both in the industrial sector and trade-services sector in this period. The rise in real unit wages in the services sector is considered to be a risk factor for the prices of services.



Recent increases in minimum wages besides the arrangements on civil servants' salaries are thought to entail information on increases in salaries and wages in the private sector as well as the disposable income. Gross minimum wage for those older than 16 was estimated to be TL 886.5 and TL 940.5 for the first and second halves of 2012, respectively. Thus, calculated by the current data, minimum wage increases in the first and second halves of the year are 11.3 and 12.4 percent year-on-year, respectively corresponding to a rise of 4.7 percent in real terms throughout 2012. Moreover, rate of increases in civil servants' salaries was determined to be 4 percent for both halves of 2012. Accordingly, the said increase is estimated to be 8.2 percent across 2012. These developments suggest real increases in disposable incomes of households.

In sum, in the first quarter of 2012, the increase in non-farm employment was mostly triggered by the industrial sector. In the meantime, construction employment declined, whereas the employment in the services sector edged up. Non-farm employment was fuelled by all sectors, and primarily the construction sector in April 2012. Second-quarter leading indicators show that the modest rise in industrial employment will be maintained. Moreover, the job opportunities index under the CBRT's Consumer Tendency Survey, which reflects

the employment prospects for households, also confirms a flat course in employment opportunities (Chart 4.3.9). Amid limited employment increases in all sectors in the second quarter of 2012, non-farm employment is estimated to continue with a modest course (Chart 4.3.10). Nevertheless, these developments should be interpreted without neglecting that the labor supply dynamics and uncertainties pertaining to the global economic outlook as well as employment have also been influential on unemployment in recent years (Box 4. 3).



Box
4.1

The Underlying Trend of Economic Activity in the Second Quarter

Evaluation of the underlying trend of economic activity is based on quarterly changes of seasonally adjusted figures rather than annual changes incorporating base effects. As for the national accounts data, a decrease (increase) in the quarterly growth rate is interpreted as a slowdown (speeding up) of the economic activity. However, depending on the sample size and model specification as well as the methodology and choice of direct or indirect approach, the results of the seasonal adjustment may change. Besides, seasonally adjusted data are subject to revisions with the inclusion of the new data (Table 1).¹ Thus, a clear evaluation of the underlying trend of economic activity becomes a challenging issue. To give an example, a 3 percent quarterly growth with a reasonable uncertainty band implies a strong economic activity. On the other hand, a 1-1.5 percent quarterly growth close to potential is critical in terms of the monetary policy reaction as the change in the output gap may have a different sign depending on the uncertainty band.

Table 1. Quarterly Growth Rates by Alternative Initial Point Specifications (Percent)

PERIOD	1998*	1998	1999	2000	2001	2002	2003	2004	2005
2010Q4	4.2	4.1	4.2	3.8	3.9	4.0	3.9	4.1	3.8
2011Q1	1.6	2.1	2.0	2.2	2.2	2.1	2.2	1.9	1.8
2011Q2	1.3	1.3	1.4	1.0	1.0	1.1	1.1	1.3	1.5
2011Q3	1.3	1.0	0.9	1.2	1.2	1.2	1.2	1.1	1.0
2011Q4	0.6	0.4	0.5	0.2	0.2	0.3	0.2	0.4	0.2
Average of 2011Q2, 2011Q3, 2011Q4	1.1	0.9	0.9	0.8	0.8	0.9	0.8	0.9	0.9
2012Q1	-	-0.4	-0.5	-0.3	-0.3	-0.3	-0.3	-0.6	-0.9
2012Q2**	-	2.0-2.4	-	-	-	-	-	-	-

* Calculated by real-time national accounts data announced for 2011Q4.

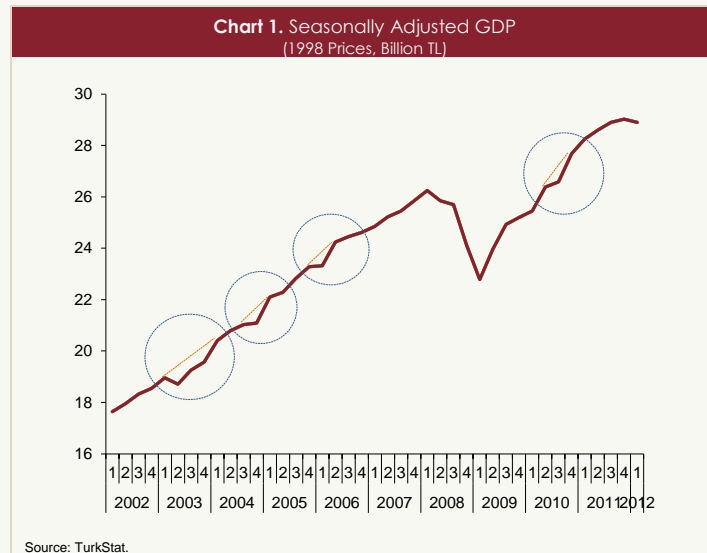
** Denotes growth rate range satisfying 2011Q2, 2011Q3 and 2011Q4 average. Thus, this answers the question of "in response to a temporary contraction in the first quarter of 2012, at what rate should the economy grow in the second quarter so that the economic activity compensates this loss and return back to its underlying trend?".

Source: TurkStat, CBRT.

Economic growth close to potential is described as "mild" in monetary policy practices with a price stability focus. As a result of the monetary policy implementations aiming to slow down the economy within a balanced growth path, economic activity has been decelerating gradually following the last quarter of 2010 (Table 1). Thus, the economy has clearly steered towards a mild growth path, while on quarterly basis, the growth rates have occasionally derailed from the underlying trend. Leaving aside the uncertainty associated with the quarterly growth rates as mentioned above, one can possibly

¹ See Box 4.1, Inflation Report 2012-II.

conclude that the first quarter contraction in 2012 has been detached from the underlying trend. Temporary factors like adverse weather conditions, energy problems, internal/external uncertainties etc. play a major role on the excessive slowdown during such periods. When the effect of these factors fade away, a rapid return to the underlying trend may be observed. In other words, rapid recoveries subsequent to a temporary slowdown or contraction detached from the underlying trend actually compensates for the previous losses. Rapid recoveries after periods such as the Iraq War in early 2003, the slowdown episode in the second half of 2004, the natural gas crisis in the first quarter of 2006, global uncertainties led by Greece in the third quarter of 2010 illustrate this compensation effect (Chart 1).



The second-quarter figures should be evaluated in this perspective. As of April-May period, the industrial production was 2.2 percent above the previous quarter, signaling a rapid recovery for the national income in the second quarter. Rather than interpreting this movement as an excessive speeding up or a less-than- envisaged slowdown of the economy, as frequently underlined in previous policy statements, one should better evaluate it as a correction towards the underlying trend after restraining factors like external uncertainties and adverse weather conditions taper off. The simplest way to express this quantitatively is to take the average of the quarterly growth rates of the consecutive periods, which then enables us to see that the average growth rate in these two quarters are close to previous periods' averages (Table 1).

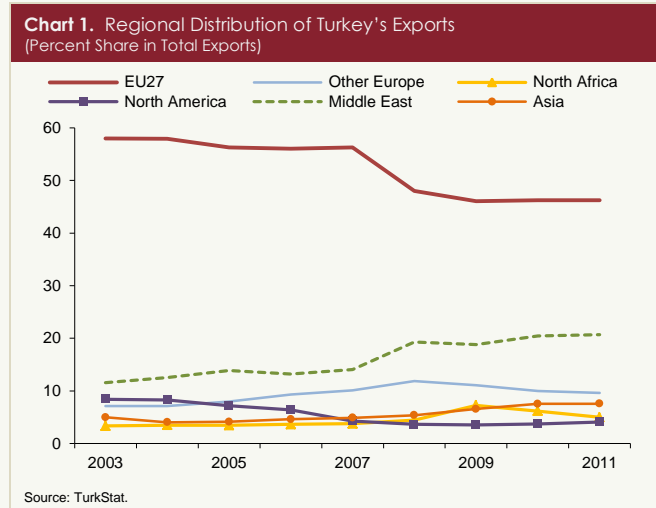
In sum, it should be underlined that analyzing economic activity using seasonally adjusted data necessitates a cautious approach. Focusing solely on the last observation may result in ignoring the uncertainty inherent in seasonally adjusted data, while a typical rebound and in fact a correction following a temporary adverse shock may be interpreted as a strong underlying trend. Even though a rapid return is implied by the second quarter indicators, this should better be read as the return of the economy to its mild underlying trend.

Box
4.2

Regional and Sectoral Export Diversification: The Case of Turkey

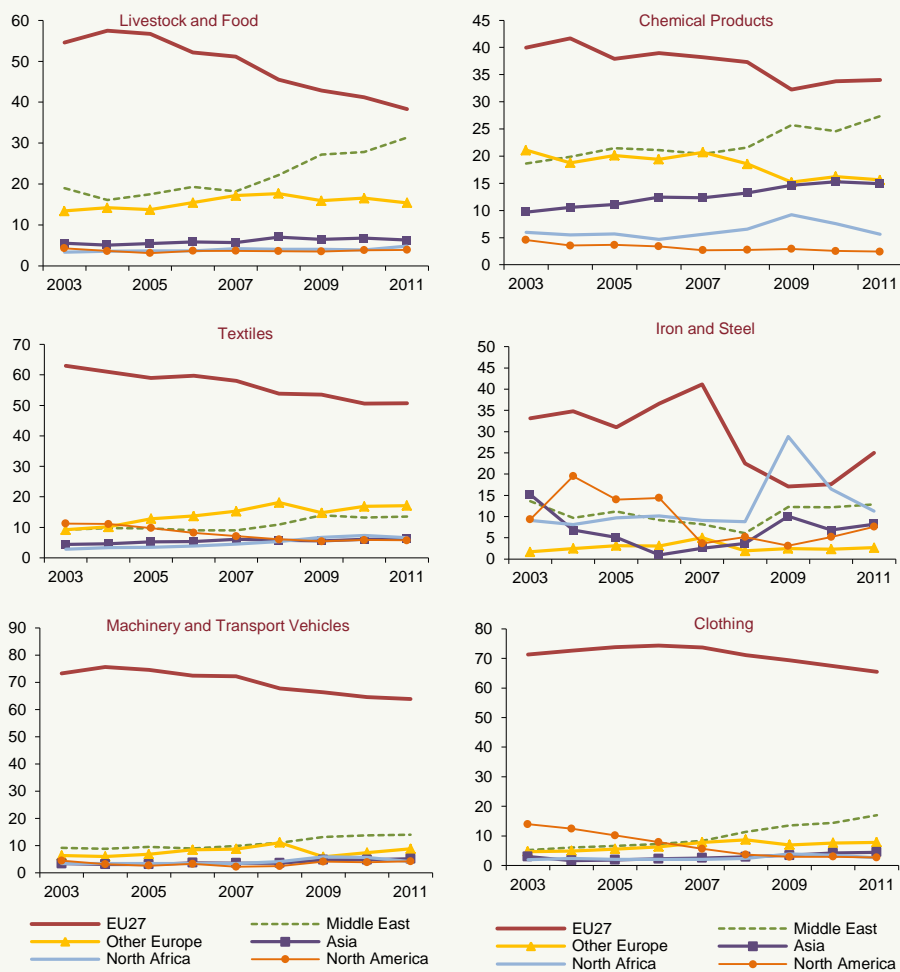
Concentration of exports to certain products or countries increases the vulnerability of export revenues to regional or sectoral shocks, which thus challenges the sustainability of export growth in the long term. In this respect, diversification of the product basket and the country groups lessens the vulnerability of the economy to external shocks, irrespective of the global economic outlook. Given this fact, this Box analyzes sectoral and regional evolution and diversification of Turkey's exports by share and concentration ratios for the 2003-2011 period.

As of the last quarter of 2008, the share of EU countries in Turkey's exports has fallen remarkably amid the aggravating global crisis. However, the region has remained historically crucial for Turkey's exports. The share of Middle East, the second crucial region in Turkey's exports, has increased as of 2003 owing to Turkey's strategy to search for new markets, reaching notably high levels in 2008 during the global crisis. Despite having a relatively smaller share, North Africa and Asia have also been emerging export markets during this period (Chart 1).



In order to understand whether the observed change in Turkey's export destinations is limited to certain products, the above analysis should be repeated for Turkey's main export items. Accordingly, the sectoral analysis reveals that the share of EU declined for all analyzed items, while the share of the Middle East, which has gained importance in total exports, increased across all items except for iron and steel (Chart 2).

Chart 2. Regional Distribution of Sectoral Exports
(Percent Share in Regional Exports)



Source: TurkStat, CBRT.

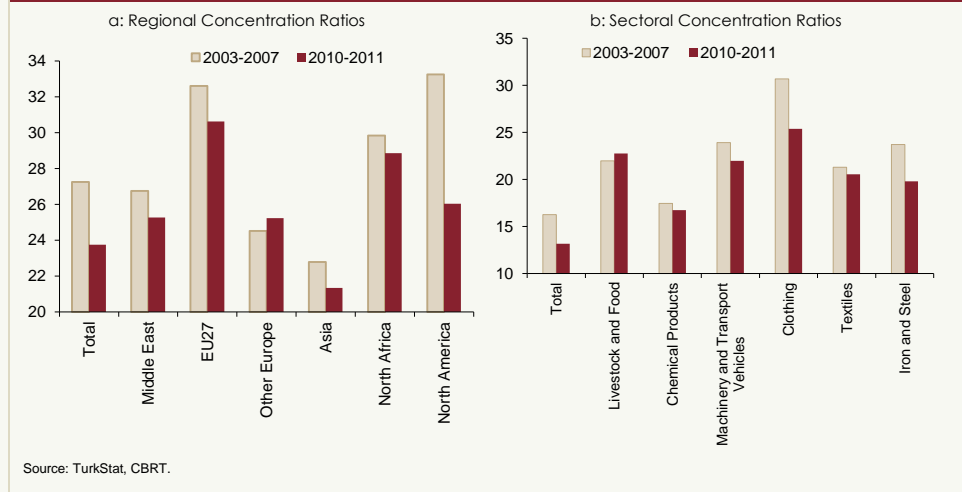
The changes in the share of total and sectoral exports in traditional markets as displayed in Charts 1 and 2 hint important clues regarding Turkey's export potential when evaluated with the forward-looking growth projections of target destinations. In this regard, Table 1 depicts that Turkey has shifted towards relatively rapid-growing economies in total and sectoral exports.

Table 1. GDP in Regions with Changing Share in Exports
(Average Annual Percent Change)

	2011	2012*	2012-2015*
Countries with an Increasing Share in Exports	4.1	2.9	3.5
Middle East and North Africa	3.5	4.2	4
Countries with a Decreasing Share in Exports	1.3	2.3	2.9
EU	1.4	-0.3	0.9

*IMF-WEO estimates.

Gini-Hirschman (GH) concentration index, an indicator for export diversification, shows increased diversification of export items during 2010-2011 period compared to the 2003-2007 period of surging exports across all regions except other Europe.² The most significant increase in sectoral diversification has been in North America, while sectoral diversification has also occurred in our major export destinations such as the EU and the Middle East. (Chart 3a). On the other hand, the analysis of regional diversification by main export items (with the exception of livestock and food) shows a more balanced distribution of exports, during 2010-2011 compared to the 2003-2007 period. Meanwhile, the regional diversification of iron and steel as well as clothing, Turkey's major export items, has increased notably as well (Chart 3b).

Chart 3. Regional and Sectoral Concentration Ratios

²Sectoral and regional Gini-Hirschman concentration ratios are measured by the following formulas, respectively:

$$GH_{ij}^{sectoral} = 100 * \left[\sum_{j=1}^n \left[\frac{X_{ij}}{X_i} \right]^2 \right]^{\frac{1}{2}} \quad \text{and} \quad GH_{ij}^{regional} = 100 * \left[\sum_{j=1}^n \left[\frac{X_{ij}}{X_i} \right]^2 \right]^{\frac{1}{2}}$$

In the first formula, $GH_{ij}^{sectoral}$ shows the concentration ratio of sector j in country i with n being the number of sectors analyzed and X_{ij} shows country i 's exports in sector j while X_i denotes country i 's total exports. GH concentration ratio declines as the number of sectors, hence sectoral diversification increases. The maximum value the GH coefficient can get is 100, denoting the case of a single export item. In the second formula, $GH_{ij}^{regional}$ shows the concentration ratio of sector i in country j with n being the number of target countries analyzed and X_{ij} shows exports in sector i in target country j , while X_i denotes total exports in sector i . In this case, GH concentration ratio declines as the number of markets, hence market diversification increases. The maximum value the GH coefficient can get is 100, denoting the case of a single export market.

In sum, the share of EU and North America in Turkey's total and sectoral exports has fallen dramatically towards the global crisis, while the share of Middle East, North Africa and Asia has increased considerably. Meanwhile, the sectoral diversification of exports has improved in major export markets and country diversification has enhanced across sectors. Under current circumstances, the diversification of regional and sectoral composition of exports has lessened the vulnerability of the Turkish economy to external shocks through trade channel. Moreover, in the period ahead, Turkey's export potential is expected to be robust given the growth forecasts in target export destinations.

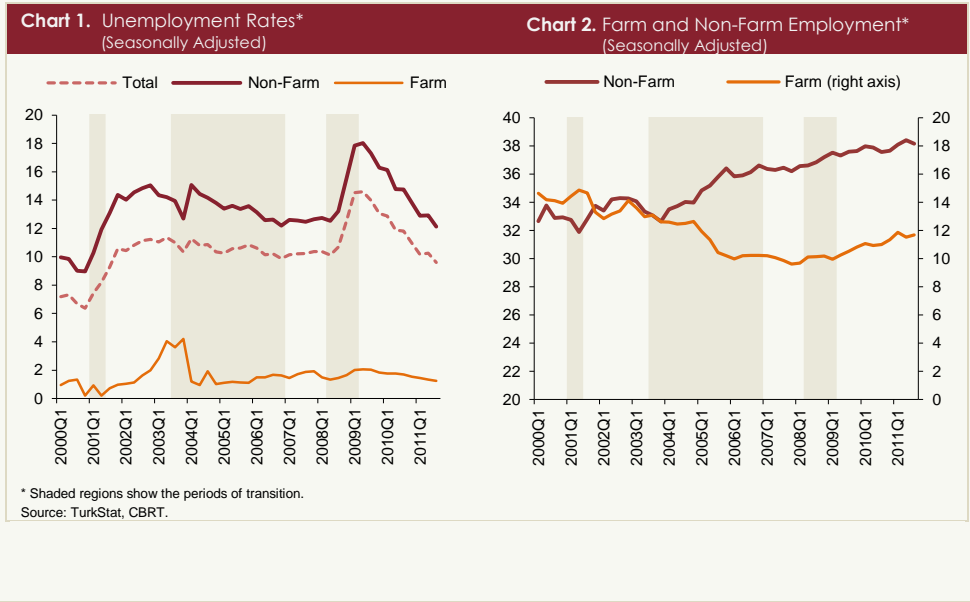
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Box 4.3 Analysis of Unemployment in the Aftermath of 2001 and 2008 Crises by Labor Force, Employment and Growth Dynamics

Unemployment rate is a fundamental indicator monitored by the policymakers in assessing the robustness of the economic activity. However, in countries like Turkey where labor force dynamics are significant for unemployment along with the employment, evaluating unemployment solely by overlooking its determinants will not suffice to assess the level of the economic activity under current circumstances. Hence, for a correct interpretation of the economic conjuncture and estimating the course of unemployment, understanding the unemployment dynamics is crucial.

During the last decade, unemployment rates in Turkey have surged amid 2001 and 2008 crises. However, these two crises differed in terms of the evolution of the unemployment rates. In fact, unemployment rates declined marginally in the aftermath of the 2001 crisis, while in the post-2008 crisis period, unemployment rates have fallen rapidly to even below the pre-crisis level (Chart 1). The aim of this Box is to analyze unemployment in the post-2001 period through labor force, employment and growth dynamics.³ The analysis shows that in addition to employment, labor force dynamics have also considerable effects on the periodically diverging course of unemployment.



³ The analyses utilize TurkStat's Household Labor Force Survey and the National Accounts statistics. As of 2009, the results of the Household Labor Force Survey are published by population projections according to the Address Based Population Registration System. The results have been revised as of 2005 by the updated population projections. This study merges the pre-2005 and post-2005 data.

In view of the differences in non-farm employment and also taking into account of the two crises, the analysis is conducted in sub-periods (Table 1). The first sub-period 2001Q1-2001Q2 covers the first half of 2001 during which unemployment rates have surged on the back of the losses in non-farm employment. In this period, unemployment rates have increased by 1 percentage point in each quarter, while in non-farm and farm sectors, labor force and employment dropped and increased, respectively. This finding hints that labor force has moved from non-farm to farm sectors during the crisis period.⁴ In the second half of 2001, this outlook was reversed and non-farm employment started to rebound. Employment continued to recover until 2002, and in the following period, employment increased only weakly while unemployment declined further amid rising non-farm labor force (Table 1, 2001Q2-2003Q2). Furthermore, farm unemployment temporarily rose to as high as 4 percent in 2003 (Chart 1).

Table 1. Determinants of the Monthly Change in Unemployment* (Percentage Point, Seasonally Adjusted)

(1)		Change in Unemployment (Quarterly Average) (2)=(3)+(4)	Labor Force Increase (Quarterly Average) (3)		Employment Loss (Quarterly Average) (4)	
			Farm (3a)	Non-Farm (3b)	Farm (4a)	Non-Farm (4b)
2001Q1-2001Q2	Unemployment rate surges due to crisis	0.9	1.1	-0.7	-1.1	1.6
2001Q2-2003Q2	Unemployment rate increases further	0.4	-0.3	0.6	0.5	-0.4
2003Q2-2006Q4	Unemployment rate declines	-0.1	-0.3	0.7	0.3	-0.8
2006Q4-2008Q2	Unemployment rate is flat	0.0	0.0	0.3	-0.1	-0.2
2008Q2-2009Q2	Unemployment rate surges due to crisis	1.1	0.1	0.6	-0.1	0.5
2009Q2-2011Q4	Unemployment rate declines to its pre-crisis level	-0.5	0.4	0.5	-0.4	-1.0

* The table shows the sources of the changes in unemployment. The changes in the unemployment rate are decomposed as the effect of the increases in labor force and employment losses in farm and non-farm sectors, with both factors affecting the unemployment rate positively. For example, during 2001Q1-2001Q2, unemployment rate has increased by 0.9 percentage points in each quarter amid decreasing labor force and employment in the non-farm sectors and increasing labor force and employment in the farm sector. Hence, non-farm employment added 1.6 percentage points to unemployment. Meanwhile, the increase in non-farm labor force reduced the unemployment rate by 0.7 percent. Overall, non-farm sector raised the employment by about 1 percent.

Source: TurkStat, CBRT.

Despite the sharp increase in non-farm employment from the second half of 2003 till end-2006, unemployment rate declined only marginally by 0.1 percent due to the surge in non-farm labor force (Table 1, Chart 2).⁵ In 2007, the growth of employment decelerated amid the economic slowdown, thus causing the unemployment rates to be flat (Table 1, 2006Q4-2008Q2).

⁴ Fallon and Lucas (2002) analyzes the movement of labor force across farm and non-farm sectors during crisis periods for similar emerging countries.

⁵ Coupling of the increase in non-farm employment with the declining farm employment during this period may be interpreted as the result of the movement of the labor force from farm to non-farm sectors or may simply be the result of the change in the TurkStat's survey question in 2005 (Türkan and Yükseler 2008).

Unemployment rates have surged as of the second quarter of 2008 as the effects of the global financial crisis were felt. Unlike the 2001 crisis, the surging unemployment rates were not only due to employment losses, but also due to the increases in the labor force (Table 1, 2008Q2-2009Q2). Moreover, changes in the farm labor force and employment in 2008 lagged behind the changes in 2001 crisis. As of the second quarter of 2009, unemployment rates have declined amid increases in employment (Table 1, 2009Q2-2011Q4). The relatively faster decline in unemployment in this period compared to the post-crisis period of 2003Q2—2006Q4 was owed to robust increases in employment as well as the weaker growth of the labor force in the farm sector. The slightly growing non-farm labor force in this period may be interpreted as the limited movement of the labor force from the farm sector or that the ongoing increase in the non-farm labor force during the crisis may have restrained the post-crisis increase.

Table 2. The Growth Elasticity of Employment (Average Quarterly Increase in Employment/Average Quarterly Increase in Value Added, Seasonally Adjusted)

	Non-Farm	Industrial	Construction	Services	Trade, Restaurant and Hotel	Transport-Comm.	Financial Inst.-Real Estate	Community Services
2001Q2-2008Q2	0.49	0.42	0.39	0.55	0.53	0.21	1.12	1.39
2003Q2-2006Q4	0.56	0.53	0.85	0.53	0.58	0.38	0.75	1.15
2009Q2-2011Q4	0.60	0.54	1.08	0.58	0.25	0.40	1.43	2.12

Source: TurkStat, CBRT.

In order to evaluate the effect of the growth elasticity of employment on the divergence of employment increases in the post-crises periods, Table 2 presents the growth elasticity by sectors. Elasticity is measured by dividing the average growth of employment to the average growth of the value added in the respective time period. The growth elasticity of employment is 0.49 during 2001Q2-2008Q2, 0.56 during the strong economic growth period of 2003Q2-2006Q4 and 0.60 in the post-2008 period. Hence, elasticity in the last period differs significantly from the 2001 crisis, while it differs only slightly from the period of robust growth of the value added.⁶ By sectoral analysis, the growth elasticity of employment has been notably high in the construction, real estate leasing and business services as well as community services as of end-2011.

⁶ During 2001 and 2008 crises, the contraction and the recovery of the value added and employment have not been simultaneous. Hence, elasticity measures differ depending on which of the series are taken as benchmark for setting the beginning of the recovery. When the start of the recovery of the employment is taken as the benchmark, the elasticity is 0.53 and 0.68 during 2001Q2-2008Q2 and 2009Q2-2011Q4, respectively. On the other hand, when the start of the recovery of the value added is taken as the benchmark, elasticity declines to 0.45 and 0.52 for 2001Q2-2008Q2 and 2009Q2-2011Q4 periods, respectively. Table 2 presents the average elasticity.

In sum, the first appealing difference between the two crises is that the unemployment rates have fallen rapidly after the 2008 crisis, whereas unemployment rates were flat in the aftermath of the 2001 crisis. This difference was mainly owed to the divergences in employment as well as labor force increases. On the other hand, the changing relation between employment and growth during these periods has a limited effect on changing employment dynamics.

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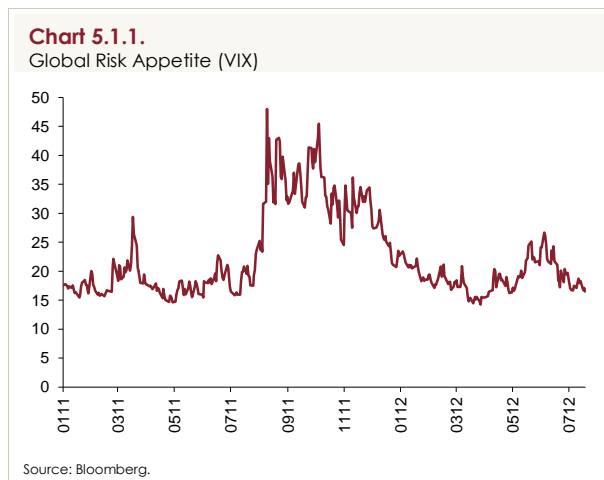
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5. Financial Markets and Financial Intermediation

5.1. Financial Markets

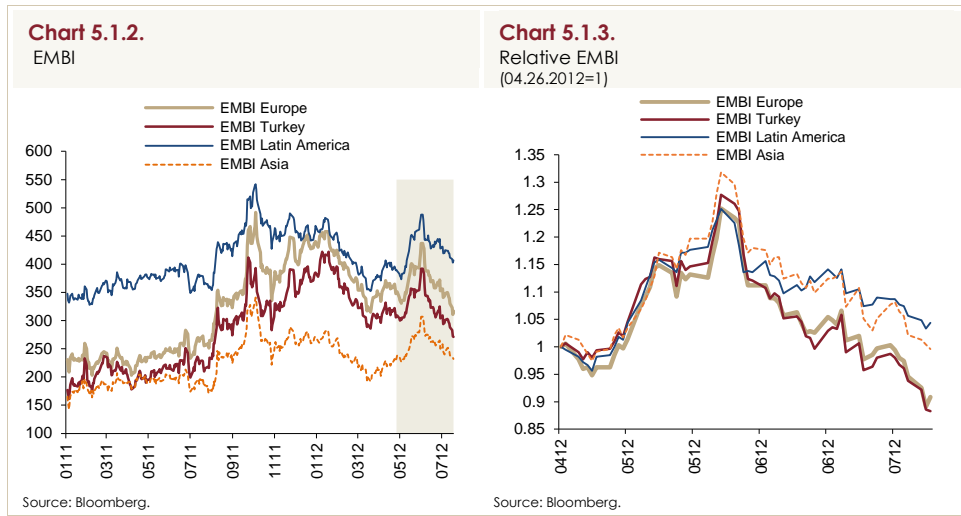
Global Risk Perceptions

Data released regarding the global economy in the second quarter of the year signal for a longer-than-expected period of recovery. Persisting downside risks on growth led advanced economies to continue with easing in monetary policy practices. In this period, the ECB, the Federal Reserve, the Bank of England and the Bank of Japan continued with monetary easing. Moreover, the ECB opted for a policy rate cut to bolster economic growth. Concerns over the Euro Area debt problem besides global growth in April and May led to the global risk appetite to attenuate (Chart 5.1.1). In June, more concrete measures were taken to weather the Euro Area debt problem and following the elections in Greece, expectations for Greece to exit from the monetary union faded. Monetary easing practices of advanced economies accompanied by diminishing uncertainties regarding the Euro Area debt problem have brought about a notable increase in global risk appetite since early June. Following the publication of the April Inflation Report, central banks of many emerging economies besides the major central banks took decisions to support economic growth. Despite the adopted measures, neither advanced nor emerging economies recorded improvement in growth forecasts (Table 2.1.1).

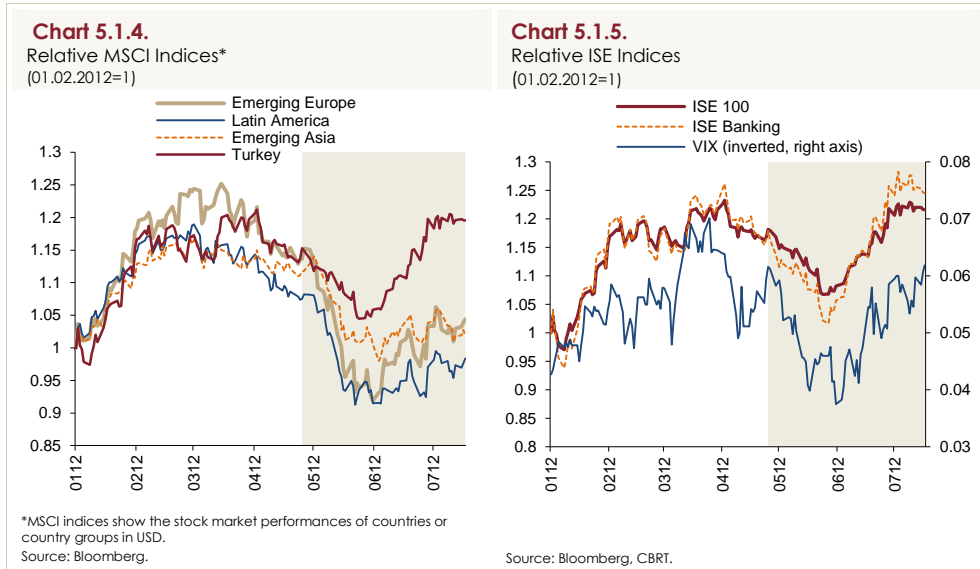


Parallel to the decline in the global risk appetite in April and May, risk premiums of emerging economies also increased (Chart 5.1.2). However,

favorable news coming from the Euro Area since June besides the lingering monetary easing in advanced economies led the risk premiums of emerging economies to decline. In this period, these favorable developments were consistent with the soft landing scenario of macroeconomic indicators, which ensured Turkey's risk premium to perform better than other emerging economies (Chart 5.1.3). In fact, sovereign credit rating of Turkey was upgraded in early June along with the realization of credit rating upgrades to some Turkish banks.

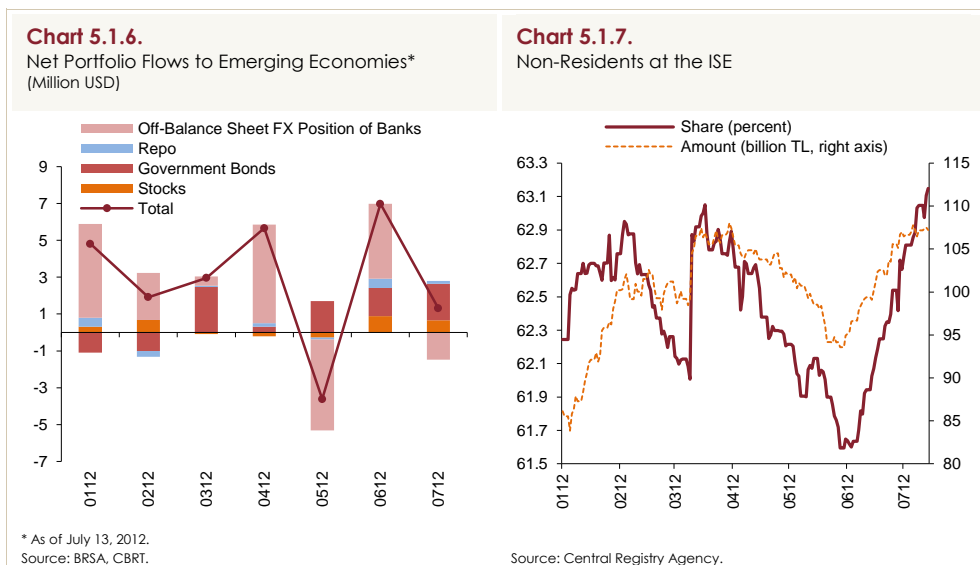


Global developments that determine the course of risk premiums were also influential on stock indices. In the second quarter of the year, stock markets in Turkey as well as in other emerging economies depreciated throughout May parallel to the decline in the global risk appetite, but have recently rebounded (Chart 5.1.4). In this period, following the credit rating upgrade especially in June, the ISE performed better than the stock markets of other emerging economies. Credit rating upgrade strengthened the perceptions regarding the sustainability of the favorable course of macroeconomic indicators in the longer term and also stimulated the interest towards investment tools in Turkey. Following the rating upgrades, the overall index in Turkey and especially the banking sector equities saw sudden appreciations (Chart 5.1.5).

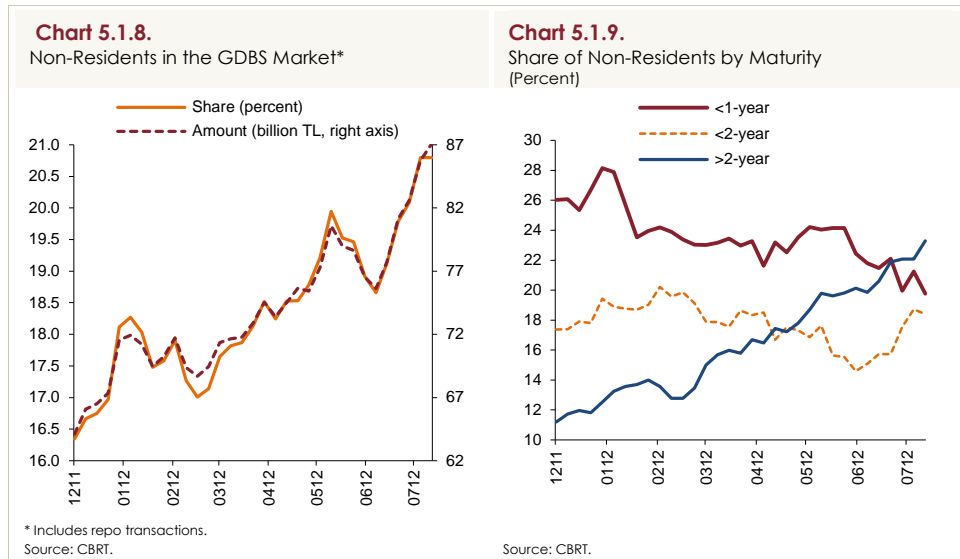


Portfolio Flows

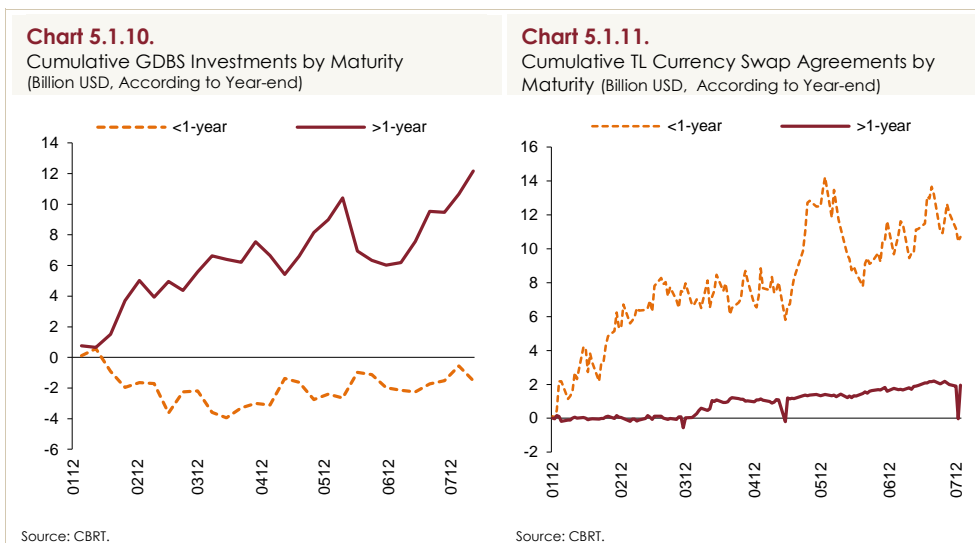
Due to the negative developments in Europe, capital inflows to emerging economies, including Turkey, declined during May (Chart 5.1.6). Creation of the atmosphere of confidence regarding the solution of the problems in Europe as of June besides the better-than-expected inflation and current account deficit figures as well as credit rating upgrades stimulated the non-residents' investments in Turkey. Against this background, the share of non-residents went up at the ISE in June (Chart 5.1.7).



Share of non-residents in the GDBS market continued to trend upwards in the second quarter (Chart 5.1.8). Non-residents in the GDBS market have lately tended towards securities with maturities of longer than two years (Chart 5.1.9). This indicates that medium-term expectations of foreign investors regarding inflation and other macroeconomic indicators are positive.

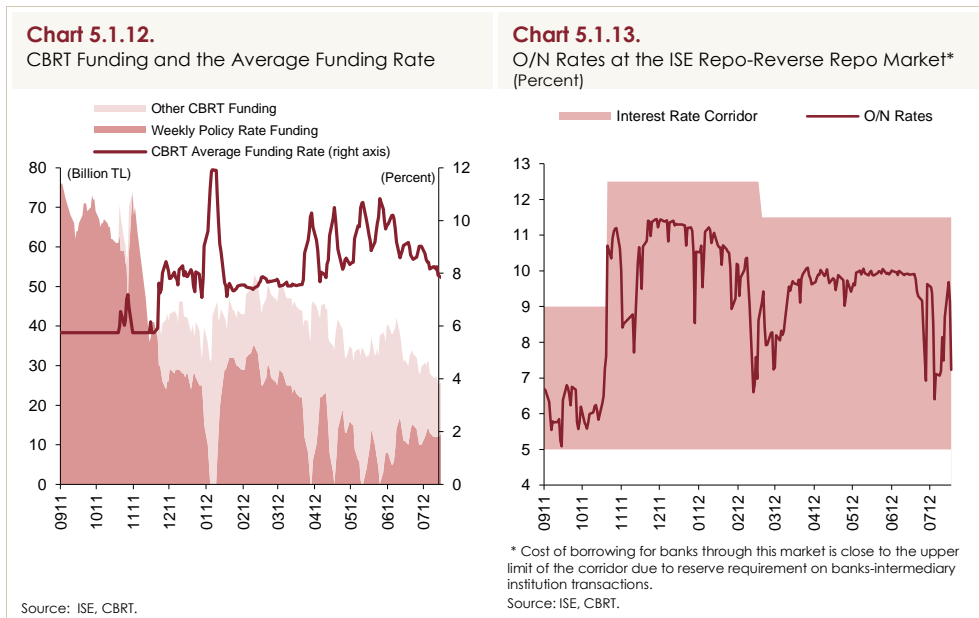


In 2012, total cumulative GDBS investments of non-residents were longer than 1 year maturity; and outflows were seen in maturities shorter than 1 year (Chart 5.1.10). TL cross currency swap agreements which have a significant share in portfolio flows trended upwards in the first half of 2012. These investments, a great part of which had maturities less than 1 year, maintained the same trend also in the second half of 2012 (Chart 5.1.11).



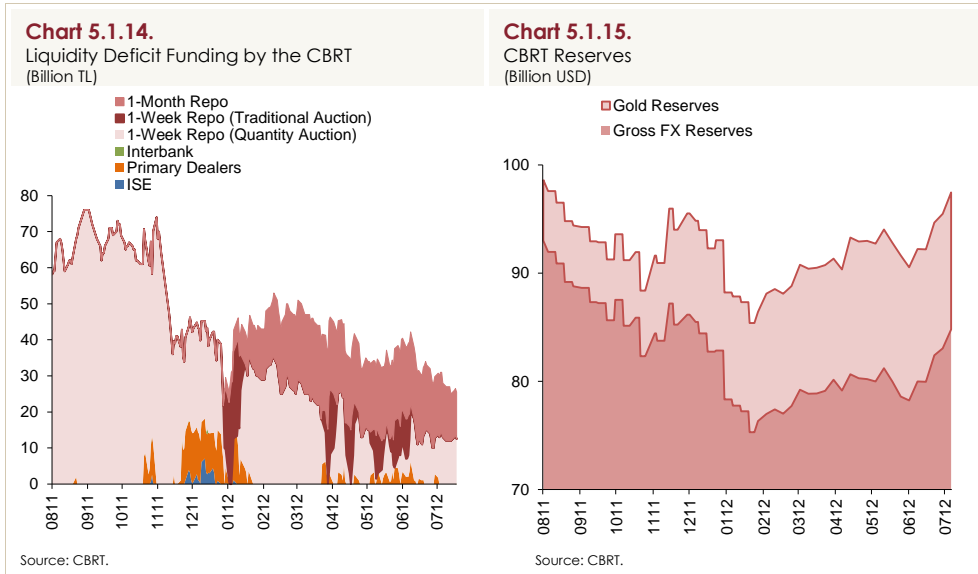
Monetary Policy Implementation

In order to prevent any deterioration in the inflation outlook to stem from temporary rises in inflation, the CBRT emphasized in the April MPC Meeting that additional monetary tightening might be implemented more frequently. Accordingly, additional tightening was implemented between May 4-11 and 21-25 (Chart 5.1.12). Notwithstanding the expectation for a decline in inflation, the CBRT intended to contain the risks on pricing behavior to stem from the inflation which will post higher-than- expected figures until the last quarter of the year. Accordingly, the existing tight stance was preserved at the May MPC Meeting and the CBRT opted for an additional monetary tightening between May 31 and June 4. In fact, in the second quarter of the year, alternative funding tools except for the weekly repo funding implemented under the quantity auction method were used more frequently compared to the first quarter. In the subsequent period, monetary policy preserved its tight stance. However, both the average funding rate and the overnight market rate in July were ensured to become low amid soaring risk appetite (Charts 5.1.12 and 5.1.13). Persisting uncertainties despite the favorable developments in the global economy led the flexibility in the monetary policy to be maintained.



At the May MPC Meeting, in order to underpin financial stability, the flexibility for Turkish lira reserve requirements that can be held in foreign currency was raised from 40 percent to 45 percent. The said flexibility provides the banks with an easing in Turkish lira and foreign exchange liquidity management and acts as an automatic stabilizer against external financing shocks. This facility will contribute to the easing of the volatility on foreign exchange liquidity and exchange rate. On the other hand, so as to diminish the cost gap to arise from holding Turkish lira required reserves in Turkish lira or foreign exchange, a higher fraction of foreign exchange per each unit of Turkish lira was decided upon for additional increases in allowance ratios. Thus, the sum corresponding to the 40 percent of Turkish lira required reserve liabilities was to be multiplied by "1" as in the past, while the second tranche corresponding to 5 percent was to be multiplied by "1.4". Then, it was facilitated to hold these liabilities upon the resulting amount in the USD and/or euro. The said facility was raised by 5 points to 55 percent in June and July and for the sum that corresponds to third and fourth tranches of 5 percent, coefficients were determined as "1.7" and "1.9". Additionally, the upper limit for the facility to hold Turkish lira required reserves in gold was raised to 25 percent in June. Meanwhile, the amount corresponding to 20 percent of the facility was to be used by being multiplied by "1" as in the previous case; whereas the second tranche corresponding to 5 percent was to be multiplied by "1.5". Required reserves will continue to be used under macroprudential measures in a way to observe financial stability in the forthcoming period.

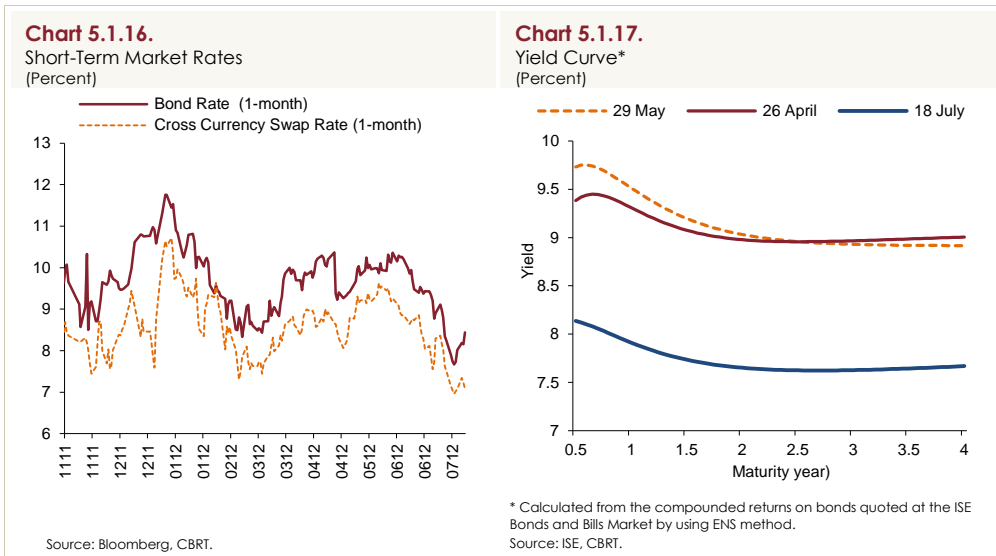
Through cost and liquidity channels, these facilities ensure liquidity requirements of the banks to be met in a more permanent and flexible manner. In fact, these facilities contribute to the decline in the Turkish lira liquidity deficits of banks (Chart 5.1.14). Moreover, facilitation of holding Turkish lira required reserves in foreign exchange and gold favorably affects the CBRT's foreign exchange and gold reserves (Chart 5.1.15). Total reserves have trended upwards since early 2012.



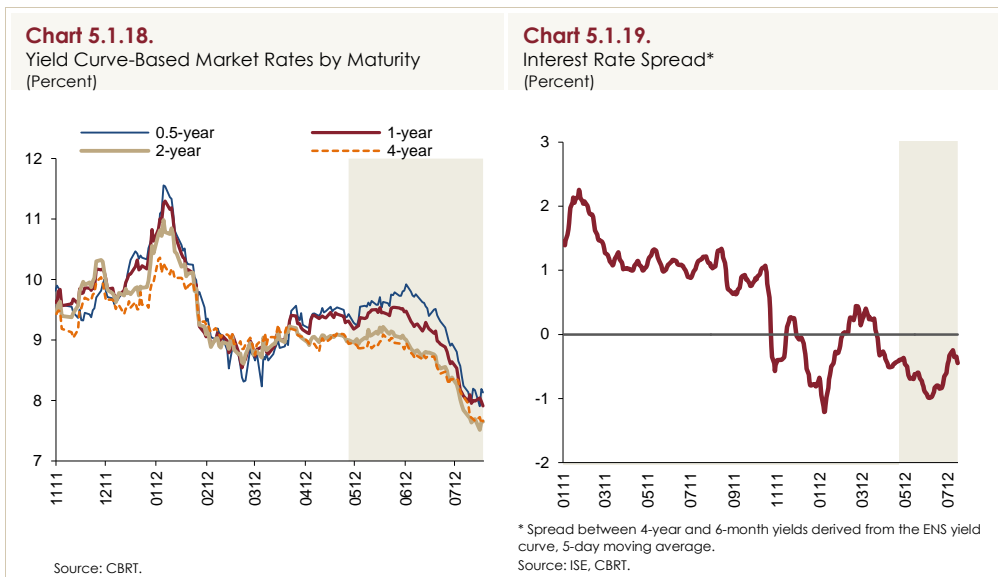
In order to enhance liquidity managements of banks and help them project their total funding costs, the CBRT continued to announce the funding amount on the days of quantity auctions besides the upper limit for the monthly repo auctions in the second quarter of the year. Under the scope of the TL liquidity projections, the lower limit for the May funding quoted at the policy rate was preserved as TL 1 billion, while the upper limit thereof was reduced from TL 6 billion to TL 5 billion. In July, the amount of this funding was set between the range of TL 0.5 billion and TL 6.5 billion. The upper limit for the monthly repo auctions held under the traditional auction method was not changed and the upper limit was preserved as TL 5 billion.

Market Rates

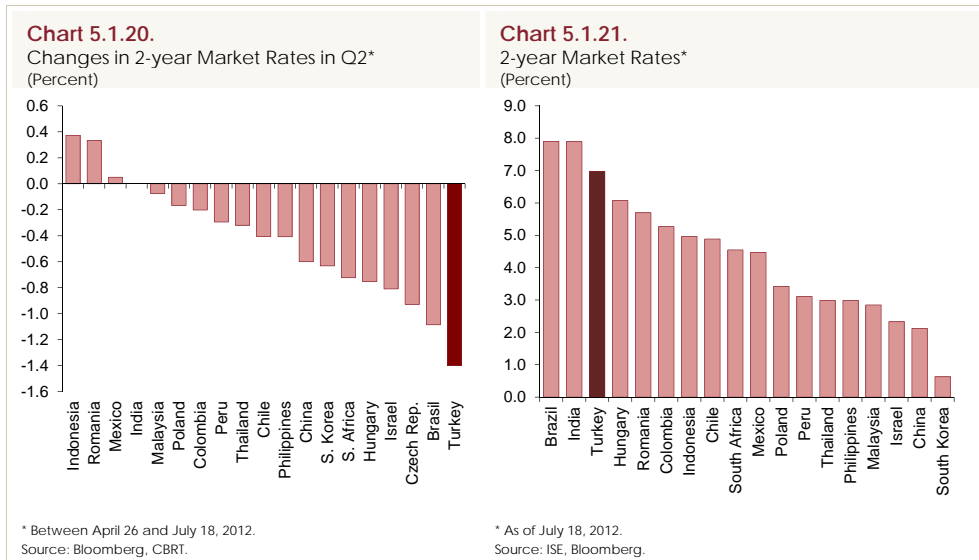
In May, more frequent implementation of additional monetary tightening led to a rise especially in short-term rates in the GDBS markets. Short term cross currency rates moved similar to GDBS rates (Chart 5.1.16, Box 5.1). However, the faster-than-expected decline in inflation following May, the favorable course of global risk perceptions, the sustained balancing in the current account deficit, the support granted by domestic demand conditions to disinflation and the credit rating upgrade led the market rates to record a decline in all maturities (Chart 5.1.17).



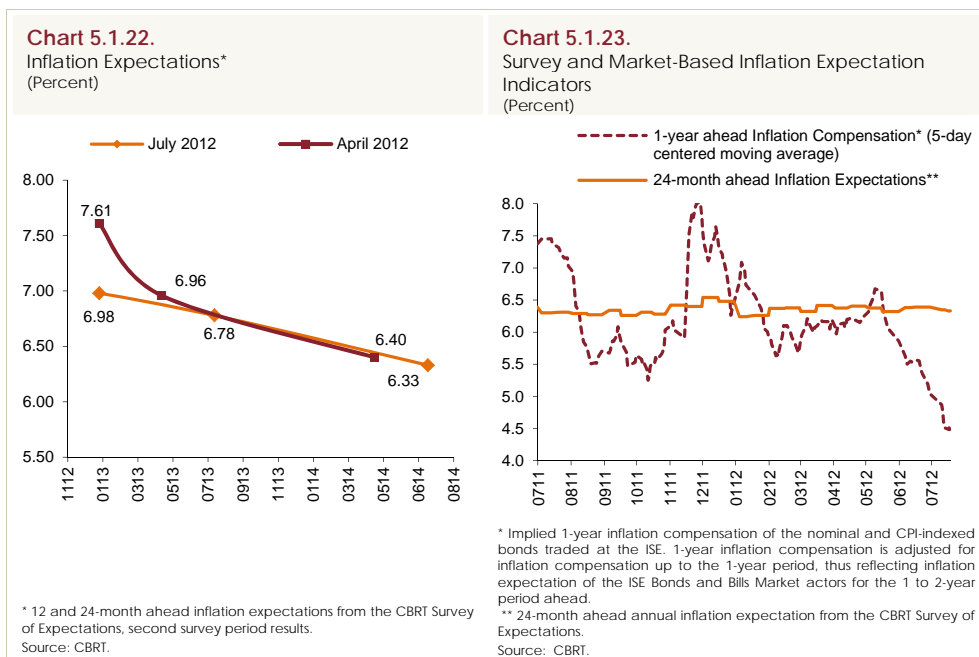
Interest rates in differing maturities exhibit similar trends, yet the spread between long and short-term rates is slightly flat, but still has a negative trend thus implying that the CBRT's monetary policy stance is relatively tight (Charts 5.1.18 and 5.1.19).



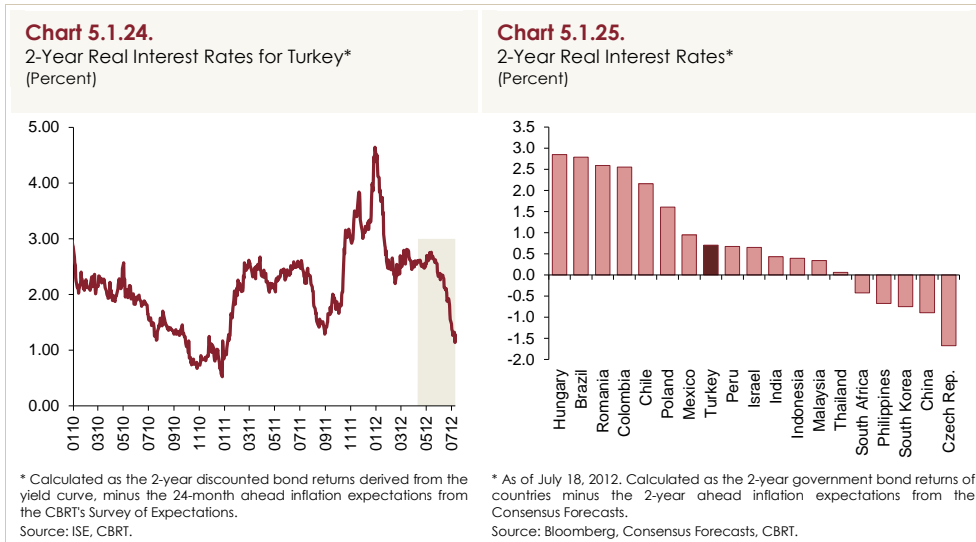
Following the release of the April Inflation Report, due to the aforementioned favorable cyclical developments exclusive to Turkey, 2-year market rate recorded a higher decline than other emerging economies (Chart 5.1.20). Nevertheless, 2-year market rates in Turkey still linger in relatively high levels (Chart 5.1.21).



Being among factors influential on market rates, inflation expectations recorded a marked decline in short-term maturities compared to the period preceding the April Inflation Report (Chart 5.1.22). The Survey of Expectations does not exhibit a significant change in medium-term inflation expectations, while inflation compensation that mostly reflects market expectations fell below the survey expectations following the release of May inflation figures; and then recorded a sharp decline (Chart 5.1.23). This is also attributed to the recently favorable data regarding inflation besides the diminished uncertainties in inflation (see October 2011 Inflation Report, Box 5.1).

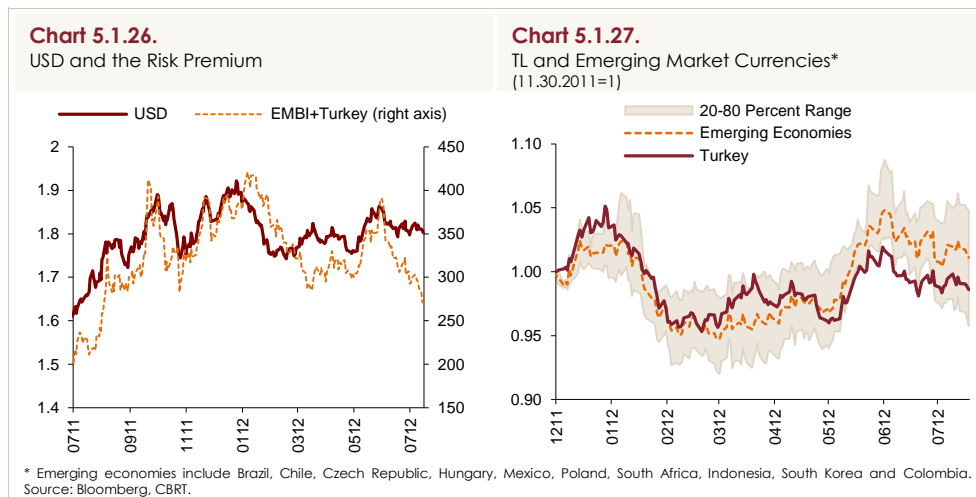


The decline in market rates in the second quarter of the year also influenced real interest rates (Chart 5.1.24). Accordingly, Turkey's real interest rates ranked below other emerging economies compared to the April reporting period (Chart 5.1.25).

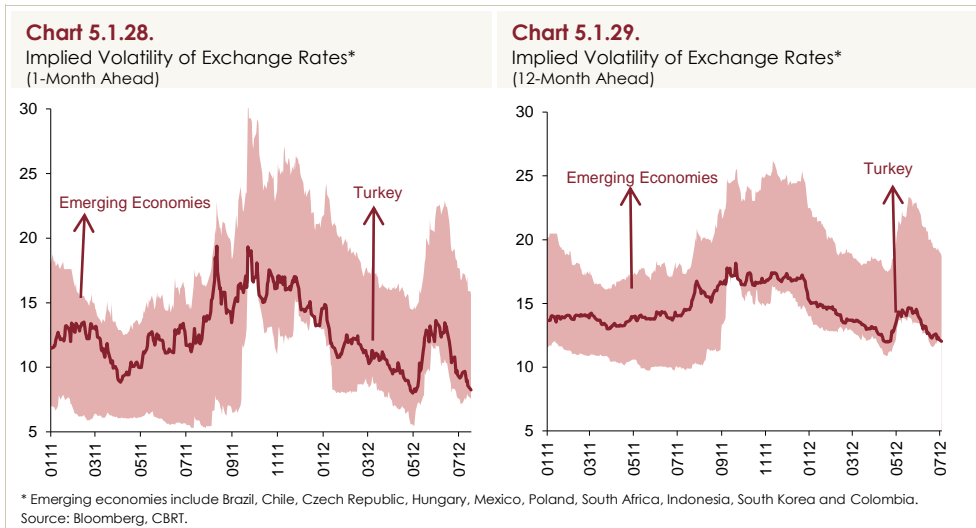


Exchange Rate Markets

In the second quarter of the year, the Turkish lira followed a volatile course like other currencies in peer emerging economies. Parallel to the developments in the risk premium, the Turkish lira depreciated against the USD throughout May, but re-appreciated in June (Chart 5.1.26). In this period, in tandem with the better-than-expected macroeconomic indicators and the credit rating upgrade in June, the Turkish lira performed better than the currencies of other emerging economies (Chart 5.1.27).

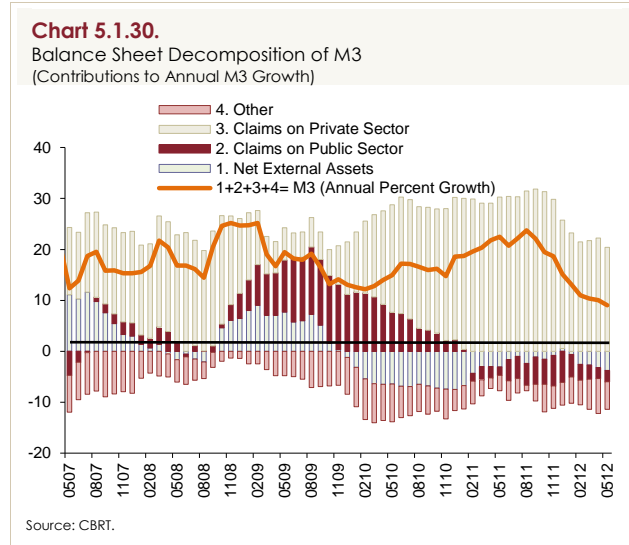


Also influencing the implied exchange rate volatility of the currencies of emerging economies, improvements in the global risk appetite in June and July led them to decline to a remarkable extent. Recently released macroeconomic indicators remained consistent with the soft landing scenario and the CBRT maintained its tight monetary stance, which gave way to the implied volatility of the Turkish lira to realize lower both in short and long-term maturities than the currencies of other emerging economies in the second quarter of the year (Charts 5.1.28 and 5.1.29). Relatively low risk perceptions regarding the Turkish lira reflect the confidence in the monetary policy besides the country's economic performance.

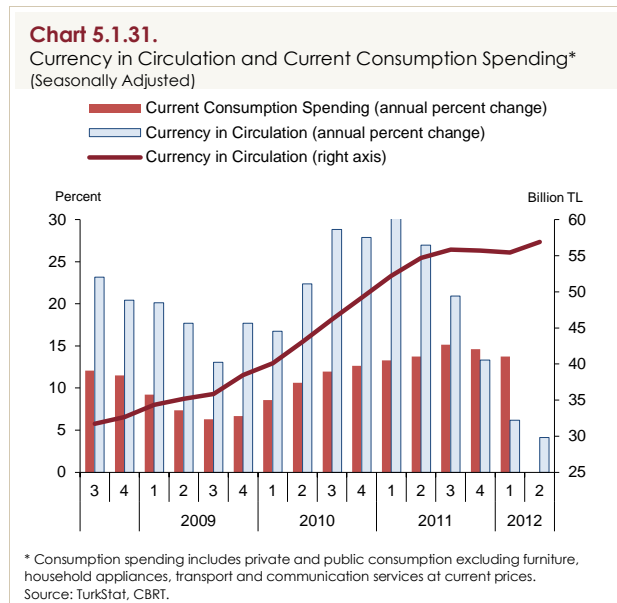


Monetary Developments

Effects of the measures for tightening taken in the second quarter of 2011 continued to shape monetary indicators. Accordingly, the annual growth of M3, the broad measure of money supply, continued to decline. In fact, the balance sheet decomposition of M3 points that the downward trend in Claims on Private Sector, which mostly consist of bank loans extended to non-financial private individuals and institutions, has recently lost pace. Meanwhile, Claims on Public Sector continued to provide negative contribution to M3 growth. The fall in Net External Assets is mainly attributed to the increase in the liabilities of commercial banks' against non-residents. Lastly, parallel to bank profits, the item Other continued to generate non-deposit resources for the banking sector in the second quarter (Chart 5.1.30).

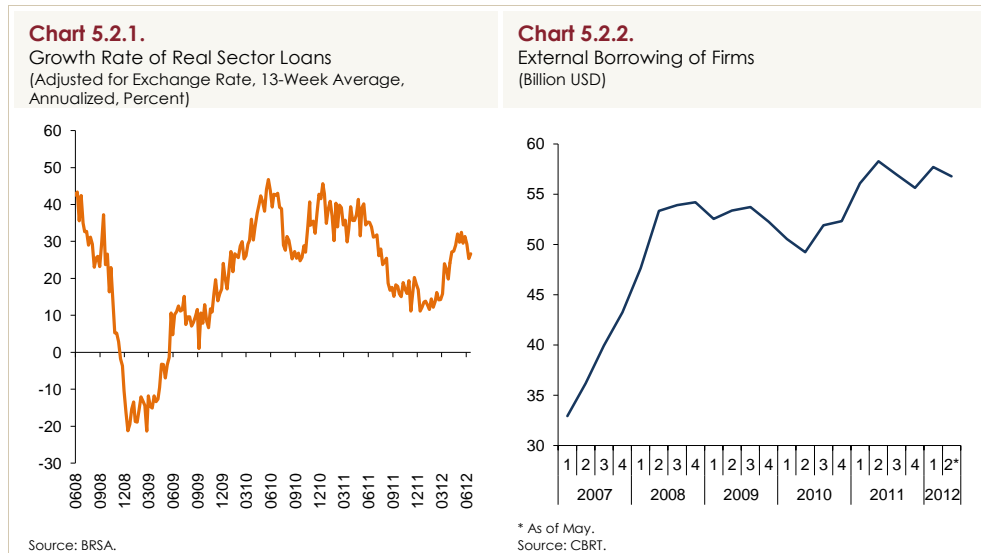


The rate of increase in the seasonally adjusted money in circulation continued to decline in the second quarter of the year (Chart 5.1.31). Nevertheless, in terms of level, the same item exhibits a rebound on a quarterly basis, albeit limited. This is consistent with the projection that current consumption spending will experience a mild quarterly recovery in the second quarter of the year.



5.2. Financial Intermediation and Loans

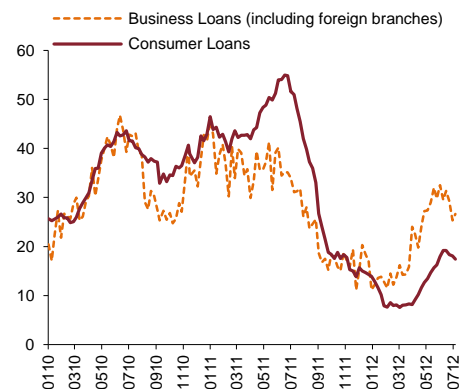
Growth rate of loans extended to the corporate sector by domestic banks has increased as of late March mostly upon seasonal trends; yet trended downwards again as of early June (Chart 5.2.1). This was attributed to the slight easing in lending standards of banks in the first quarter besides the recovery in economic activity as of the second quarter. Accordingly, real sector loans posted a year-on-year increase by 17.5 percent in the second quarter, growing by 22.2 percent in annualized terms (Chart 5.2.1). Meanwhile, external borrowing by the corporate sector has increased in the first five months of the year (Chart 5.2.2).



In the second quarter of the year, growth rate of consumer loans lagged behind business loans extended to the corporate sector (Chart 5.2.3). Notwithstanding the more remarkable decline in consumer loan rates compared to business loan rates, the lower growth rate of consumer loans points to the weak demand for consumer loans. Despite the flat course of domestic demand since the second quarter of 2011, the composition of consumption and investment spending has gradually shifted towards domestically manufactured products, which led to an increase in loan demand of firms for working capital. A substantial part of the growth in consumer loans was driven by seasonal effects. Compared to the same period of the preceding years, growth of consumer loans has notably been lower than the average of the 2007-2011 period (Chart 5.2.4).

Chart 5.2.3.

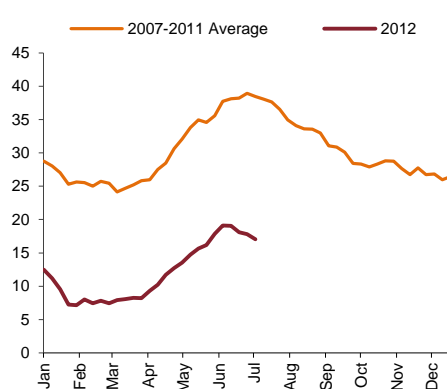
Growth Rates of Business and Consumer Loans*
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)



* Including automobile loans extended by consumer financing firms.
Source: CBRT.

Chart 5.2.4.

Consumer Loan Growth
(Adjusted for Exchange Rate, 13-Week Average, Annualized, Percent)

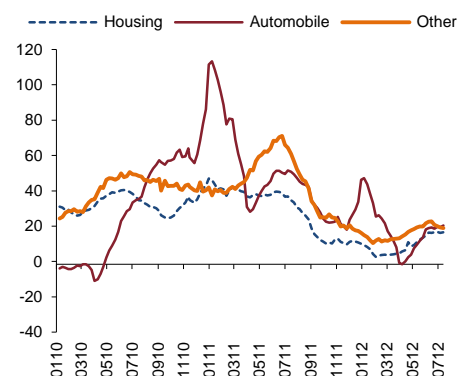


Source: CBRT.

Growth rates of consumer loans started to edge up in the first quarter of the year. Being also influenced by seasonal factors, this recovery became more pronounced in the second quarter of the year (Chart 5.2.5). Nonetheless, growth rates of consumer loans still exhibit a relatively poor outlook compared to the period preceding monetary tightening. Banks raised the interest rates on housing, automobile and other consumer loans to a sizeable extent following the CBRT'S monetary tightening in October 2011 (Chart 5.2.6).

Chart 5.2.5.

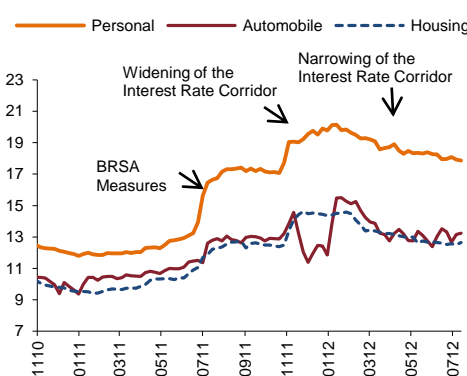
Weekly Growth Rates of Consumer Loans*
(13-Week Average, Annualized, Percent)



* Including automobile loans extended by consumer financing firms.
Source: CBRT.

Chart 5.2.6.

Consumer Loan Rates
(Flow, Annualized, Percent)



Source: CBRT.

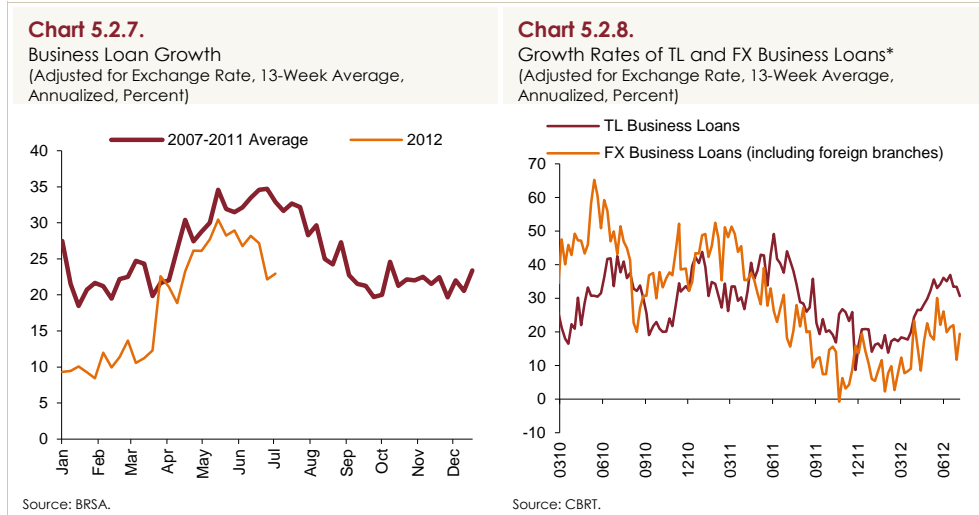
In addition to the rising interest rates, the tightening in retail and automobile loans in the last quarter of 2011 was influential on the growth rates of these loans. The Loan Tendency Survey suggests that banks opted for a slight easing in standards applied to retail loans, while a limited tightening was implemented in housing loans in the first quarter of 2012 due to the negative

expectations regarding the real estate markets. As for the standards regarding retail loans, the competition among banks eased lending conditions, while factors regarding risk perception had a tightening role for standards. Additionally, in all types of consumer loans, conditions for fees and commissions excluding interest experienced tightening in the first quarter. The Loan Tendency Survey of April reports that a slight easing is expected in credit standards in all types of consumer loans, especially in retail loans in the second quarter. As a matter of fact, interest rates on retail and housing loans assumed a modest downward trend in the first quarter following the surge amid the monetary tightening in October and declined further in the second quarter of the year. All these developments indicate that the aggravated concerns of banks over the credit risk in the preceding two quarters have waned since the second quarter of 2012.

On the other hand, developments regarding banks' financing are also influential on the decline in consumer loan rates. As cross currency swap transactions have longer maturities than deposits, banks prefer using the sizeable amounts of financing provided from abroad through cross currency swaps in the first half of the year, in financing consumer loans and business loans for investment purposes, which have longer maturities on average. Due to this preference of banks, consumer loan rates and TL-denominated long-term business loan rates fell notably in the first half of the year. Nevertheless, short-term business loan rates did not exhibit a trend alike.

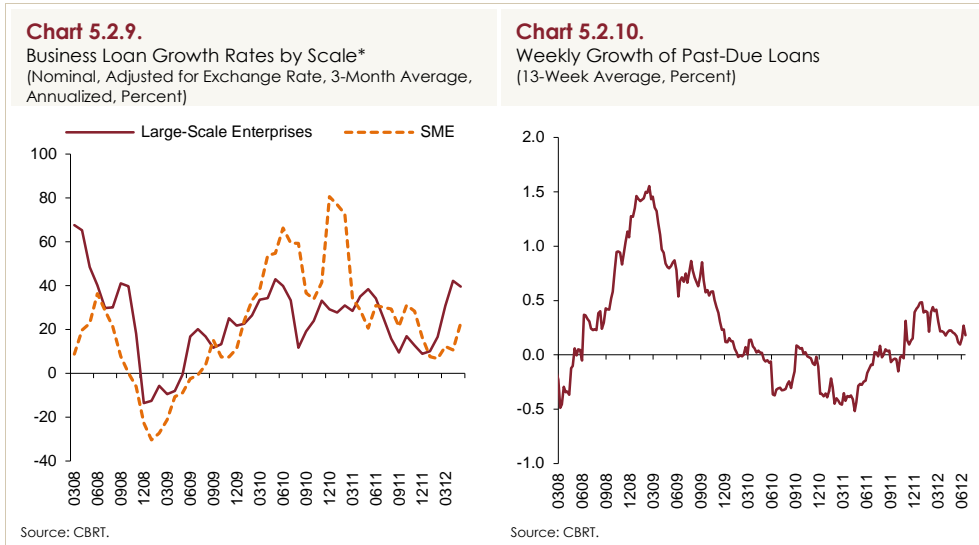
The jump in the growth rate of business loans as of the last week of the first quarter was reversed in late June (Chart 5.2.7). This jump was seen in only one week, highlighting that this is a one-time event not pointing to a strong acceleration in business loans. In fact, upon adjusting for this rise through 13-week average estimation, the decline in the growth rate of business loans in late June was seen to be more severe than the average of the preceding years. This trend was more evident in FX-denominated loans rather than TL-denominated loans (Chart 5.2.8). Data on the decomposition of business loans according to maturity show that the hikes in TL and FX-denominated loans in April were concentrated on loans with maturities of shorter than one year. In fact, results of the Loan Tendency Survey indicate that the slackening in standards for long-term loans in the first quarter did not enhance the demand for long-term loans used by firms mostly for investment purposes. In this period, the effect of fixed investment among other determinants of the loan demand

of firms fell drastically, while the demand for business loans was mostly oriented towards restructuring of debts and capitalization of the enterprises.

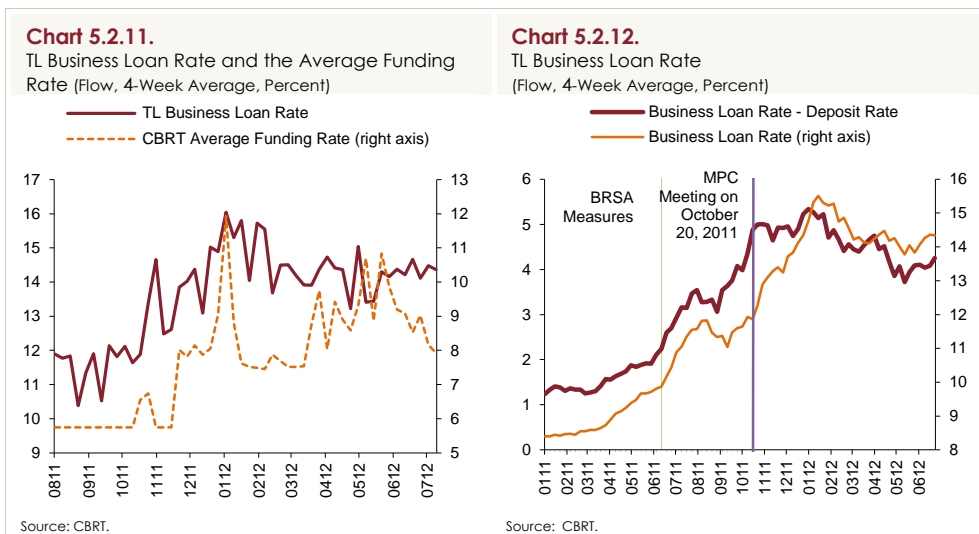


An analysis of business loans by scale reveals that growth rates of loans extended to large-scale enterprises and to SME have diverged since March (Chart 5.2.9). This stemmed from tighter lending conditions applied by banks for the SME, which have more fragile financial conditions than large-scale enterprises as of the last quarter of 2011, which was marked by aggravated concerns of banks on credit risk. In tandem with the re-acceleration of SME loans as of May, the divergence between loan growth rates according to scale was partially closed. As per the implementation of Basel II, which was effected on 1 July 2012, the lower risk weight regarding the SME loans to be placed in the retail portfolios of banks is believed to bolster SME loans on the supply-side in the forthcoming period.

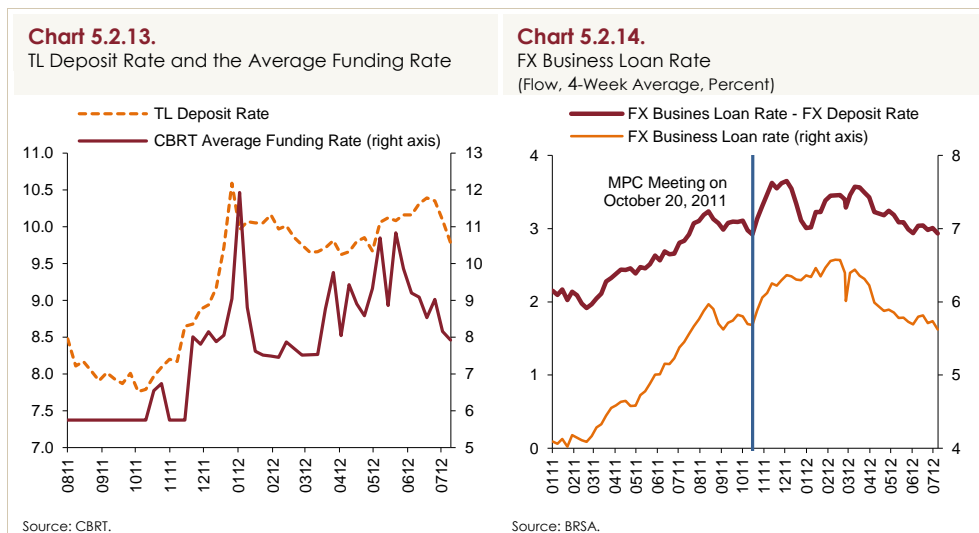
In the Loan Tendency Survey released in April, banks stated that parallel to the favorable perceptions regarding economic activity, they may preserve the partial easing in the standards for loans extended to both large-scale enterprises and SME in the second quarter. Furthermore, the rise in the growth rate of non-performing loans in the first quarter being replaced by a decline again in the second quarter also supports the mentioned approach by banks (Chart 5.2.10).



The upper limit of the interest rate corridor was raised in October, and following this decision, owing to effective liquidity policies, the average interest rate on funding provided by the CBRT soared (Chart 5.2.11). In line with this, business loan rates also surged; yet, edged down following the slight reduction in CBRT's overnight lending rate in February. In periods of additional monetary tightening implemented as of March, as the CBRT pointed to a tighter monetary policy outlook, banks are thought to base their decisions of loan rates on the upper limit of the interest rate corridor in this period. The course of spread between loan and deposit rates were mostly shaped by the movements in loan rates from the start of the year to May. Meanwhile, as of May, the rise in deposit rates played a great role on the loan-deposit rate spread (Chart 5.2.12).



Recent monetary policy measures taken by the CBRT have proved influential on deposit rates as well. More frequent implementation of additional monetary tightening by the CBRT as of late April led to a month-on-month increase by 100 basis points in the CBRT's average funding rate in May. On the other hand, climbing unrest in the Euro Area attenuated the risk appetite, which led to a plunge in the financing provided by banks through cross currency swap transactions in May. Against this background, deposit rates have seen a slight increase as of May (Chart 5.1.13). Despite the fall in the weighted average funding rate of the CBRT in June, the rise in deposit rates continued, which is attributed to banks' efforts towards improving balance sheet besides the competition in deposit markets. In fact, deposit rates recorded a slight slackening following June.



FX-denominated business loan rates decreased by around 60 basis points in the second quarter (Chart 5.2.14). In this period, as the decline in interest rates on foreign currency accounts was more limited, the fall in FX-denominated loan-deposit rate spread lagged behind the fall in loan rates.

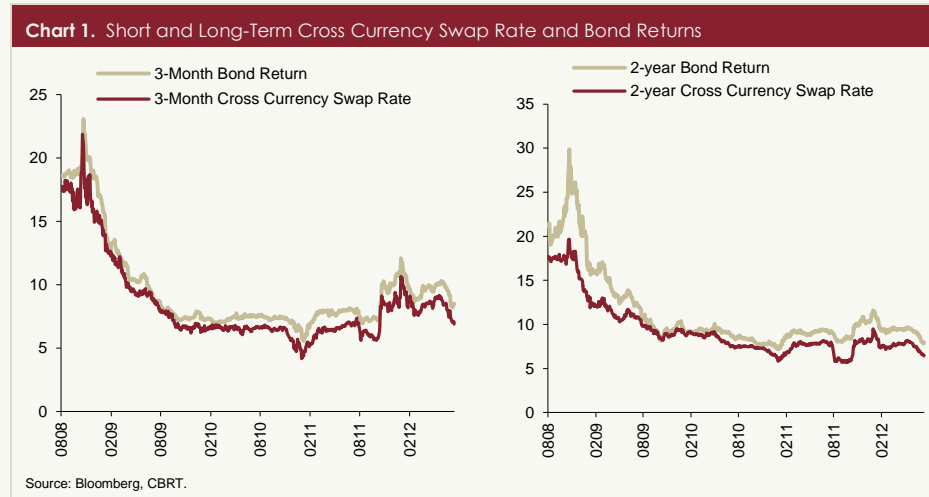
As a result, the effect of the monetary tightening implemented in October got slightly alleviated on loans in the second quarter. Nevertheless, the acceleration seen both in consumer and business loans in the second quarter was largely driven by seasonal factors, and growth rates attained by end-June hover around eligible levels for financial stability. Moreover, the change in the composition of loan growth in favor of the firms is also likely to affect the current account balance favorably in the medium term. Estimating that the rebound in

domestic economic activity and aggregated demand will continue at a modest pace, loan developments in the period ahead are expected to be largely shaped by demand-side factors.

Box
5.1

The Relation Between Cross Currency Swap Rates and Bond Returns

In the last decades, financial markets have been more complex, integrated and interrelated as a result of spreading and the diversification of derivative instruments. However, the arbitrage mechanism minimizes the mismatch between the prices of the rapidly increasing number of financial instruments and the functioning of financial markets. On the other hand, the more common use of derivative instruments in Turkey had some major impacts on financial markets. Hence, this Box analyzes the relation between bonds market and TL/USD cross currency swap markets. The co-movement of cross currency swap rates and bond returns in recent years hints for a close relation between these two markets in Turkey (Chart 1).



The Arbitrage Mechanism between Cross Currency Swap Rates and Bond Returns

A cross currency swap agreement is a financial instrument that provides the exchange of payments on principal and interest denominated in two different currencies between parties. In general, the interest on one leg is fixed and the other is floating in these agreements. The floating rate on cross currency swaps is commonly quoted as LIBOR versus fixed rate on the other leg and interest payments are annual in general (Hull, 2009). The cash flow structure of the fixed rate leg of the cross currency swap is similar to coupon bonds. The cash flow structure of a hypothetical TL/USD cross currency swap with a nominal value of 1 USD is shown in Table 1.

Table 1. Cash Flow of a Cross Currency Swap

	Initial Cash Flow	Periodic Cash Flow	Final Cash Flow
In USD	-1	+LIBOR _t	+1+LIBOR _t
In TL	+S ₀ *	-S ₀ .r _{d,0} *	-S ₀ (1+r _{d,0})

* S₀ and r_{d,0} are spot exchange rate and the cross currency swap rate in TL.

Cross currency swap agreements enable hedging against exchange rate risk and thus provides comparability of the returns on financial instruments in different currencies. Covered interest parity is also based on this comparability. Assuming absence of transaction costs and market imperfections, the return that is provided to an investor through a derivative instrument with no exchange rate risk should be equal to the return that can be provided through another financial instrument in domestic currency with similar cash flow and risk profile. Otherwise, covered interest parity allows for an arbitrage opportunity. The return from a foreign financial instrument will equal the total net cash flows from a cross currency swap in domestic currency with no exchange rate risk. (Popper, 1993). In that case covered interest parity can be expressed as follows:

$$r_d = r_f + r_{s,d} - r_{s,f}$$

Where r_d and r_f show the return on domestic and foreign financial instruments, respectively, while $r_{s,d}$ and $r_{s,f}$ denote the rate on domestic and foreign currency leg of the cross currency swap, respectively. The above expression also shows the relation between cross currency swap rate and bond returns. For example, a bank in Turkey converts the USD-denominated syndication loan with LIBOR cost to fixed-rate and TL-denominated liability through a cross currency swap, and the cost of the liability to the bank is the interest on the TL leg of the cross currency swap.¹ If the return of a TL bond with the same maturity exceeds this interest rate, the bank obtains a riskless arbitrage return. However, in that case, bond returns would fall and cross currency swap rates would rise, thus eliminating the arbitrage opportunity. Hence, the arbitrage mechanism relates bond returns to cross currency swap rates.

¹ The cost of syndication loan converted to fixed-rate TL-denominated liability through cross currency swap is $r_f + r_{s,d} - r_{s,f} = LIBOR + r_{s,d} - LIBOR = r_{s,d}$. The TL cost of the syndication loan changes to $r_{s,d} + 1\%$ if the original cost is LIBOR+1% instead of LIBOR.

The theoretically smooth arbitrage mechanism may be impaired in practice mainly due to transaction costs, varying conditions and operating hours in different markets, legal restrictions on short-selling and investors' portfolio structure and the insufficient liquidity or funds of investors (Shleifer and Vishny, 1997; Gromb and Vayanos, 2010). Furthermore, due to differences in credit riskiness, investors may face different costs while borrowing in foreign currency. Hence, this provides riskless profit opportunity to some investors, whereas the others may not benefit from the arbitrage opportunity.

Methodology and Findings

This Box analyzes the long-run relation between daily bond returns and TL/USD cross currency swap rates for different maturities during August 2008 and January 2012 period by co-integration relationship. A co-integration implies that any deviation from the equilibrium relation between bond returns and cross currency swap rates is stationary and temporary. In other words, in case of a co-integration relation, bond returns and cross currency swap rates do not deviate from each other systematically and permanently. Moreover, if the co-integration vector comprising the long-run equilibrium relation can be expressed as $[b, -b, c]$, where b is the error correction coefficient and c is a stable constant, the covered interest parity condition holds in the long run.

This Box estimates the co-integration relation and coefficients through the unrestricted error correction model by Pesaran, Smith and Shin (2001) as below:

$$\Delta Y = \Delta X\delta + \gamma Y_{-1} + \theta X_{-1} + \varepsilon$$

Where Y is the dependent variable, X is the vector of independent variables, ε is the error term, δ , γ and θ are the coefficients. The above model concludes that the series are co-integrated if γ is significantly less than zero by using the critical values estimated by Pesaran, Smith and Shin (2001). Meanwhile, as the model's specification requires setting one of the series as the dependent and the other series as the independent variable, the co-integration tests are conducted separately for bond returns and cross currency swap rates for every maturity.

Table 2. Pesaran, Smith and Shin Co-Integration Test Results						
Dependent Variable	Cross Currency Swap Rate			Bond Return		
		Error Correction Coefficient	Long-Run Equilibrium Coefficient^a		Error Correction Coefficient	Long-Run Equilibrium Coefficient^a
Maturity	t-statistic			t-statistic		
1-month	-5.624****	-0.154	0.926	-2.848	-0.033	1.095
2-month	-4.695****	-0.108	0.891	-3.746***	-0.033	1.016
3-month	-6.157****	-0.102	0.902	-3.608***	-0.035	0.977
6-month	-3.026**	-0.033	0.835	-3.016**	-0.025	0.974
9-month	-1.777	-0.014	0.640	-2.726	-0.019	0.905
1-year	-1.143	-0.008	0.284	-3.045**	-0.019	0.739
2-year	-1.073	-0.006	-	-3.136**	-0.021	-
3-year	-1.219	-0.007	-	-2.640	-0.016	-
4-year	-1.165	-0.006	-	-2.247	-0.017	-

^a Shows the ratio of the coefficient of the cross currency swap rate to the coefficient of the bond return.
** Statistically significant at 90 percent.
*** Statistically significant at 95 percent.
**** Statistically significant at 99 percent.
Source: Duran and KÜÇÜKSARACI (2012).

Table 2 shows that bond returns and cross currency swap rates are co-integrated at shorter maturities, while the statistical significance of the co-integration and the error correction in deviations from the equilibrium relation decline at longer maturities. At shorter maturities, bond returns and cross currency swap rates are mainly determined by near-term monetary policy expectations, while credit risk, liquidity risk and other factors adversely affecting arbitrage are more evident at longer maturities, and hence, the relation between bond returns and cross currency swap rates weaken. These findings are also consistent with other country experiences presented by Skinner and Mason (2012).

Furthermore, the finding of a higher statistical significance in co-integration relation where the cross currency swap rates are selected as the dependent variable hints that the arbitrage mechanism works from bond returns to cross currency swap rates. This finding is highly reasonable as banks and foreign investors particularly respond to bond markets through cross currency swap transactions. Moreover, short position in cross currency swaps can easily be taken, while short-selling in bonds is quite challenging.

On the other hand, the long-run equilibrium coefficients in Table 2 are close to 1, especially at shorter maturities. Accordingly, a 1 percent increase in bond returns raises cross currency swap rates by about 1 percent, which thus indicates that covered interest parity condition holds at least in the short term. Error correction coefficients for short maturities also show that deviations from the equilibrium relation between bond returns and cross currency swap rates are not permanent and arbitrage mechanism is strong especially at maturities up to 3 months.

Conclusion

The empirical findings in this Box discussed with respect to covered interest parity condition and the arbitrage mechanism show a strong relation between bond returns and cross currency swap rates in Turkey especially at short maturities, while the market dynamics differ at longer maturities. Furthermore, the empirical results indicate that investors benefit from arbitrage opportunities usually through cross currency swap transactions. However, the findings also show that the spread between bond returns and cross currency swap rates is more permanent, especially at maturities of 1 year or more.

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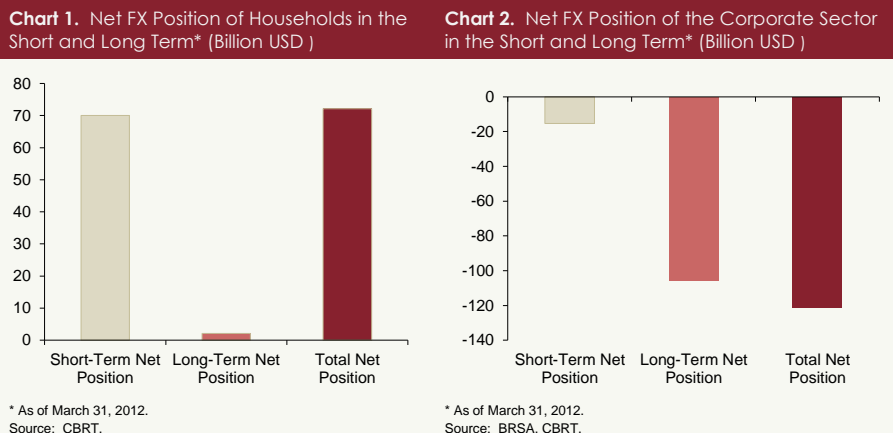
**Box
5.2**

Net Financial FX Position in Turkey

This Box analyzes the net FX position of Turkey released in November 2011 Financial Stability Report by its maturity breakdown. Short-term FX position is the difference between assets and liabilities with maturity equal to or less than 1 year. The Box discusses the net FX position of households, non-financial firms (corporate sector), banks, non-bank financial institutions, CBRT and the public sector.

Households

As of 31 March 2012, FX assets of households comprise of deposits and Eurobonds. With the amendment to the Decree No. 32 on the Protection of the Value of Turkish Currency, households are not allowed to borrow in FX-denominated or FX-indexed loans. FX-indexed loans borrowed prior to this amendment constitute the FX liabilities of households. Moreover, FX liabilities of households also include FX-indexed loans borrowed from consumer financing firms. The analysis of FX assets and liabilities of households by term-to-maturity demonstrates that households have net FX position surplus in both short and long-term as of 31 March 2012 (Chart 1).



In addition to the above FX assets and liabilities, households also have FX-denominated investment funds and retirement funds which have a relatively small share in their portfolios. Furthermore, households also have unregistered gold and FX assets, the amount of which is not known, and hence, not included in the analysis.²

² Households and the corporate sector also take position in derivative markets. However, due to absence of data on the liability or asset breakdown of derivative instruments, these are not included in the analysis.

Corporate Sector

As of 31 March 2012, FX assets of the corporate sector comprise of FX deposits in domestic and foreign banks, Eurobonds, export receivables, portfolio and direct investment by foreigners. FX deposits of the corporate sector in foreign banks and export receivables are assumed to be short term, while portfolio and direct investment by foreigners are long term. FX deposits at the domestic banks and the Eurobonds are decomposed as short and long-term. FX liabilities of the corporate sector, which is decomposed into short and long-term by term-to-maturity, contain FX-denominated and FX-indexed loans borrowed from domestic and foreign banks in addition to import liabilities.

Corporate sector has net FX position deficit in both short and long term (Chart 2). However, the share of short-term FX position is low in the total FX position. Given the fact that firm owners or partners may hold their income also in their personal accounts, a part of the FX position surplus of households may in fact be owned by the corporate sector.

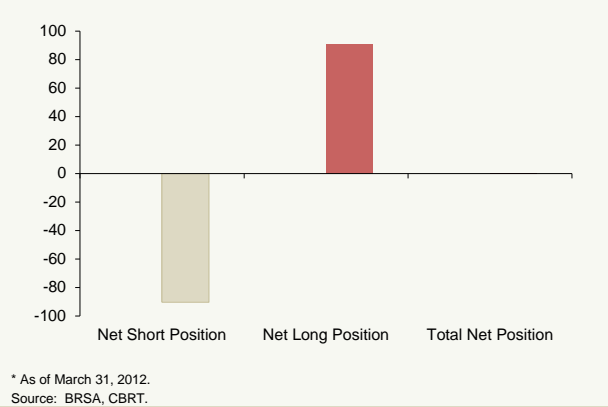
Financial Sector

A majority of FX assets in the banking sector balance sheet constitutes Eurobonds, FX-denominated and FX-indexed loans, FX reserve requirements and receivables from banks. Main FX liabilities in the banking sector balance sheet are foreign currency and precious metal deposit accounts, funds from the repo transactions and external loans. Balance sheet assets and liabilities are decomposed as short and long-term by term-to-maturity. The off-balance sheet FX position of the banking sector includes currency swaps as well as forward, futures and option transactions. The off-balance sheet derivative instruments are also decomposed as short and long-term by term-to-maturity.

The FX assets and liabilities of the non-bank financial institutions including factoring, financial leasing and consumer financing firms are decomposed as short and long-term by term-to-maturity, while their off-balance sheet foreign currency position is not decomposed, but simply accepted to be short term.

As of 31 March 2012, the financial sector including banks and non-bank financial institutions has a net FX position deficit of about USD 90 billion in the short term, with an almost equal amount of net FX position surplus in the long term (Chart 3).

Chart 3. Net FX Position of the Financial Sector in the Short and Long Term* (Billion USD)



CBRT

The CBRT conducts reserve management by directing the foreign currency resources of its own or other institutions to FX-denominated instruments. The CBRT's FX assets including gold, domestic correspondents, domestic credits, provisions for claims under legal proceedings, miscellaneous receivables, foreign credits and share participations are accepted as long term. Convertible FX receivables including cash and correspondent accounts are decomposed as short and long term.

CBRT's FX liabilities including banks' deposits, public deposits, FX assets of extrabudgetary funds including SDIF, letters of credit and provisional liabilities are assumed to be short term, while notes and remittances payable and foreign credits are accepted as long term. Banks' deposits contain FX reserve requirements in addition to TL required reserves that can be kept as foreign currency or gold. As of 31 March 2012, the CBRT has a net FX position in both short and long term (Chart 4).

Chart 4. Net FX Position of the CBRT in the Short and Long Term* (Billion USD)

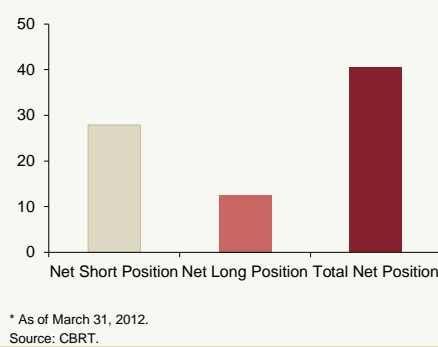
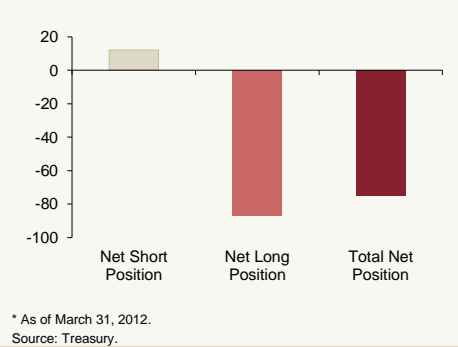


Chart 5. Net FX Position of the Public Sector in the Short and Long Term* (Billion USD)



Public Sector

FX assets of the public sector comprise FX deposits and securities of the general budget and extrabudgetary institutions as well as regulatory and supervisory institutions, social security institutions, state economic enterprises, funds, local governments, revolving funds and other public institutions. FX liabilities of the public sector include Eurobonds and loans. FX assets and liabilities of the public sector are decomposed as short and long term. The public sector has USD 12 billion of net FX position surplus in the short term, while USD 87 billion net FX position deficit in the long term (Chart 5).

Conclusion

The Box decomposes the net FX position of Turkey to short (with a maturity of equal to or less than 1 year) and long-term components. The analyzed sectors are households, non-financial firms, banks, non-bank financial institutions, CBRT and the public sector. As of 31 March 2012, Turkey has a net FX position surplus of USD 4.3 billion in the short term, while a deficit of USD 87 billion in the long term (Table 1).

Table 1. Net FX Position of Turkey in the Short and Long Term
(Billion USD)³

	Short-Term	Long-Term	Total
Households	69.98	2.09	72.08
Corporate Sector	-15.27	-105.68	-120.95
Financial Sector	-90.38	90.79	0.41
CBRT	27.91	12.57	40.48
Public	12.06	-86.77	-74.71
Total	4.31	-87.00	-82.69

Calculation and the maturity decomposition of FX position are significant indicators showing the degree of exchange rate and foreign currency liquidity risk for Turkey. Analysis of the total FX position deficit by sectors hints information on the possible imbalances that may be caused by sectoral divergences. This Box demonstrates that Turkey's net FX position deficit is USD 82.69 billion. On a sectoral basis, households, CBRT and the financial sector have net FX position surplus, while other sectors have net FX position deficit. Meanwhile, Turkey has a net FX position surplus in the short term.

³ The figures in Table 1 for the financial sector comprising of banks and non-bank financial institutions differ from May 2012 issue of the Financial Stability Report since the off-balance figures of the non-bank financial institutions are also included in net FX position calculations as well as due to revisions in financial sector figures.

6. Public Finance

In the second half of 2012, growth of tax revenues decelerated relatively due to the slowdown in the economic activity and interest payments surged owing to the maturity structure of the debt stock, thus weighing on the budget performance. Tax revenues will continue to be collected as per the Law No. 6111 on the restructuring of public claims in 2012, albeit posting a year-on-year decline. SCT rate hikes to some products under the fiscal measures enforced in October 2011, as well as the expected decline in the quarterly rate of increase in interest payments in the subsequent months will contribute to the improvement in the budget performance in 2012. On the other hand, possible decline in tax revenues amid a potential slowdown in the economic activity in 2012 besides a lower-than-targeted privatization revenues and upside risks to public expenditures, especially to personnel expenditures, may adversely affect the budget performance. Thus, it should be emphasized that in order to ensure sustainability of the favorable fiscal outlook as well as the fiscal discipline, reinforcement of the fiscal framework through institutional and structural improvements envisaged in the MTP remains critical.

6.1. Budget Developments

Central government budget posted a deficit of TL 6.7 billion, while primary balance recorded a surplus of TL 19.6 billion in the first half of 2012 (Table 6.1.1). The increase in interest expenditures by 17 percent was mainly influential on the year-on-year deterioration in the budget performance. Meanwhile, non-tax revenues surged owing to the profit transfer by the CBRT, thus compensating for the deterioration in the budget performance. On the other hand, the quarterly increase in interest expenditures is associated with the maturity structure of the debt stock, and is anticipated to slow down in the following months. Moreover, in the first half of the year, growth of tax revenues remained relatively subdued due to the deceleration in the economic activity, while primary budget revenues continued to increase mildly.

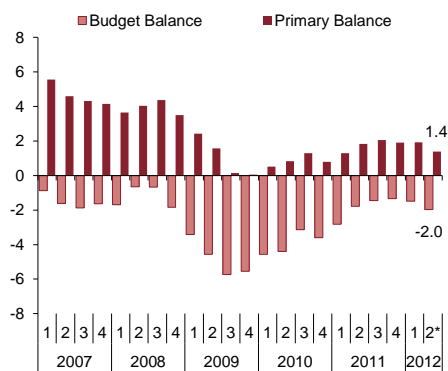
Table 6.1.1.
Central Government Budget Aggregates
(Billion TL)

	January-June 2011	January-June 2012	Rate of Increase (Percent)	Actual/Target (Percent)
Central Government Budget Expenditures	143.2	168.9	17.9	48.1
Interest Expenditures	22.4	26.3	17.0	52.3
Primary Expenditures	120.8	142.6	18.1	47.4
Central Government Budget Revenues	146.1	162.2	11.0	49.2
I. Tax Revenues	122.7	131.2	6.9	47.2
II. Non-Tax Revenues	18.5	24.9	35.1	56.6
Budget Balance	2.9	-6.7	-	31.8
Primary Balance	25.3	19.6	-22.7	67.1

Source: Ministry of Finance.

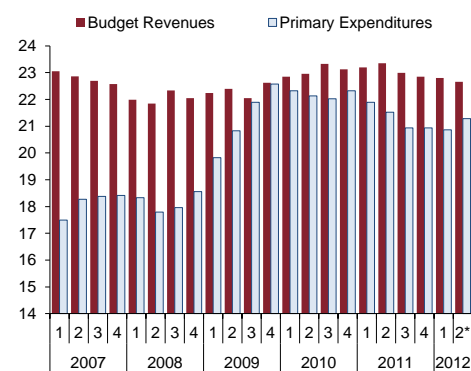
The central government budget balance to GDP, which displayed a year-on-year improvement in 2011 on the back of the favorable budget outturn, deteriorated moderately in the first half of 2012 due to falling budget revenues amid the slowdown in economic activity. Having worsened in the last quarter of 2011 amid rapidly soaring primary expenditures, the central government primary balance to GDP deteriorated further in the second quarter of 2012 (Chart 6.1.1). Central government budget revenues posted a modest year-on-year decline in 2011 and remained virtually unchanged from end-2011 in the second quarter of 2012, while central government primary expenditures to GDP has edged up since end-2011 (Chart 6.1.2).

Chart 6.1.1.
Central Government Budget Balance
(Annualized, Percent of GDP)



* Estimate.
Source: Ministry of Finance.

Chart 6.1.2.
Central Government Budget Revenues and Primary Expenditures
(Annualized, Percent of GDP)



Central government primary expenditures posted a year-on-year growth by 18.1 percent in the January-June period of 2012. Current transfers and personnel expenditures, which are major components of the primary expenditures, were up 21.3 percent and 19 percent, respectively, while expenditures on goods and services declined by 0.4 percent, mainly on the back of the dramatic fall in health expenditures due to the coverage of green

card holders under the general health insurance plan. Meanwhile, expenditures within the general health insurance plan are a component of current transfers, not a sub-item of the purchases of goods and services. Accordingly, health, pension and social benefits, the major component of current transfers, went up by 26.5 percent following the amendment to the coverage of the health insurance, contributing to the increase in current transfer expenditures. The rise in personnel expenditures in the first half of 2012 was mainly driven by the surge in salaries and severance pay. Capital expenditures increased relatively mildly by 6.1 percent, whereas capital transfers went down by 36.3 percent due to the decline in infrastructural rural support project and other capital transfer items (Table 6.1.2).

Table 6.1.2.
Central Government Primary Expenditures
(Billion TL)

	January-June 2011	January-June 2012	Rate of Increase (Percent)	Actual/Target (Percent)
Primary Expenditures	120.8	142.6	18.1	47.4
1. Personnel Expenditures	36.8	43.8	19.0	53.6
2. Government Premiums to SSI	6.3	7.3	15.3	51.3
3. Purchase of Goods and Services	12.4	12.3	-0.4	42.8
a) Defense and Security	3.5	3.8	8.4	35.9
b) Health Expenditures	2.6	0.4	-85.0	42.4
4. Current Transfers	55.0	66.7	21.3	51.2
a) Duty Losses	0.9	0.9	1.0	19.9
b) Health, Pension and Social Benefits	27.2	34.4	26.5	49.7
c) Agricultural Support	5.5	6.3	13.1	87.1
d) Shares Reserved from Revenues	14.6	16.7	14.3	49.3
5. Capital Expenditures	6.8	7.2	6.1	25.9
6. Capital Transfers	1.7	1.1	-36.3	26.0

Source: Ministry of Finance.

Central government general budget revenues posted a year-on-year increase by 10.6 percent in the first half of 2012. Meanwhile, tax revenues and non-tax revenues soared by 6.9 percent and 35.1 percent, respectively due to the profit transfer by the CBRT (Table 6.1.3). Corporate taxes surged in the first five months of 2012 amid soaring profits owing to high growth in 2011, while increasing only mildly in the first half of the year by 3.8 percent owing to the base effect in June due to the Law No. 6111 on the restructuring of public claims. The income tax revenues increased by 15.7 percent on the back of the ongoing increase in registered employment. This has partially compensated for the deceleration in total tax revenues amid the relative slowdown in the growth of indirect taxes. On the other hand, the rate of increase in consumption-based taxes went down due to the slowdown in economic activity. In the first half of 2012, SCT revenues increased by 4.5 percent, while domestic VAT revenues edged up by 1.7 percent. The slowdown in the growth of SCT revenues mainly

stemmed from the year-on-year decline in SCT collection on oil and natural gas products, as well motor vehicles. In the meantime, amid the slowdown in domestic demand, VAT revenues on imports registered a decline by 0.3 percent, remaining well below the growth rate by 34.5 percent in 2011.

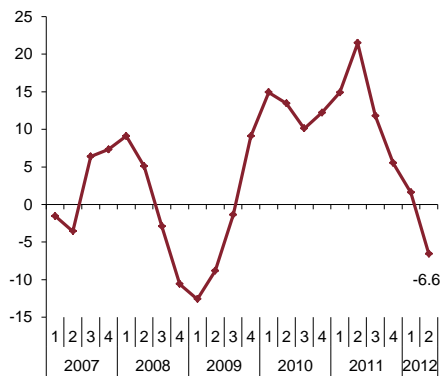
Table 6.1.3.
Central Government General Budget Revenues
(Billion TL)

	January-June 2011	January-June 2012	Rate of Increase (Percent)	Actual/Target (Percent)
General Budget Revenues	141,2	156,1	10,6	48,5
I-Tax Revenues	122,7	131,2	6,9	47,2
Income Tax	23,2	26,8	15,7	49,8
Corporate Tax	13,9	14,4	3,8	53,0
Domestic VAT	15,1	15,4	1,7	45,8
SCT	29,8	31,3	5,4	44,4
VAT on Imports	23,3	23,3	0,3	43,3
II-Non-Tax Revenues	18,5	24,9	35,1	56,6
Enterprises and Property Revenues	6,0	10,9	82,2	117,9
Interests, Shares and Fines	9,9	10,2	3,7	46,7
Capital Revenues	1,8	1,4	-24,7	12,2

Source: Ministry of Finance.

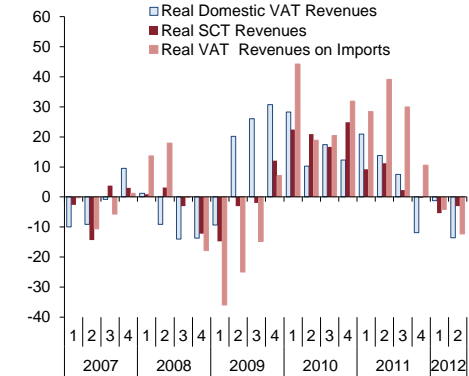
Having decelerated since the third quarter of 2011, annual growth of real tax revenues turned negative for first time in a 10-quarter period amid the slowdown in the economic activity as well as the base effect, and posted a 6.6 percent decline in the second quarter of 2012 (Chart 6.1.3). Consumption-based tax revenues are the primary tax revenue items which are adversely affected by the slowdown in the economic activity. Accordingly, in the second quarter of 2012, SCT revenues, a major component of the tax revenues, fell by 3.1 percent year-on-year in real terms, while domestic VAT revenues and VAT revenues on imports posted a year-on-year decline by 13.6 percent and 12.3 percent, respectively, in real terms (Chart 6.1.4).

Chart 6.1.3.
Real Tax Revenues
(Annual Percent Change)



Source: Ministry of Finance.

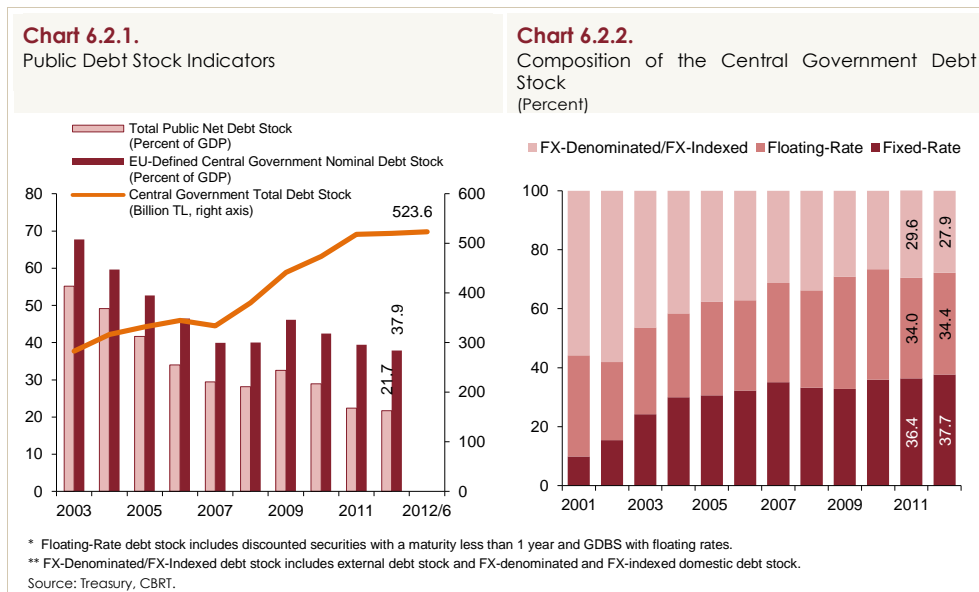
Chart 6.1.4.
Real VAT and SCT Revenues
(Annual Percent Change)



6.2. Developments in the Debt Stock

Public debt stock indicators improved further in the second quarter of 2012. Public debt rates continued to decrease and the real cost of borrowing remained low. Meanwhile, the average maturity of the debt stock was extended, the share of interest and exchange-rate-sensitive securities in the debt stock declined and domestic debt rollover ratio went down.

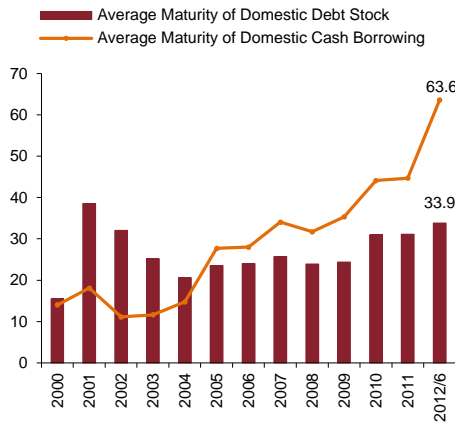
The ratio of total public net debt stock and EU-defined general government nominal debt stock to GDP posted a year-on-year decline by 0.7 points and 1.5 percentage points, to 21.7 percent and 37.9 percent, respectively, in the first quarter of 2012 (Chart 6.2.1). Meanwhile, the central government debt stock remained unchanged in June 2012 from end-2011 (Chart 6.2.1).



As of June 2012, the Treasury has maintained its borrowing strategy to alleviate the sensitivity of the debt stock to liquidity, interest rate and exchange rate. Accordingly, the share of fixed-rate securities increased in the total debt stock (Chart 6.2.2). The ratio of public deposits to the average monthly debt service reached 249.7 percent. Term-to-maturity of the domestic debt stock hit 33.9 months amid the marked year-on-year increase in the average maturity of the domestic cash borrowing (Chart 6.2.3). External borrowing by bond issues amounted to USD 4.6 billion, with the average maturity remaining unchanged since 2011 (Chart 6.2.4).

Chart 6.2.3.

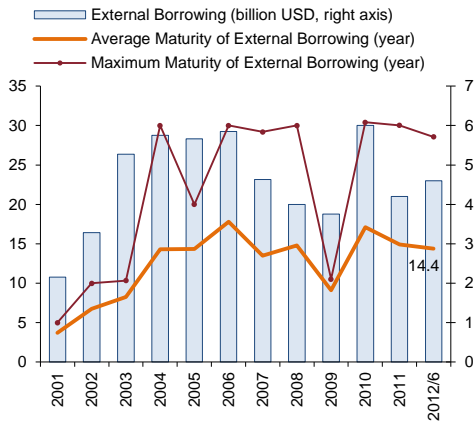
Average Maturity of Domestic Cash Borrowing and Term-to-Maturity of the Domestic Debt Stock (Month)



Source: Treasury, CBRT.

Chart 6.2.4.

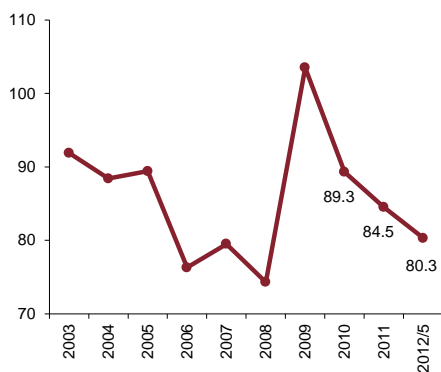
Borrowing By Bond Issue



Domestic debt rollover ratio stood at 80.3 percent at the end of the first five months of 2012 (Chart 6.2.5). However, according to the Treasury's announced strategy on domestic borrowing for July-September 2012 period, domestic debt rollover ratio is envisioned to reach 81.3 percent by end-September. Having plunged from early 2009 to the start of 2011, the average real interest rates at discount auctions remain currently low (Chart 6.2.6).

Chart 6.2.5.

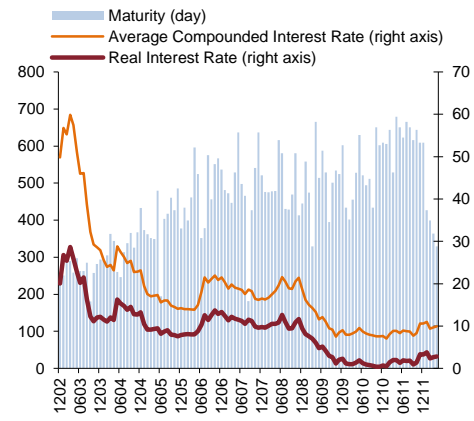
Total Domestic Debt Rollover Ratio (Percent)



Source: Treasury, CBRT.

Chart 6.2.6.

Average Maturity of Borrowing and Interest Rates at Discount Auctions



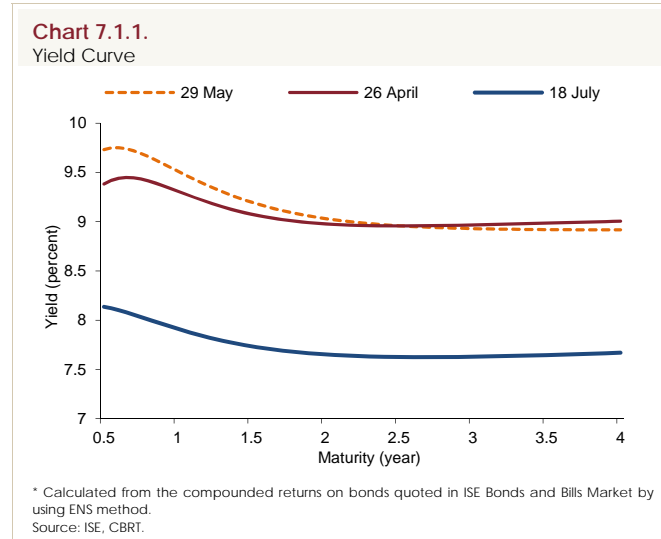
7. Medium-Term Forecasts

This Chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Policy and Conditions

In the inter-reporting period, the CBRT continued with its tight monetary stance. With a view to preventing the possible adverse effects of a higher-than-targeted inflation on the pricing behavior, additional tightening was implemented more frequently as per the decisions taken in the April meeting of the MPC. Accordingly, the weighted average interest rate for the liquidity the CBRT provides to the market was raised in May and early June (Chart 5.1.12). Starting from June, due to the favorable developments in inflation and the balancing between domestic and external demand, the average cost of the funds provided by the CBRT was reduced. In the meantime, O/N repo rates at the ISE trended downwards (Chart 5.1.13).



Short-term market rates which went up in May, has decreased remarkably since June. This is attributed to the suspension of the monetary tightening as well as the upgraded sovereign risk owing to the improvement in the global risk appetite and the better-than-expected macroeconomic outlook. As of the first half of July, the yield curve declined across all maturities compared to the April Inflation Report (Chart 7.1.1).

It was stated in the MPC meeting of July 19, 2012 that as inflation will continue to hover at high levels for an extended period, thus posing risks to the pricing behavior, the cautious stance will be maintained. In this respect, also considering the prevailing uncertainties regarding the global economy, the MPC has stated that it would be appropriate to preserve the flexibility of the monetary policy. It was reiterated that the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, as needed.

Inflation

Annual consumer inflation in the second quarter of 2012 remained below the forecast presented in the April Inflation Report with 8.87 percent (Chart 1.2.1). This was driven by the more-than-expected decline in unprocessed food and energy prices. Annual inflation in core goods maintained its downward trend in this period, while services inflation increased modestly. Meanwhile, amid the alleviation of demand and cost-side pressures, core inflation indicators trended downwards.

The favorable course of unprocessed food prices in the first quarter strengthened further in the second quarter. Thus, the contribution of unprocessed food prices to inflation in the second quarter lagged behind the level envisaged in the April Inflation Report. Meanwhile, processed food prices recorded a higher-than-expected increase. However, the contribution of food prices to inflation declined relative to the previous reporting period. Against this background, food inflation assumption for end-2012 was revised downwards from 7.5 percent to 7 percent (Table 7.1.1). This revision reduced the inflation forecast for end-2012 by about 0.15 percentage points. Moreover, envisioning that the slowdown in the global economy will contain rises in agricultural commodity prices in the medium term, food inflation assumption for 2013 has been revised downwards by 0.5 percentage points.

Table 7.1.1.
Revisions to 2012 Assumptions

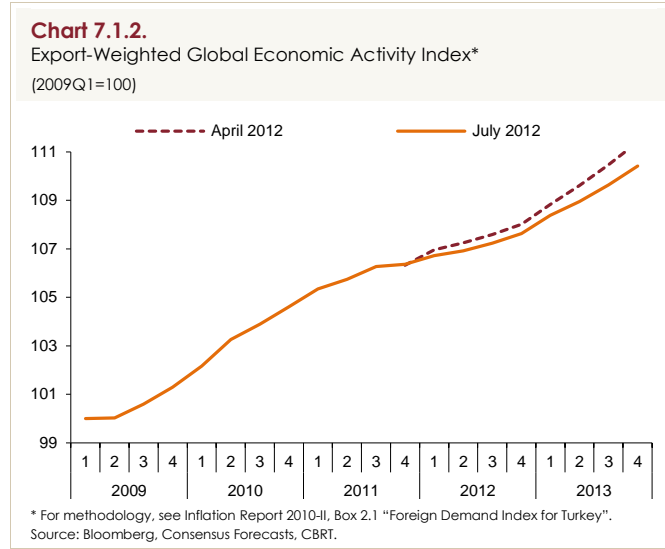
		April 2012	July 2012
Output Gap	2012Q1	-1.20	-1.20
	2012Q2	-1.45	-1.45
Food Price Inflation (Year-end Percent Change)	2012-2013	7.5	7.0
Import Prices (Average Annual Percent Change, USD)	2012	-0.7	-3.9
	2013	-0.7	-1.8
Oil Prices (Annual Average, USD)	2012	120	110
	2013	115	100
Export-Weighted Global Production Index (Average Annual Percent Change)	2012	1.4	1.1
	2013	2.4	2.1

Demand Conditions

In the first quarter of 2012, economic activity remained consistent with the projections presented in the April Inflation Report. Final domestic demand grew moderately, while net external demand fuelled annual growth, thus resulting in a further balancing of the demand composition in the second quarter. Although the national accounts data regarding the first quarter of 2012 point to a persisting deceleration since the first quarter of 2011, indicators for the second quarter suggest that this negative course will not be permanent. In fact, industrial production boomed on a quarterly basis in the April-May period. This strong recovery is attributed to the compensation of the poor figures of the first quarter, resulting in a mild course in the underlying trend of the economic activity.

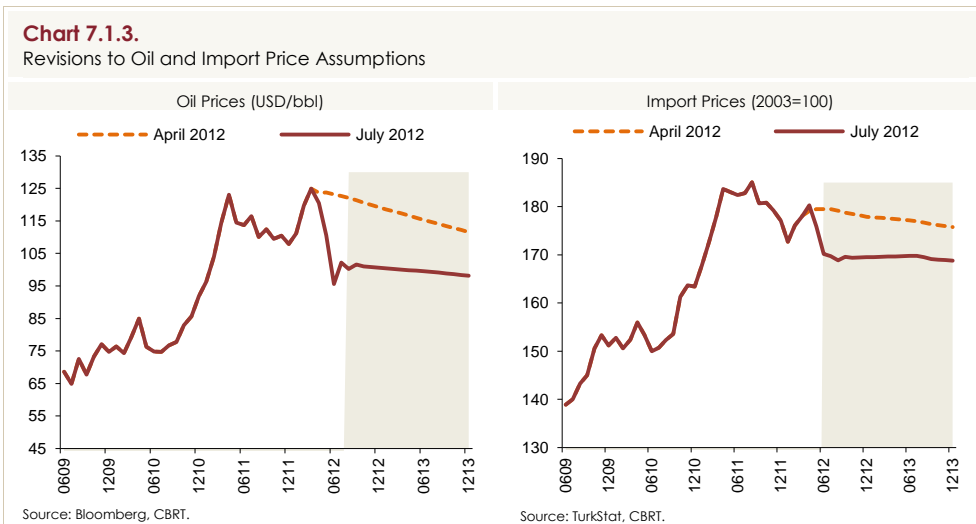
The deterioration of the global growth outlook in the inter-reporting period led to a slightly downward revision of the export-weighted global production index (Chart 7.1.2). Nevertheless, both the cumulative effects of the counterbalancing policies and market diversification in external markets contained the effect of the slowdown in global growth on exports.

Against this background, output gap forecasts for the first quarter of 2012 have remained unchanged since the publication of the April Inflation Report (Table 7.1.1).



Import Prices

In the second quarter of 2012, oil prices remained below projections presented in the April Inflation Report due to the deterioration in the global growth outlook besides demand-side developments. Accordingly, the assumption for average oil price was reduced from USD 120 to USD 110 for 2012. This revision was mainly led by the decline in forecast for average oil price from USD 114 in the first half to USD 105 in the second-half of the year. As for 2013, average oil price is assumed to be USD 100 (Table 7.1.1 and Chart 7.1.3).



Import prices in general also displayed a favorable course similar to oil prices. Current projections based on futures prices assume that USD-

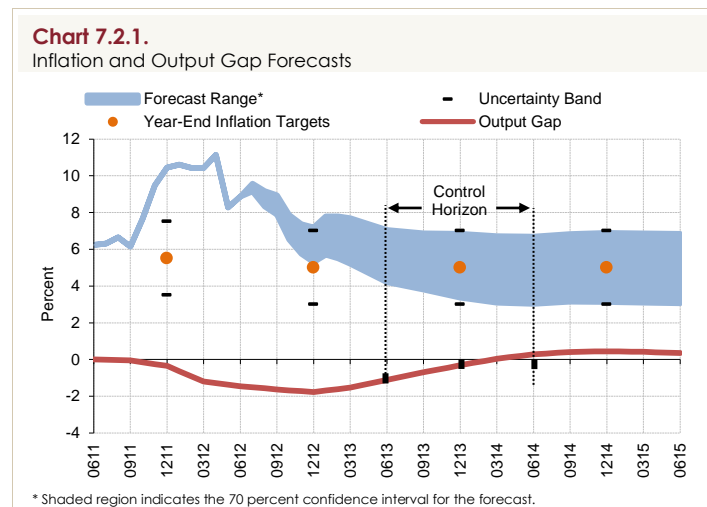
denominated import prices will go down by a year-on-year 3.9 percent in 2012. Thus, our assumptions for import prices in 2012 were revised notably downwards in the inter-reporting period (Chart 7.1.3). This revision in addition to the developments in the exchange rate lowered the inflation forecast for end-2012 by 0.15 percentage points.

Fiscal Policy and Tax Adjustments

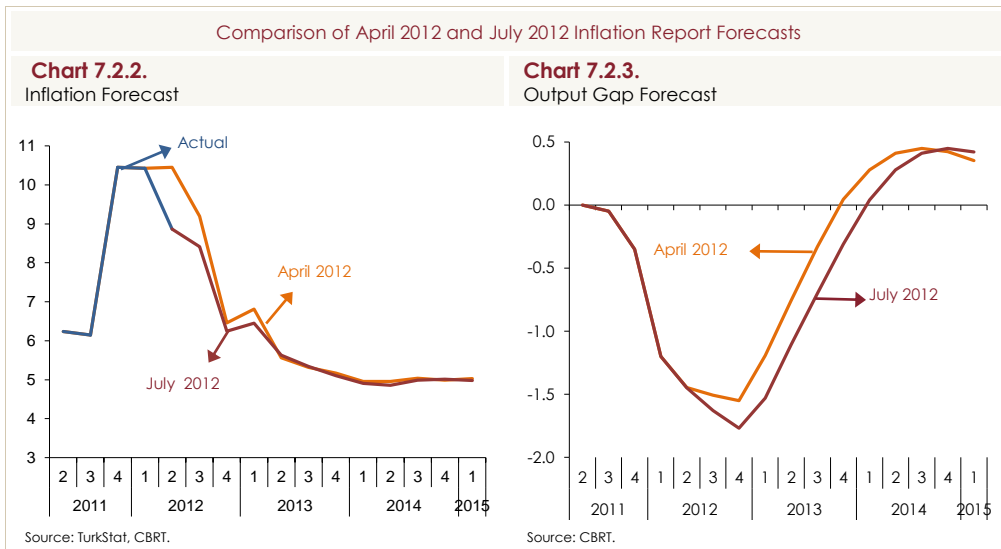
Regarding the fiscal outlook, medium-term inflation forecasts take the revised projections of the MTP as given. Accordingly, the ratio of primary expenditures to GDP is assumed to remain broadly unchanged in the second half of the year. As per the arrangements introduced to taxes imposed on tobacco products in the last quarter of 2011, tobacco prices are envisaged to remain unchanged throughout 2012, and increase at the beginning of 2013 at rates implied by the tax adjustments announced in October 2011. Furthermore, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and the automatic pricing mechanisms.

7.2. Medium-Term Outlook

Forecasts are based on the assumption that monetary policy will maintain its cautious and flexible stance, and annual loan growth rate will be around 14 percent by the end of the year as in the previous Report. Accordingly, inflation is expected to be, with 70 percent probability, between 5.3 and 7.1 percent (with a mid-point of 6.2 percent) at the end of 2012, and between 3.4 and 6.8 percent (with a mid-point of 5.1 percent) at the end of 2013. Inflation is expected to stabilize around 5 percent in the medium term (Chart 7.2.1).



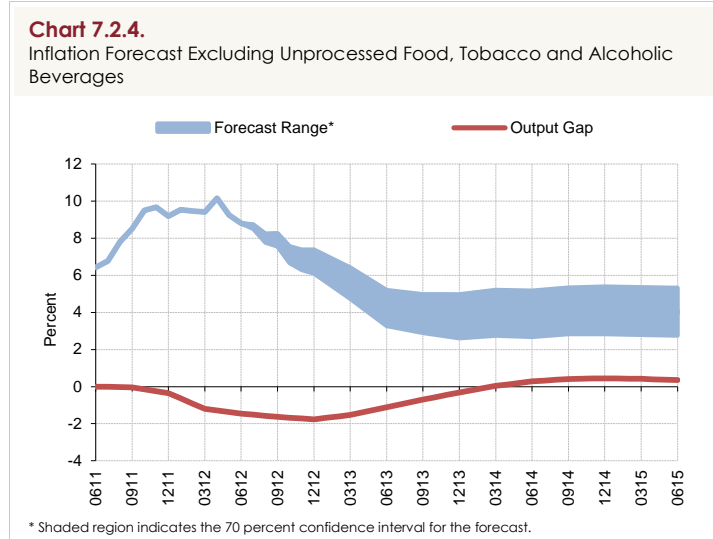
Overall, the year-end inflation forecast is lowered by 0.3 percentage points owing to positive developments in factors affecting inflation (Chart 7.2.2). Revised forecasts indicate that inflation will resume a downward trend following a slight increase in July. The fall in inflation will become more evident in the last quarter of the year as the base effect stemming from tax adjustments in administered products will be removed and inflation will reach 6.2 percent in end-2012.



As the latest data releases were largely consistent with the projections presented in the April Inflation Report, output gap forecasts for the second quarter of 2012 remained unchanged. Meanwhile, owing to the weak course of the global economy, forecasts are based on the outlook assuming that aggregate demand conditions will provide a slightly increased support to disinflation as of the second quarter of 2012 (Chart 7.2.3).

Unpredictable fluctuations in the prices of items that are beyond the domain of the monetary policy, such as unprocessed food, tobacco and alcoholic beverages, are among major factors causing deviations in inflation forecasts. Hence, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are publicly announced. Forecasts are based on the assumption that year-end unprocessed food inflation will be 6.0 percent and the prices of tobacco and alcoholic beverages will remain constant throughout the year. Inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are presented in Chart 7.2.4. The inflation indicator, as

measured above, is expected to maintain its downward trend it has assumed since May 2012 and stabilize around 5 percent in the medium term.



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.

Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents, being aware of the temporary factors, should focus on the underlying medium-term inflation, and therefore, take the inflation target as a benchmark in their pricing plans and contracts. In this respect, to serve as a reference guide, CBRT's current inflation forecasts should be compared to inflation expectations of other economic agents. Accordingly, year-end inflation expectations as well as 12-month and 24-month ahead inflation expectations of the Survey of Expectations' respondents are slightly above our baseline scenario forecasts (Table 7.2.1).

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2012 Year-end	6.25	6.98	5.0
12-month ahead	5.53	6.78	5.0
24-month ahead	4.90	6.33	5.0

* July 2012, second survey period results.

** Calculated by linear interpolation of year-end inflation targets for 2012-2014.

Source: CBRT.

7.3. Risks and Monetary Policy

Ongoing uncertainty regarding the global economy requires the maintenance of a flexible approach in monetary policy. The perception that leading central banks will keep interest rates at low levels for a prolonged period encourages the search for yield. On the other hand, despite the steps taken for the resolution of problems regarding the Euro Area, risk appetite remains highly sensitive to news due to ongoing fragilities in the financial system, elevated levels of sovereign borrowing costs and weakening growth outlook. Therefore, it is highly likely that short-term capital inflows will continue to be volatile in the forthcoming period. Under these conditions, it is important to preserve the flexibility of monetary policy in either direction.

A further weakening in global economic outlook may prompt central banks of the advanced economies to implement additional monetary easing. Such an event would feed into macro financial risks for emerging economies like Turkey. A resurgence in short-term capital inflows may slow down the balancing process through rapid credit growth and appreciation pressures on domestic currency. Should such a risk materialize, the CBRT may keep short-term rates at low levels while delivering tightening through reserve requirements, including the mechanism it has developed for reserve requirements by increasing the coefficients which define the amount of foreign exchange to be held per unit of Turkish lira reserve requirements.

It is also likely that problems in the Euro Area may further intensify, given the ongoing deleveraging process in banking, household and public sector balance sheets and possible delays in the institutional mechanisms to resolve the related problems. Should such a risk materialize, the immediate reaction could be to implement an active liquidity policy via the interest rate corridor to be followed by measures to relieve the tension in the banking system through the use of reserve requirements as well as other liquidity instruments.

On the other hand, aggregate demand and commodity prices may increase faster than expected should the measures taken towards the solution of problems regarding the global economy are completed sooner and more decisively than envisaged. Materialization of such a risk would possibly require a tightening using all policy instruments, as it would mean increased pressures on the medium-term inflation outlook.

Another risk factor in the forthcoming period is the uncertainty regarding commodity prices. Although the weak course of the global economy largely contains the upside risks to commodity prices, ongoing geopolitical and supply-side problems pose upside risks to energy prices in the short term. Moreover, recent hikes in agricultural commodity prices pose risks to processed food prices. Should such risks materialize, the CBRT will not react to temporary price movements, yet will not tolerate any deterioration in expectations.

Unprocessed food prices pose downside risk to inflation outlook over 2012 as also highlighted in the April Inflation Report. A rather cautious approach was adopted in the current Report, assuming a reversal in the favorable trend observed during the first half of the year. Year-end inflation may be lower than projected in the baseline scenario should unprocessed food prices follow a more favorable course than expected.

Inflation will continue to stay above the target for some time, necessitating a cautious stance regarding pricing behavior. Although the monetary tightening implemented since last October and the moderate aggregate demand outlook reduce the likelihood of the materialization of second round effects, pricing behavior will be monitored closely in the forthcoming period.

The CBRT monitors fiscal policy developments closely while formulating its monetary policy. The baseline scenario forecasts of the Report are based on the MTP framework. Therefore, neither a deterioration in the budget balance nor an increase in administered prices is assumed. A revision in 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.

Maintaining the prudent fiscal policy implemented in recent years is crucial for preserving the resilience of our economy against existing global uncertainties. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving deficit would support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. This will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities at low levels. In this respect,

steps towards implementation of the structural reforms envisaged by the MTP remain to be of utmost importance.

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Abbreviations

AMA	Automotive Manufacturers Association
bbI	barrel
BRSA	Banking Regulation and Supervision Agency
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Price Index
ECB	European Central Bank
EMBI	Emerging Markets Bond Index
EPFR	Emerging Portfolio Fund Research
EU	European Union
Fed	Federal Reserve Bank
FHFA	Federal Housing Finance Agency
FX	Foreign Exchange
GBP	Great British Pound
GDP	Gross Domestic Product
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
MPC	Monetary Policy Committee
MSCI	Morgan Stanley Capital International
MTP	Medium-Term Program
OECD	Organization for Economic Co-Operation and Development
O/N	Overnight
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
PPI	Producer Price Index
SCA	Special CPI Aggregate
SCT	Special Consumption Tax
SDIF	Savings Deposit Insurance Fund
SME	Small and Medium-Sized Enterprises
S&P	Standard and Poor's
SSI	Social Security Institution
TL	Turkish Lira
TurkStat	Turkish Statistical Institute
UK	United Kingdom
US	United States
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax
VIX	Volatility Index
WEO	World Economic Outlook
WGMA	White Goods Manufacturers Association
WTO	World Trade Organization

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24 Ocak 2012 (Salı)	31 Ocak 2012 (Salı)	
21 Şubat 2012 (Salı)		
27 Mart 2012 (Salı)		
18 Nisan 2012 (Çarşamba)	26 Nisan 2012 (Perşembe)	
29 Mayıs 2012 (Salı)		31 Mayıs 2012 (Perşembe)
21 Haziran 2012 (Perşembe)		
19 Temmuz 2012 (Perşembe)	26 Temmuz 2012 (Perşembe)	
16 Ağustos 2012 (Perşembe)		
18 Eylül 2012 (Salı)		
18 Ekim 2012 (Perşembe)	24 Ekim 2012 (Çarşamba)	
20 Kasım 2012 (Salı)		29 Kasım 2012 (Perşembe)
18 Aralık 2012 (Salı)		