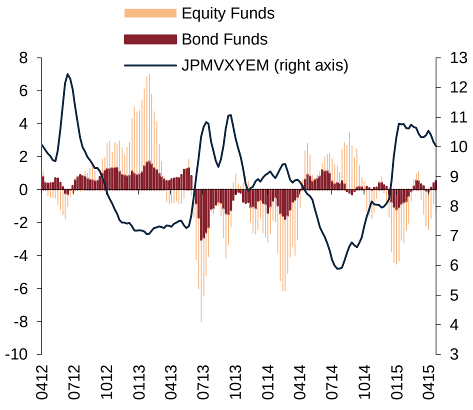
1. Overview

The first quarter of 2015 was marked by the ongoing turbulence in global financial markets, which was attributed to the continued divergence among global monetary policies, the uncertainties over the normalization process and the feeble economic activity. In this context, portfolio flows to emerging economies remained weak and the volatility of exchange rates increased (Chart 1.1). Similarly, emerging market risk premiums exhibited a fluctuating pattern (Chart 1.2). In this period, global economic activity likewise remained weak. Growth rates in emerging economies started to slow down following the fast recovery after the global financial crisis, recording the lowest levels in the post-crisis period as of 2014. Looking at advanced economies, the US economy continues to perform relatively strong, while growth in the EU is still weak despite the limited recovery in economic activity in the last quarter of 2014. Leading indicators regarding the first quarter of 2015 signal a limited improvement in global economic activity. Meanwhile, the EU economy, which is crucial for the external demand for Turkish exports, has shown signs of recovery.

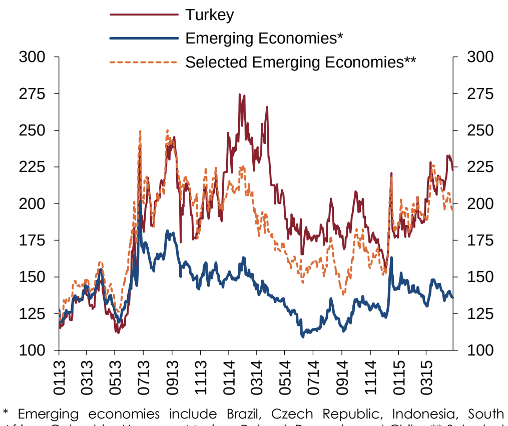
Volatility across global markets had implications for the Turkish economy as well, causing fluctuations in risk premium indicators and exchange rates. This period of heightened global uncertainty poses several opportunities and challenges for the Turkish economy. Falling commodity prices help to improve inflation and the external balance by affecting input costs positively. Additionally, the increase in disposable income driven by declining energy prices is likely to support growth. Low levels of long-term interest rates are also contributing positively to the economy. In an environment of low global interest rates, extending the maturities of external debt and supporting prudential borrowing will strengthen financial stability. However, the weak global economy weighs on growth by restraining exports. Moreover, the high volatility in the EUR/USD parity caused by the divergence among monetary policies may have an adverse effect on the export outlook owing to Turkey's external demand composition.

Chart 1.1.
Portfolio Flows to Emerging Economies
(4-Week Moving Average, Billion USD) and JPMVXYEM Volatility Index (Percent)



Source: EPFR, Bloomberg.

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



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

Annual growth saw some deceleration in 2014. On the production side, the supply-related contraction in the agricultural value added was a factor in this slowdown. On the expenditures side, net exports were the main contributor to growth. Thus, the current account balance improved substantially in 2014. Data released for the first quarter of 2015 point to a loss of pace in economic activity driven by both domestic and external demand. Following the sluggish first quarter, economic activity is expected to display a moderate and gradual recovery.

The positive effects of the cautious monetary policy stance and the macroprudential measures helped core inflation indicators improve in the first quarter of the year. High food inflation, however, was the key factor delaying the decline in consumer inflation. The inflation outlook has somewhat deteriorated due to cost pressures, yet disinflation is expected to resume due to the cautious monetary policy stance and a possible correction in food prices.

1.1. Monetary Policy and Financial Conditions

In the first quarter of 2015, the CBRT implemented measured policy rate cuts and maintained its cautious monetary policy stance by employing a tight liquidity policy (Chart 1.1.1). In view of the improved core inflation indicators, the CBRT lowered the 1-week repo auction rate from 8.25 percent to 7.75 percent in January and 7.5 percent in February. Moreover, overnight borrowing and lending rates were lowered by 50 basis points each in February. Rate cuts were kept modest in January and February due to ongoing global uncertainty, volatility in energy prices, rising domestic food prices and relatively high levels of inflation expectations. The CBRT average funding rate has been slightly above 7.5 percent due to the recent liquidity policy.

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

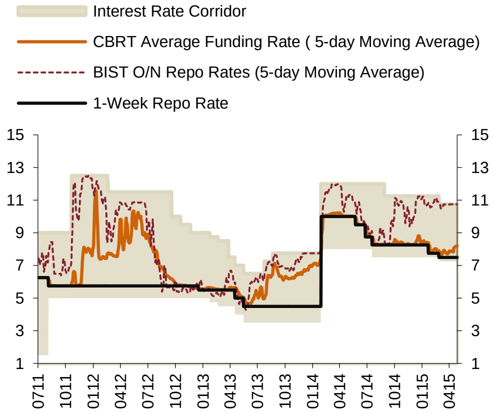
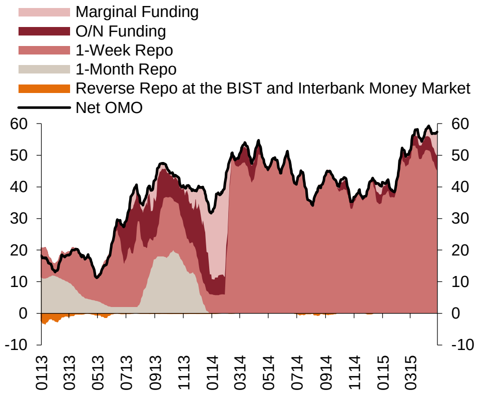


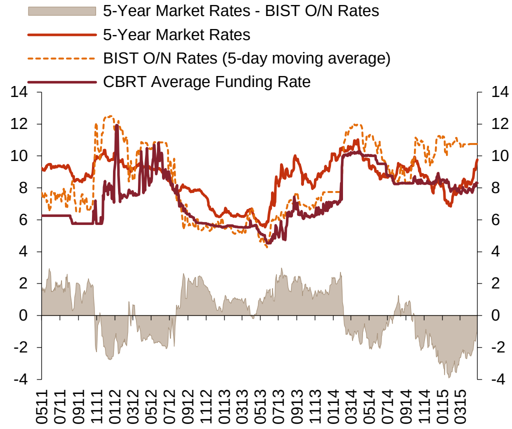
Chart 1.1.2.
CBRT Funding
(2-Week Moving Average, Billion TL)



Source: BIST, CBRT.

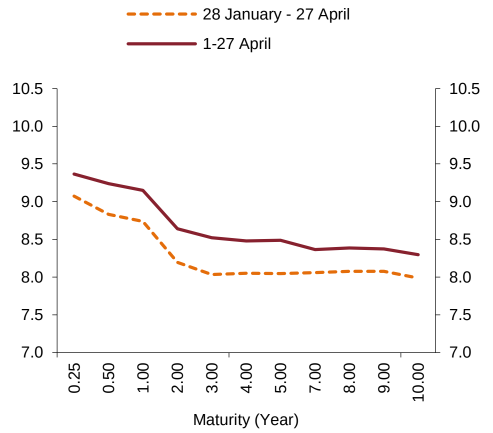
The CBRT stated that uncertainty in global markets and elevated food prices necessitated implementing a cautious monetary policy stance. Thus, it was emphasized that inflation expectations, pricing behavior and other factors that affect inflation would be monitored closely and the cautious monetary policy stance would be maintained until there is a significant improvement in the inflation outlook. Owing to the tight liquidity policy stance, the spread between 5-year market rates and the overnight repo rates at the BIST Interbank Money Market continued to take negative values (Chart 1.1.3). Along with these developments, the yield curve has remained nearly flat (Chart 1.1.4).

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



Source: BIST, Bloomberg, CBRT.

Chart 1.1.4.
Yield Curve
(Percent)



Source: Bloomberg.

The CBRT has taken several measures regarding foreign exchange liquidity due to the recently heightened volatility in exchange rates. Starting from 27 February 2015, the amount of foreign exchange selling auctions has been set more flexibly. On 10 April 2015, it was announced that on days when deemed necessary the FX selling auction amount might be increased by up to 30 million USD above the pre-announced minimum amount. Additionally, on 10 March 2015, in order to meet the temporary foreign exchange liquidity needs of the banking sector and to reduce the TL-denominated intermediation costs, some technical adjustments were made to different tranches of the reserve option coefficients. Again, to this end, the remuneration rate for the required reserves maintained in Turkish lira was raised by 50 basis points at the MPC meeting in April, effective as of 8 May 2015.

Moreover, in order to lessen macrofinancial risks and to support prudential borrowing, the required reserve ratios applied to non-core FX short-term liabilities of banks and financing companies were raised to encourage banks to extend the maturity of their external borrowing. In addition, in view of the global interest rate developments, the rates applied to banks' 1-week FX borrowings from the CBRT were reduced on 9 March and 22 April 2015. Accordingly, the 1-week FX deposit interest rate, which was 7.5 percent and 6.5 percent before early March, was lowered to 4 percent and 2 percent for US dollar and euro, respectively, as of 24 April 2015.

Thanks to the tight monetary policy stance and the macroprudential measures, the loans provided to the non-financial sector continued on a moderate course in the first quarter of 2015. Adjusted for exchange rate changes, loans provided to the non-financial sector increased by 17.6 percent year-on-year and by 16 percent in annualized 13-week moving average terms that cover the first quarter of 2015. Although annual loan growth may increase slightly in the short term due to the weak base from the past year, no acceleration is expected for the underlying trend and loans will keep growing at a reasonable pace given the modest course of financial conditions. A comparison of consumer and commercial loans shows that commercial loans continue to grow more rapidly than consumer loans. The annualized growth rate of commercial loans moved closer to the 2007-2014 average towards the end of the first quarter of 2015, whereas the annualized growth rate of consumer loans remained below the 2007-2014 average (Charts 1.1.5 and 1.1.6). The macroprudential policies in recent years have helped to bring the credit expansion rate to sustainable levels and to direct the loan composition towards encouraging production rather than consumption. In this sense, the faster growth rate of commercial loans contributes to both the re-balancing process and to financial stability.

Chart 1.1.5.
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)

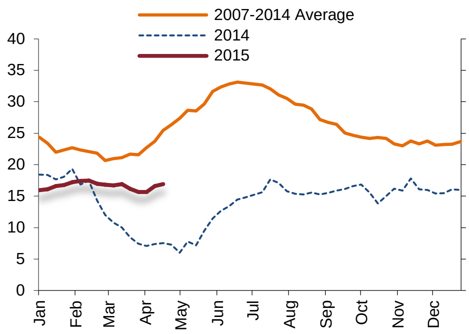
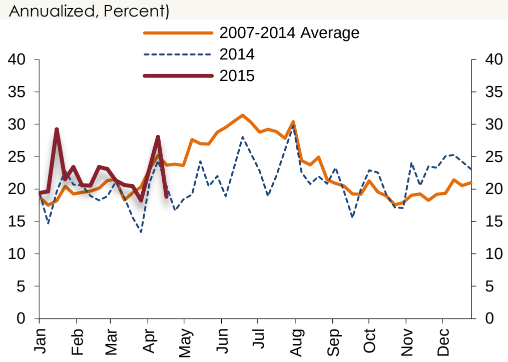


Chart 1.1.6.
Commercial Loan Growth
(Adjusted for Exchange Rate, 13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the first quarter of 2015, annual consumer inflation declined by about 0.6 points from end-2014 to 7.61 percent, overshooting the forecasts of the January Inflation Report (Charts 1.2.1 and 1.2.2). In this period, core inflation saw a major improvement but the elevated food inflation curbed the fall in annual inflation. Food prices continued to follow an unfavorable course in the first quarter and remained the highest contributor to annual inflation with 3.47 points. After pulling inflation down notably in the fourth quarter of 2014, oil prices started to rise in February, and consequently the positive impact of the energy prices on inflation has been restrained.

Chart 1.2.1.
January Inflation Forecasts and Realizations
(Percent)

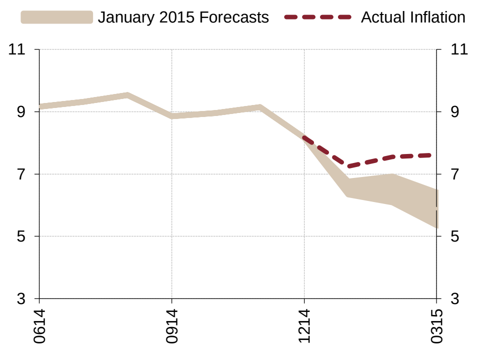
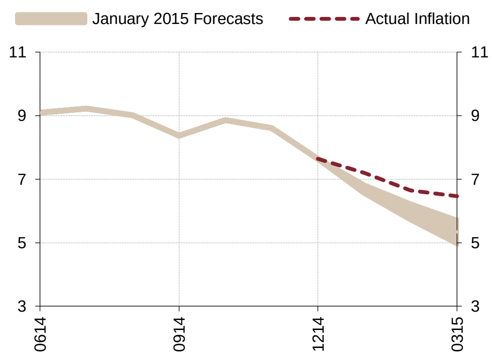


Chart 1.2.2.
January Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco (Percent)



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

The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). Accordingly, in the first quarter, the underlying trend of core inflation indicators registered a significant quarter-on-quarter improvement (Chart 1.2.3). Due to developments in food and oil prices and TL-denominated import prices in the first quarter, inflationary cost pressures gained some strength compared to the previous period. Yet, the cautious monetary policy stance and the moderate course of domestic demand have helped to restrain these pressures. High food prices continued to pass through to prices of catering services, bringing the annual food and catering services inflation that accounts for about 30 percent of the consumption basket up to 14 percent as of March. In this period, consumer inflation excluding food and catering services declined further to 4.82 percent (Chart 1.2.4).

Chart 1.2.3.
Core Inflation Indicators SCA-H and SCA-I
(Seasonally Adjusted, 3-Month Moving Average, Annualized)

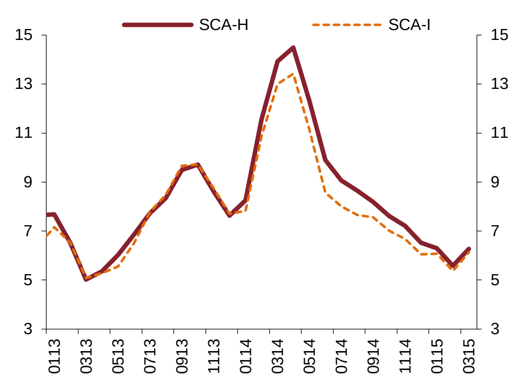
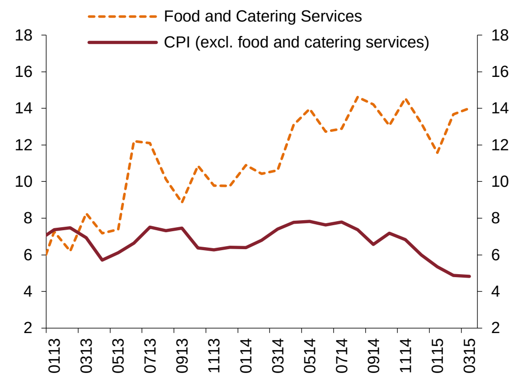


Chart 1.2.4.
Food and Non-Food Prices
(Annual Percent Change)



Source: TurkStat, CBRT.

To sum up, despite the notable improvement in core inflation indicators during the first quarter, rising food prices put a restraint on disinflation. In this period, oil prices and TL-denominated import prices led to cost pressures on inflation. With accommodative weather conditions and possible policy measures, food inflation may have ample room to decline. The measures that the Food Committee might suggest (the Food and Agricultural Products Markets Monitoring and Evaluation Committee, founded in December 2014) are expected to drive food inflation down. Thus, with an ongoing cautious monetary policy stance and with an outlook of food inflation receding to the average of previous years, consumer inflation is likely to slow further in the second half of the year. Yet, food prices continue to constitute an upward risk on the inflation outlook.

Supply and Demand

According to the GDP data for the last quarter of 2014, economic activity was largely consistent with the outlook presented in the January Inflation Report. In the last quarter, the GDP rose by 2.6 percent and 0.7 percent on an annual and quarterly basis, respectively. Real GDP growth stood at 2.9 percent in 2014 (Chart 1.2.5). An analysis of national income components on the production side indicates that the contraction in agricultural value added led by adverse weather conditions lowered the growth rate of 2014. Data on the expenditures side reveal that in the last quarter, final domestic demand rose owing to the increase in private consumption demand as it did in the previous quarter (Chart 1.2.6). Across the year, net exports stood out as the leading contributor to growth among the expenditure items.

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

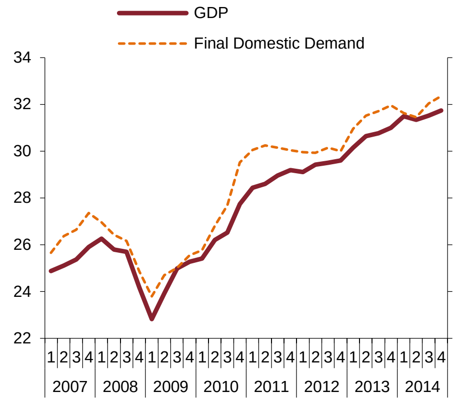
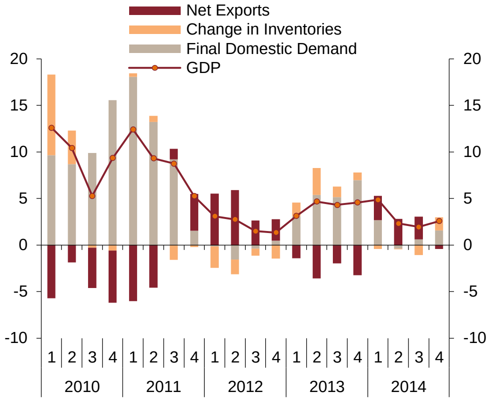


Chart 1.2.6.
Contribution of Demand Components to Year-on-Year GDP Growth (Percentage Points)



Source: TurkStat.

Data regarding the first quarter of 2015 suggest a weak outlook in economic activity. Industrial production remained unchanged in the January-February period compared to the last quarter of 2014. Among March indicators, the BTS and the PMI data also signal that the weak production outlook may continue. External demand remains weak due to slowing global economy and geopolitical tensions. Accordingly, economic activity is envisaged to follow a sluggish course in the first quarter of 2015 and then settle into a gradual track of moderate recovery. Downside risks regarding external demand persist due to geopolitical developments, while the signals for recovery in Europe suggest a favorable outlook for exports. On the production side, growth may be boosted by agriculture provided that accommodative weather conditions increase agricultural added value alongside the base effect caused by the decline in 2014.

The re-balancing of the current account that started in 2011 is projected to continue in 2015. The low levels of international energy prices cause a notable decline in energy import costs and support the external trade balance (Chart 1.2.7). Moreover, the cautious monetary policy stance and the macroprudential measures bring loan growth rates to reasonable levels and improve the loan composition in favor of commercial loans, thus contributing to the re-balancing of the current account deficit. Accordingly, import coverage ratio of exports has been improving significantly (Chart 1.2.8).

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

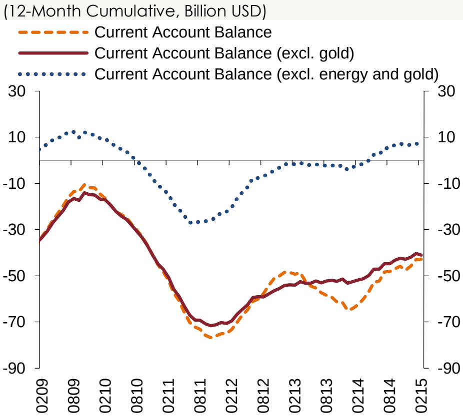
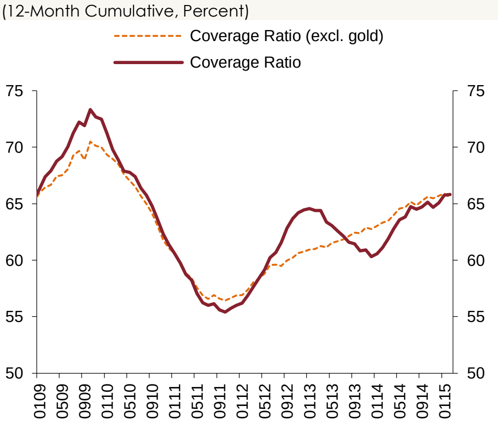


Chart 1.2.8.
Export/Import Coverage Ratio
(12-Month Cumulative, Percent)



Source: CBRT.

Oil, Import and Food Prices

In the first quarter of 2015, oil and import prices remained above projections, while USD-denominated import prices stood below the previous report's forecasts (Charts 1.2.9 and 1.2.10). Accordingly, average medium-term oil assumptions were revised upwards by 9 percent for 2015 and 5 percent for 2016. Considering the possibility of a correction in food prices, especially in unprocessed food, the end-2015 food inflation forecast was left unchanged at 9 percent.

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

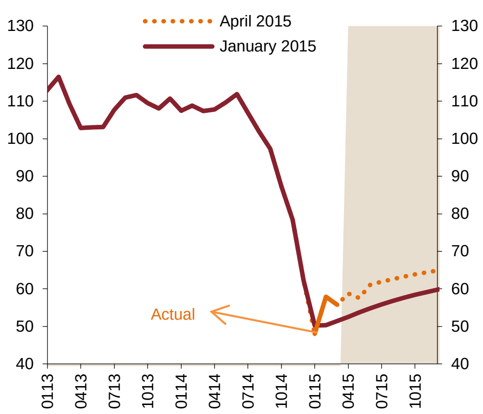
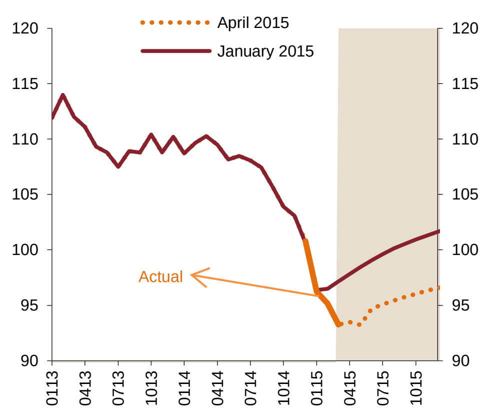


Chart 1.2.10. Revisions in Import Prices*
(USD, 2010=100)



* Shaded region denotes the forecast horizon.
Source: TurkStat, CBRT.

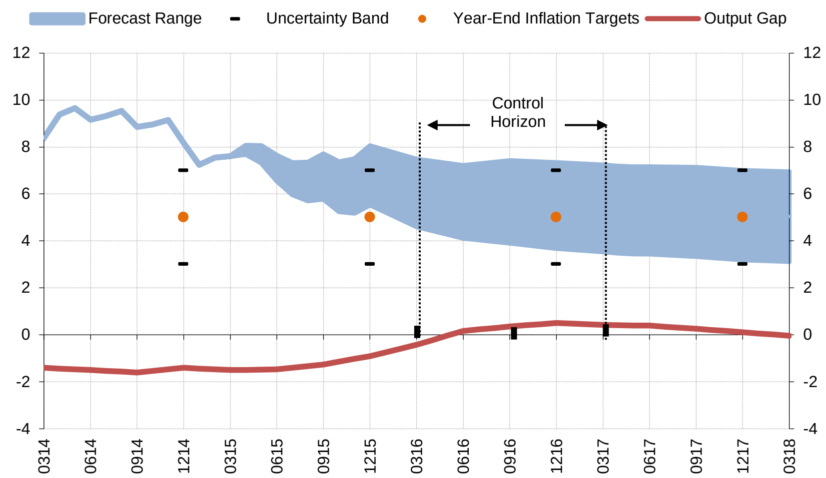
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with inflation targets and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a cautious fiscal stance will be implemented and the primary expenditures to the GDP ratio will decrease gradually.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the framework that a cautious monetary policy stance will be maintained by keeping the yield curve flat until there is a significant improvement in the inflation outlook. Moreover, the annual loan growth rate is envisioned to continue to hover around the recent reasonable levels in 2015, also thanks to the macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 5.6 percent and 8 percent (with a mid-point of 6.8 percent) at end-2015 and between 3.7 percent and 7.3 percent (with a mid-point of 5.5 percent) at end-2016. Inflation is projected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts*
(Percent)



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

The end-2015 inflation forecast, which was presented as 5.5 percent in the January Inflation Report, was revised upwards by 1.3 points (Chart 1.3.1). This revision was led by the higher-than-projected oil prices compared to the figures in the January Inflation Report besides the import prices in TL. Accordingly, the revision in oil prices and the movements in TL-denominated import prices are estimated to push the year-end inflation forecast by 0.4 and 1 points, respectively. The downward revision in economic activity and the output gap, on the other hand, lowered the end-2015 inflation forecast by 0.1 point. Moreover, the end-2016 inflation forecast, which was set as 5 percent in the previous report, was revised upwards to 5.5 percent. Of this revision, 0.3 points are attributed to the lagged effects of the developments in TL-denominated import prices and 0.2 points are due to the upward revision in the oil prices for 2016.

Base effects will continue to determine the course of inflation for the rest of 2015, causing a rise in annual inflation starting from August. Accordingly, annual inflation is envisaged to decline until the third quarter, and increase slightly afterwards, reaching 6.8 percent in the last quarter.

1.4. Risks and Monetary Policy

Loans continue to grow at reasonable levels amid the tight monetary policy stance and macroprudential measures. The composition of loans is moving in the favored direction as well. Commercial loans are growing faster than consumer loans on an annual basis. This loan outlook not only limits medium-term inflationary pressures but also contributes to the improvement in the current account balance.

The weak external demand caused by the sluggish growth across European countries, the largest export market for Turkey, and geopolitical developments in neighboring countries continues to limit the growth of exports. In addition to the weak external demand, the recent plunge in the value of the euro against the US dollar may have an adverse impact on firms that export in euro, but Turkey's share in the European market remains robust. The recent signs of recovery for the European economy might be a development that would boost the external demand.

Economic activity lost some pace in the first quarter. This slowdown was largely due to the weak external demand, volatility in financial markets and adverse weather conditions. Although economic activity is expected to grow gradually and moderately from the second quarter onwards, downside risks remain important. Lingering volatility in global financial markets and the weak course of confidence indices are the risk factors that may limit the contribution of the private sector final demand to growth. In case of an additional slowdown in external demand and a sizeable decline in global growth rates, the decrease in commodity prices will pull inflation down but at the same time lead to notable adverse effects on domestic economic activity. Under such circumstances, the CBRT will employ the policy tools to support the economy.

The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially inflation excluding energy and food (core inflation indicators). Low levels of international commodity prices and the moderate course of aggregate demand conditions support disinflation. The annual inflation of core indicators is projected to decline further, also with the contribution of base effects. However, the recent exchange rate movements may have an adverse impact on the core inflation outlook.

Food prices remain as the main risk factor on the inflation forecast. Although food inflation is expected to remain high in the short term according to the baseline scenario, food prices are likely to see a notable correction upon the introduction of new season products in the summer months. Moreover, measures that may be proposed by the Food Committee are estimated to contribute to the decline in the food inflation in the upcoming period. However, prices of some food items are sensitive to the exchange rate and there are uncertainties over supply-side developments, which necessitate caution against food inflation.

Global financial markets continue to follow a volatile course. The reduced predictability of the global economy and increased uncertainties amid the divergence among the monetary policies of advanced economies cause global markets to remain highly data-sensitive. Against this background, the volatility in the risk appetite and capital flows continues. The CBRT emphasized that measures have been taken recently in the FX liquidity, intermediation costs and prudential borrowing aimed at reducing macrofinancial risks stemming from uncertainties regarding global financial markets and the course of economic activity. Macrofinancial risks will be closely monitored in the upcoming period and additional measures will be taken when deemed necessary.

In sum, the uncertainty in global markets and elevated food prices necessitates maintaining the cautious stance in monetary policy. Future monetary policy decisions will be conditional on the pace of improvements in the inflation outlook. Inflation expectations, pricing behavior and other factors that affect inflation will be monitored closely and the cautious monetary policy stance will be maintained by keeping the yield curve flat, until there is a significant improvement in the inflation outlook.

Developments in the fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes on administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

Implementation of the announced structural reforms is considered to contribute to the potential growth significantly. Measures to ensure the sustainability of the fiscal discipline and reduce the savings deficit are envisioned to support macroeconomic stability and boost the social welfare by keeping interest rates of long-term government securities at low levels.