1. Overview

Although uncertainties regarding the global economy have eased slightly in the third quarter of 2012, they still remain critical. Meanwhile, global growth has continued to lose momentum. In this period, measures taken have alleviated the risk of further deepening of the problems in the Euro Area; yet growth outlook for both advanced and emerging economies was revised downwards. Data released in the US pertaining to employment, housing and production suggested that the recovery was weaker than envisaged. The unfavorable outlook for the Euro Area persisted, and the economic activity in emerging economies including China continued to decelerate. In this context, central banks of advanced economies announced quantitative easing packages to bolster economic activity and reduce macro financial risks, while expectations regarding emerging market policy rates were revised downwards.

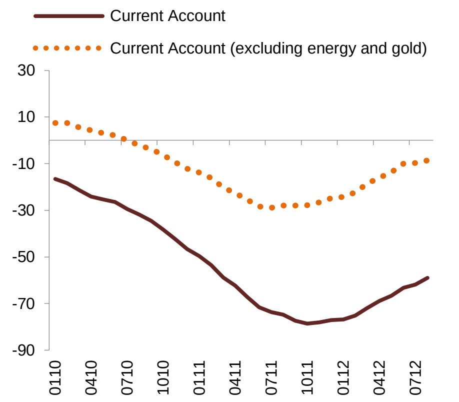
The persistent weakness in global economic outlook reduces inflationary risks, yet keeps concerns over financial stability and growth on the agenda. Uncertainties regarding the Euro Area, concerns over the US and Chinese economies and geopolitical risks remain significant. Notwithstanding the recent measures, ongoing fragilities and imbalances in the global economy continue to keep the volatility of risk appetite at relatively high levels. Taken together with extraordinarily ample and low-cost liquidity injected to the market by advanced economies, this leads to high volatility in short-term capital flows and confirms the importance of building a flexible policy framework.

1.1. Monetary Policy and Monetary Conditions

Since 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.

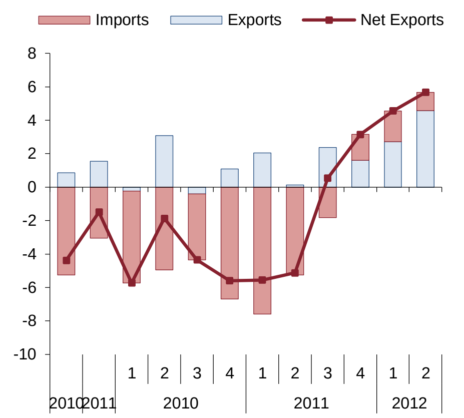
Recent data releases suggest that policies were largely successful in delivering the intended results. The composition of growth has displayed a healthier outlook, while the rebalancing process became more significant. In fact, during this period, current account has continued to improve (Chart 1.1.1) and the contribution of net exports to growth has increased markedly (Chart 1.1.2).

Chart 1.1.1.
Current Account Balance
(12-Month Cumulative, Billion USD)



Source: TurkStat, CBRT.

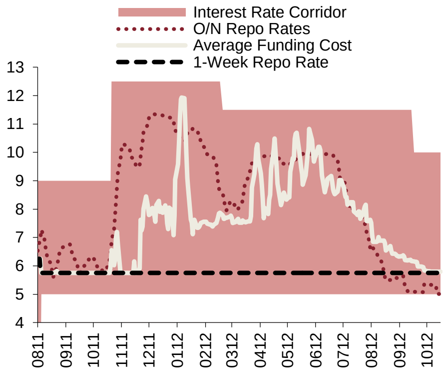
Chart 1.1.2.
Contribution of Net Exports to Annual GDP Growth
(Percent)



Source: TurkStat, CBRT.

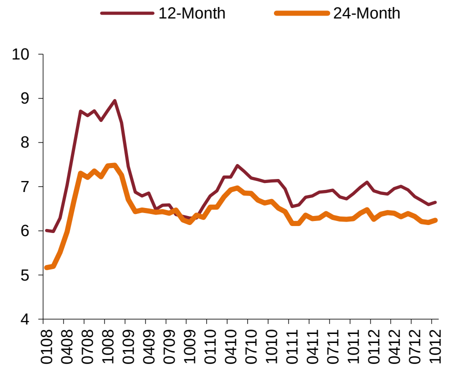
Having started to achieve the intended results in terms of reducing macro financial risks, monetary policy shifted the emphasis to price stability as of October 2011. In this respect, the CBRT implemented a strong monetary tightening by widening the interest rate corridor upwards and using liquidity operations effectively. Due to the volatility in risk appetite and upside risks regarding inflation outlook, the CBRT implemented additional monetary tightening occasionally until mid-2012. During this period, the upper bound of the interest rate corridor was kept high to preserve the tightening flexibility (Chart 1.1.3) These policies, in turn, have prevented a possible deterioration in medium-term inflation expectations, amid a period of intensified supply-side pressures and double digit inflation (Chart 1.1.4).

Chart 1.1.3.
Monetary Policy



Source: ISE, CBRT.

Chart 1.1.4.
12- and 24-Month Ahead CPI Expectations*
(Annual Percent Change)



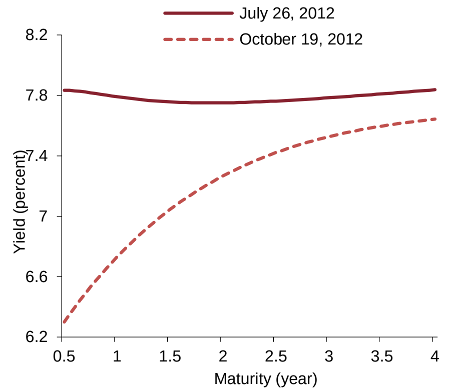
* CBRT Survey of Expectations, second survey period results.
Source: CBRT.

Monetary policy assumed a more accommodative stance since mid-2012. Improving global risk appetite, along with clearer signs of a more robust rebalancing process evidenced by recent data on the current account and the composition of growth, had favorable impact on risk perceptions towards Turkish economy. Moreover, the disinflationary impact of domestic demand has become more significant. Against this backdrop, the CBRT increased the liquidity injected to the market since early June, and decreased its average funding rate gradually. Meanwhile, the O/N market rates have fallen to low levels (Chart 1.1.3). Since September, considering the decreasing tail risks regarding the global financial system and also to support credit conditions, the CBRT has cut the upper bound of the interest corridor gradually and further eased liquidity conditions.

Despite the more accommodative liquidity policies, the CBRT has adopted a cautious stance in general. In this respect, the Monetary Policy Committee (the Committee), highlighting the risks related to pricing behavior due to administered price hikes and rise in energy prices, stated that cautious stance will be preserved. Moreover, the Committee has stated that it would be appropriate to preserve the flexibility in monetary policy on both sides amid the prevailing uncertainties regarding the global economy. Accordingly, 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.

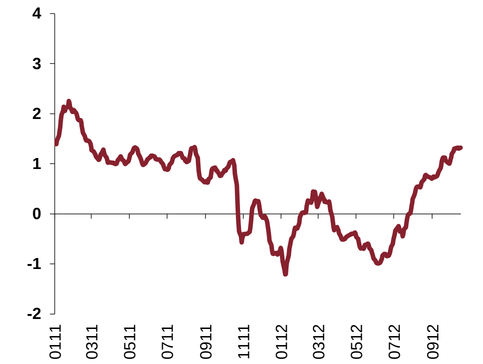
The short-term interest rates declined significantly in the third quarter due to liquidity policies pursued by the CBRT. Long-term rates, on the other hand, displayed a limited fall mainly owing to lower risk premium. As a consequence, the yields have shifted down across all maturities while the slope of the yield curve turned positive (Chart 1.1.5).

Chart 1.1.5.a.
Yield Curve*
(Percent)



* Calculated from the compounded returns on bonds quoted at the ISE Bonds and Bills Market by using ENS method.
Source: ISE, CBRT.

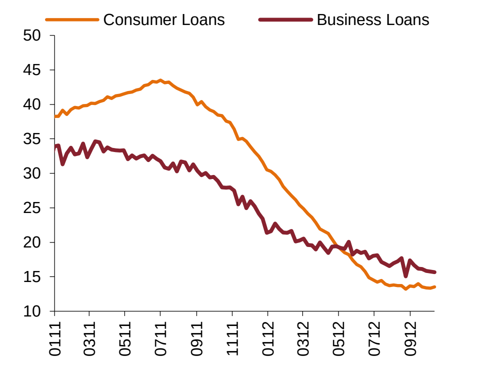
Chart 1.1.5.b.
Interest Rate Spread**
(Percent)



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

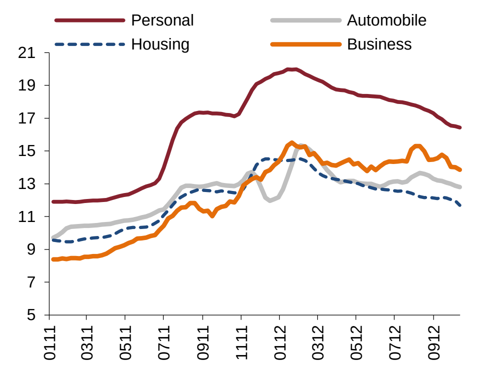
Annual growth rate of credits continued to slow down during the third quarter (Chart 1.1.6). Both supply and demand conditions are likely to be more supportive for the credit growth in the final quarter of the year. In fact, consumer loan rates have been trending downwards along with the falling market rates (Chart 1.1.7). Business loan rates are also expected to decline with the cuts in the upper bound of the interest rate corridor. Accordingly, as predicted, annual rate of growth in total credits is expected to materialize around 14 percent at the end of the year.

Chart 1.1.6.
Growth of Consumer and Business Loans
(Adjusted for Exchange Rate, Excluding Credit Cards, Annualized, Percent)



Source: BRSA, CBRT.

Chart 1.1.7.
TL Loan Rates
(4 Week Average, Percent)



Source: CBRT.

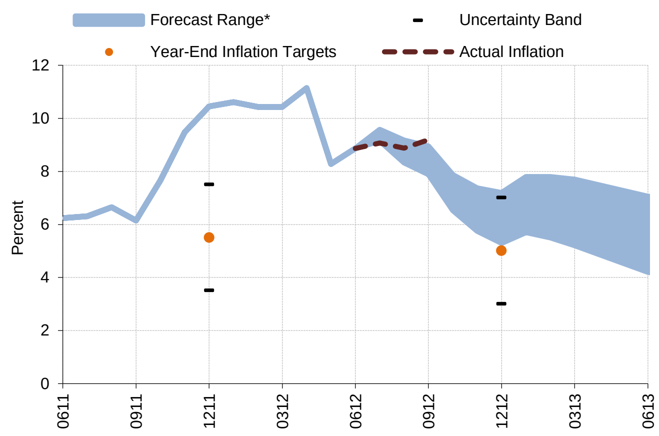
Another noticeable development regarding financial stability issues during the third quarter is the steps the CBRT has taken regarding the Reserve Option Mechanism (ROM). ROM is a tool allowing banks to hold a certain fraction of their Turkish lira reserve requirements in FX or gold. This mechanism aims at increasing the resilience of the economy against external financial shocks (Box 5.1). This system is expected to smooth the imbalances between FX supply and demand due to shifts in capital flow movements. The mechanism is targeted to operate as an automatic stabilizer, once the construction process is completed.

1.2. Macroeconomic Developments and Assumptions

Inflation

Inflation displayed a slight increase in the third quarter of 2012 and stood at 9.2 percent in September, overshooting the projections presented in the July Inflation Report (Chart 1.2.1). This higher-than-expected inflation rate is attributed to recent hikes in oil and unprocessed food prices as well as adjustments in administered prices and tax hikes.

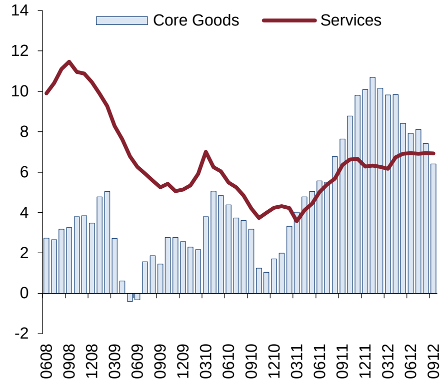
Chart 1.2.1.
July 2012 Inflation Forecasts and Realizations
(Percent)



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

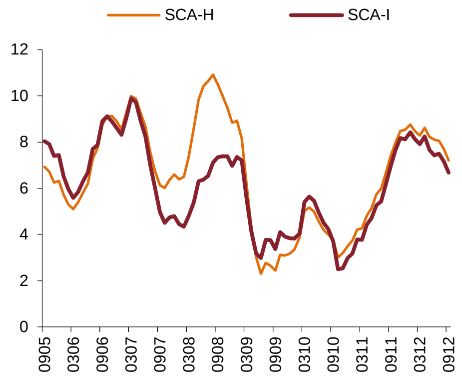
Annual inflation in core good prices continues to fall as the cumulative effects of last year's exchange rate and import price movements gradually fade and the slowdown in domestic demand continues. Meanwhile, services inflation remain moderate (Chart 1.2.2). Against this background, core inflation indicators maintain a downward trend (Chart 1.2.3).

Chart 1.2.2.
Core Goods and Services Prices
(Annual Percent Change)



Source: TurkStat.

Chart 1.2.3.
Core Inflation Indicators SCA-H and SCA-I
(Annual Percent Change)



Source: TurkStat.

Supply and Demand

National accounts data for the second quarter of 2012 indicate that owing to investment, domestic demand conditions were weaker than the outlook presented in the July Inflation Report (Chart 1.2.4). Meanwhile, recent data releases signal that the deceleration in final domestic demand continues in the third quarter. Accordingly, short-term forecasts for output gap are revised downwards in the inter-reporting period.

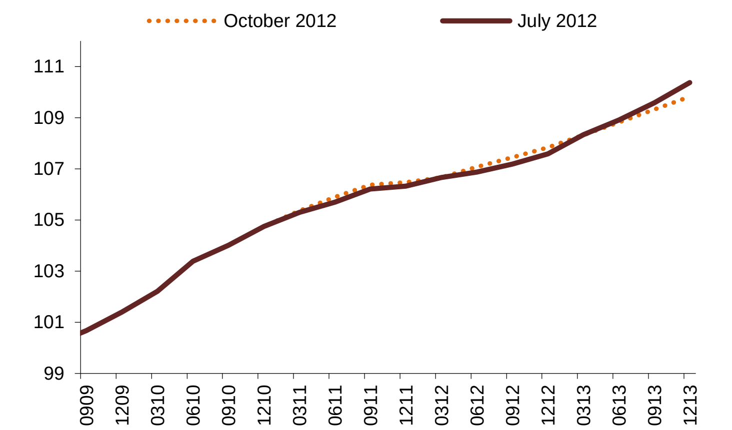
Chart 1.2.4.
2012 Q2 Final Domestic Demand: Forecast and Realizations
(Seasonally Adjusted, 2008Q1=100)

Source: TurkStat, CBRT.

Leading indicators indicate a mild recovery trend in consumption demand in the last quarter of the year. Given the recent developments in the credit market and lagged effects of accommodative monetary policy implemented since the midst of the year, consumption demand is expected to rise in the forthcoming period. As for the investment, the recovery is expected to be more delayed.

In the third quarter of the year, external demand also continued to decelerate like domestic demand. External demand outlook has followed a weaker-than-expected course since the publication of the July Inflation Report. In fact, downward revisions in global growth forecasts in the third quarter point to lower levels for the export-weighted global economic activity index (Chart 1.2.5). The sustained poor outlook for growth, especially in the Euro Area, restricts the external demand. Nevertheless, thanks to market and product diversification, exports are estimated to maintain a relatively favorable course in the forthcoming period.

Chart 1.2.5.
Export-Weighted Global Economic Activity Index (2009Q1=100)*



* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

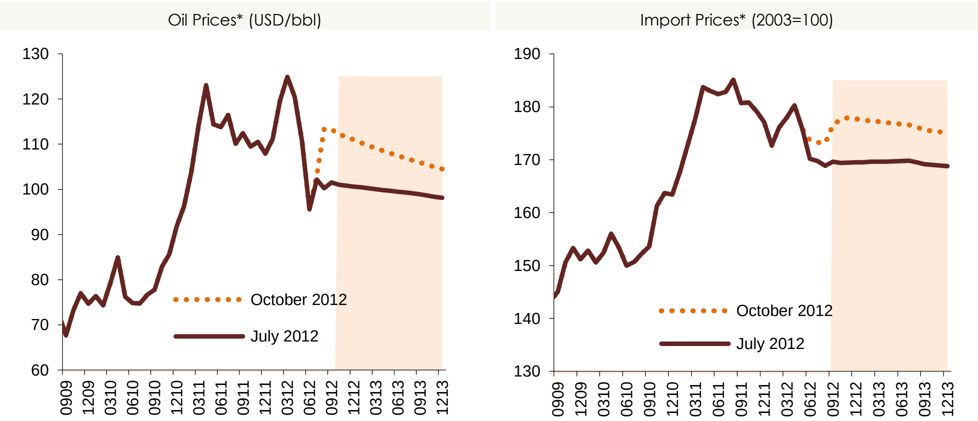
In sum, forecasts are based on the assumption that aggregate demand conditions will provide a higher contribution to disinflation compared to the previous reporting period. The effect of this development on end-2012 inflation forecast is 0.1 percentage point on the downside.

Energy, Imports and Food Prices

Owing to supply-side factors, oil prices remained above projections in the inter-reporting period (Chart 1.2.6). Accordingly, average oil price assumption for 2012, which was set as USD 110 in the July Inflation Report, was revised upwards to USD 112. Although the revision for the entire year seems limited, it implies a notably higher average oil price assumption for the second half of the year. Accordingly, assumptions for 2013 were revised upwards from USD 100 to USD 107.

Likewise, import prices also remained above projections. In line with the actual data and futures prices, assumptions for import prices were revised upwards compared to the previous period (Chart 1.2.6). The revisions in oil and import prices combined with the developments in the exchange rate pushed the inflation forecast for end-2012 upwards by 0.40 percentage points in total.

Chart 1.2.6.
Oil and Import Price Assumptions



* Shaded region indicates the forecast period.
Source: Bloomberg, CBRT.

* Shaded region indicates the forecast period.
Source: TurkStat, CBRT.

The volatility in unprocessed food prices continues to pose uncertainty regarding the short-term forecasts. As we reach the last quarter of the year, unprocessed food prices exhibit a significantly better course compared to historical averages. However, following a cautious approach, the assumption for the annual rate of increase in food prices was preserved at 7 percent.

Fiscal Policy and Tax Adjustments

Recent tax increases and adjustments to energy prices were the main development calling for a revision in short-term inflation forecasts compared to the July Inflation Report. These developments pushed the year-end inflation forecast upwards by 0.9 percentage points.

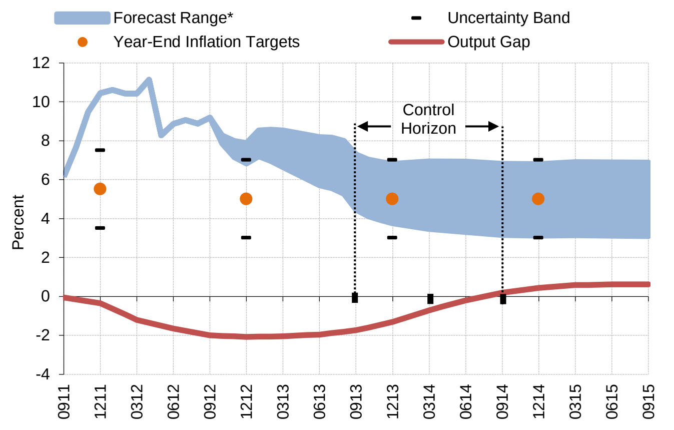
Medium-term forecasts are based on the projection that tobacco prices will increase in early 2013 in accordance with the rates implied by the tax adjustments announced in October 2011. On the other hand, other tax adjustments and administered prices are assumed to be consistent with inflation targets and automatic pricing mechanisms.

Regarding the fiscal outlook, medium-term inflation forecasts take the revised projections of the Medium Term Program (MTP) as given. Accordingly, it is assumed that fiscal discipline will be preserved and the structural budget balance will not display a notable change in the forthcoming period.

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 hover around 14 percent. Accordingly, inflation is expected to be, with 70 percent probability, between 6.9 and 7.9 percent (with a mid-point of 7.4 percent) at the end of 2012, and between 3.8 and 6.8 percent (with a mid-point of 5.3 percent) at the end of 2013. Inflation is expected to stabilize around 5 percent in the medium term (Chart 1.3.1).

Chart 1.3.1.
Inflation and Output Gap Forecasts



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

In short, owing mainly to the adjustments in energy prices, inflation forecast for end-2012 was revised upwards by 1.2 percentage points to 7.4 percent. Table 1.3.1 gives a summary account of this revision.

Table 1.3.1.
Sources of Revision to 2012 Year-end Inflation Forecast

Oil and Import Prices	**+0.4 percentage points**
Tax and Administered Price Adjustments	**+0.9 percentage points**
Output Gap	**-0.1 percentage points**
Total	**+1.2 percentage points**

Revised forecasts suggest that inflation will display a noticeable decline in the last quarter despite the recent adjustments in taxes and administered prices. In the forthcoming period, mild domestic demand conditions will contain the second-round effects of the rise in energy prices and core inflation indicators will continue with their gradual decline. Accordingly, inflation is expected to near the target of 5 percent by end-2013.

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 the Monetary Policy

The expectation that inflation will overshoot the target for an extended period coupled with the recent hikes in energy prices necessitate a close monitoring of the pricing behavior. The baseline scenario in the Report assumes that second-round effects will be limited. On the other hand, it should be noted that necessary measures will be taken should a different outlook unfold.

Ongoing uncertainty regarding the global economy and the ensuing volatility in capital flows requires preserving the flexibility of monetary policy in either direction. Uncertainties still persist regarding deleveraging of public, household, and banking sector balance sheets. The protracted nature of the global recovery has been prompting the extension of quantitative easing packages across advanced economies. Despite the steps taken for the resolution of problems in the Euro Area, risk appetite remains highly sensitive to any new developments due to ongoing fragilities in the financial system, elevated levels of borrowing costs across peripheral economies and the weakening growth outlook. Therefore, it is highly likely that short-term capital inflows will continue to be volatile in the forthcoming period.

Measures taken by advanced economies during the third quarter have eased the tail risks and alleviated the fluctuations in the global financial system. However, uncertainties regarding the implementation of the policy measures remain critical. The CBRT possesses adequate tools at its disposal to resort to under this uncertain environment.

A prolonged weakness in global economic growth may prompt major central banks to sustain their monetary easing packages. Extension of the duration of new packages would feed into macro financial risks in emerging economies like Turkey. In such a case, a resurge in short-term capital inflows may slow down the rebalancing process through rapid credit growth and appreciation pressures on the domestic currency. Should such a risk materialize, the CBRT may keep short-term rates at low levels, while implementing tightening through macroprudential tools such as reserve requirements. Moreover, the automatic stabilizing nature of the Reserve Option Mechanism will support financial stability.

Quantitative easing policies at a global scale also pose risks to commodity prices. However, upside risks on inflation could be contained in such a case, as periods of quantitative easing typically coincide with a weakening in the global economy. However, the CBRT will take the necessary tightening measures, should the increase in commodity prices prove persistent and consequently lead to a deterioration in the pricing behavior.

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 be 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.

Unprocessed food price developments may lead to a more-than-predicted favorable inflation outlook at the end of 2012. Despite the favorable course of leading indicators, a rather cautious approach was adopted, assuming that the rate of increase in unprocessed food prices will be close to the past years' average. Year-end inflation may be lower than projected in the baseline scenario, should unprocessed food prices display a more favorable course than envisaged.

The CBRT monitors fiscal policy developments closely while formulating its monetary policy strategy. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. In this respect, it is assumed that fiscal discipline will be sustained and there will be no unanticipated hikes to administered prices. 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.

Prudent fiscal policy 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 savings 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 Medium Term Program remain to be of utmost importance.