CENTRAL BANK OF
THE REPUBLIC OF TURKEY

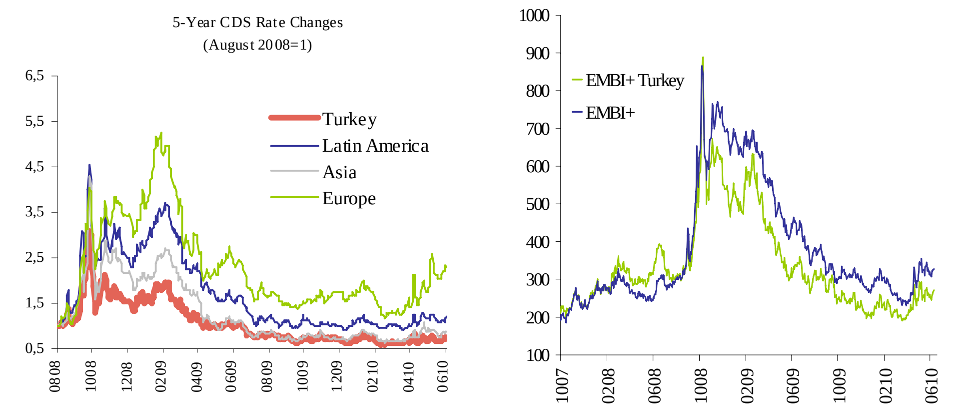
inflation report
2010-III

Contents

1. Overview

Global economic activity continued to recover in the second quarter. However, recent developments confirmed that the global recovery remains fragile. Rising concerns regarding the debt sustainability of several Southern European countries have caused risk appetites to follow a volatile and downward trajectory, which in turn, have triggered capital outflows from emerging markets and increased risk premiums. While risk premium indicators have increased, particularly across some European countries, during this period, the increases in emerging market risk premiums—especially in Turkey—were limited (Graph 1.1).

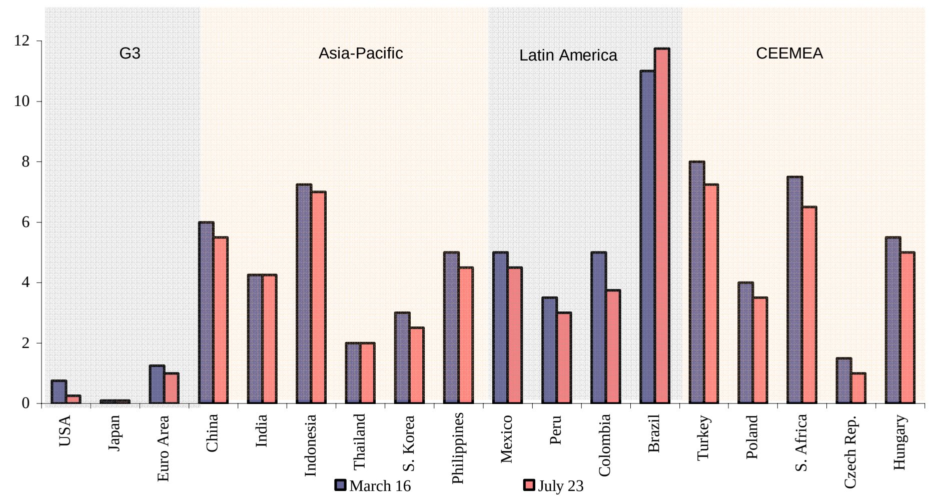
Graph 1.1. Risk Premium Indicators



Source: Bloomberg, CBRT.

The sovereign debt-related problems in Europe have once again confirmed that downside risks regarding global economy activity remain. This development led many central banks to adopt a monetary policy stance with an increased emphasis on downside risks, especially in advanced countries. Accordingly, the central banks of the advanced economies have underscored that the current monetary policy stance would be kept accommodative for a long period, while emerging economies have also adopted similar changes in their rhetoric through policy statements. These developments have postponed the expectations regarding the timing of policy normalization (Graph 1.2).

Graph 1.2. Expected Policy Rates at 2010 Year-end

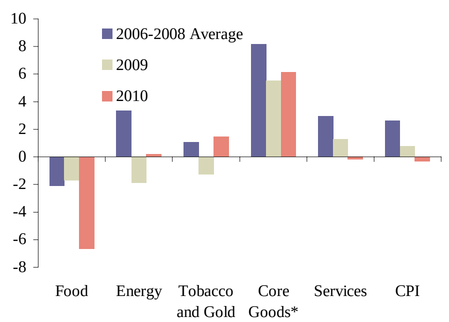


Source: Bloomberg.

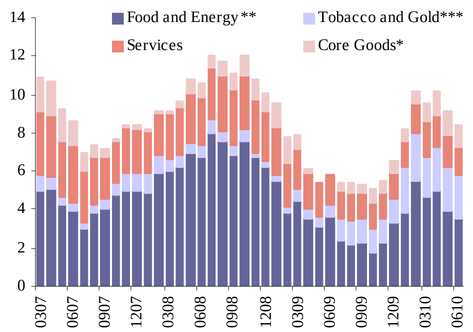
1.1. Inflation Developments

Developments during the second quarter of 2010 have confirmed the CBRT's assessment that the increase in inflation since the last quarter of 2009 was temporary. The April Inflation Report stated that aggregate demand conditions would support disinflation and that the rise in inflation can be attributed to factors beyond the control of monetary policy such as increases in food, energy and administered prices. In fact, with the reversal of these adverse factors, consumer prices declined by 0.33 percentage points, bringing the annual inflation down to 8.37, which was the first decline ever in consumer prices in a given quarter (Graph 1.1.1).

Graph 1.1.1. CPI by Categories
(Second Quarter Percentage Change)



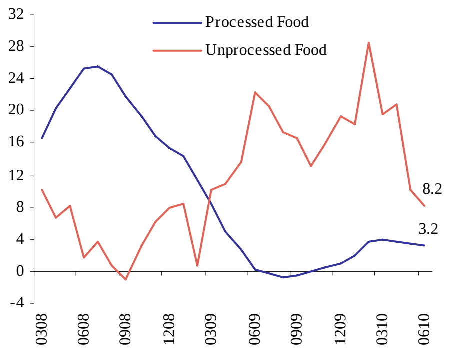
Graph 1.1.2. Contribution to Annual CPI Inflation



*Core Goods: Goods excluding food, non-alcoholic beverages, energy, alcoholic beverages, tobacco and gold.
**Food and Energy: Food, non-alcoholic beverages and energy.
***Tobacco and Gold: Alcoholic beverages, tobacco and gold.
Source: TURKSTAT, CBRT.

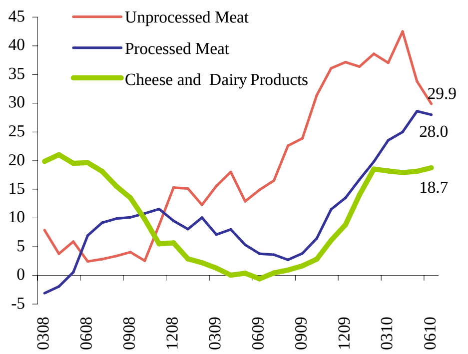
During the second quarter, the dynamics of inflation were mainly determined by unprocesessed food prices (Graphs 1.1.3 and 1.1.4). The fall in fruit and vegetable prices, which was envisaged to materialize towards the last quarter of the year, came sooner and stronger than expected, owing to the marked increase in supply. Moreover, regulations that loosened meat import restrictions have contributed to the stronger-than-expected drop in unprocessed food prices.

Graph 1.1.3. Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

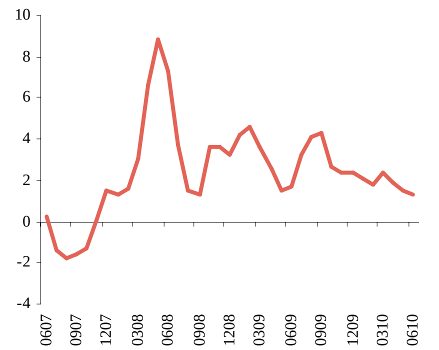
Graph 1.1.4. Prices of Animal Products
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

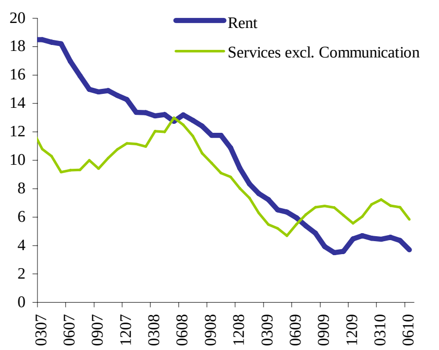
The favorable developments in inflation during the second quarter were not confined to food prices, as the inflation rates of core goods and services also displayed a significant deceleration. Seasonally adjusted data suggest that inflation in both services and core goods (goods excluding food, energy, gold, alcoholic beverages and tobacco) have been slowing down compared to the previous quarter (Graphs 1.1.5 and 1.1.6).

Graph 1.1.5. Prices of Core Goods
(Adjusted for Seasonal and Tax Effects, 3-Month Average, Annualized)



Source: TURKSTAT, CBRT.

Graph 1.1.6. Prices of Services
(Seasonally Adjusted, 3-Month Average, Annualized)



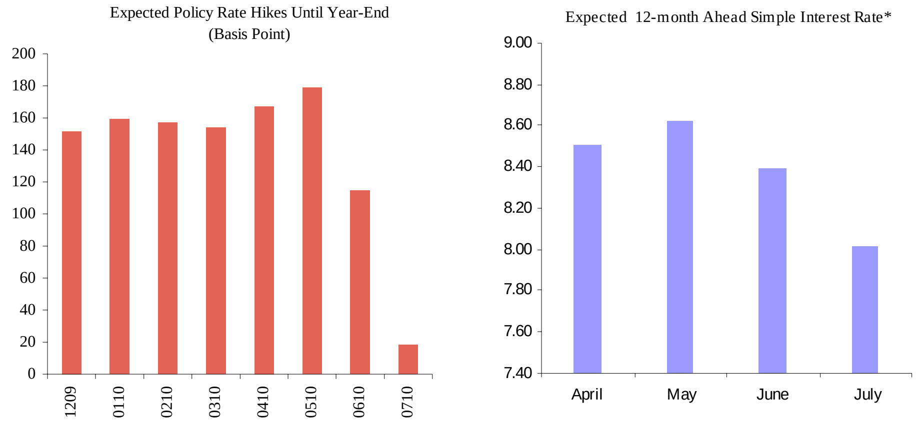
Source: TURKSTAT, CBRT.

1.2. Monetary Policy

Anticipating that inflation would decrease sharply following the last quarter of 2008, the CBRT focused on alleviating the harsh impact of the global financial crisis on the domestic economy. In this respect, the CBRT has delivered sizable cuts in policy rates, while providing liquidity support to facilitate the smooth operation of credit markets. Accordingly, policy rates were cut by 1025 basis points between November 2008 and November 2009. Considering the favorable developments in credit markets and the moderate recovery in the economic activity, the Monetary Policy Committee (the Committee) has ended the easing cycle in December 2009. Notwithstanding the rapid increase in inflation during the last quarter of 2009 and the first quarter of 2010, the Committee, highlighting the persisting downside risks regarding the gobal economy and the consistency of core inflation indicators with the medium-term inflation targets, expressed that policy rates would stay at low levels for a long period.

During the second quarter, the fall in inflation and the increased downside risks regarding global economy have vindicated the monetary policy stance of the Committee—that it may be necessary to maintain policy rates at current levels for some time, and to keep them at low levels for a long period. Accordingly, market expectations regarding future policy rates were revised downwards (Graph 1.2.1).

Graph 1.2.1. Expected Policy Rate Changes



Source: Reuters, CBRT.

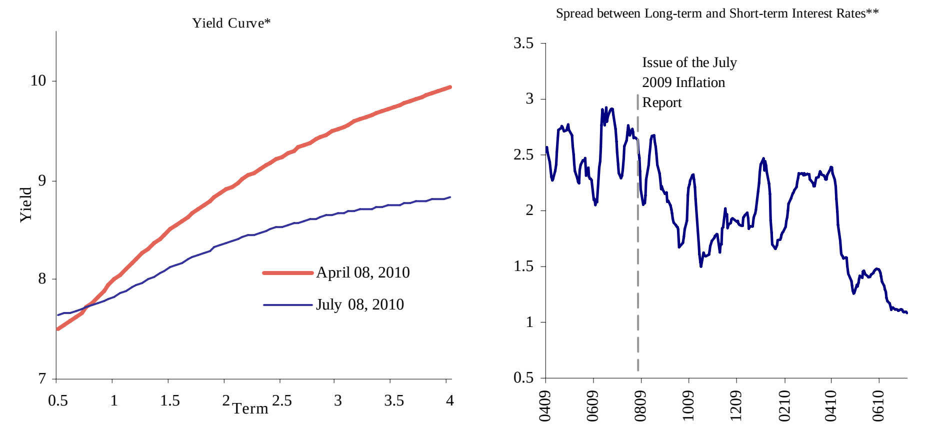
* CBRT Survey of Expectations, first survey period results.

1.3. Outlook for Inflation and Monetary Policy

Monetary and Credit Conditions

Despite the increase in risk premiums during the second quarter of 2010, with the decline in inflation and growing expectations that policy rates will stay low for a long period, longer-term market interest rates continued on a downtrend and the yield curve flattened out (Graph 1.3.1).

Graph 1.3.1. Term Structure of Market Interest Rates



* Calculated from the compounded returns on bonds quoted in ISE Bonds and Bills Market by using Extended Nelson-Siegel (ENS) method.
**The spread between the 4-year and 6-month yields derived from the ENS yield curve, 5-day moving average.
Source: CBRT, ISE.

During the second quarter, bank lending rates stayed at low levels, while lending standards continued to ease, leading to an acceleration in credit growth. Both consumer and commercial loans continued to increase, implying that credit markets are supporting domestic activity. Therefore, similar to the previous Report, it is envisioned that the tightness in financial conditions would disappear over time.

Despite heightened uncertainty regarding the global economic recovery, the soundness of the Turkish banking system provides a favorable climate to support the recovery in credit volumes. Accordingly, assuming that the fiscal stance does not crowd out domestic funding, credit volumes should continue to expand in the short term. However, ongoing problems in the global financial markets pose downside risks to external financing, and thereby, to credit supply over the medium term. Moreover, the elevated levels of unemployment continue to be a potential factor that might restrain credit demand in the forthcoming period.

Outlook for Aggregate Demand

The first-quarter GDP release was mostly in line with the outlook presented in the April Inflation Report. Over this period, weak global activity has continued to restrain output and employment growth in export-oriented sectors, and the contribution of government expenditures to GDP growth declined considerably. Meanwhile, the recovery in private demand has gained traction as anticipated.

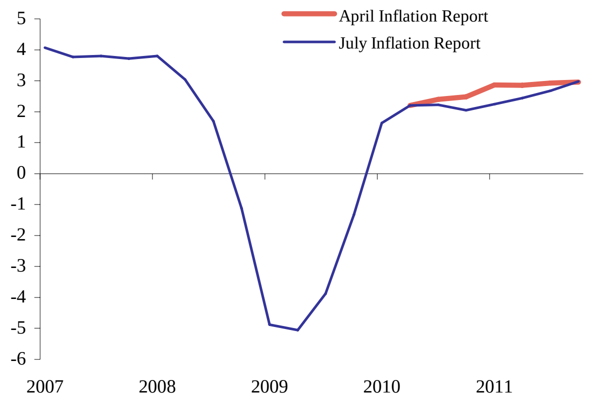
Coincident indicators regarding consumption and investment demand suggest that final domestic demand continued to recover during the second quarter of 2010. Improving employment conditions and the low level of bank lending rates are supporting the recovery in consumption demand. Yet, investment demand remains significantly below the pre-crisis levels, despite the rebound in the first half of the year.

The uncertainty caused by the fiscal problems in the euro area in May, and the consequent sharp depreciation of the euro have led to a weaker external demand in the second quarter than envisaged in the April Inflation Report. Accordingly, output gap estimates for the second quarter of 2010, the starting point for medium-term projections, have been revised slightly downward.

Although weak external demand has continued to dampen industrial activity, there has been a significant increase in non-farm employment during the past year, with the recovery in construction and services. Leading indicators suggest that non-farm employment would continue to recover, albeit at a decelerating pace. However, unemployment rates are expected to remain at higher than pre-crisis levels, suggesting that no significant upside pressures on unit labor costs are envisioned.

The global growth forecasts remain basically unchanged compared to April Inflation Report. However, euro area growth forecasts have been revised slightly downwards, reflecting the change in the outlook owing to the problems in Greece, Portugal, and Spain spreading throughout the financial systems of the euro area—our largest export destination. In this respect, the export-weighted global economic activity index constructed by the CBRT implies weaker external demand than that envisaged in April (Graph 1.3.2).

Graph 1.3.2. Export-Weighted Global Economic Activity*



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

When assessing the external demand outlook, it is important to consider our trading partner's headline growth forecasts as well as the composition of growth In this respect, it is noteworthy that the latest Consensus Forecasts release indicates a noticeable change in the composition of the euro area 2011 growth forecasts. More specifically, along with the depreciation of the euro owing to the financial distress and weaker growth outlook, the euro area private consumption and investment forecasts have been revised downwards, thereby standing out as a potential factor to affect our external demand prospects adversely (Table 1.3.1). In other words, despite the absence of a major revision in the euro area growth forecasts, the change in the composition of GDP growth indicates a weaker external demand outlook for Turkey compared to the previous Report.

Table 1.3.1. Revision of Euro Area 2011 Growth Forecasts
(Percent)

	Growth	Private Consumption	Public Consumption	Investment	Exports	Imports
April 2010	1.5	1.0	1.1	2.6	4.9	4.8
July 2010	1.4	0.7	0.5	2.1	5.3	4.4

Source: Consensus Forecasts, April 2010 and July 2010 Bulletins.

In light of these assessments, our expectations are based on an outlook with weaker external demand conditions compared to the previous Report, while domestic demand continues to recover as anticipated. Therefore, our revised forecasts envisage that the resource utilization would stay at low levels and the contribution of aggregate demand conditions to disinflation would increase slightly.

Fiscal Policy and the Risk Premium

Another global reflection of the fiscal problems in Europe has been the decline in investor risk appetites. Increasing risk premiums, particularly for the highly-indebted European countries, have generally spilled over to emerging markets. Heightened risk premiums could be mainly attributed to concerns regarding debt sustainability, which in turn, could jeopardize financial stability. The rise in the risk premium of Turkey has been relatively limited, owing to comparatively low debt ratios and sound debt sustainability indicators.

Regarding fiscal policy, in line with the MTP projections, it is envisioned that the fiscal stance will remain expansionary throughout 2010, albeit less strongly than in 2009, and that fiscal consolidation would gradually ensue starting from 2011 as guided by the fiscal rule set out in the MTP. In this respect, it is assumed that the fiscal space created by the stronger-than-expected economic activity leading to better-than-expected performance in budget revenues, would be used mostly to reduce the government debt stock, and hence fiscal adjustment in 2011 and onwards will be implemented through institutional and structural improvements. In other words, tax adjustments would be consistent with the inflation targets and automatic pricing mechanisms throughout the forecast horizon according to our outlook for fiscal policy.

Consequently, it is envisaged that the rising debt-to-GDP ratios would reverse course gradually starting in 2011, while the risk premium would not display any significant changes throughout the forecast horizon.

Revisions on the Assumptions of the Forecast

Important developments since the April Inflation Report warranted a downward revision in the 2010 inflation forecast:

- The April Inflation Report envisaged food inflation to be 9 percent at end-2010 and 7 percent for 2011 and 2012. However, better-than-expected outcomes regarding unprocessed food prices led to a downward revision in the assumption for food inflation from 9 percent to 7.5 percent for 2010, which had a 0.4 percentage point downside impact on the end-2010 inflation forecast. Assumptions for food inflation for 2011 and 2012 are maintained at 7 percent.

- With the increased dowside risks regarding global economic activity, oil price outturns in the second quarter were below the levels assumed in the April Inflation Report. In this context, the previous assumption of oil prices are revised down from 85 USD per barrel to 80 USD for 2010, and from 90 USD to 85 USD for 2011. Oil price assumptions for 2012 are maintained at 90 USD. This revision shifted the 2010 inflation forecast down by 0.2 percentage point.

- The deceleration in the core goods and services inflation (underlying trend of inflation) during the second quarter have been stronger than envisaged. This development has contributed to the downward revision in our end-year inflation forecast by 0.2 percentage point.

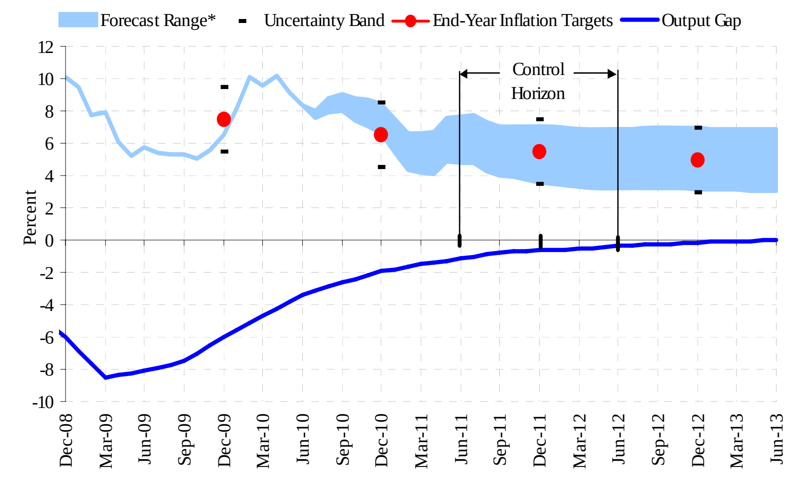
- The contribution of aggregate demand conditions to disinflation in the revised forecast is slightly higher than envisaged in the previous Report due to the weaker external demand outlook, yielding 0.1 percentage point downward revision in end-2010 inflation forecast.

Overall, the mid-point of the end-2010 inflation forecast has been revised down by 0.9 percentage point, owing to the downward revisions in food and energy prices assumptions and the recent slowdown in core inflation.

Inflation Outlook

Against this background, assuming that the measures outlined in our exit strategy are completed to a large extent during rest of the year, and that policy rates are kept constant at current levels for some time followed by limited increases in 2011, with policy rates staying at single digits throughout the 3-year forecast horizon, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 6.5 and 8.5 percent with a mid-point of 7.5 percent at end-2010, and between 3.6 and 7.0 percent with a mid-point of 5.3 percent by the end of 2011. Furthermore, inflation is expected to decline to 5.0 percent by the end of 2012 (Graph 1.3.3).

Graph 1.3.3. Inflation and Output Gap Forecasts*

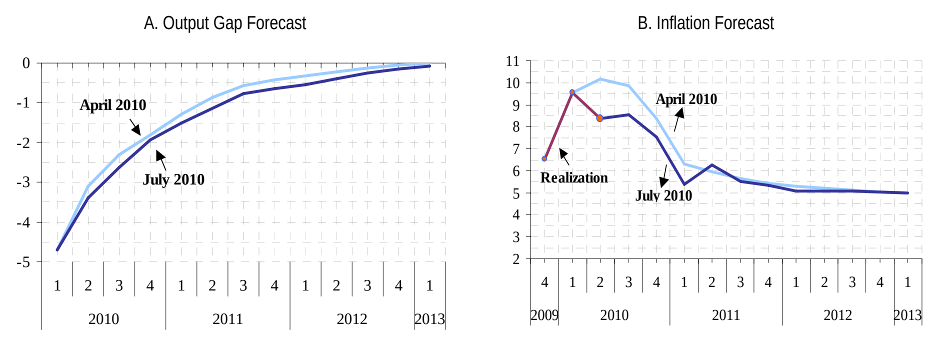


* The shaded region indicates the 70 percent confidence interval for the forecast.

In sum, our revised forecast indicates that the monetary tightening required to keep inflation in line with medium-term targets would start later and would be more limited than implied by the previous forecast.

Our output gap estimates have been revised slightly downwards compared to the April Inflation Report, owing to the anticipated impacts of the problems in euro area on aggregate demand (Graph 1.3.4A.). However, there is no significant revision in the pace of the recovery, as the downward revision in monetary policy stance is expected to partially compensate for the adverse impact of weaker external demand. Accordingly, there have been no significant revision in the inflation forecasts for 2011 and onwards (Graph 1.3.4B).

Graph 1.3.4. Comparison of April and July 2010 Inflation Report Forecasts



Source: CBRT.

Source: TURKSTAT, CBRT.

Although trend inflation is expected to remain consistent with the medium-term targets and follow a stable path, the exact course of headline inflation until mid-2011 would depend on the base effects driven by the volatile unprocessed food prices in the past year and the tax hikes implemented at the beginning of 2010. Therefore, in order to help the economic agents to better interpret the developments in headline inflation, these base affects are described in detail in the final chapter of the Report.

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 future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

By influencing commodity prices and external demand conditions, global economic activity would continue to be the main factor driving inflation dynamics and the monetary policy outlook. In this respect, the timing and the extent of monetary tightening to be implemented during 2011 under the baseline scenario may change depending on the course of the economic activity.

Recently, rising concerns regarding debt sustainability in several euro area countries and the spillover effects to the financial system have led to a renewed turmoil across financial markets, underscoring the downside risks to the global economic recovery. Furthermore, ongoing problems in credit, real estate and labor markets across advanced economies, with little policy options left in case of another disruption to global economic activity, suggest that the downside risks regarding the pace of global growth are likely to persist for some time. Should the global economy face a longer-than-anticipated period of anemic growth, which would consequently delay the domestic recovery significantly, the monetary tightening envisaged in 2011 under the baseline scenario may be postponed towards the end of 2011. Moreover, an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity, may trigger a new easing cycle. By contrast, monetary tightening may be implemented in an earlier period during 2011, should the recovery in economic activity turn out to be faster than expected.

Despite the increased downside risks pertaining to external demand, domestic demand remains strong. Although problems regarding the global economy have the potential to restrain domestic demand through confidence and financing channels, countercyclical monetary policy and the ongoing improvement in employment conditions are likely to support the recovery in domestic demand. On the other hand, given the relative improvement in the creditworthiness of Turkey during the post-crisis period, a possible strengthening in capital inflows in the forthcoming period stands out as another factor that may lead to a faster recovery in the domestic demand in contrast to external demand. Should the divergence in the growth rates between domestic and external demand continue in the forthcoming period, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity management facilities more effectively. Accordingly, if the composition of strong domestic demand and weak external demand continue as envisaged, and if this pattern of growth co-exists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, than the CBRT may bring forward the measures outlined in the exit strategy that are expected to be implemented until the end of 2010.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. Since the second half of 2009, economic activity has been stronger than envisaged in the MTP, leading to a better-than-expected performance in budget revenues. Using this fiscal space mostly to reduce the government debt would facilitate demand management and reduce any need for indirect tax hikes, therefore providing more flexibility regarding the conduct of countercyclical monetary policy. In this respect, should the fiscal discipline be implemented through institutional and structural improvements, such as enacting and establishing the fiscal rule, it would be possible to keep policy rates at single-digit levels over the medium term.

Since the last quarter of 2008, the CBRT, without conflicting with its primary objective of maintaining price stability, has focused on containing the adverse effects of the global crisis on the domestic economy—which has been achieved to a large extent. Monetary policy will continue to focus on price stability in the period ahead. Strengthening the commitment to fiscal discipline and the structural reform agenda would support the improvement of Turkey’s sovereign risk, and thus facilitate macroeconomic and price stability. In this respect, timely implementation of the structural reforms envisaged by the MTP and the EU accession process remains to be of utmost importance.

2. International Economic Developments

The global economy continued to recover during the second quarter of 2010. However, the recent financial turmoil, particularly in European economies, has added to the fragility of the economic recovery, raising concerns about increased downside risks to the global economic outlook.

The discrepancy between growth in advanced and emerging economies has become more evident, while growth performances have varied across regions (Box 2.1). Among advanced economies, the United States and Japan experience a relatively moderate growth, while European economies falter. On the emerging economies side, Eastern European countries are suffering from the developments in the euro area, whereas China continues to be the key driver of the global growth.

Likewise, monetary and fiscal policies have been differing widely across country groups. Due to concerns about the global growth outlook, there has been a growing consensus that the US and the European central banks are unlikely to raise policy rates in coming months. Yet, rising inflationary pressures have led to a gradual monetary tightening in some countries. For example, Canada and New Zealand hiked policy rates during the second quarter, following Australia and Norway. Among emerging economies, Brazil, Chile and Peru have tightened monetary policy in recent months. The rebound in commodity prices and the high growth performances of their trading partners has mainly caused these countries to differ from the others.

During the past three months, fiscal policy responses have varied significantly across advanced economies. There have been concerns that the early exit from fiscal support may hinder growth, particularly in the US. On the other hand, there is a consensus among most European countries, especially in Germany, that maintaining fiscal support would heighten concerns about public debt sustainability and thus add to the financial instability.

The main reason for fiscal policy to stand out in the past few months is the concerns over to what extent some European countries would manage to roll over their debt. The spillover of sovereign risks to the financial system has deepened these concerns. For example, banks have faced a growing pressure of financing in Spain, the fourth biggest economy in Europe. The contagion has spread to other countries via banks, leading to a mass depreciation of the euro against other currencies.

There are two main reasons behind the recent financial collapse that first emerged as a debt crisis in Greece and spilled over into several other countries. Firstly, some European banks that bought bonds from Greek, Portuguese and Spanish governments have been exposed to serious risks. In fact, according to data from the Bank for International Settlements (BIS), German, Belgian, French, Dutch and Italian banks hold 17 percent of all outstanding Greek bonds as of end-2009.[1] Secondly, policy options against another financial crisis seem to have been exhausted. In fact, interest rates have already been down to record lows in major advanced economies and central bank balance sheets have expanded to unprecedented levels (Box 6.1). Moreover, escalating deficits and debt levels in many countries have been the root cause of financial troubles, thus leaving no fiscal space to allow for new policy measures.

In sum, highlights of the second quarter were the fragile global economy and rising downside risks. The US housing market has yet to stabilize, thus continuing to depress banks that are exposed to commercial real-estate risks. Moreover, credit demand remains weak even though the tight lending conditions in the euro area and the US seem to have relatively eased. In addition, ongoing high levels of unemployment in advanced economies is another factor clouding the growth outlook.

The weakening growth outlook for advanced economies feeds concerns about deflation in those countries and restricts hikes in commodity prices. On the other hand, massive food and energy price fluctuations place upward pressure on costs.

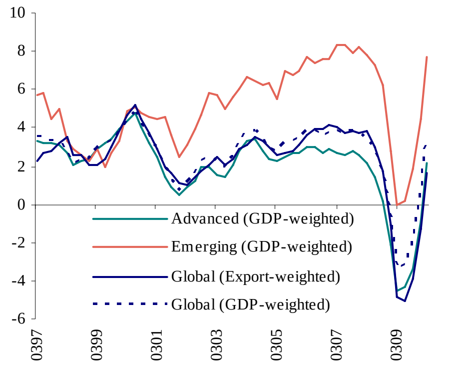
2.1. Global Growth

According to annual growth figures for the first quarter of 2010, emerging economies, especially China and India, continued to grow faster than advanced economies (Graph 2.1.1). With the deepening financial distress, the euro area experienced a weaker growth than other advanced economies, pulling down the growth rate for advanced economies.

[1] 80th Annual Report of BIS.

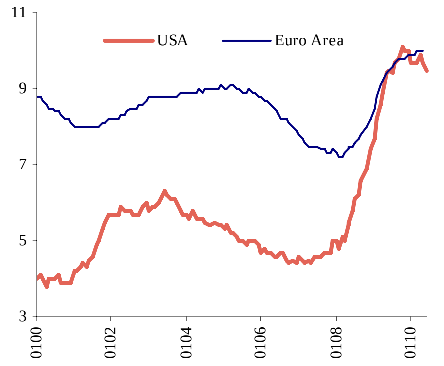
The comparison between the GDP-weighted and export-weighted global growth, where weights are assigned according to each country's share in world's GDP and Turkey's exports, respectively, shows that the export-weighted growth points to a relatively slower recovery, mainly due to high share of euro area countries in Turkey's exports.

Graph 2.1.1. Aggregated Growth Rates
(Percent)



Source: Bloomberg, CBRT.

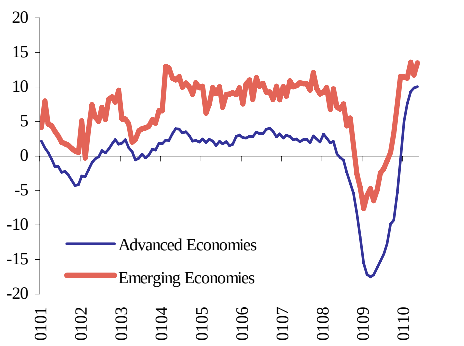
Graph 2.1.2. Unemployment in Advanced Economies
(Percent)



Source: Bloomberg.

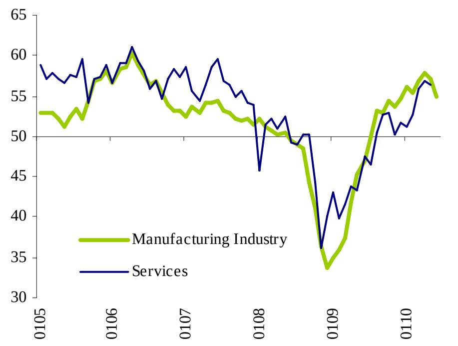
While growth in advanced economies is on the rebound, labor markets have yet to improve. In fact, euro area unemployment rate remained flat at 10 percent in May (Graph 2.1.2). In the US, 0.2-percentage point drop of unemployment rate to 9.5 percent in June, mainly owing to the falling labor force participation rate, does not sufficiently imply a recovery in the market. High unemployment rates continue to be detrimental to sustainable recovery in these countries.

Graph 2.1.3. Industrial Production in Advanced and Emerging Economies
(Annual Percentage Change)



Source: Bloomberg.

Graph 2.1.4. JP Morgan Global PMI



Source: Bloomberg.

Industrial production indices for both advanced and emerging economies continued to recover in May, albeit more slowly (Graph 2.1.3). Similarly, the JP Morgan Global PMI index continued to hover above the neutral level of 50 points during the second quarter of 2010, but displayed a slight drop (Graph 2.1.4).

Table 2.1.1. Growth Forecasts
(Annual Percentage Change)

	2010	
	April	July
Consensus Economics		
World	3.2	3.5
United States	3.2	3.1
Euro Area	1.2	1.1
Eastern Europe	3.3	3.9
Latin America	4.0	4.9
Asia-Pacific	5.7	6.3

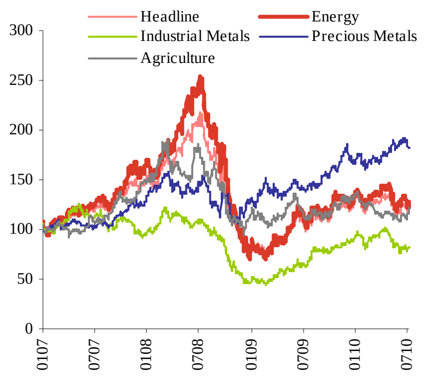
Source: Consensus Forecasts.

Growth forecasts for 2010 have been revised upwards since the April Inflation Report (Table 2.1.1). However, euro area growth forecasts are revised downward due to the economic downturn in the periphery, particularly in Greece, and the resulting deterioration in expectations. Given its strong links to the euro area, Eastern Europe is likely to grow at a slower pace than the Asia-Pacific in 2010. Thus, our forecasts in the final chapter are based on a slightly weaker outlook for external demand, compared with the previous Inflation Report.

2.2. Commodity Prices

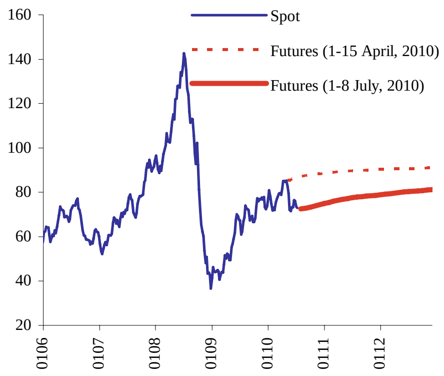
Global growth prospects continue to have a key impact on commodity prices. Commodity prices hit their peak early in the second quarter, while oil and metal prices fell sharply amid euro area’s financial troubles and mounting fears of a slow down in the Chinese economy (Graphs 2.2.1 and 2.2.2). Accordingly, futures prices have also trended down. On the other hand, agricultural prices remained relatively flat. Supply and demand forecasts for 2010 and 2011 by the US Department of Agriculture have also placed downward pressure on prices.

Graph 2.2.1. S&P Goldman Sachs Commodity Prices*



*The average for January 2007 is indexed at 100.
Source: Goldman Sachs.

Graph 2.2.2. Crude Oil (Brent) Prices (USD/bbl)



Source: Bloomberg.

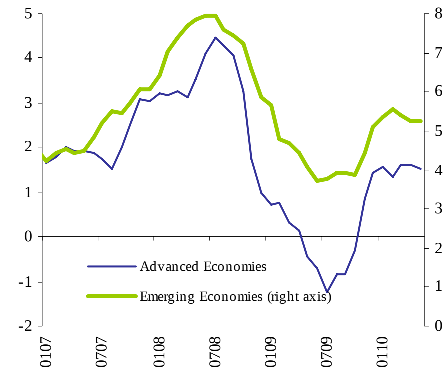
Even though metal and oil prices might rise slightly in coming months, the uncertainty surrounding global growth balances the upside risks to prices. Growth performances of emerging economies may undoubtedly have a significant effect on oil and metal prices. Inventories of agricultural products are expected to be robust over the upcoming harvest season. Hence, agricultural prices are unlikely to soar unless there is a sudden supply shock.

Accordingly, our forecasts in the final chapter are updated based on an outlook where oil prices are revised downwards compared to the previous Inflation Report, and commodity and thus import prices rise modestly throughout the forecast horizon.

2.3. Global Inflation

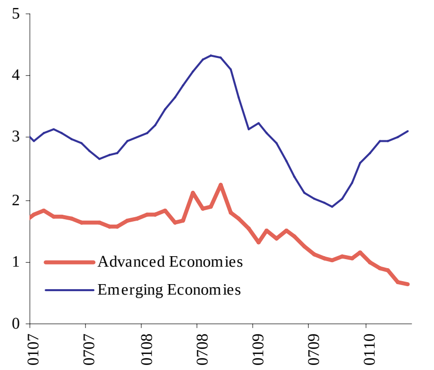
The year-on-year inflation in consumer prices has been flat in both advanced and emerging economies during the second quarter, while core inflation continued to diverge between both groups of economies. Core CPI inflation fell to 0.7 percent year-on-year in advanced economies, sparking fears of deflation, whereas inflation increased, especially in Asia, to 3.1 percent year-on-year in emerging economies. Thus, after having narrowed to 0.9 percentage points in September 2009, the core inflation spread between two groups widened to 2.4 percentage points in May (Graphs 2.3.1 and 2.3.2).

Graph 2.3.1. CPI Inflation in Advanced and Emerging Economies
(Annual Percentage Change)



*The average for January 2007 is indexed at 100.
Source: Goldman Sachs.

Graph 2.3.2. Core CPI Inflation in Advanced and Emerging Economies
(Annual Percentage Change)



Source: Bloomberg.

According to Consensus Forecasts figures, inflation expectations hover around inflation targets in advanced economies. In emerging economies, inflation forecasts for Eastern Europe have been revised downward following the financial distress in the euro area, while those for the fast-growing Asia-Pacific and Latin America were revised upwards (Table 2.3.1).

Table 2.3.1. Inflation Forecasts
(Annual Percentage Change)

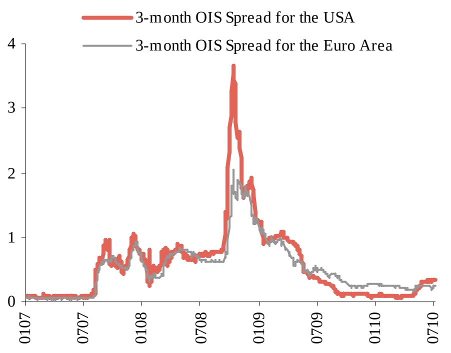
	2010	
	April	July
Consensus Economics		
World	2.7	2.7
USA	2.1	1.7
Euro Area	1.2	1.5
Emerging Economies		
Eastern Europe	6.0	5.8
Latin America	7.5	7.7
Asia-Pacific	2.1	2.2

Source: Consensus Forecasts.

2.4. Financial Conditions and Risk Indicators

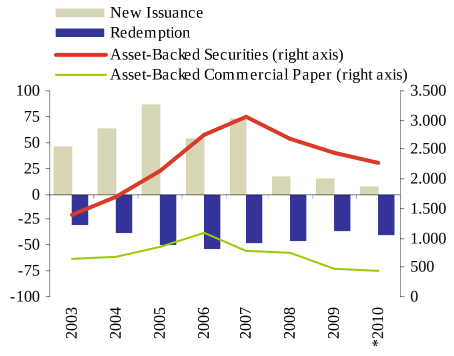
Higher sovereign risk in the euro area due to mounting concerns over public debt rollover also fueled concerns about European banking system and financial stability in the second quarter. Amid economic uncertainty, financial conditions deteriorated, while Interbank rates increased (Graph 2.4.1). Moreover, the new issuance of asset-backed securities and commercial papers financed by short-term money markets slowed, hardly showing signs of a sustainable financial recovery (Graph 2.4.2).

Graph 2.4.1. Money Market Rates
(Percent)



Source: Bloomberg.

Graph 2.4.2. Asset-Backed Securities in the US
(Billion USD)

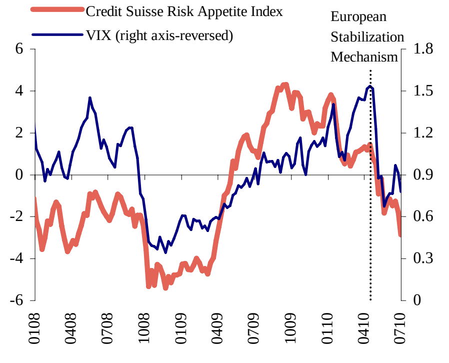


* As of June.
Source: Bloomberg.

The financial distress from the euro area debt crisis has spread across other countries via banks where European banks holding Greek, Portuguese and Spanish bonds have been exposed to serious risks, raising unease over banks in some already weak euro area countries. Stress tests for assessing the resilience of the European banks are critical in order to reduce the uncertainty surrounding the markets.

Fears that China's monetary and fiscal tightening would drag global growth, and ongoing concerns over debt rollover in the euro area dampened risk appetite in the second quarter. With the debt crisis having already spilled over into the banking system, the European Stabilization Mechanism announced in early May has been perceived as a late attempt to ease the strain on banks, and therefore failed to boost the risk appetite (Graphs 2.4.3 and 2.4.4).

Graph 2.4.3. Global Risk Appetite



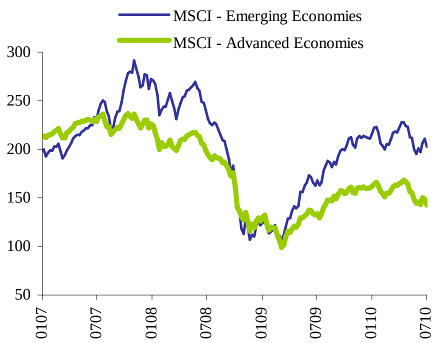
Source: Bloomberg.

Graph 2.4.4. CDS Rates

Source: Bloomberg.

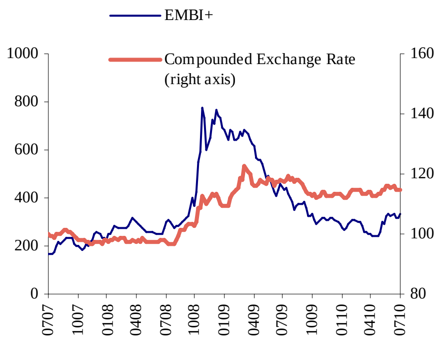
After the second-quarter fall, the current level of global risk appetite curbs the demand for high-yielding assets of advanced and emerging economies (Graphs 2.4.5 and 2.4.6). Growing at a more rapid pace and offering higher yields than advanced economies, emerging economies attract relatively more capital flow under current circumstances. Yet, ongoing global fragilities and resulting fluctuations in risk appetite may prevent the permanence of these flows.

Graph 2.4.5. Global Stock Markets



Source: Bloomberg.

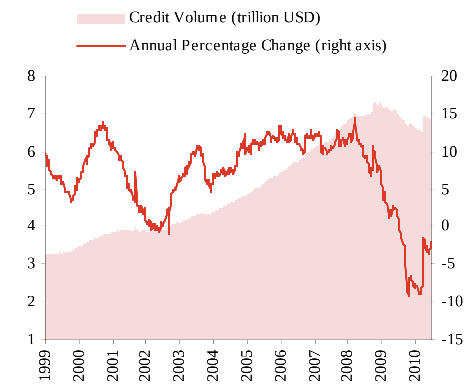
Graph 2.4.6. Exchange Rate and Risk Premium Indicators for Emerging Economies*



*Arithmetical average of the exchange rates of emerging market currencies against the currency basket of 1 euro and 1 US dollar. Equals 100 on June 2007 and an upward movement denotes depreciation in emerging market currencies.
Source: Bloomberg.

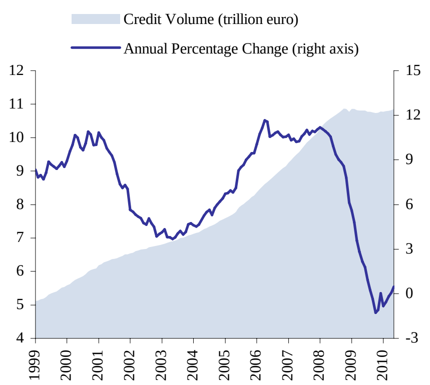
The second-quarter expansion in global credit markets point to an easing in credit squeeze. The ongoing contraction since the onset of the crisis has gradually eased in the US credit market which is less dependent on bank lending and therefore more sensitive to changes in the economic activity in investment financing. Meanwhile, the euro area credit volume started to expand year-on-year (Graphs 2.4.7 and 2.4.8).

Graph 2.4.7. US Credit Developments



Source: Bloomberg.

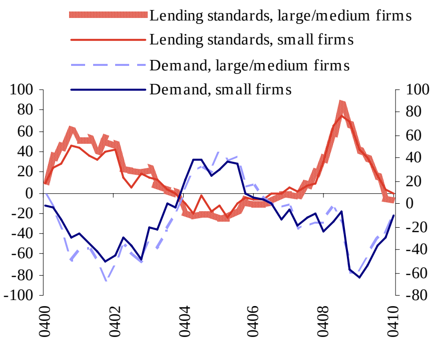
Graph 2.4.8. Euro Area Credit Developments



Source: ECB.

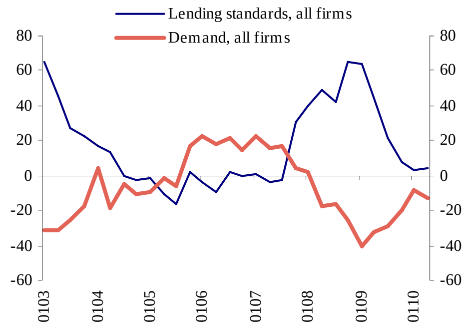
Bank lending surveys in April 2010 by Fed and ECB announcing first-quarter loan developments reveal that US commercial banks have generally ended tightening on loans to businesses, whereas lending standards tightened further in the euro area (Graphs 2.4.9 and 2.4.10). Loan supply varies between regions, while loan demand remains weak in both regions. However, the recent uncertainty surrounding the euro area and the increased cost of funding as well as difficulties in finding a financing source added to the pressure on banks, which would cause European banks to tighten loan standards and pose a downside risk to loan supply in coming months.

Graph 2.4.9. Lending Survey by the FED
(Percent)



Source: Fed.

Graph 2.4.10. Lending Survey by the ECB
(Percent)



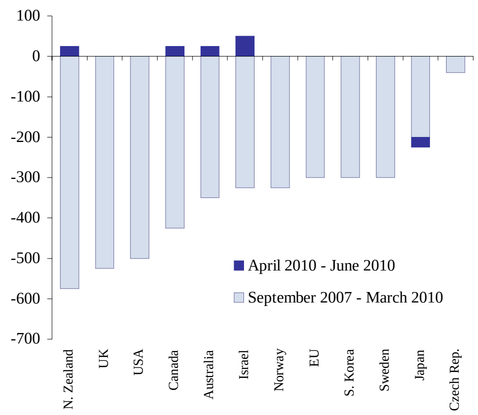
Source: ECB.

2.5. Global Monetary Policy Developments

Amid concerns about increased downside risks to global economic outlook, most central banks continued to keep policy rates low in the second quarter of 2010 and signaled that policy rates may remain low longer than anticipated a quarter earlier. Thus, there have been stronger expectations about central banks in both advanced and emerging economies to be more prudent than in the previous quarter and to postpone the policy normalization process.

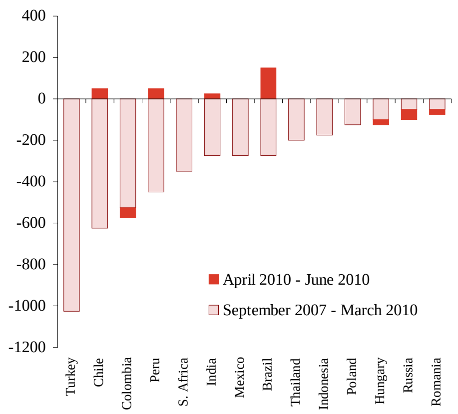
In the second quarter, most central banks continued to support economic recovery by leaving policy rates low. Yet, a small number of central banks hiked policy rates and tightened their monetary stance. Among advanced economies, Australia continued to tighten monetary policy in the second quarter after the hike in the fourth quarter of 2009, and raised the policy rate by 25 basis points in April and May. Norway, New Zealand and Canada hiked their policy rates by 25 basis points in the second quarter (Graph 2.5.1).

Graph 2.5.1. Policy Rate Changes in Advanced Economies
(Basis Point)



Source: Fed.

Graph 2.5.2. Policy Rate Changes in Emerging Economies
(Basis Point)

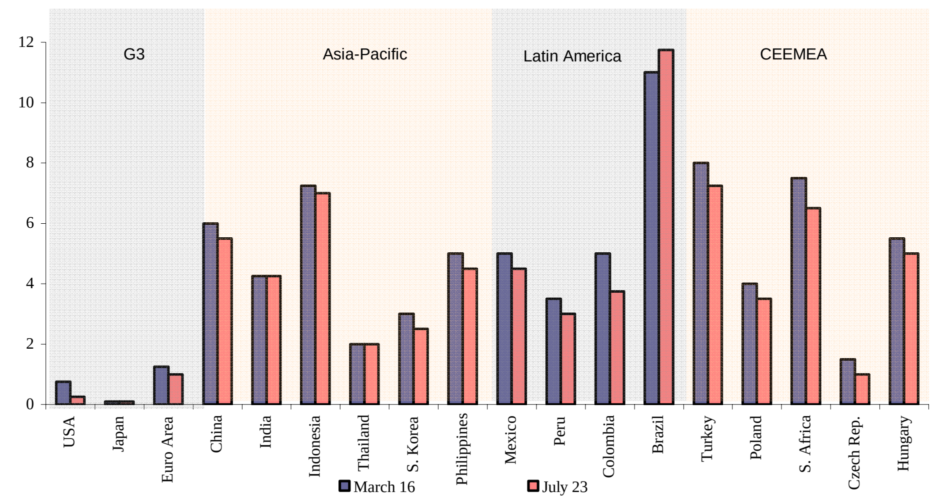


Source: ECB.

Among emerging economies, Latin American central banks switched to monetary tightening earlier than elsewhere in the group due to rising inflationary pressures amid rapid economic recovery. Accordingly, Brazil, Chile and Peru raised policy rates in the second quarter. Similarly, in the Asia-Pacific region, India continued to tighten monetary policy for the second consecutive quarter on climbing inflation and raised key rates by 25 basis points in April and June. The Reserve Bank of India hinted at another rate hike in coming months. On the other hand, Hungary, Romania and Russia, which follow the global monetary easing cycle with a lag, continued to cut policy rates in the second quarter, albeit more moderately than in the first quarter (Graph 2.5.2).

As of the mid-year, some central banks in advanced economies seem to have altered their monetary policy stance for the period ahead. In the first quarter, the Fed and the ECB were expected to start hiking rates towards the end of 2010, whereas, policy rate hikes are now expected to be unlikely before mid-2011. In fact, policy rate forecasts for end-2010 are revised down from the April Inflation Report round (Graph 2.5.3). The main reason for central banks in advanced economies to remain on hold is the rising downside risks to global economic activity due to the uncertainty surrounding Europe.

Graph 2.5.3. Expected Policy Rates at 2010 Year-end

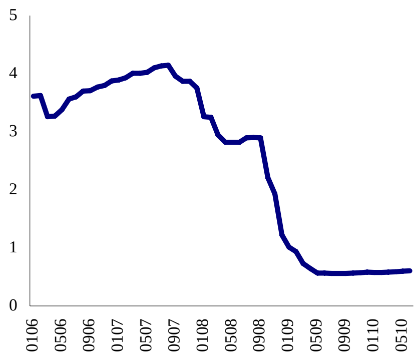


Source: Bloomberg.

Likewise, in emerging economies, most central banks have delayed raising interest rates for a while and are now expected to increase rates very moderately. Expectations of a prolonged period of low policy rates in advanced economies, reduced inflation risk, and increased downside risks to global economic outlook caused emerging economies to postpone policy rate hikes. In fact, end-2010 policy rate forecasts for all emerging economies, except Brazil, Thailand and India, are revised down from the April Inflation Report round (Graph 2.5.3).

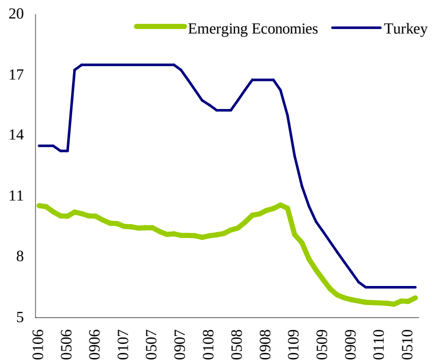
In aggregated indices, global policy rates remained flat during the second quarter of 2010. As most central banks of advanced economies kept policy rates low and only a few central banks raised rates during the second quarter, the composite policy rate for advanced economies remained virtually unchanged quarter-on-quarter, ending June at 0.61 percent (Graph 2.5.4). Meanwhile, a number of emerging market central banks hiked policy rates, and hence the composite policy rate for these economies edged up slightly for the first time during the second quarter to 5.98 percent at end-June (Graph 2.5.5).

Graph 2.5.1. Policy Rate Changes in Advanced Economies
(Basis Point)



Source: Bloomberg, CBRT calculations.

Graph 2.5.2. Policy Rate Changes in Emerging Economies
(Basis Point)

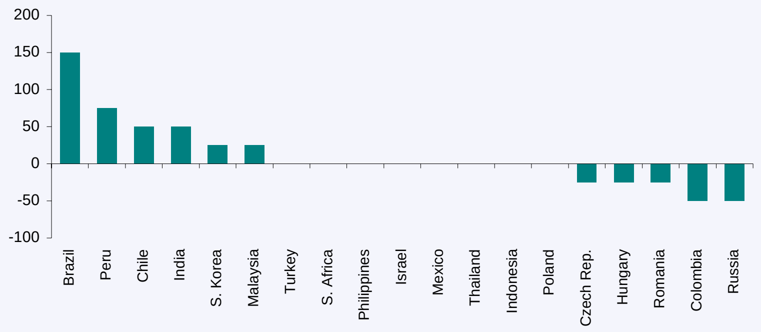


Source: Bloomberg, CBRT calculations.

Box 2.1 Determinants of the Monetary Stance in Emerging Economies During the Second Quarter of 2010

Some emerging market central banks started normalizing monetary policy during the second quarter by raising policy rates, while others maintained their expansionary policy stance (Graph 1). This Box focuses on the divergence in the monetary policy stance across emerging economies, and assesses the relative position of Turkey.

Graph 1. Policy Rate Changes during the Second Quarter*
(Basis Point)

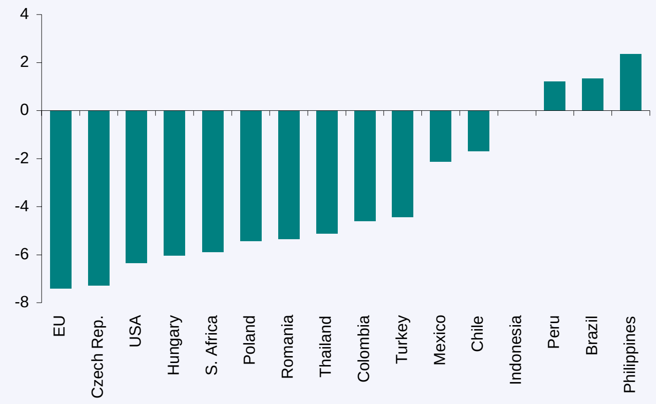


* April-June 2010.
Source: Bloomberg.

Capacity utilization rates are one of the indicators frequently used by central banks to assess future inflationary pressures. Graph 2 shows the deviation in second-quarter capacity utilization rates of selected emerging economies from their long-term averages.[2] This graph reveals that the level of capacity utilization in emerging European and advanced economies are well below their long-term averages in the second quarter. On the other hand, the level of capacity in Latin American and Asia-Pacific emerging economies differs from the EU, with Brazil, Peru and the Philippines in the lead, having capacity utilization rates above their long-term averages as of the second quarter.

[2] Long-term average capacity utilization rate is calculated as the average capacity utilization rate from early 2005 until the onset of the crisis.

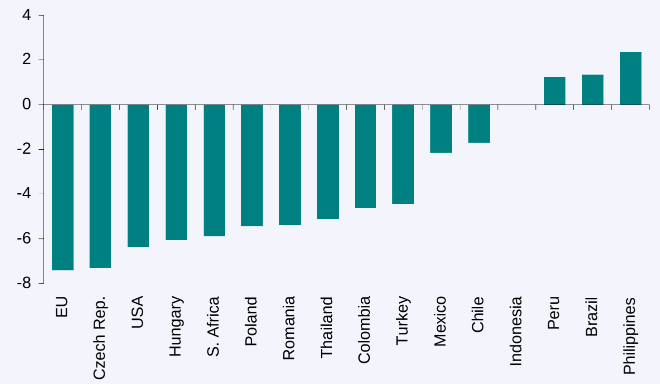
Graph 2. Deviation in Capacity Utilization Rates from Long-Term Averages



Source: Bloomberg, Datastream.

Moreover, core inflation indices that provide useful information on underlying inflation also point to a similar divergence across emerging economies. As shown in Graph 3, core inflation rates in the EU, excluding Hungary, ended the second quarter well below their year-end inflation targets. While there is barely an inflationary pressure on EU economies, a majority of Latin American emerging economies face inflationary pressures, with core inflation rates surpassing targets and trending upwards.

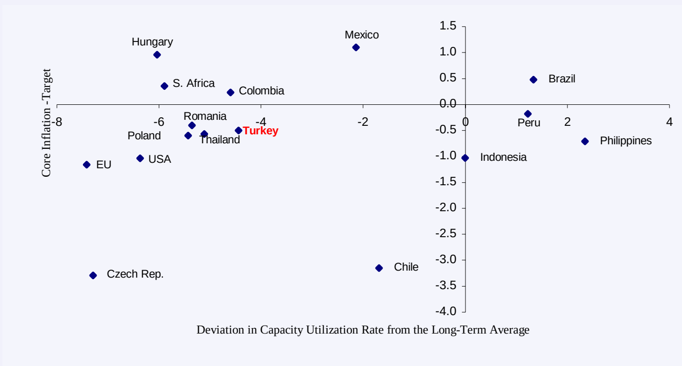
Graph 3. Deviation in Core Inflation Rates from Targets*



* For Romania, CPI excluding energy, food, alcohol and tobacco.
Source: Bloomberg, Datastream.

Capacity utilization and inflation rate are considered to be essential to central banks' monetary policies and hence assessing both simultaneously provides valuable insight for the monetary policy stance. For selected countries, Graph 4 shows the deviation of capacity utilization rate and core inflation from long-term average capacity utilization rate and inflation target, respectively. As illustrated in the graph, all countries with capacity utilization rates lower than long-term averages maintained expansionary policies in the second quarter by either cutting policy rates or keeping rates low. Some countries hardly faced an inflationary pressure against their expansionary policies, while the others continued to implement expansionary monetary policies prioritizing the objective of stimulating the economy even though their core inflation figures hovered above their targets. For example, Hungary and Colombia lowered policy rates in the second quarter, although their core inflation rates exceeded their targets. Meanwhile, economies with no inflation risk but with high idle capacity, such as Poland, Czech Republic, Thailand and Turkey, maintained low policy rates.

Graph 4. Determinants of Monetary Policies during the Second Quarter



Economies with capacity utilization rates exceeding their long-term averages in the second quarter and inflation rates above or close to targets, such as Brazil and Peru, raised policy rates during the second quarter. However, despite having a capacity utilization rate above long-term averages, the Philippines kept its policy rate low during the second quarter owing to the increasing downside risks to the global economic outlook.

In sum, many emerging economies, including Turkey, operating at a capacity below their long-term averages continued to cut policy rates or kept rates low during the second quarter.

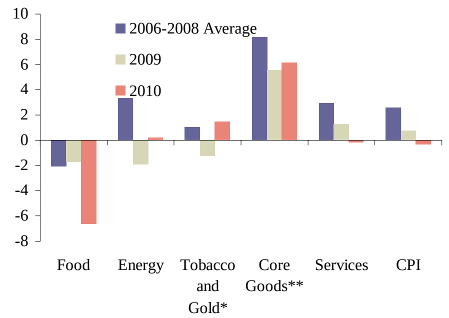
3. Inflation Developments

3.1. Inflation

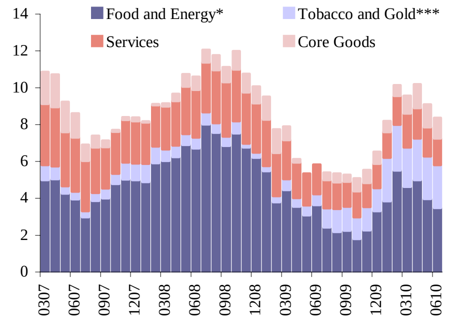
Consumer prices decreased by 0.33 percent during the second quarter of 2010, bringing annual inflation down to 8.37 percent. Thus, consumer prices dropped quarter-on-quarter for the first time since the inception of the index amid lower food prices and easing commodity prices. Yet, despite the relatively stable recovery in domestic demand, aggregate demand conditions continued to restrain core inflation indicators. Hence, underlying inflation remained consistent with medium-term targets.

Prices had a favorable outlook across all subcategories during the second quarter of 2010. After having climbed dramatically in the past two quarters and prompting consumer prices to soar, food prices plunged sharply during the second quarter (Graph 3.1.1). Energy prices, on the other hand, remained relatively flat amid lower oil prices. Thus, the contribution of food and energy prices to annual inflation has declined to 3.48 percentage points as of mid-2010 (Graph 3.1.2). The benign inflation outlook hinges not only on food and energy prices, but also on slowing prices for core goods and services. Seasonally adjusted data also indicate that prices of services were down quarter-on-quarter for the first time. Likewise, prices of core goods moderated owing to the euro depreciation as well as the easing commodity prices.

Graph 3.1.1. CPI by Categories
(Second Quarter Percentage Change)



Graph 3.1.2. Contribution to Annual CPI Inflation

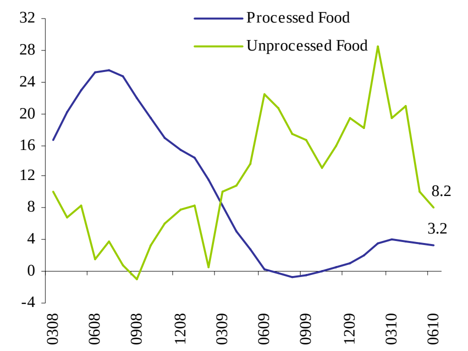


*Core goods: Goods excluding food, energy, alcoholic beverages, tobacco and gold.
**Food and energy: Food, non-alcoholic beverages and energy.
***Tobacco and gold: Alcoholic beverages, tobacco and gold.
Source: TURKSTAT, CBRT.

Food prices plummeted during the second quarter amid lower unprocessed food prices (Graphs 3.1.1 and 3.1.3). With the significantly growing supply of products, fruit and vegetable prices saw a sooner and sharper downward correction than envisioned in the April Inflation Report. In addition, the adoption of import regulations for red meat at the end of April brought red meat prices down. White meat prices also dropped during this period, thus causing unprocessed meat prices to fall by 3.7 percent (Graph 3.1.4). Accordingly, the direct contribution of meat prices to annual CPI inflation fell to 1.4 percentage points at the end of the second quarter.

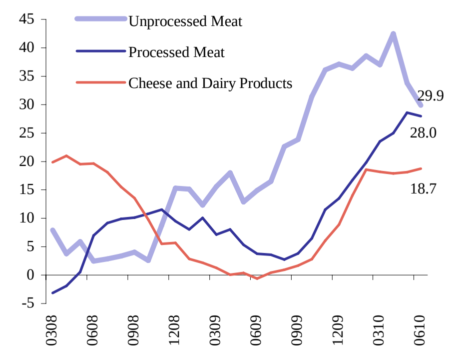
Processed food prices also decreased during the second quarter, pushing food prices further down (Table 3.1.1). The decline in processed food prices was driven by the drop in the prices of liquid fats, bread and cereals, and milk products. On the other hand, the outlook for processed meat prices remained negative despite the recent drop in unprocessed meat prices due to the cumulative effect of previous hikes (Graph 3.1.4).

Graph 3.1.3. Food Prices
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Graph 3.1.4. Prices of Animal Products
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

To sum up, food inflation plunged from 11.21 to 5.62 percent year-on-year during the second quarter, undershooting the April Inflation Report forecast. The fall in food inflation has largely been owed to the temporary abundance of fruits and vegetables due to early summer harvest. In this respect, fruit and vegetable prices are expected to see a more moderate year-on-year decline in the third quarter. Yet, food inflation forecasts for end-2010 are likely to be revised downward given the high possibility of observing low meat prices for a prolonged period (Table 7.1.1).

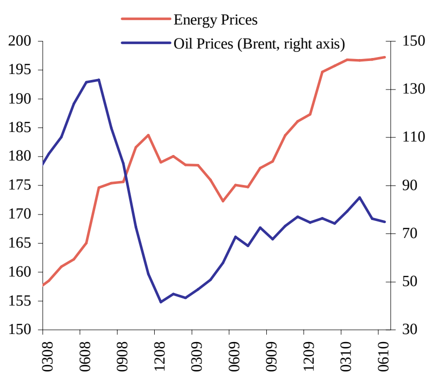
Table 3.1.1. Prices of Goods and Services
(Quarterly and Annual Percentage Changes)

	2009				2010	
	II	III	IV	Annual	I	II
CPI	**0.77**	**0.34**	**4.26**	**6.53**	**3.93**	**-0.33**
1. Goods	**0.60**	**-0.22**	**5.32**	**7.01**	**4.50**	**-0.38**
Energy	-1.90	2.32	4.54	4.64	5.08	0.21
Unprocessed Food	-3.68	-4.90	15.00	19.35	13.40	-12.76
Processed Food	0.09	0.61	1.27	1.04	1.93	-0.62
Goods excl. Energy and Food	4.21	0.17	3.65	6.15	1.81	5.07
Core Goods	5.55	-2.32	4.08	2.56	-3.27	6.16
Durable Goods	-2.76	2.70	4.18	3.76	1.32	1.30
Durable Goods excl. Gold	-2.23	2.83	3.25	1.22	1.32	0.36
Semi-Durable Goods	4.55	-1.65	5.33	4.55	-0.73	6.20
Non-Durable Goods	-1.22	0.04	5.62	9.80	9.17	-5.08
2. Services	**1.27**	**1.96**	**1.28**	**5.13**	**2.32**	**-0.17**
Rents	1.14	1.43	1.10	5.28	0.96	0.65
Restaurants and Hotels	1.19	1.73	2.32	7.31	3.30	2.28
Transportation	1.43	1.15	1.25	2.53	2.44	1.32
Other	1.31	2.57	0.87	4.96	2.42	-2.13

Source: TURKSTAT, CBRT.

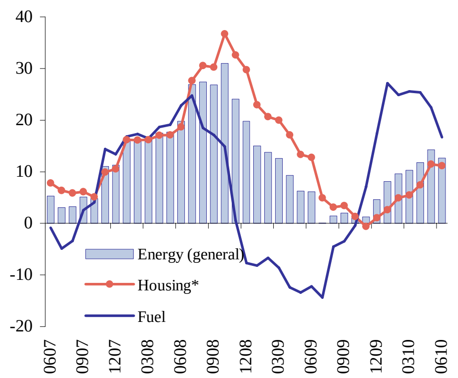
Energy prices have been flat in the second quarter (Graph 3.1.5). While tap water rates and solid fuel prices were up, the resulting upward pressure on domestic fuel prices was counterbalanced by lower international oil prices (Graph 3.1.6). Despite the flattening of energy prices, energy price inflation rose to 12.63 percent year-on-year on the back of the low base effect from a year earlier. Annual energy price inflation is expected to slow down in the second half of 2010 unless international oil prices rise dramatically.

Graph 3.1.5. Energy and Oil Prices
(Index and Price Level)



Source: TURKSTAT, CBRT.

Graph 3.1.6. Energy Prices
(Annual Percentage Change)

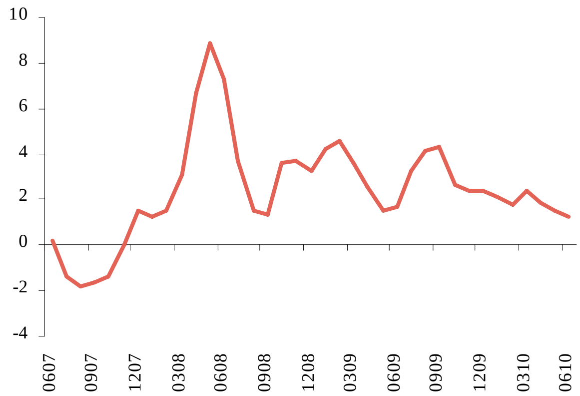


* Home utilities include electricity, water, natural gas, bottled gas and solid fuel.
Source: TURKSTAT, CBRT.

The year-on-year rate of increase in core goods (goods excluding food, energy, alcoholic beverages, tobacco and gold) was up by 0.6 percentage points from the previous quarter to 4.38 percent mainly owing to the base effects from the previous year's tax incentives on durable goods. In fact, adjusted for tax changes, core goods inflation fell by 0.5 percentage in the second quarter to 2.4

percent year-on-year. Seasonally adjusted data even point to a lower underlying inflation in core goods for the second quarter (Graph 3.1.7). Falling import prices and the depreciation of the euro also support the benign outlook in core goods prices.

Graph 3.1.7. Prices of Core Goods
(Adjusted for Seasonal and Tax Effects, 3-Month Average, Annualized)



Source: TURKSTAT, CBRT.

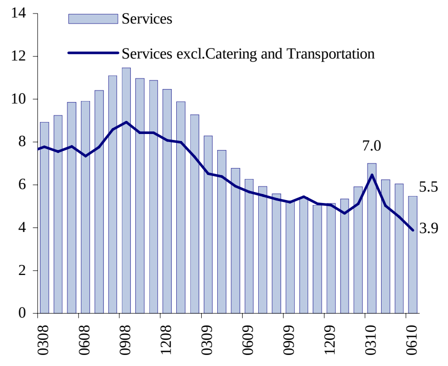
Table 3.1.2. Prices of Core Goods
(Quarterly and Annual Percentage Change)

	2009				2010	
	II	III	IV	Annual	I	II
Core Goods	**5.55**	**-2.32**	**4.08**	**2.56**	**-3.27**	**6.16**
Clothing	**23.00**	**-11.91**	**10.27**	**3.39**	**-12.62**	**23.73**
Durable Goods Excl. Gold	**-2.23**	**2.83**	**3.25**	**1.22**	**1.32**	**0.36**
Furniture	-7.61	1.03	7.86	-2.51	1.41	3.76
Electrical and Non-Electrical Appliances	-2.54	3.53	-1.11	-4.47	-0.16	-1.01
Automobiles	-0.11	3.20	4.72	6.49	2.17	-0.11
Other Durable Goods	0.20	1.81	0.41	2.79	0.56	2.17
Pharmaceuticals	**7.65**	**0.00**	**-1.51**	**6.02**	**-1.77**	**0.00**
Other	**0.86**	**0.72**	**0.34**	**3.14**	**-0.86**	**0.12**

Source: TURKSTAT, CBRT.

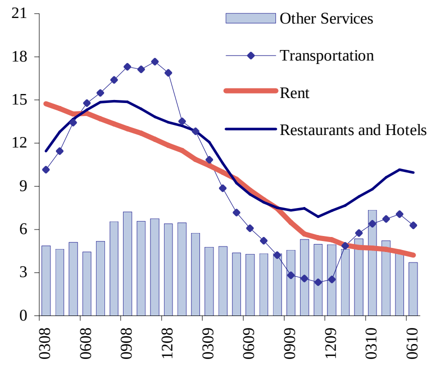
During the second quarter, prices of services recorded a quarter-on-quarter drop of 0.17 percent for the first time since the inception of the index, bringing annual services inflation down by 1.53 percentage points to 5.48 percent (Graph 3.1.8, Table 3.1.1). The decrease was attributable to the sizable fall in mobile call rates. Pursuant to the decision of the Information and Communication Technologies Authority (ICTA), postpaid rates are reduced, while prepaid plans are now quoted in Turkish lira terms, thus allowing mobile telecommunications providers to offer more competitive prices. Accordingly, services inflation fell by about 1 percentage point quarter-on-quarter.

Graph 3.1.8. Prices of Services
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

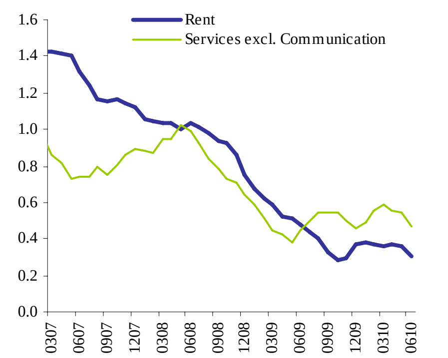
Graph 3.1.9. Prices of Services by Subcategories
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

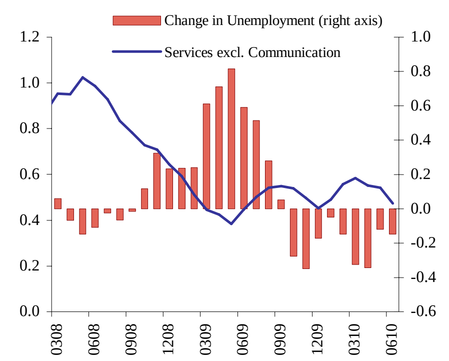
The rate of increase in other subcategories of services also slowed during the second quarter. Seasonally adjusted data indicate that price increases were slower quarter-on-quarter across all services subcategories (Graph 3.1.10). Although employment conditions continue to improve, currently high level of unemployment rates puts a cap on price hikes in services (Graph 3.1.11). Specifically, the annual rental inflation continued to fall steadily during the second quarter to an all-time low of 4.21 percent (Graph 3.1.9). However, rising catering prices contained the downtrend in services inflation. Despite the recent fall in meat prices, catering prices continued to soar during April and May due to lagged effects of cumulative increases in meat prices. Yet, the rate of increase in catering prices slowed rapidly in June. Prices of services are unlikely to face a major inflationary pressure in the second half of 2010, while the annual rate of increase in services is expected to stay at current levels.

Graph 3.1.10. Prices of Services
(Seasonally Adjusted, 3-Month Average, Annualized)



Source: TURKSTAT, CBRT.

Graph 3.1.11. Prices of Services and Change in Unemployment
(Seasonally Adjusted, 3-Month Average, Annualized)*

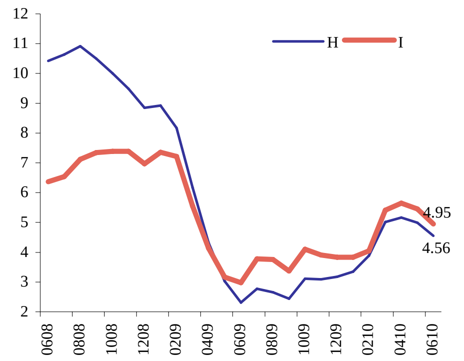


*Change in unemployment for each period is the 4-month ago reading.
Source: TURKSTAT, CBRT.

Annual inflation in core prices decreased during the second quarter (Graph 3.1.12). Underlying inflation is believed to be better gauged by analyzing 3-month averages of monthly changes in seasonally adjusted core CPI measures (Box 3.1). In this regard, underlying inflation appears to have slowed dramatically in the second quarter (Graph 3.1.13). Therefore, core inflation indicators are expected to remain consistent with medium-term targets in the upcoming period.

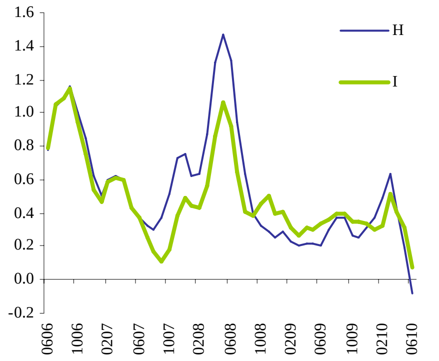
It should be reminded that the tax incentives in 2009 would put downward pressure on the annual rate of increase in core price indicators during July and October. This base effect may account for –0.2 and –0.5 percentage points of the H inflation, and for –0.3 and –0.7 percentage points of the I inflation in the respective months.

Graph 3.1.12. Core CPI Indices H and I
(Annual Percentage Change)



Source: TURKSTAT, CBRT.

Graph 3.1.13. Core CPI Indices H and I
(Adjusted for Seasonal and Tax Effects, 3-Month Average, Annualized)

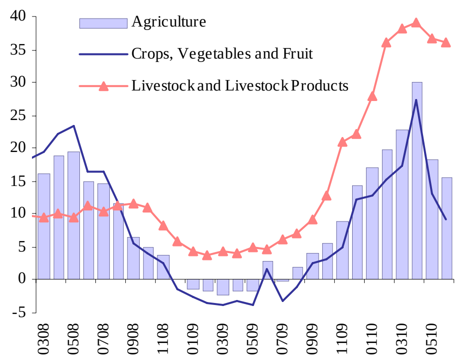


Source: TURKSTAT, CBRT.

Developments in producer prices, one of the determinants of inflation, indicate that cost pressures have significantly moderated compared to the previous quarter. Agricultural prices rose slightly less during the second quarter than in previous years, while plummeting international commodity prices curbed the rise in manufacturing industry prices. Accordingly, producer prices increased by a mere 0.67 percent in the second quarter. Lower fruit and vegetable prices and the resulting slowdown in CPI inflation spilled over into agricultural prices (Graph 3.1.14). On the other hand, despite having declined in May after the newly adopted import regulation, livestock prices were back on the rise in June, albeit modestly.

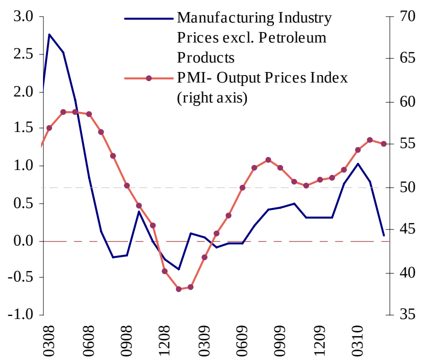
Manufacturing industry prices remained mainly unchanged during the second quarter, while prices for intermediate goods increased slightly. In particular, although prices for base metals were significantly down amid lower commodity prices during the past two months, the massive increase in prices for textile fibers (fuelled by rising cotton prices) drove prices for intermediate goods higher. Therefore, cost factors are likely to exert pressure on clothing prices in coming months. Meanwhile, producer prices for meat and meat products were down for the past two months, placing downward pressure on manufacturing industry prices. Overall, the second quarter of 2010 was marked by the weakening of the upward producer price pressure on CPI inflation.

Graph 3.1.14. Agricultural Prices
(Annual Percentage Change)



Source: TURKSTAT.

Graph 3.1.15. Manufacturing Industry Prices and PMI Output Prices Index
(3-Month Average, Annualized)

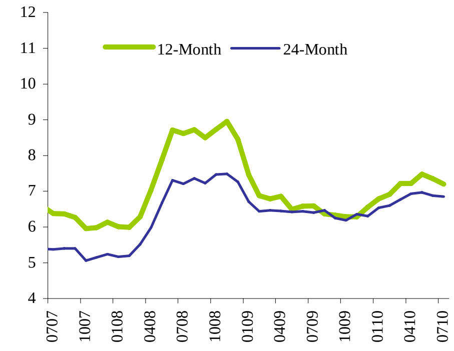


Source: TURKSTAT, Markit.

3.2. Expectations

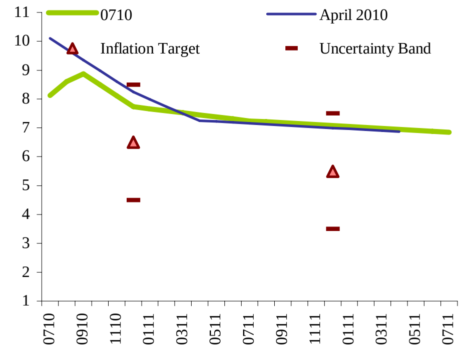
The uptrend in medium-term inflation expectations that started in the final quarter of 2009 slowed during the second quarter of 2010 (Graph 3.2.1). In fact, following the better-than-expected price developments during May and June and the return of annual inflation to single digits, near-term inflation expectations were revised down markedly quarter-on-quarter. Longer-term expectations, though, remained virtually unchanged quarter-on-quarter (Graph 3.2.2). Currently, 12 and 24- month ahead inflation expectations hover slightly above year-end targets of 5.5 and 5 percent for 2011 and 2012, respectively.

Graph 3.2.1. 12 and 24-Month Ahead CPI Expectations*
(Annual Percentage Change)



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

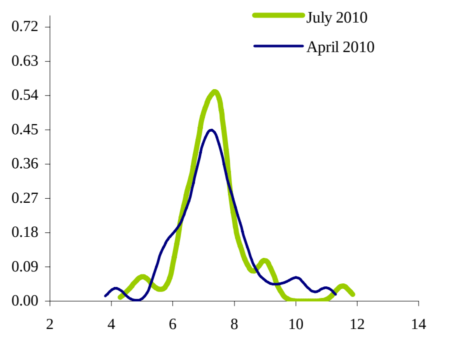
Graph 3.2.2. Inflation Expectations Curve*
(Annual Percentage Change)



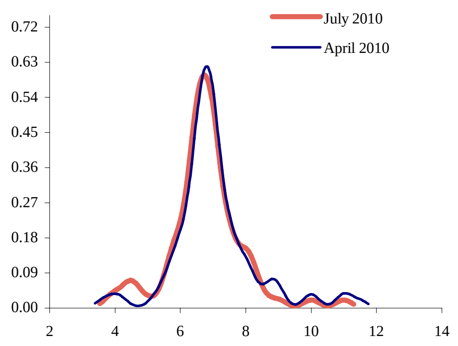
*Calculated by linear interpolation of expectations at different maturities in the CBRT Survey of Expectations. Expectations are from the second survey period of the CBRT Survey of Expectations.
Source: CBRT.

In July, the dispersion of participants' 12-month ahead inflation expectations rose from April (Graph 3.2.3), while that of 24-month ahead inflation expectations remained unchanged (Graph 3.2.4).

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



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



*Horizontal axis shows inflation rate, vertical axis indicates Kernel forecast. CBRT Survey of Expectations, Second survey period results.
Source: CBRT.

Box 3.1 Underlying Inflation

Having adopted the inflation-targeting regime, the CBRT closely monitors the developments regarding inflation, the point target, and publicly shares the extensive analyses on these developments. Short-term inflation developments may arise due to sector-specific seasonal or period-specific temporary effects, and therefore may signal an inflation process independent from the underlying inflation. In other words, it is difficult to properly analyze the changes in the consumer price index when such effects are prevalent. Thus, to monitor the underlying inflation, the CBRT uses and regularly follows core inflation indicators by excluding subcategories that exhibit temporary changes and show extreme volatility, and thus, are relatively outside the scope of monetary policy.[1]

In evaluating the underlying inflation, the choice of indicators to be monitored is as equally important as how these indicators should be analyzed. Taking the annual percentage change of the index is a common method for analyzing core inflation indicators. This method relatively eliminates seasonal variations that cause price fluctuations, but fails to fully reflect the information that is contained in the recent trend of indicators. In fact, in cases where seasonality changes by years (for example, shifts in discounts or new season, early or late summer harvest of fresh fruits and vegetables), annual percentage changes in indicators can display temporary fluctuation. Moreover, in some cases, annual changes may contain less information on recent price dynamics. For example, in a case where monthly inflation rates soar sharply on several shocks during the first 9 months over a 12-month period and remain flat during the last 3 months as these shocks fade out, annual inflation at the end of 12-month horizon would be far too high to reflect the slowdown in the last 3 months.

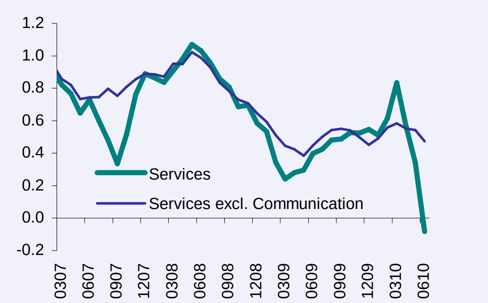
Similarly, in case of a strong base effect, the annual percentage change of the indicator may hint at an incidental effect from 12 months earlier rather than a recent change.[2] Therefore, an assessment depending merely on annual changes may provide limited information.

1 To this end, SCA-H (CPI excluding energy, unprocessed food, alcoholic beverages, tobacco and gold) and SCA-I (SCA-H excluding processed food) are widely used in Turkey.
2 For further information on the definition of base effects, see Inflation Report 2010-I Box 3.2. “Base Effects and Their Implications for the 2010 Inflation Outlook”.

For an inflation-targeting central bank, recent trends are more essential in terms of their implications for future than past trends. However, short-term price changes over a month or a few months may be widely subject to seasonal effects. Thus, it is very common to seasonally adjust recent price changes in evaluating the underlying inflation. As monthly changes in seasonally adjusted data may also fluctuate due to month-specific factors, it is useful to smooth out these fluctuations by taking the moving average of monthly changes over a certain period (2, 3 or 6-month, etc).[3]

CBRT adopts a similar approach and frequently refers to seasonally adjusted values for recent core price movements. Yet, in order to determine the underlying trend, it is critical to avoid the mechanical use of this method, and to be able to detect one-time temporary price changes in core price indicators. In this sense, CBRT's statement on underlying services inflation following the changes in prices of services during April 2010 sets a useful example. The Information and Communication Technologies Authority's decision to lower the ceiling for postpaid rates and enable prepaid plans to be quoted in Turkish lira increased the competition among mobile network operators, leading to a significant decrease in mobile call rates. In such a case, it has been more instrumental to analyze the underlying services inflation by excluding communication from general services price index. In fact, seasonally adjusted data for services excluding communication prices provide a clearer insight into the underlying services inflation (Graph 1). From this perspective, it can clearly be seen that communication prices have accounted for most of the recent slump in prices of services, and excluding communication prices, the slowdown in the underlying trend has been more limited.

Graph 1. Prices of Services
(Seasonally Adjusted, 3-Month Average, Annualized)



Source: TURKSTAT, CBRT.

In sum, in assessing the underlying inflation, CBRT refers to seasonally adjusted averages of recent monthly increases in core price indicators (SCA-H, SCA-I, services, core goods, etc). In case of a one-time effect that contradicts with the general pattern, these effects are removed from the relevant items in analyzing the underlying trend. Thus, handling underlying trends is usually judgmental, yet, there is no absolute standard to be applied. Hence, monetary policy is shaped by a broad set of data based on various approaches.

3 The longer the time horizon, the flatter the underlying trend, which may cause to miss the turning points in the underlying trend. Therefore, in determining the time horizon, there is a trade-off between smoothness and the timely detection of turning points.

4. Supply and Demand Developments

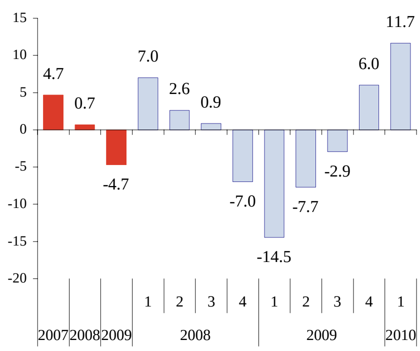
The first-quarter national accounts data are consistent with the outlook presented in the April Inflation Report. While annual GDP growth has been robust due to low base effect from the previous year, quarterly GDP remained virtually flat in seasonally adjusted terms, growing by a mere 0.1 percent. Domestic demand continued to recover solidly, except for the public sector, whereas exports remained sluggish amid ongoing problems in the global economy.

Recent data releases indicate that economic activity continues to recover. Yet, the European debt crisis that emerged in May added to the aggregate demand uncertainty for the rest of the year. Accordingly, the pace of economic recovery is likely to face greater downside risks, while aggregate demand conditions are expected to further support disinflation for a while.

4.1. Gross Domestic Product Developments and Domestic Demand

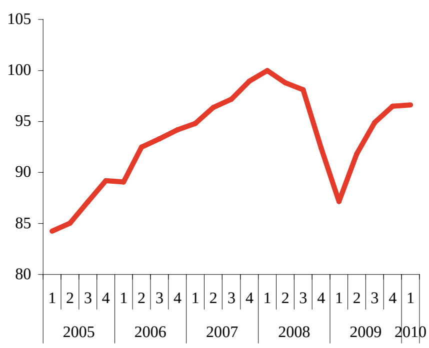
According to the national accounts data released by TURKSTAT, GDP expanded by 11.7 percent year-on-year during the first quarter of 2010 (Graph 4.1.1). In seasonally adjusted terms, GDP growth has been by 0.1 percent quarter-on-quarter (Graph 4.1.2).

Graph 4.1.1. Annual GDP Growth by Quarters
(Percent)



Source: TURKSTAT.

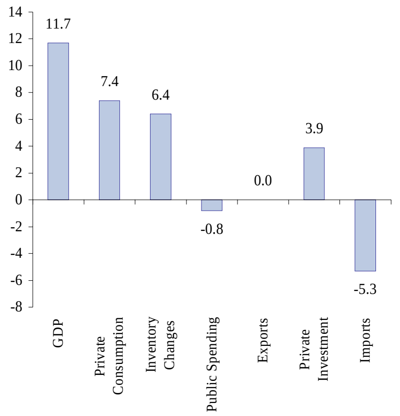
Graph 4.1.2. GDP
(Seasonally Adjusted, 2008 Q1=100)



Source: TURKSTAT, CBRT.

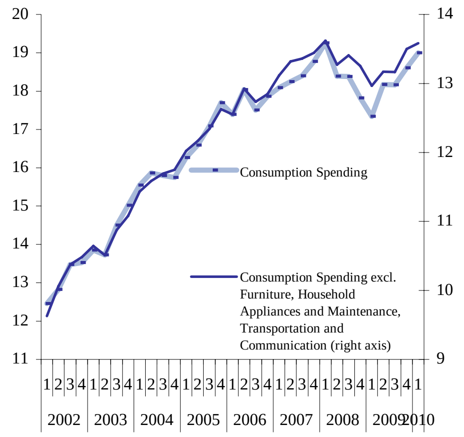
On the spending side, private consumption spending and inventory changes were the primary drivers of the annual GDP growth in the first quarter also owing to the low base effect from a year earlier (Graph 4.1.3). Seasonally adjusted data indicate that private demand has increased at a solid pace, with private consumption demand regaining pre-crisis levels. Among subcategories of resident and nonresident household spending, furniture, household appliances and maintenance, and transportation and communication services provided the largest contribution to the annual consumption growth during the first quarter of 2010. The moderate recovery in the consumption demand for spending categories that are sensitive to current income continued into the first quarter of 2010 (Graph 4.1.4).

Graph 4.1.3. Contribution to Annual GDP Growth from Spending
(Percent)



Source: TURKSTAT, CBRT.

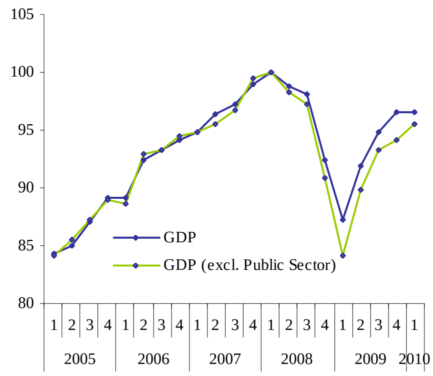
Graph 4.1.4. Resident and Non-Resident Household Spending
(Seasonally Adjusted, 1998 Prices, Billion TL)



Source: TURKSTAT, CBRT.

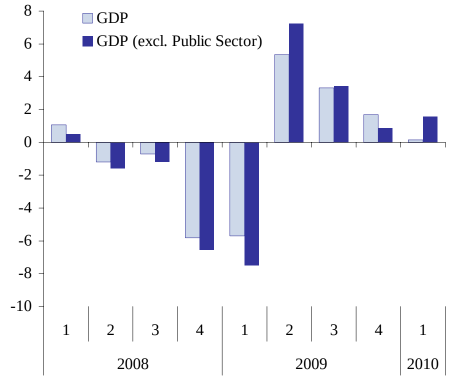
Economic recovery that started in the second quarter of 2009 has relatively suspended mostly due to public sector demand. As stated in the April Inflation Report, the advance payment of health care expenditures for 2010 boosted quarterly GDP growth during the final quarter of 2009. However, massive cutbacks in public spending on construction during the first quarter of 2010 slowed the pace of quarterly GDP growth. In fact, underlying economic activity can be better gauged by excluding public demand. Accordingly, having turned around quickly during the second and third quarters of 2009 amid fiscal stimulus measures, the economy now recovers at a slower yet steady pace following the gradual withdrawal of these measures (Graphs 4.1.5 and 4.1.6).

Graph 4.1.5. GDP
(Seasonally Adjusted, 2008Q1=100)



Source: TURKSTAT, CBRT.

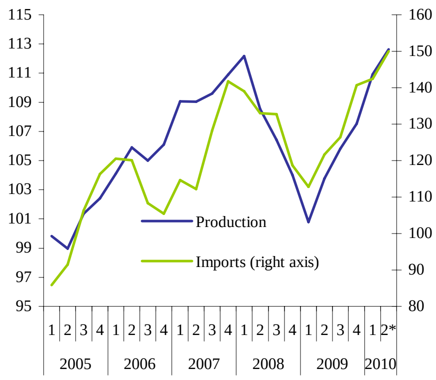
Graph 4.1.6. GDP and Non-Government GDP
(Seasonally Adjusted, Quarterly Percentage Change)



Source: TURKSTAT, CBRT.

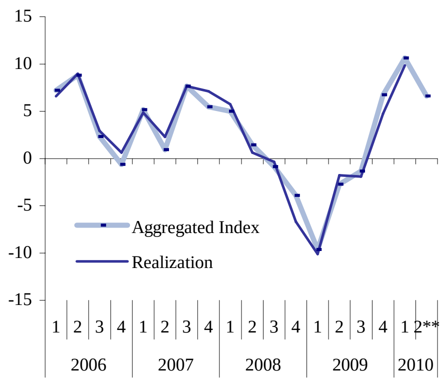
The recent outlook for domestic demand shows that private consumption demand continues to grow. April-May data on production and imports indicate that the demand for consumption goods is running above the previous quarter's average (Graph 4.1.7). In the second quarter, private consumption demand is expected to exceed pre-crisis levels, but slow down year-on-year due to the fading low base effect of the first quarter (Graph 4.1.8).

Graph 4.1.7. Production and Import Quantity of Consumption Goods
(Seasonally Adjusted)



* April-May figures.
Source: TURKSTAT, CBRT.

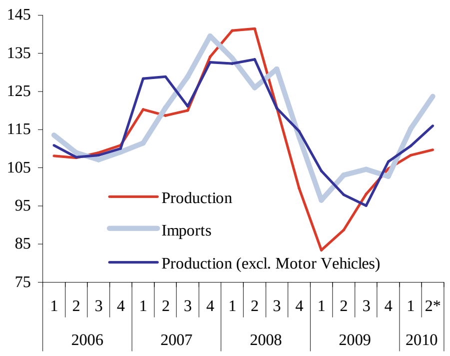
Graph 4.1.8. Aggregated Index* and Private Spending
(Annual Percentage Change)



*Aggregates data on production, imports and exports of consumption goods.
** Forecast.
Source: TURKSTAT, CBRT.

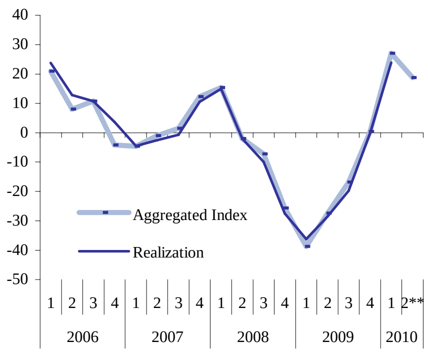
Investment demand continues to recover, but remains below pre-crisis levels. The production of capital goods excluding motor vehicles continues to grow steadily, while imports of capital goods also remain on the rise. Production and import data suggest that private investment may increase significantly year-on-year during the second quarter of 2010 (Graphs 4.1.9 and 4.1.10).

Graph 4.1.7. Production and Import Quantity of Consumption Goods
(Seasonally Adjusted)



* April-May figures.
Source: TURKSTAT, CBRT.

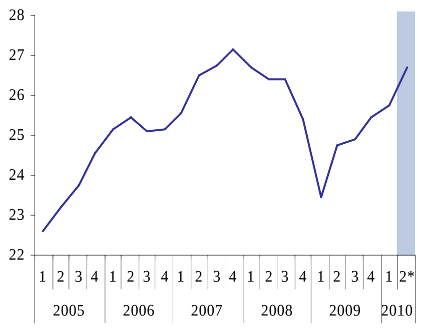
Graph 4.1.10. Aggregated Index* and Private Machinery-Equipment Investments
(Annual Percentage Change)



*Aggregates data on production, imports and exports of capital goods.
** Forecast.
Source: TURKSTAT, CBRT.

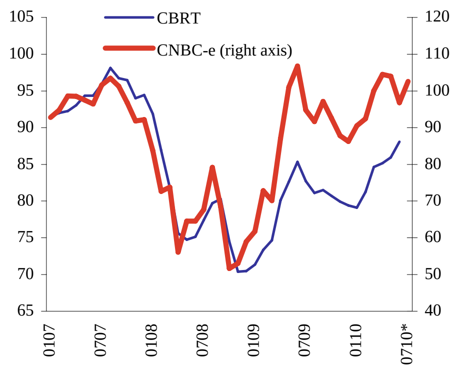
In light of figures on consumption and investment demand, total final domestic demand is expected to grow further and at a faster pace in the second quarter (Graph 4.1.11). The slow yet steady growth in the labor market as well as lower loan rates and improving financial conditions boost consumer confidence, helping domestic demand increase at a relatively more stable pace (Graph 4.1.12). Nevertheless, external demand may face more downside risks in the remainder of the year due to the financial distress in the euro area that has come up since May. June and July surveys show signs of decline in new export orders, particularly in the manufacturing industry (Graph 4.1.13).

Graph 4.1.11. Final Domestic Demand
(Seasonally Adjusted, 1998 Prices, Billion TL)



*Forecast.
Source: TURKSTAT, CBRT.

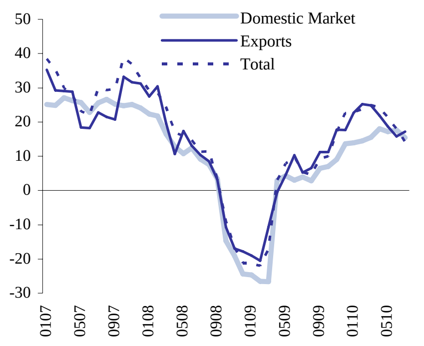
Graph 4.1.12. Consumer Confidence
(Seasonally Adjusted)



*Tentative data for CNBC-e index.
Source: CNBC-e , CBRT.

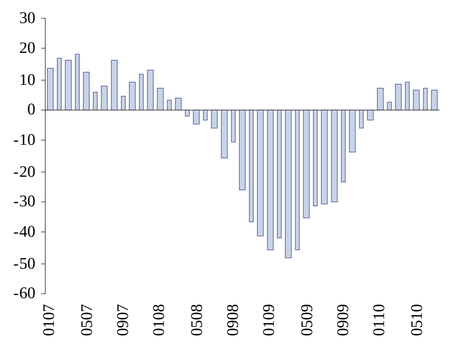
Although recent expectations for new orders have been slightly weaker, June figures are insufficient to determine whether weaker expectations imply a permanent shift in the pace of economic recovery. The European debt crisis currently seems to have minor implications for economic activity. 12-month ahead forecasts for investment spending, another indicator for expectations of manufacturing firms, remained upbeat during May, June and July, signaling that firms' expectations on aggregate demand outlook have barely deteriorated (Graph 4.1.14). However, global economic problems have the potential to restrain domestic demand through external demand and expectations channel in the second half of 2010. Thus, recent developments are believed to have increased the downside risks to the growth outlook.

Graph 4.1.13. 3-Month Ahead BTS Expectations for Orders
(Seasonally Adjusted, Up-Down)



Source: CBRT.

Graph 4.1.14. 12-Month Ahead BTS Expectations for Investments
(Seasonally Adjusted, Up-Down)

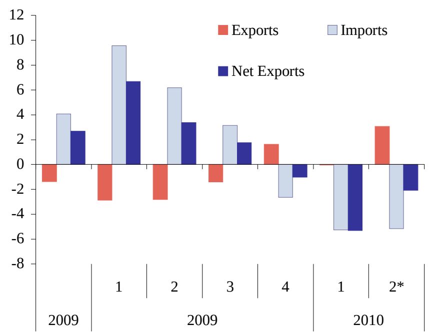


Source: CBRT.

4.2. External Demand

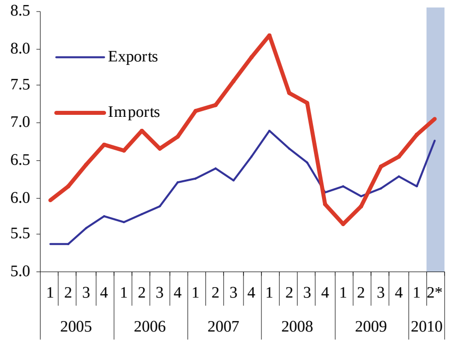
During the first quarter, exports of goods and services were down by 0.1 percent 2010 year-on-year, whereas imports of goods and services were up by 21.1 percent year-on-year. Thus, external demand outlook has been compatible with the April Inflation Report forecasts and net exports contributed –5.3 percentage points to annual GDP growth (Graph 4.2.1). In seasonally adjusted terms, exports fell quarter-on-quarter due to weaker external demand, while imports continued to rise amid improving final domestic demand. Therefore, net external demand made a negative contribution to the quarterly GDP during the first quarter (Graph 4.2.2).

Graph 4.2.1. Contribution to Annual GDP Growth from Exports, Imports and Net Exports
(Percent)



* Forecast.
Source: TURKSTAT, CBRT.

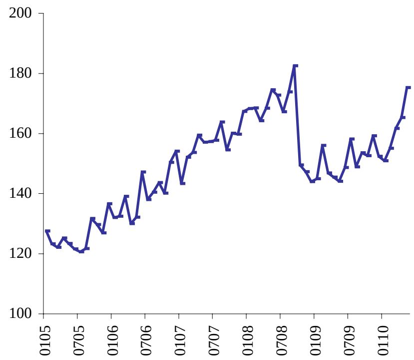
Graph 4.2.2. Exports and Imports of Goods and Services
(Seasonally Adjusted, 1998 Prices, Billion TL)



* Forecast.
Source: TURKSTAT, CBRT.

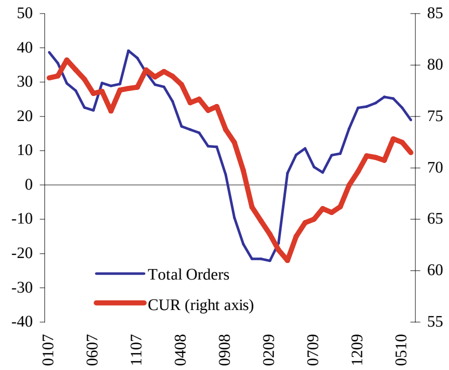
Recent data releases indicate that exports have grown markedly during the second quarter. Excluding gold, the quantity index for exports rose for the fourth consecutive month in May (Graph 4.2.3). The index increased by 17.8 percent year-on-year during April-May, exceeding the first-quarter level. Exports of goods and services are expected to soar sharply during the second quarter and make a positive contribution to quarterly GDP growth, unlike the first quarter (Graph 4.2.2).

Graph 4.2.3. Quantity Index for Exports Excluding Gold
(Seasonally Adjusted, 2003=100)



Source: TURKSTAT, CBRT.

Graph 4.2.4. 3-Month Ahead BTS Expectations for Orders and Capacity Utilization
(Seasonally Adjusted)

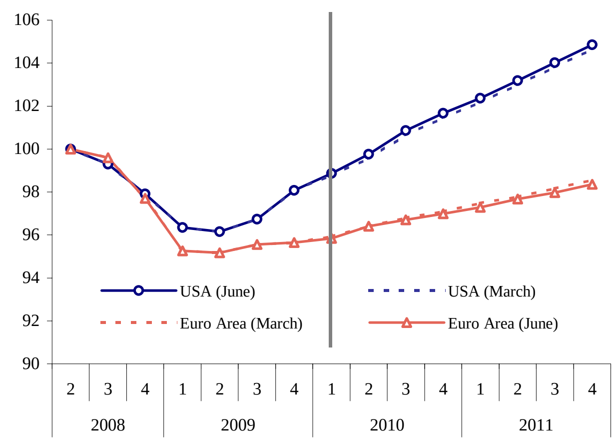


Source: CBRT.

Recent readings suggest that the rapid increase in exports in the second quarter may not be permanent. According to the figures by the Turkish Exporters Assembly (TEA), despite having expanded by 13.1 percent year-on-year in June, exports were down month-on-month in seasonally adjusted terms. As of July, manufacturing firms that mostly serve external markets are operating at lower capacity than domestic market-oriented firms (Box 4.1).

Moreover, recent survey indicators for the manufacturing industry signal slowing export orders (Graph 4.2.4). In view of the lag of 2-3 months for the changes in order expectations to pass through to capacity utilization rates, the strains in external markets are expected to weigh on resource utilization in coming months (Graph 4.2.4). In fact, the downside risks to the pace of external demand growth have risen amid the fiscal crisis in the euro area – Turkey's largest export destination. July forecasts for euro area growth remain basically unchanged from April, but point to significant changes in the composition of demand. With the depreciation of the euro, the growth outlook has improved for exporters such as Germany and Italy, fueling expectations of an increased contribution from net external demand to growth across the euro area. These developments imply a weaker external demand outlook for Turkey despite the absence of a substantial deterioration in the global growth outlook (Graph 4.2.5, Table 7.1.2).

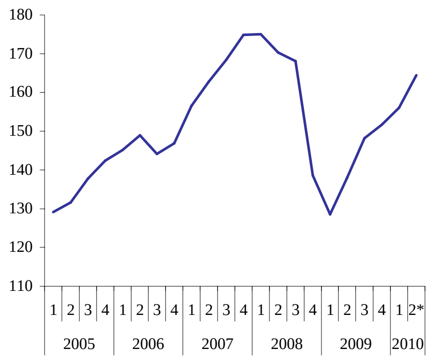
Graph 4.2.5. GDP Forecasts for Advanced Economies
(Seasonally Adjusted, 2008Q2=100)



Source: Consensus Forecasts, March and June 2010.

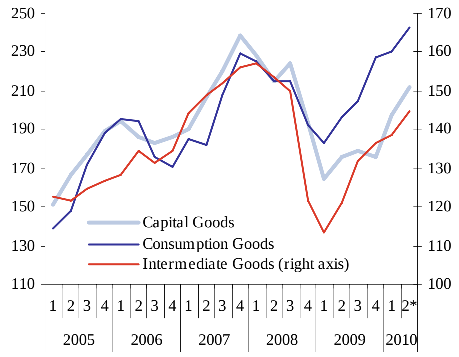
Imports of goods and services continued to recover in the second quarter amid improved final domestic demand. The quantity index for imports increased by 22 percent year-on-year during April-May, running above the first-quarter average in seasonally adjusted terms (Graph 4.2.6). Across main industrial subcategories, capital and intermediate goods remained below pre-crisis levels, whereas imports of consumption goods were relatively more robust (Graph 4.2.7).

Graph 4.2.6. Quantity Index for Imports
(Seasonally Adjusted, 2003=100)



* April-May figures.
Source: TURKSTAT, CBRT.

Graph 4.2.7. Quantity Index for Imports by Subcategories
(Seasonally Adjusted, 2003=100)



* April-May figures.
Source: TURKSTAT, CBRT.

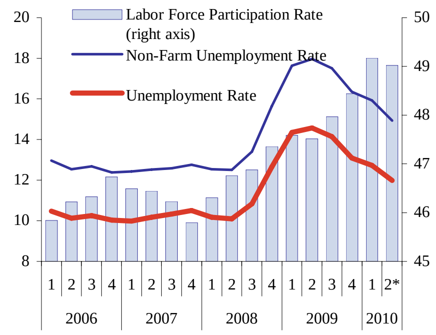
Imports of goods and services are expected to grow further quarter-on-quarter and sharply year-on-year, and therefore, continue to make a negative contribution to annual GDP growth. Yet, with the relative recovery in exports, net external demand may have a smaller negative contribution to annual GDP growth than in the previous quarter (Graphs 4.2.1 and 4.2.2).

In sum, domestic demand is expected to maintain its ongoing recovery during the second half of 2010, albeit more slowly, while external demand may decrease due to problems in the euro area. Accordingly, imports are expected to increase faster than exports, while net external demand may continue to make a negative contribution to GDP growth.

4.3. Labor Market

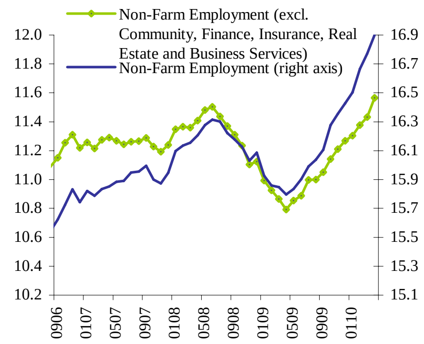
Although employment conditions improved during the first quarter, rising labor force participation rates limited the fall in unemployment. Unemployment rates fell markedly during April-May amid increased employment and reduced labor force participation (Graph 4.3.1). In this period, non-farm employment continued to grow across all sub-sectors in seasonally adjusted terms, and exceeded the pre-crisis levels. Excluding services sectors that are relatively less sensitive to business cycles, non-farm employment has just restored to pre-crisis levels in crisis-struck sectors (Graph 4.3.2).

Graph 4.3.1. Unemployment
(Seasonally Adjusted, Percent)



* As of April.
Source: TURKSTAT, CBRT.

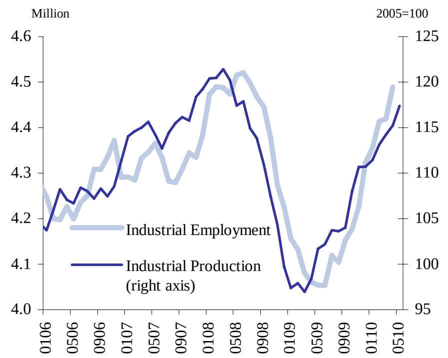
Graph 4.3.2. Non-Farm Employment
(Seasonally Adjusted, Million)



Source: TURKSTAT, CBRT.

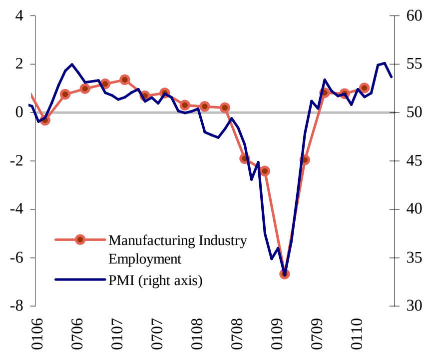
Household labor force data show that employment continues to recover in the industrial sector that suffered the largest employment loss (Graph 4.3.3). Industrial production figures and the PMI employment index indicate that industrial employment continued to recover during the second quarter (Graph 4.3.4). However, as stated in the previous section, the increased downside risks to external demand also concern industrial employment.

Graph 4.3.3. Industrial Employment and Production
(Seasonally Adjusted)



Source: TURKSTAT, CBRT.

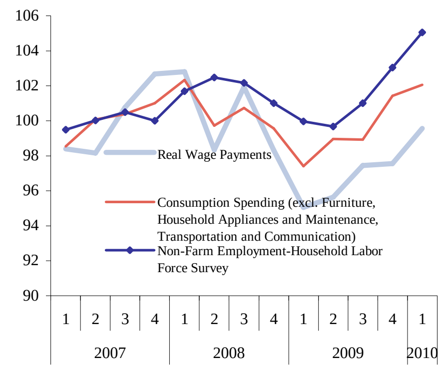
Graph 4.3.4. Manufacturing Industry and PMI Employment Index
(Seasonally Adjusted)



Source: TURKSTAT, CBRT, Markit.

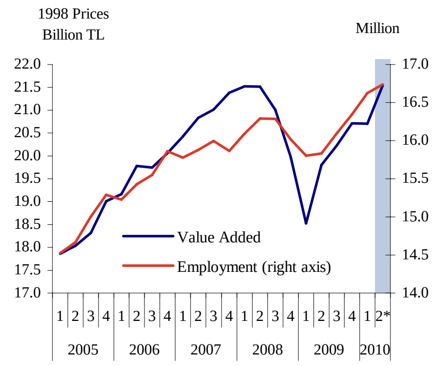
The Household Labor Force Survey points to a marked recovery in post-crisis employment rates, with non-farm employment rebounding to higher than pre-crisis levels. Yet, indicators for the quality of employment and other employment-related data resources signal that employment conditions are yet to recover completely (Box 4.2). In fact, figures on employment and wages, as derived from the business survey, are well below pre-crisis levels (Graph 4.3.5).

Graph 4.3.5. Household Spending, Real Wages* and Non-Farm Employment
(Seasonally Adjusted, 2007=100)



*Calculated by the weighted average of total wages paid in industrial, construction, trade, restaurant and hotels, and transportation and communication sectors. Converted to a real index by using the household consumption deflator.
Source: TURKSTAT, CBRT.

Graph 4.3.6. Non-Farm Value Added and Employment
(Seasonally Adjusted)



* Forecast.
Source: TURKSTAT, CBRT, Markit.

In sum, weak external demand postponed the recovery in industrial employment, while non-farm employment returned to pre-crisis levels amid the recovery in construction and services sectors. Second-quarter indicators reveal that non-farm employment continues to recover (Graph 4.3.6). However, unemployment is likely to remain well above pre-crisis levels for a long while, and therefore, will exert no significant pressure on unit labor costs in the upcoming period.

Box 4.1 Capacity Utilization Rates for Domestic and External Markets

The global economic crisis that erupted in the final quarter of 2008 led to a sharp drop in world trade volume, severely affecting export-oriented manufacturing firms. New indicators are required to make a well-founded assessment of the spillover effects into Turkish economy. This Box introduces such new indicators derived from the BTS and Company Accounts data of the CBRT's Department of Statistics in order to measure capacity utilization rates of manufacturing firms producing for both external and domestic markets.

Business Tendency Survey

BTS is conducted monthly, querying firms on their assessment of recent developments, current economic climate and their future expectations. Thus, the survey helps develop new indicators to capture short-term changes in the manufacturing industry. To meet international standards, the scope of the questions was revised and the survey was fully harmonized with the EU Industry Survey. As a further step in the harmonization process, the scope of enterprises was expanded in 2006. The survey covers the same set of units surveyed for deriving TURKSTAT's Industrial Production Index, with base 2005. The harmonized survey with expanded set of enterprises was initially conducted in January 2007. The harmonized monthly survey seeks opinions on production, orders, employment, inventories, selling prices, unit costs, producer price inflation, loan rates and general business climate, and also asks questions about participants' capacity utilization rate. Data on capacity utilization rates have been released monthly during the final week of each month along with the BTS since January 2010.

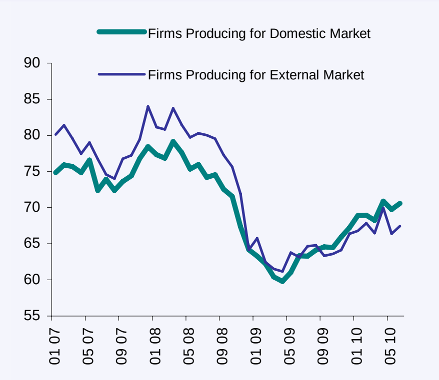
Company Accounts

In order to monitor real sector developments, data on annual financial statements and identification of real-sector firms has been compiled since 1990 and disseminated annually in aggregated form covering 13 main sectors and 26 sub-sectors as "Company Accounts". The database for the Company Accounts contains income tables of firms. Income tables include data on gross sales as well as details of gross sales with a breakdown for domestic sales and external sales. These figures help understand which markets firms mostly serve.

Methodology

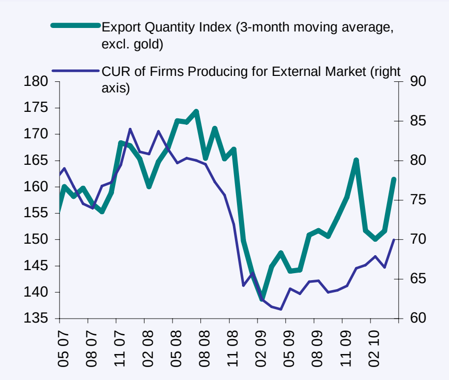
Firms included in Company Accounts database and the BTS are paired and grouped as firms producing for domestic markets and firms producing for external markets. Firms with a ratio of sales to external markets to total gross sales less than 0.4 are classified as firms producing for domestic markets, while those with a ratio equal to or higher than 0.4 are classified as firms producing for external markets. Capacity utilization rates for both categories are derived using weights of firms and sectors. In the first stage, firms are weighted according to their annually reported data on average number of employees in the previous year. The weighted responses of the firms are aggregated in the 3-digit activity level. In the transition from 3-digit level to 2-digit level, data are weighted with production values[1], and in transition from 2-digit level to overall manufacturing industry, data are weighted with the value-added figures in the overall Turkish manufacturing industry.[2]

Graph 1. Monthly Capacity Utilization Rates of Manufacturing Firms
(Seasonally Adjusted)



Source: CBRT.

Graph 2. Capacity Utilization Rates of Manufacturing Firms and Export Quantity Index Excluding Gold
(Seasonally Adjusted)



Source: CBRT.

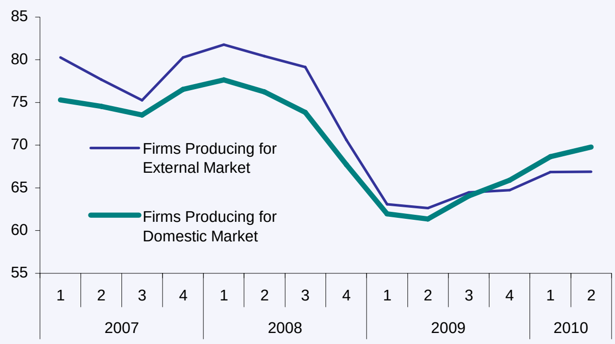
1 Production value weights at 3-digit level are calculated using the production data provided by the enterprises for the compilation of the industrial production index for the previous year.

2 Value-added weights are calculated by extrapolating the latest available value-added ratios by using the manufacturing industry production index. Weights are updated annually by using the most recently released data on value-added figures and annual industrial production index data for the previous year.

Conclusion

The newly derived indices show that manufacturing firms producing for external markets were operating at higher capacity than those producing for domestic markets during the pre-crisis period (Graph 1). However, spilling over into the export market, the global crisis caused a major slump in capacity utilization rates of manufacturing firms producing for external markets (Graph 2). During the exit from the crisis, domestic demand recovered more robustly than external demand on the back of policy rate cuts and fiscal stimulus measures. In fact, capacity utilization rates remain recently flat for manufacturing firms producing for external-markets, but continue to grow for those producing for domestic markets (Graph 3). Yet, capacity utilization rates of domestic-market-oriented manufacturing firms are still below pre-crisis levels, confirming the low level of resource utilization in the overall economy.

Graph 3. Quarterly Capacity Utilization Rates of Manufacturing Firms Producing for Domestic and External Markets (Seasonally Adjusted)



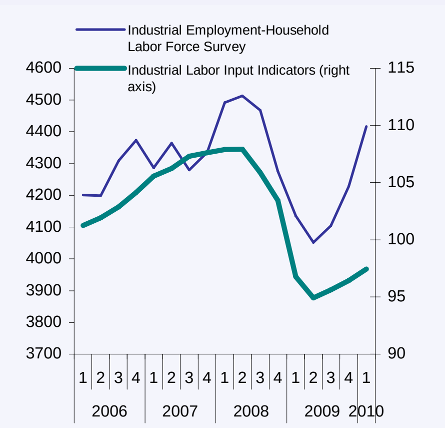
Source: CBRT.

Box 4.2 Observations on Employment Conditions

The primary source of data on employment is TURKSTAT's Household Labor Force Survey and Statistics. According to recent household data, non-farm employment has rebounded above pre-crisis levels. On the other hand, different data sources on employment do not suggest a strong recovery.

Another source of data that enables to monitor employment is the industrial labor input index compiled and disseminated quarterly by TURKSTAT. These indicators point to a slower recovery in industrial employment than implied by the Household Labor Force Survey (Graph 1). Understanding the difference between these data sources is essential to gain insight into the trend of employment. Labor input indicators are derived using data on firms above a certain size, and this can potentially explain why these two sources of data have different implications regarding employment.[3] However, industrial employment growth has been modest, according to the SSA data on registered employment as well, indicating that the difference between household labor force statistics and industrial labor input indicators can largely be explained by unregistered employment (Graph 2).[4]

Graph 1. Industrial Employment
(Seasonally Adjusted, Thousand)



Source: TURKSTAT, CBRT.

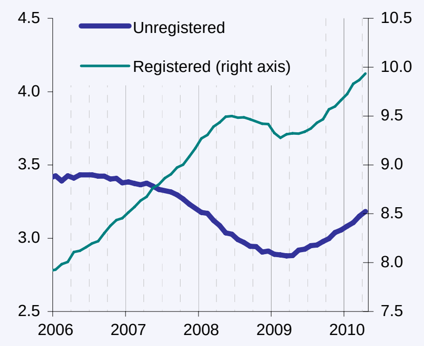
Graph 2. Industrial Employment Registered with the SSA
(Thousand)

Source: SSA, CBRT.

[3] Labor input indicators are derived using data on enterprises with 20 or more employees and that represent 80 percent of the value added. Firms with 1 to 19 employees are not included.
[4] Household data may provide information on unregistered employment, while firms only report registered employees.

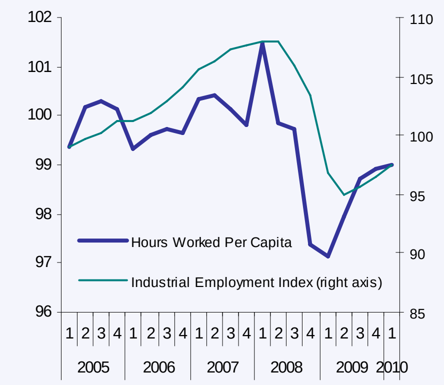
In fact, the post-crisis growth in non-farm employment party reflects unregistered employment (Graph 3). Moreover, hours worked per capita in the industrial sector run below pre-crisis levels, pointing to a decline in the use of employment (Graph 4). Therefore, although non-farm employment regained pre-crisis levels, employment conditions have yet to fully improve.

Graph 3. Non-Farm Salary or Daily Wage Workers (Seasonally Adjusted, Million)



Source: TURKSTAT, CBRT.

Graph 4. Industrial Employment and Hours Worked Per Capita (Seasonally Adjusted, 2005=100)



Source: TURKSTAT, CBRT.

Box 4.3 A Comparison of Non-Farm Employment and Production During Two Crisis Episodes: 2000-2001 and 2008-2009

Production and employment slowed markedly during 2000-2001 and 2008-2009 in the Turkish economy. A comparison of the contraction and the following recovery in employment and production may provide valuable insight into the implications of the recovery in the production on labor markets amid Turkey's impending exit from the recession. Therefore, this Box analyzes the correlation between changes in production and employment during economic contractions of 2000-2001 and 2008-2009, and the preceding expansions.

This analysis is based on three alternative datasets. The first dataset is quarterly available since 2000 and obtained from the Household Labor Force Survey, including non-farm employment and unregistered employment.[5] In order to better gauge the fluctuations of employment around its long-term trend during 2000-2010, semi-annual data from the Household Labor Force Survey for 1989-1999 is also included in the analysis for calculating the long-term trend.[6] Alternatively, same analysis is repeated using annual data from the Household Labor Force Survey for 1989-2009 merged with data for 1968-1988 obtained from Bulutay (1995) study.[7] Thirdly, Industrial Production Indices with base 2005 and TURKSTAT's Annual Industry and Service Statistics are used in order to analyze labor/capital intensity of industries contributing to the industrial production growth observed since March 2009.

This statistical analysis studies production and employment dynamics in Turkey from two different aspects. Firstly, changes in non-farm value-added and employment are compared for economic contractions of 2000-2001 and 2008-2009. Secondly, relation between non-farm value-added and employment is compared for 1994-2000 and 2002-2008 with the aim to find out about the extent of expansion in employment prior to the contraction periods. Unlike 2002-2008, 1994-2000 is not an uninterrupted expansion period. Therefore, absolute values are used instead of using deviations from their initial and final values.

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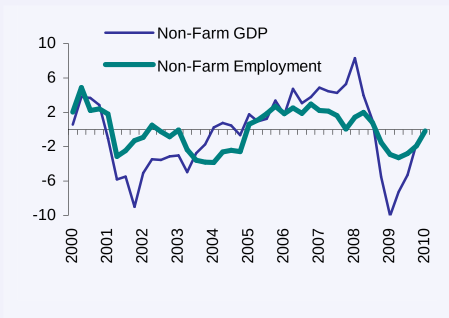
[5] As farm employment includes disguised unemployment and follows a very dissimilar pattern to business cycles due to the measurement method, our analyses are based on non-farm employment and non-farm value added.

[6] All data in the study are seasonally adjusted using Tramo-Seats method by the Demetra software. Semi-annual data are quarterly interpolated by the standard Kalman filter using Tramo-Seats. The long-term trend of non-farm GDP and employment indicators are calculated by Hodrick-Prescott (HP) filter with the smoothing parameter of 1600 for quarterly data and 100 for annual data.

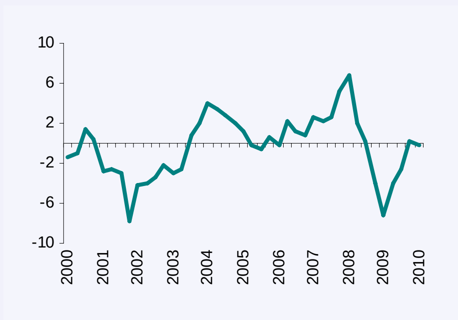
[7] See Bulutay, Tuncer, (1995), "Employment, Unemployment and Wages in Turkey", International Labour Organization, Ankara Office. Two data sets are merged using annual percentage changes by industries.

Table 1 shows the relation between deviations of Household Labor Force Survey's non-farm employment and non-farm GDP from their long-term trend. Non-farm GDP contracted by 12.8 percentage points from its peak in 2000Q1 to the trough in 2001Q4, while non-farm employment fell by 6.2 percentage points. Similarly, non-farm GDP narrowed by 18.3 percentage points from its peak in 2008Q1 to the trough in 2009Q1, whereas non-farm employment decreased by only 4.3 percentage points. These findings show that employment contraction in response to a one-unit fall in value added was more moderate in 2008-2009 than in 2000-2001 (Graphs 1 and 2).

Graph 1. 2000-2010 Non-Farm GDP and Employment
(Percent Deviation from Long-Term Trend)

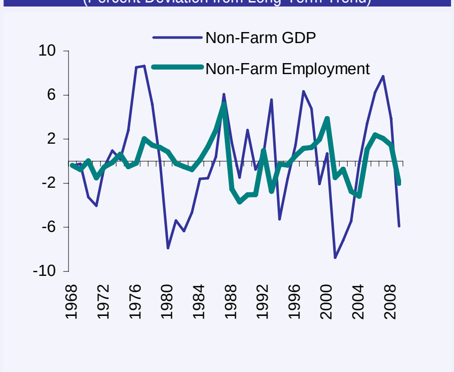


Graph 2. 2000-2010 Non-Farm Production Per Worker
(Percent Deviation from Long-Term Trend)



Findings obtained from annual data for 1968-2009 and illustrated in Table 2 show that non-farm GDP and employment fell by 9.4 and 5.4 percentage points, respectively, between 2000 and 2001, and by 9.8 and 3.4 percentage points, respectively, between 2008 and 2009. In other words, the fact that production fell more sharply and employment contracted more moderately in 2008-2009, compared to 2000-2001, is also confirmed by annual data (Graphs 3 and 4).

Graph 3. 1968-2009 Non-Farm GDP and Employment,
(Percent Deviation from Long-Term Trend)



Graph 4. 1968-2009 Non-Farm Production Per Worker
(Percent Deviation from Long-Term Trend)

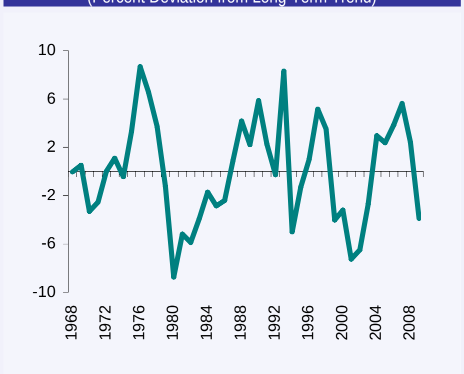


Table 1. Peak-to-Trough Fall in Non-Farm GDP and Non-Farm Employment during Crisis Episodes 2000-2001 and 2008-2009 Using Quarterly Data*

	2000-2001	
	Non-Farm Employment	Non-Farm GDP
Peak (2000Q2)	4.9	3.8
Trough (2001Q4)	-1.3	-9.0
Total Fall from Peak to Trough	6.2	12.8
	2008-2009	
	Non-Farm Employment	Non-Farm GDP
Peak (2008Q1)	1.4	8.3
Trough (2009Q1)	-2.9	-10.0
Total fall from peak to trough	4.3	18.3

*Percent deviation of non-farm GDP and employment from their long-term trend using Household Labor Force Survey for the period between 1989Q1-2010Q1.

Table 2. Peak-to-Trough Fall in Non-Farm GDP and Non-Farm Employment during Crisis Episodes 2000-2001 and 2008-2009 Using Annual Data*

	2000-2001	
	Non-Farm Employment	Non-Farm GDP
Peak (2000)	3.9	0.7
Trough (2001)	-1.5	-8.7
Total Fall from Peak to Trough	5.4	9.4
	2008-2009	
	Non-Farm Employment	Non-Farm GDP
Peak (2008Q1)	1.4	3.9
Trough (2009Q1)	-2.0	-5.9
Total Fall from Peak to Trough	3.4	9.8

*Percent deviation of non-farm GDP and employment from their long-term trend for the period between 1968-2009.

Table 3 shows the correlation between production growth and employment growth during 1994-2000 and 2002-2008. Accordingly, employment grew by 0.58 percent quarter-on-quarter and 0.68 percent year-on-year during 1994-2000, and by 0.44 percent both quarter-on-quarter and year-on-year during 2002-2008 in response to a 1-percent increase in production. In other words, the employment growth that corresponded to a one-unit increase in production during 2002-2008 was more modest during 1994-2000. This is mainly due to the fact that economic growth has mostly been driven by labor-intensive industries in 1990s, whereas, it is now mostly driven by capital-intensive industries, especially since mid-2000s.

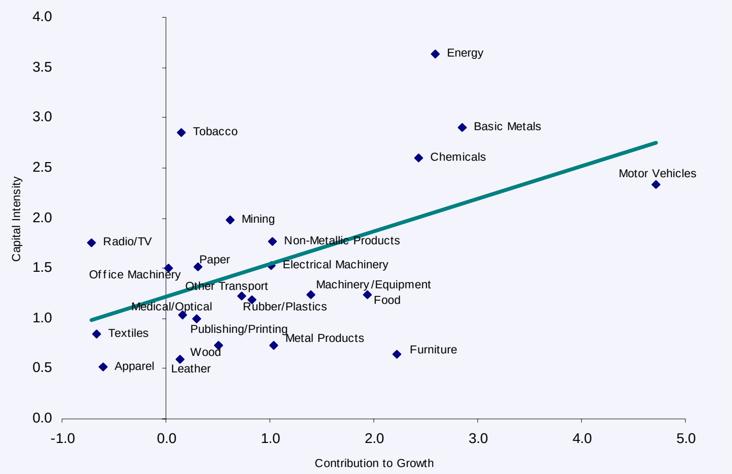
Table 3. Changes in Non-Farm GDP and Non-Farm Employment during and before Crisis Episodes 2000-2001 and 2008-2009*

Household Labor Force Survey, Non-Farm Value Added-Employment: 1987Q1-2010Q1				
	1994Q4-2000Q3	2000Q3-200Q2	2001Q2-2008Q1	2008Q1-2009Q1
Value Added	33.48	-7.21	63.38	-14.80
Employment	19.35	-3.71	27.92	-1.86
Employment/Production	0.58	0.51	0.44	0.13
Household Labor Force Survey, Non-Farm Value Added-Employment: 1968-2009				
	1994-2000	2000-2001	2001-2008	2008-2009
Production	34.39	-5.39	53.73	-5.59
Employment	23.50	-2.68	23.72	-0.96
Employment/Production	0.68	0.50	0.44	0.17

* Figures are percentage change deviation of seasonally adjusted series from their initial and final values for each sub-period.

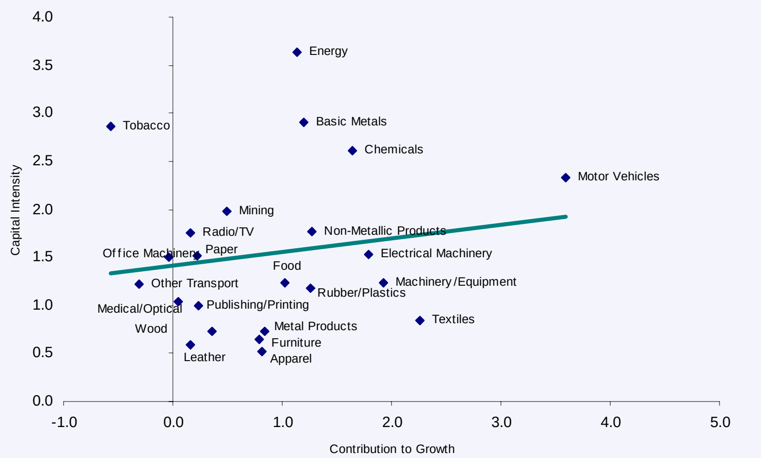
The labor-intensity ratios of industries contributing to economic growth are significant for economic recovery to feed into labor markets. The recent recovery in economic activity, which is largely driven by labor-intensive industries, is also believed to foster non-farm employment growth. In fact, capital-intensive industries contributed remarkably less in March 2009-May 2010 than in February 2005-March 2008 (Graphs 5 and 6).[8]

Graph 5. Percent Contribution to Industrial Production Growth and Capital Intensity Ratios by Industries during February 2005-March 2008*



* Data from Industrial Production Index with base 2005 and TURKSTAT's Annual Industry and Service Statistics. Capital Intensity Index is calculated using per capita value-added.

Graph 6. Percent Contribution to Industrial Production Growth and Capital Intensity Ratios by Industries during March 2009-May 2010*



* Data from Industrial Production Index with base 2005 and TURKSTAT's Annual Industry and Service Statistics. Capital Intensity Index is calculated using per capita value-added.

[8] March 2008 and March 2009 correspond to the peak of the industrial production index before the onset of the crisis and the trough of the index after the onset of the crisis, respectively.

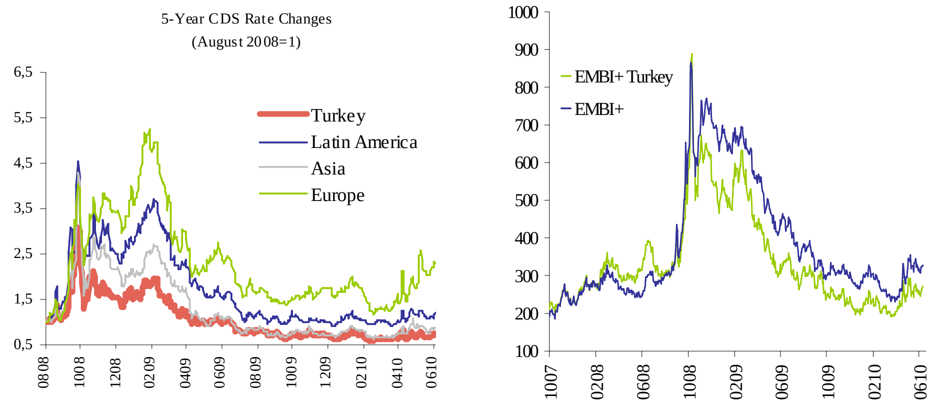
5. Financial Markets and Financial Intermediation

5.1. Financial Markets

The second-quarter data on the global economy point to a continuing global recovery. However, capacity utilization rates and labor market indicators are well below pre-crisis levels in many economies, contributing to maintain the moderate global inflation outlook. Meanwhile, the ongoing uncertainty over the balance sheets of financial institutions in advanced economies as well as high levels of corporate, household and sovereign debts continue to pose risk to the financial system and the global economic activity. Thus, the developments in the second quarter clearly confirmed the requirement to adopt a protracted, cautious and gradual exit from the crisis.

During this period, perceptions about sovereign debt problems were the main determining factor over the financial market dynamics. In particular, the growing concerns over sustainability of the Southern European sovereign debt caused the global risk appetite to follow a volatile and downward trend over the second quarter. As a result, investor sentiment has tilted towards less-risky assets, prompting a relatively slight portfolio outflow from emerging markets when compared to the crisis period, and a rise in risk premiums in these economies. Although risk premiums have increased sharply especially in European economies, risk premiums for most emerging economies, with Turkey in the lead, have seen a relatively more moderate rise, running below both mid-crisis and pre-crisis levels (Graph 5.1.1).

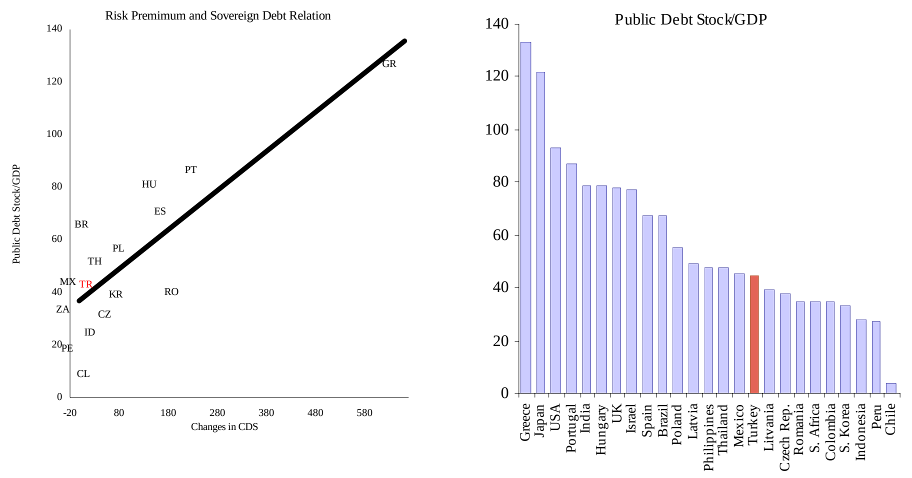
Graph 5.1.1. Risk Premium Indicators for Emerging Economies



Source: Bloomberg, CBRT.

The main reason for sovereign debt contagion to have a less marked impact on Turkey than many other countries is Turkey's relatively lower debt burden and debt risk. In fact, the recent measures to enhance fiscal discipline has improved the risk sentiment towards Turkey, placing Turkey among countries with lower debt risk. With the growing impact of debt dynamics on sovereign risk assessments, risk premiums of European economies with a higher debt burden have increased remarkably (Graph 5.1.2)

Graph 5.1.2. Sovereign Debt and Changes in Risk Premium*

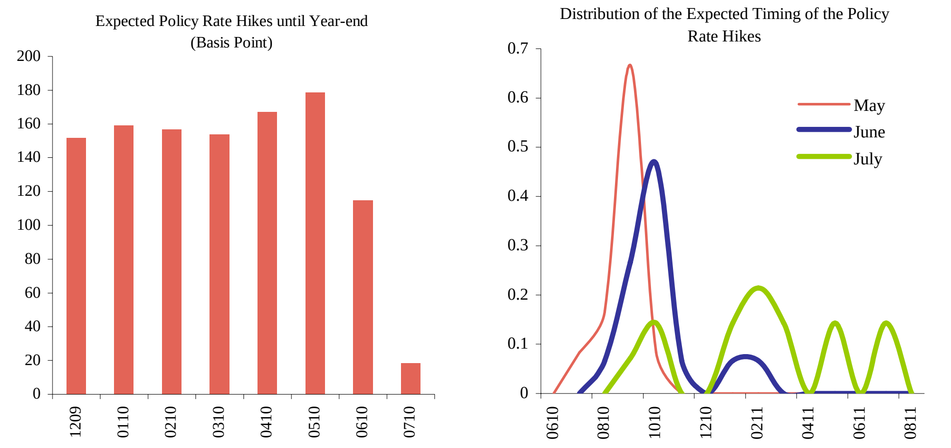


* Public debt stock/GDP figures are IMF forecasts for 2010.
Source: Bloomberg, IMF, CBRT.

The sovereign debt crisis in Europe has shown that the downside risks to global economic recovery have yet to completely disappear, prompting a majority of central banks, especially in advanced economies, to adopt a monetary stance that highlights downside risks in the face of a moderating global inflation outlook. Accordingly, central banks in advanced economies have highlighted in their statements that expansionary monetary policies would be maintained for a prolonged period. This was followed by changes in emerging market central banks' prior statements. Against this background, expectations have grown that the process of monetary policy normalization would be postponed (Graph 5.1.3).

Likewise, there are growing expectations that Turkey would also postpone the tightening process and raise policy rates more slowly. In addition to the changes in global monetary policies, the increased external demand uncertainty driven by the sovereign debt crisis in Europe as well as the benign inflation outlook helped change expectations about the course of monetary policy in Turkey. As a result, many financial institutions have revised their policy rate forecasts for end-2010 and 2011 downwards in June and July. Moreover, markets also expect the rate-hike cycle to be launched at a later date (Graph 5.1.3).

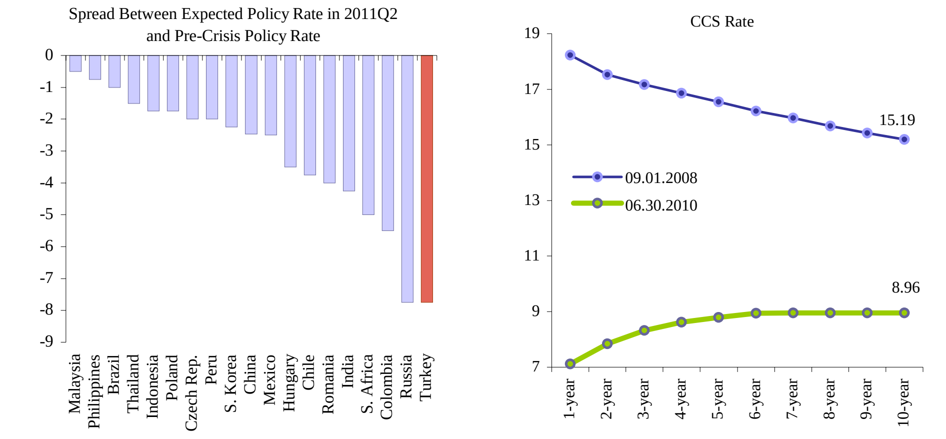
Graph 5.1.3. Policy Rate Expectations



Source: Reuters, CBRT.

For a better understanding of monetary policy implementations in Turkey, it is essential to fully grasp the motivation behind CBRT's monetary policy actions. CBRT's successful mid and post-crisis monetary policy actions were intended to minimize the damage of the crisis on the economic activity . However, these policy actions not only addressed the changing economic climate but also reflected consistency in adapting to the downtrend in Turkey's risk premium. Given the economy's sound financial structure, the declining sovereign risk and the crisis-induced monetary policy space, the CBRT was able to bring policy rates down to unprecedented lows during the crisis. With a permanent fiscal discipline, both policy and market rates may remain well-anchored at lower than pre-crisis levels. Correspondingly, Turkey may join countries delivering the most aggressive policy rate cuts compared with the pre-crisis period. In fact, policy rate expectations for end-2011 appear to be significantly lower than pre-crisis levels. Moreover, the long-term Turkish lira interest rate on CCS points to an expectation of a permanent fall in interest rates in Turkey (Graph 5.1.4).

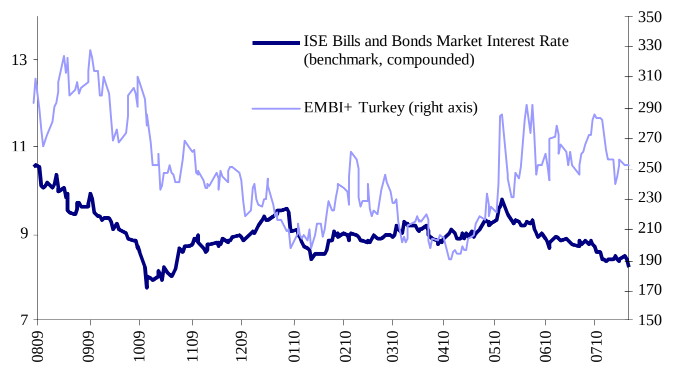
Graph 5.1.4. Policy Rates in Comparison with Pre-Crisis Levels
(Percent)



Source: Bloomberg, CBRT.

Market rates also reflect growing expectations of delay and moderation in the rate-hike cycle. Accordingly, benchmark bond yields fell during the second quarter and continued to hover around historic lows despite the increased risk aversion (Graph 5.1.5).

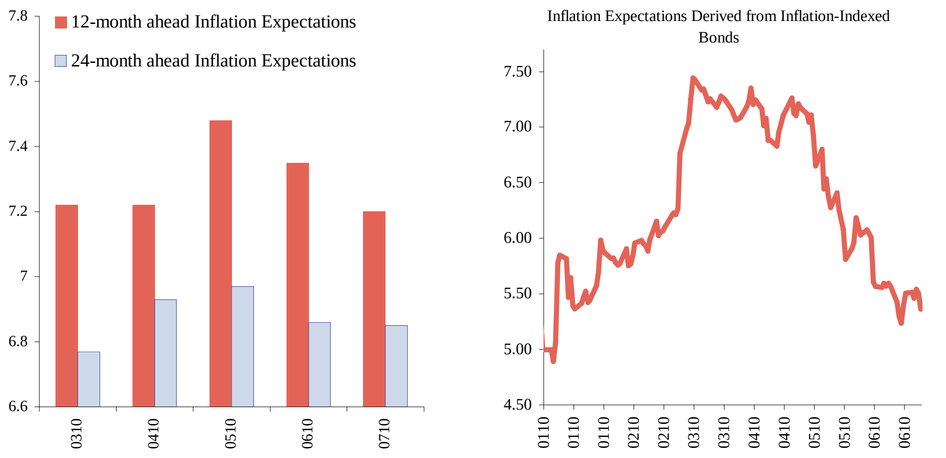
Graph 5.1.5. Interest Rates
(Percent)



Source: ISE, CBRT.

The downturn in market rates was also driven by the improved inflation outlook. May and June inflation figures which were well below market expectations while also confirming moderate course of inflation, led to a marked fall in inflation expectations (Graph 5.1.6). As a result, market rates declined, and following the release of inflation figures, the downslide gained momentum.

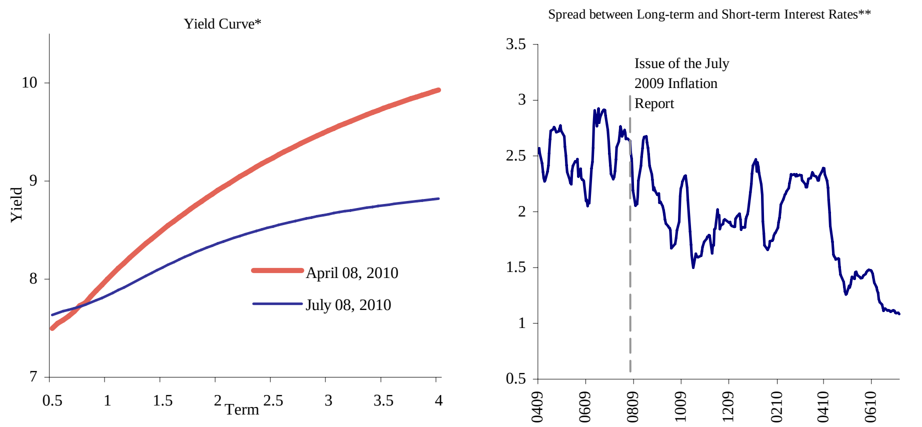
Graph 5.1.6. Inflation Expectations



Source: CBRT, ISE.

The downtrend in market rates is more pronounced in longer maturities, due to downward revisions to policy rate forecasts amid the improved inflation outlook. In addition, Turkey's improved risk perception and the confidence in the fundamentals of the Turkish economy have also fueled the downturn in long-term market rates. Accordingly, the yield curve flattened out during the second quarter (Graph 5.1.7).

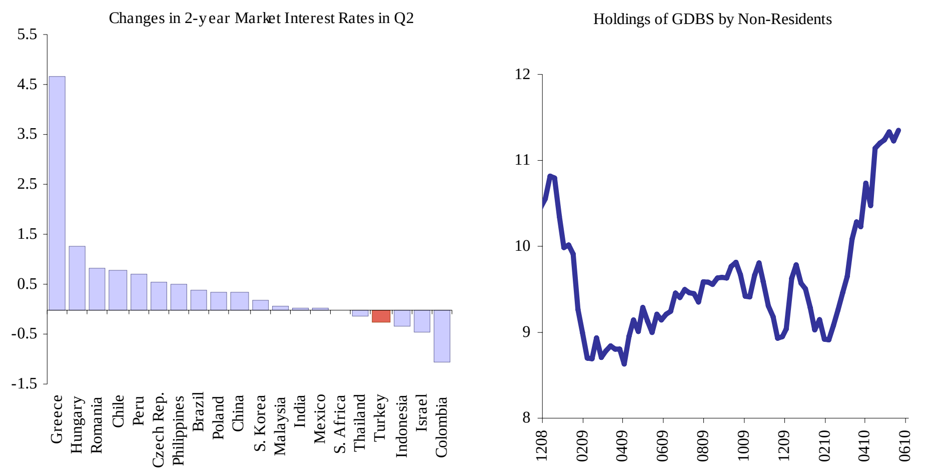
Graph 5.1.7. Term Structure of Market Interest Rates



* Calculated from the compounded returns on bonds quoted in ISE Bonds and Bills Market by using ENS method.
**Spread between 4-year and 6-month yields derived from the ENS yield curve, 5-day moving average.
Source: CBRT, ISE.

Furthermore, Turkey differs from many other emerging economies regarding market interest rates. Although monetary tightening is expected to be postponed in many countries, risk aversion and concerns over sovereign debt sustainability drove market rates higher in these countries. This trend is more notable in economies currently in the process of monetary policy normalization or with higher sovereign debt (Graph 5.1.8). However, despite increased global risk aversion, Turkish economy was able to attract a stable flow of foreign capital into Bonds and Bills Market during the second quarter thereby indicating an improved post-crisis investor sentiment towards Turkey. Recent solid measures to strengthen fiscal discipline have also contributed to maintaining low interest rates and the decline in Turkey's relative riskiness. Against this backdrop, fiscal discipline measures and debt indicators are expected to have an increasingly more pronounced effect on market rates in the future. Hence, further institutional improvements to strengthen fiscal discipline is critical in order to maintain low interest rates.

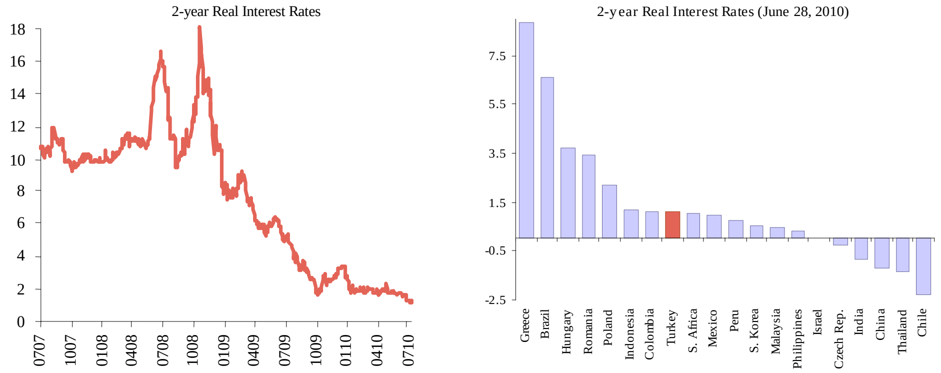
Graph 5.1.8. Market Rates and Foreign Inflows
(Percent)



Source: Bloomberg, CBRT.

The downslide was more significant in market rates than in inflation expectations during the second quarter, pushing medium-term real rates down to historic lows. Yet, real market rates are more plausible in Turkey than in many other emerging economies (Graph 5.1.9).

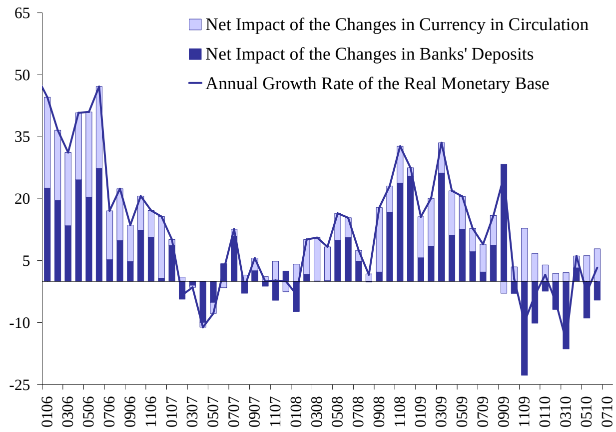
Graph 5.1.9. Medium-term Real Interest Rates Derived from Yield on GDBS*
(Percent)



*2-year real interest rates, calculated using 2-year nominal interest rates from the yield curve and inflation expectations from CBRT's Expectations Survey.
Source: ISE, Bloomberg, CBRT.

Despite the recent volatility in financial markets, economic activity continues to recover amid lower policy rates and CBRT's stabilizing liquidity measures while also spreading to monetary indicators. In fact, the run-up in consumer demand led to a year-on-year real increase in the currency in circulation during the second quarter (Graph 5.1.10). Adjusted for the 1-percentage point cut in the Turkish lira reserve requirement ratio in October 2009, bank deposits have also increased year-on-year. In sum, changes in the monetary base indicate further economic recovery and a normalized risk sentiment following the crisis.

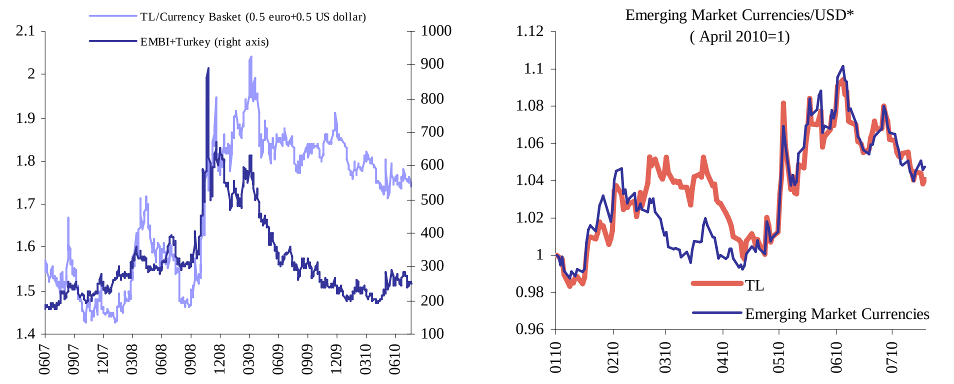
Graph 5.1.10. Annual Growth of the Real Monetary Base
(Percent)



Source: CBRT.

In spite of the increased global risk aversion in the second quarter, the value of the Turkish lira against the currency basket of US dollar and euro has not significantly changed. On the other hand, currencies of emerging European economies that were severely hit by the debt crisis have depreciated and the Turkish lira did not significantly differ from emerging market currencies in general (Graph 5.1.11).

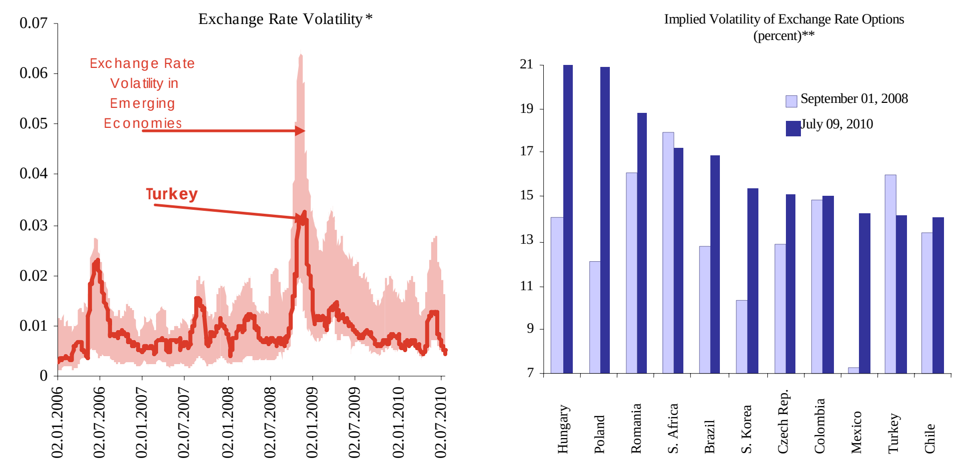
Graph 5.1.11. Performance of the Turkish Lira



*Average of emerging market currencies, including Brazil, Chile, Czech Republic, Hungary, Mexico, Poland, South Africa, South Korea and Colombia.
Source: Bloomberg, CBRT.

Having been historically volatile and extremely sensitive to global risk appetite, the relatively stable course of the Turkish lira during the crisis continued into the aftermath of the crisis. Country-specific conditions are likely to unfold in coming months, and hence, currencies of economies with lower risk ratings, positive debt dynamics, strong economic fundamentals and prospects of rapid growth are expected to be more stable. The Turkish lira therefore is likely to remain among the most stable currencies. This is in fact confirmed by implied volatility figures - a gauge of expectations for future currency swings - obtained from currency options. Being one of the currencies with the highest implied volatility before the crisis, the Turkish lira is now among currencies with the lowest implied volatility, mainly due to the improved investor sentiment towards Turkey after the crisis (Graph 5.1.12).

Graph 5.1.12. Exchange Rate Stability Indicators



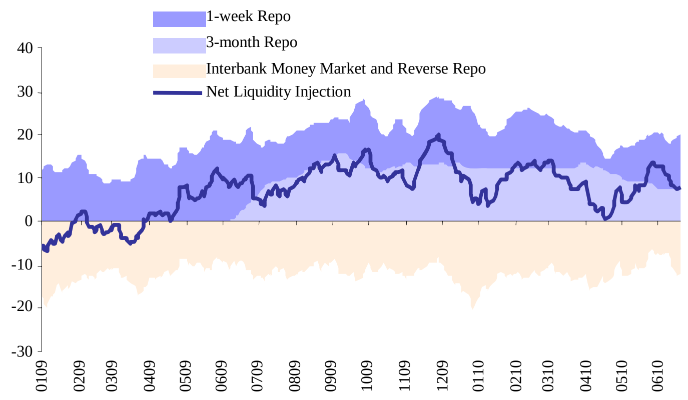
* 50-day standard deviation: Brazil, Chile, Czech Republic, Hungary, Mexico, New Zealand, Poland, South Africa, South Korea, Colombia, Turkey (highest and lowest values).

** Implied volatility on 1-year currency options.

Source: Bloomberg, CBRT.

With the easing of the global liquidity shortage and the restored stability in foreign exchange markets, the CBRT continued with the foreign exchange buying auctions that were resumed on August 4, 2009, in line with its general strategy to maintain a strong foreign exchange position. Accordingly, the CBRT purchased a total of 2.92 billion USD from the market in the second quarter, generating a liquidity of 4.50 billion TL. In order to maintain diversity of tools and operational flexibility, the CBRT also continued with the GDBS buying auctions that were resumed on December 23, 2009, and has provided a liquidity injection of 2.29 billion TL into the market, corresponding to a total nominal value of 2.4 billion TL of GDBS. Both GDBS and foreign exchange buying auctions boosted liquidity. In addition, despite its redemption of 5.5 billion TL, the Treasury’s account at the CBRT has increased. As a result, the monetary base has grown dramatically, while the liquidity shortage remained acute (Graph 5.1.13).

Graph 5.1.13. Market Liquidity
(Billion TL)



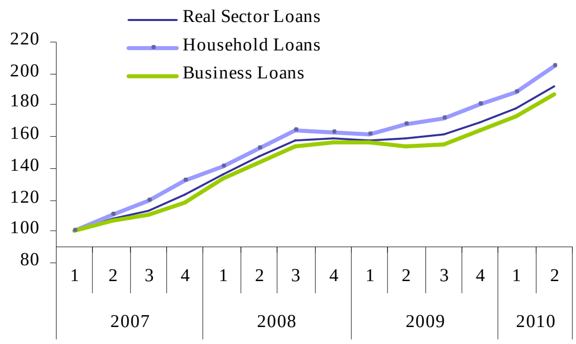
Source: CBRT.

The highlight of the second quarter regarding CBRT's liquidity management was the use of the weekly repo auction rate as the primary reference rate for the monetary policy, as stated in the previously announced exit strategy. In the first step of the technical rate adjustment process, the CBRT started gradually reducing the funds injected into the market and conducted weekly repo auctions via quantity auctions with a fixed interest rate of 7 percent as of May 20, 2010. Meanwhile, the CBRT continued to overfund the market, which accordingly, narrowed the spread between the Interbank overnight rate and CBRT's overnight borrowing rate.

5.2. Financial Intermediation and Loans

Credit markets continued to rebound robustly in the second quarter, leading to a rapid loan growth in the real sector. The rise in credit volume is mainly attributable to the growing loan demand driven by economic recovery. In addition, the improved credit risk perception, encouraging banks to lend more, and the resulting easing in loan standards helped credit volume expand. Meanwhile, growing expectations for a prolonged period of low policy rates and signs of delay in monetary tightening contributed to maintaining loan rates at low levels. In subcategories of real sector loans, business and household loans appeared to follow a similar pattern (Graph 5.2.1).

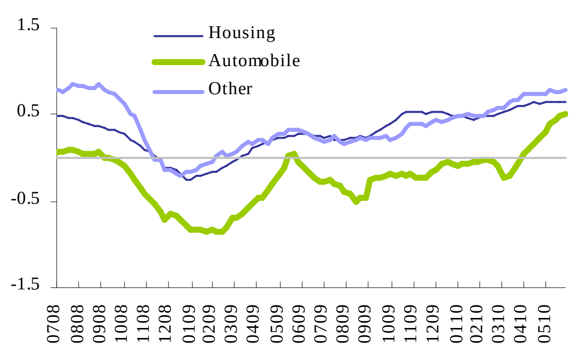
Graph 5.2.1. Real Sector Loans
(2007=100)



*Real sector loans are composed of household loans and business loans.
Source: CBRT.

The rate of increase in consumer loans converged to pre-crisis levels. The key driver of the uptrend in consumer loans was the rise in other consumer loans that account for about 50 percent of all consumer loans. The sharp increase in this subcategory is the result and the evidence of the surge in domestic demand and hence in consumer spending (Graph 5.2.2). Furthermore, the uptrend in housing and automobile loans continued into the second quarter. Moreover, amid rising sales of automobiles, automobile loans grew steadily over the second quarter for the first time since the onset of the crisis (Graph 5.2.2).

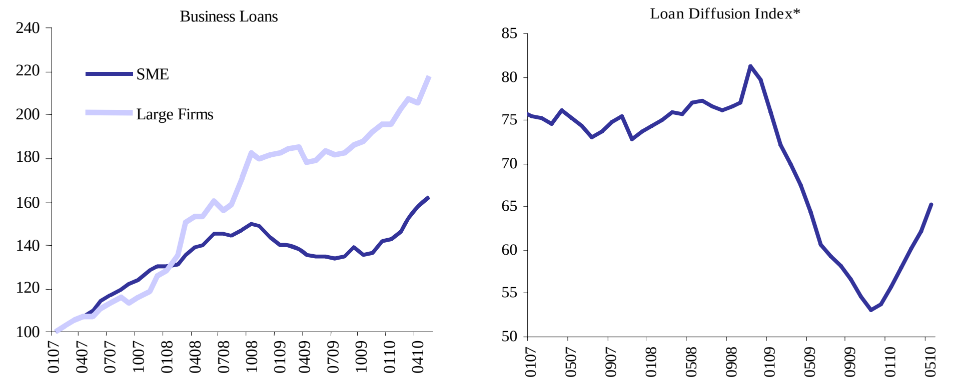
Graph 5.2.2. Subcategories of Consumer Loans
(13-week Average, Percent)



Source: CBRT.

Similarly, business loans continued to expand in the second quarter. Having been affected the most by tight lending standards during the crisis, SME loans continued to rise, reflecting better lending standards amid economic recovery, as suggested by the lending survey (Graph 5.2.3). In addition to the stable uptrend in business loans, the number of sectors benefiting from credit expansion also followed a stable uptrend (Graph 5.2.3).

Graph 5.2.3. Business Loans and Loan Diffusion Index



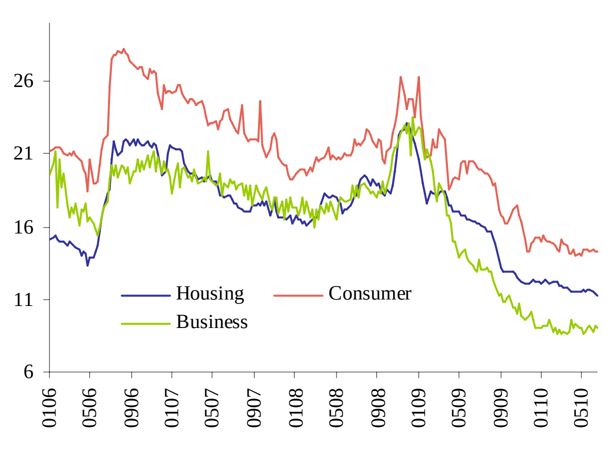
Source: CBRT.

*Derived from 12-month moving averages of the ratio of the number of sectors with increased credit volume to the total number of sectors.
Source: CBRT.

The normalization of credit markets can also be observed via the CBRT Lending Survey. In fact, the latest survey results indicate that the loan demand for debt restructuring has an increasingly less effect on total loan demand, while the demand for working capital loans has increased. Meanwhile, the drop in the demand for investment loans has ended.

Current loan rates has continued to hover below pre-crisis levels. Excluding the slight drop in housing loan rates, loan rates remained unchanged amid the ongoing recovery in credit markets in the second quarter (Graph 5.2.4).

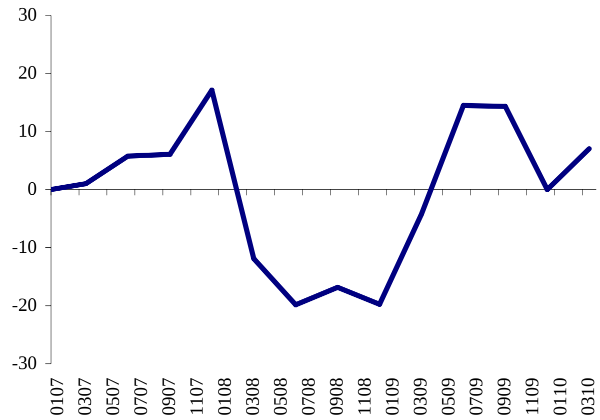
Graph 5.2.4. Loan Rates
(Annualized, Percent)



Source: CBRT.

The improved credit risk perception helped keep loan rates at low levels. Moreover, the increased competitiveness in the credit market also put downward pressure on loan rates, as evidenced by the Lending Survey results (Graph 5.2.5).

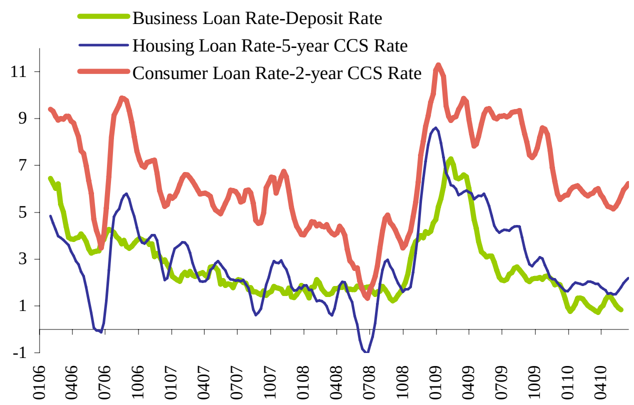
Graph.5.2.5. Business Loan Standards - Credit Market Competitiveness*



*Positive/negative values denote easing/tightening in standards.
Source: CBRT.

The spread between consumer loan rates and the Turkish lira interest rate on CCS that shows the cost of financing narrowed during the second quarter. Yet, with changing policy rate expectations, this spread has recently increased slightly amid falling CCS rates. Meanwhile, the spread between shorter-term business loan rates and deposit rates remained volatile and unchanged from the end of the first quarter around historic lows (Graph 5.2.6).

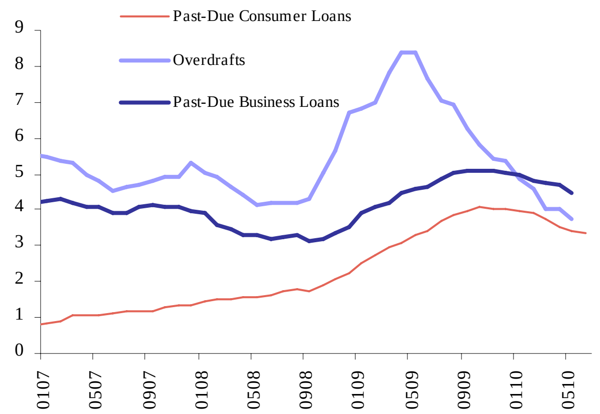
Graph 5.2.6. Spread Between Loan Rates and Cost of Financing
(Percent)



Source: Bloomberg, CBRT.

Credit risk, a key indicator of the spread between the cost of financing and loan rates during the crisis, decreased further in the second quarter (Graph 5.2.7).

Graph 5.2.7. Past-Due Loans and Overdrafts
(Percent)



Source: CBRT.

On the balance sheet side, the rise in credit volume has been the major driver of banks' balance sheet expansion as Treasury's domestic debt rollover ratio went down from 100 percent and banks' securities portfolio stopped increasing due to the higher share of holdings of GDBS by non-residents. During this period, the expansion in banks' assets was largely financed by borrowing from foreign banks while the deposits provided a smaller portion of the financing of bank assets (Table 5.2.1).

Table 5.2.1. Developments in Banks' Balance Sheet Items
(Billion TL)

		2009/IV	2010/I	Balance	2010/II	Balance/II
Assets	Loans	383.7	405.4	**21.7**	438.6	**33.3**
Assets	Securities Portfolio	262.5	275.7	**13.2**	275.6	**-0.1**
Liabilities	Deposits	511.9	532.4	**20.5**	556.8	**24.5**
Liabilities	Due to Banks Abroad	70.9	72.3	**1.4**	78.9	**6.6**

Source: BRSA.

In sum, monetary and fiscal measures continued to relieve credit markets during the second quarter. The falling credit risk perception of financial institutions encouraged their lending, while loan standards continued to normalize. As a result, credit volume expanded further. Given the recovery in economic activity, loan demand is expected to remain robust in coming months. The CBRT will closely monitor the possible implications of credit growth on financial stability as well as asset prices, and will adjust the reserve requirement ratio if necessary. Thus, as stated in the exit strategy, reserve requirement ratios might be brought gradually back to their pre-crisis levels.

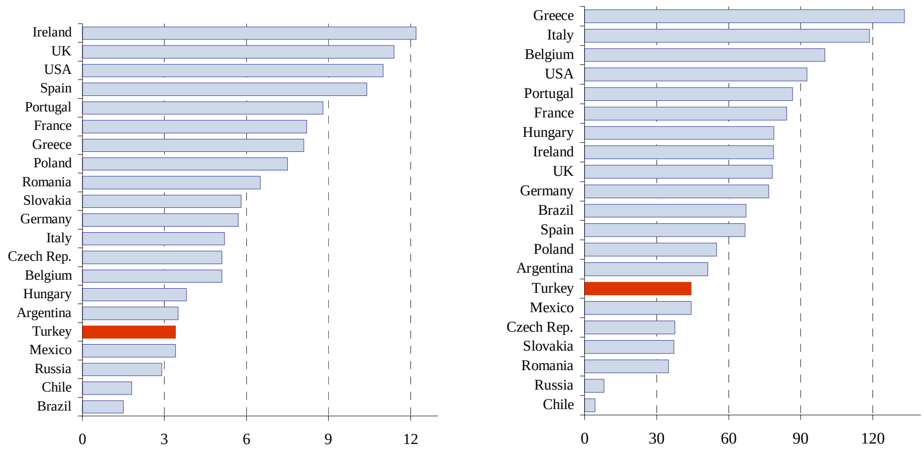
Although credit markets are expected to rebound further in the upcoming period, the spread of the European sovereign debt crisis to global financial markets has posed some downside risks. In view of the fact that the current account deficit may particularly continue to widen in coming months, the proper functioning of the credit market will critically depend on banks' access to external funds.

6. Public Finance

The massive fiscal stimulus packages and financial rescue plans adopted by advanced economies during the global economic crisis caused budget deficits to expand across these economies. Moreover, the global economic contraction slashed government revenues, especially in advanced economies, leading to larger fiscal deficits and debt stocks on a global scale (Box 6.1).

Due to the crisis-induced contraction in potential output and thus in tax base, the recent relatively modest growth in advanced economies helped only slightly to improve their fiscal outlook. Emerging economies, including Turkey, entered the global crisis with relatively smaller budget deficits and debt stocks, adopted more modest fiscal stimulus measures, and recovered more swiftly, and hence, their fiscal outlook is more favorable (Graph 6.1).

Graph 6.1. Budget Deficit and Public Debt Stock Forecasts for 2010



Source: IMF, Fiscal Monitor, May 2010.

The economic recovery that started in the fourth quarter of 2009 continued to improve Turkey's fiscal outlook in the first half of 2010. Rising tax revenues amid rapid economic growth and tax adjustments were the major driver of the improved budget balance, while the slowdown in the rate of increase in non-interest expenditures helped to maintain budget balance.

Owing to the faster-than-expected recovery in economic activity over the past one year, budget balance has improved more significantly than projected in the MTP that was launched in 2009. To ensure that Turkey continues to have more positive readings than other economies, it is critical that the fiscal space created by the economic climate be used for paying off debt instead of allocating funding to new spending. In this respect, the continued implementation of institutional and structural reforms to maintain fiscal discipline, and therefore, the timely enforcement of the institutional arrangements governing the introduction of the fiscal rule by 2011 remain of utmost importance.

6.1. Budget Developments

The central government budget produced a deficit of 15.4 billion TL in the first half of 2010, while the primary balance delivered a surplus of 12.1 billion TL (Table 6.1.1). Primary surplus rose sharply over the same period in 2009, while interest expenditures were up slightly, narrowing the central government budget deficit during the first half of 2010. The surplus in primary balance was largely driven by the recovery-induced rise in tax revenues.

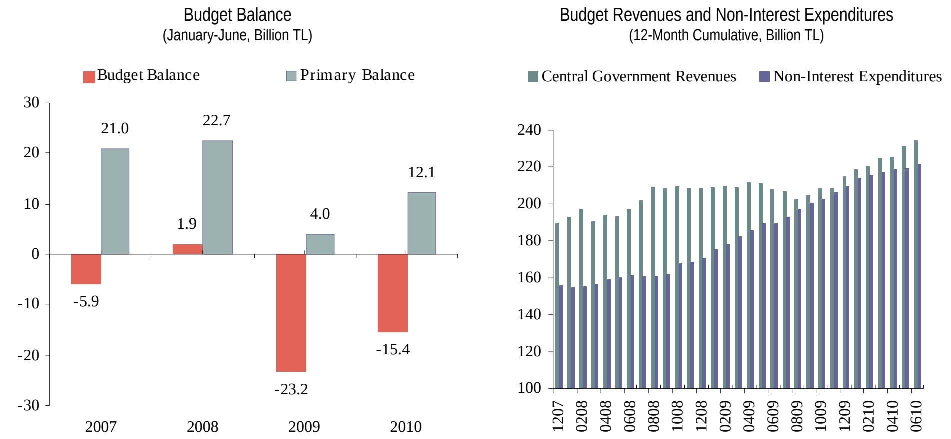
Table 6.1.1. Central Government Budget Aggregates
(Billion TL)

	January-June 2009	January-June 2010	Rate of Increase (Percent)	Actual/Target (Percent)
Central Government Expenditures	124.8	136.5	9.3	47.6
Interest Expenditures	27.2	27.6	1.2	48.6
Non-Interest Expenditures	97.6	108.9	11.6	47.3
Central Government Revenues	101.6	121.1	19.1	51.1
I. Tax Revenues	79.1	98.6	24.7	51.0
II. Non-Tax Revenues	19.2	18.2	-5.1	49.8
Budget Balance	**-23.2**	**-15.4**	**-**	**30.7**
Primary Balance	**4.0**	**12.1**	**200.4**	**184.8**

Source: Ministry of Finance.

Despite having improved substantially year-on-year during the first half of 2010, the central government budget balance and the primary budget balance had a weaker performance than in the same periods of 2007 and 2008 (Graph 6.1.1). Higher tax revenues helped central government budget revenues maintain the stable upward course, whereas the significant rate of increase in non-interest expenditures slowed down slightly during the first half of 2010 (Graph 6.1.1).

Graph 6.1.1. Central Government Budget Balance



Source: Bloomberg, CBRT.

Central government primary budget expenditures increased by 11.6 percent year-on-year during the first half of 2010. Among non-interest expenditures, current transfers and personnel expenditures were up by 12.4 and 11.5 percent, respectively, while purchase of goods and services declined by 1.7 percent. This decline was mainly due to the fall in healthcare expenditures of both public employees and green card holders, as these expenditures have been covered by the government's health insurance plan since January 2010. Furthermore, government premiums to the SSA soared by a striking 55.6 percent due to premium payments of public employees under general health insurance coverage. Shares reserved from revenues, a major component of current transfers, rose by 24.8 percent amid rapidly increasing tax revenues (Table 6.1.2).

Tablo 6.1.2. Non-Interest Expenditures
(Billion TL)

	January-June 2009	January-June 2010	Rate of Increase (Percent)	Actual/Target (Percent)
Non-Interest Expenditures	**97.59**	**108.94**	**11.63**	**47.32**
1. Personnel Expenditures	28.47	31.74	11.48	52.59
2. Government Premiums to SSA	3.45	5.36	55.56	48.26
3. Purchase of Goods and Services	10.70	10.52	-1.71	41.74
a) Defense-Security	3.01	3.38	12.16	37.05
b) Healthcare Expenditures	3.51	2.46	-29.95	51.22
4. Current Transfers	46.10	51.82	12.42	50.72
a) Duty Losses	2.34	1.38	-41.09	32.05
b) Healthcare, Pension, Social Benefits	25.72	28.42	10.48	49.25
c) Agricultural Support	3.66	4.63	26.39	82.56
d) Shares Reserved from Revenues	10.29	12.84	24.75	53.69
5. Capital Expenditures	4.99	5.46	9.54	28.86
6. Capital Transfers	1.18	1.40	19.11	40.87

Source: Ministry of Finance.

General budget revenues grew by 18.9 percent year-on-year during the first half of 2010. Tax revenues increased by 24.7 percent, while non-tax revenues dropped by 5.1 percent. A strong growth was recorded in all main tax categories, except for income tax (Table 6.1.3). The sharp rise in consumption-related tax revenues, partly driven by the base effects from the contraction in the first quarter of 2009, indicates that the economic recovery that started in the fourth quarter of 2009 continued into the first half of 2010. On the other hand, non-tax revenues remained behind their year-ago level owing to lower capital revenues as well as falling enterprise and property revenues. The drop in non-tax revenues can be attributed to the base effect from the 1.3 billion TL worth of capital revenue transfer from the Unemployment Insurance Fund to the general budget in February 2009.

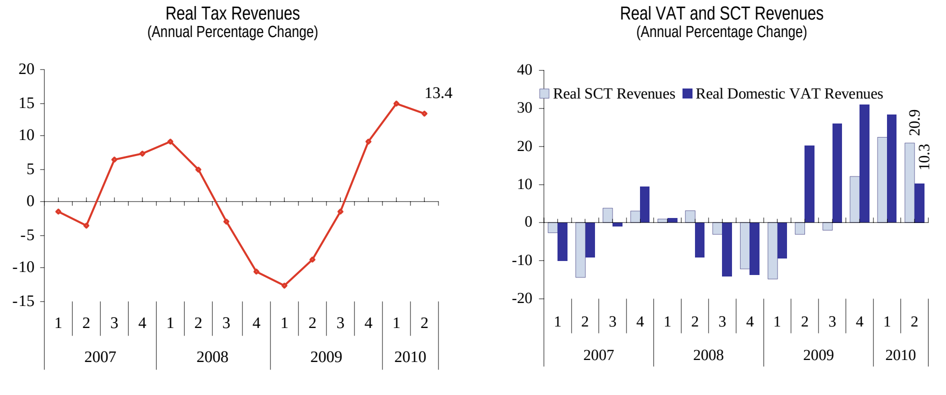
Table 6.1.3. General Budget Revenues
(Billion TL)

	January-June 2009	January-June 2010	Rate of Increase (Percent)	Actual/Target (Percent)
General Budget Revenues	**98.29**	**116.84**	**18.88**	**50.81**
I-Tax Revenues	**79.08**	**98.62**	**24.71**	**51.01**
Income Tax	18.97	19.32	1.81	46.53
Corporate Tax	7.12	10.08	41.41	56.09
Domestic VAT	9.52	12.28	29.01	54.24
SCT	19.31	25.64	32.80	46.93
VAT on Imports	11.66	16.49	41.39	54.76
II-Non-Tax Revenues	**19.20**	**18.22**	**-5.12**	**49.75**
Enterprise and Property Revenues	7.31	6.30	-13.82	93.31
Interests, Shares and Fines	9.80	10.06	2.66	56.46
Capital Revenues	1.40	0.63	-54.63	5.95

Source: Ministry of Finance.

In real terms, the year-on-year contraction in tax revenues that started in the third quarter of 2008 lost pace by the second quarter of 2009 with the recovery in private consumption demand, and has been replaced by a rapid growth as of the fourth quarter of 2009. Following the marked growth in the first quarter of 2010, tax revenues grew by 13.4 percent year-on-year in real terms during the second quarter, owing both to the base effect from the poor tax collection performance during the first half of 2009 and the tax adjustments in early 2010 (Graph 6.1.2). In fact, SCT revenues and domestic VAT revenues rose by 20.9 and 10.3 percent year-on-year, respectively, in real terms during the second quarter of 2010 (Graph 6.1.2). The sharp increase in SCT revenues was also triggered by the January hike in the lump-sum tax on fuel and tobacco.

Graph 6.1.2. Real Tax Revenues

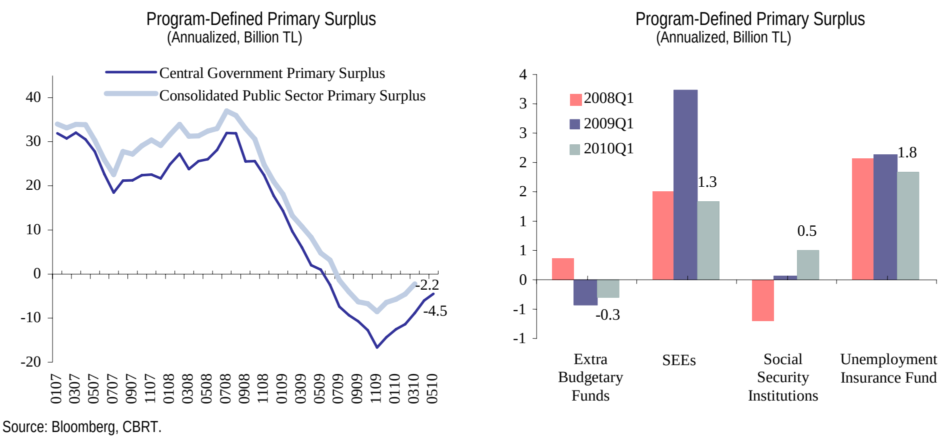


Source: Bloomberg, CBRT.

The run-up in tax revenues in the first half of 2010 may moderate in upcoming quarters once the base effects fade out, but remain robust over the entire year. As the economic recovery has been more marked than envisioned in the MTP, tax revenues are likely to soar well above the target set out in the 2010 Budget Law.

On a 12-month cumulative basis, the dramatic weakening of the public-sector primary surplus performance that started in September 2008 has been followed by an improvement since November 2009 amid the recovery-induced increase in tax revenues and the stronger base effects (Graph 6.1.3). However, the primary surplus of the SEE worsened year-on-year during the first quarter of 2010. Moreover, the primary surplus performance of extra-budgetary funds and social security institutions improved slightly year-on-year during the first quarter of 2010, while that of the Unemployment Insurance Fund restored to levels in previous years (Graph 6.1.3).

Graph 6.1.3. Primary Surplus



Source: Bloomberg, CBRT.

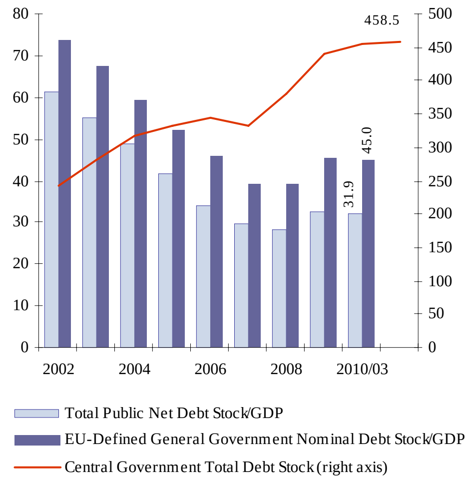
6.2. Developments in Debt Stock

The sharp drop in total public primary surplus that started in the final quarter of 2008 led to a significant increase in the public sector borrowing requirement and adversely affected public debt stock indicators during end-2009. In 2010, however, the deterioration in public debt ratios have stopped, the real cost of borrowing has fallen markedly, the average maturity of public borrowing has extended, and the ratio of TL-denominated debt to overall debt has increased.

The central government debt stock increased by a modest 3.9 percent from end-2009 to 458.5 billion TL in the first half of 2010. Changes in net domestic debt, net external debt and total exchange rate effect accounted for 13.1, 4.9 and 5.1 billion TL, respectively, of the increase in central government debt. Meanwhile, parity changes put downward pressure on the central government debt stock (Graph 6.2.1). Thus, debt ratios were slightly down from end-2009 during the first quarter of 2010. The total net public debt to GDP ratio and the EU-defined general government nominal debt to GDP ratio dropped to 31.9 and 45 percent, respectively (Graph 6.2.1).

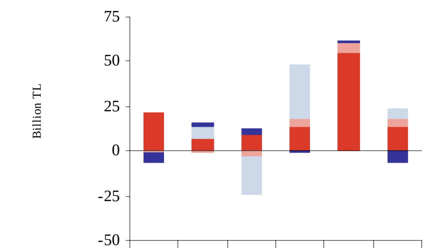
Graph 6.2.1. Public Debt Stock Indicators

Public Debt Stock Indicators



Source: Treasury, CBRT.

Analysis of the Changes in Central Government Debt Stock

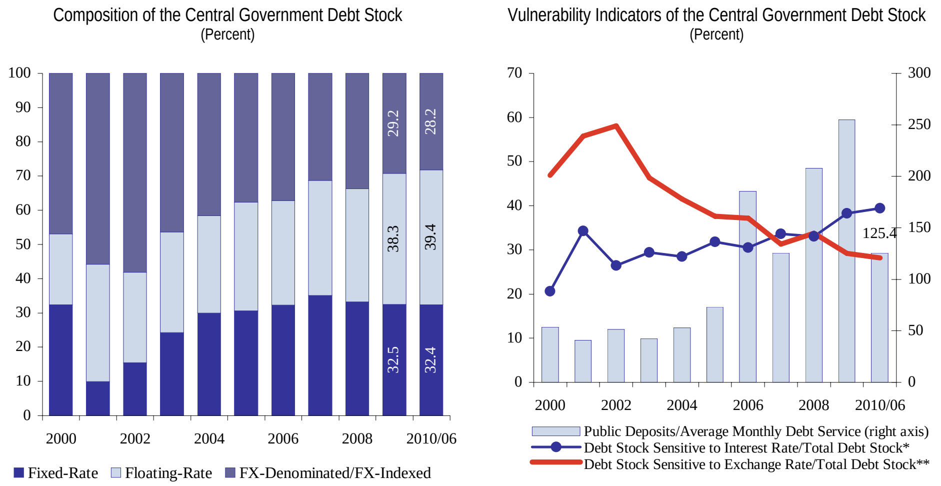


	2005	2006	2007	2008	2009	2010.06*
Parity Effect**	-4.8	3.2	3.4	-1.0	0.6	-5.9
Total Exchange Rate Effect***	-0.8	6.4	-21.2	29.9	-0.1	5.1
Net External Borrowing	-0.6	-0.5	-2.6	4.0	5.9	4.9
Net Domestic Borrowing	21.1	6.7	8.9	13.9	54.8	13.1

Changes compared to end-2009.
** Changes from fluctuations in USD/EUR and USD/SDR.
*** Changes from fluctuations in TL/USD.
Note: Changes in net debt denote changes adjusted for exchange rate and parity effect.
Source: Treasury, CBRT.

With the debt and risk management policies in place since 2003 as part of the strategic criteria in addition to the macroeconomic stability maintained so far, the vulnerability of the public debt portfolio to liquidity and exchange rate risks has decreased considerably. Recently, the share of exchange-rate-sensitive (FX-denominated and FX-indexed) instruments in central government debt stock has declined, while the share of floating rate instruments has increased. These patterns continued into June 2010 (Graph 6.2.2). Depending on market conditions, the Treasury's financing program for 2010 envisages to limit FX-denominated domestic borrowing to a maximum of 50 percent of FX-denominated domestic debt redemptions in 2010. Accordingly, the share of exchange-rate-sensitive instruments in central government debt stock may continue to fall throughout 2010, while the share of floating-rate and fixed-rate instruments may rise.

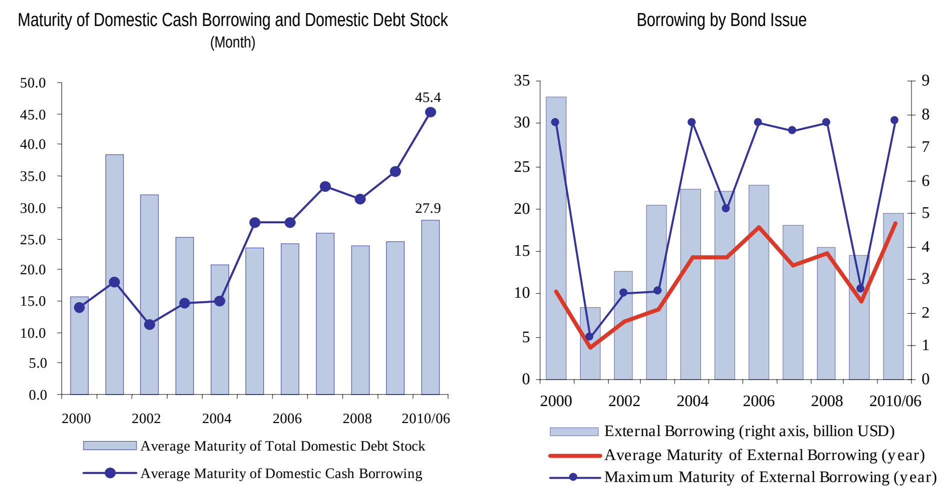
Graph 6.2.2. Structure of the Central Government Debt Stock



* Debt stock sensitive to interest rate includes discounted securities with a maturity less than 1-year and government securities with floating rates.
** Debt stock sensitive to exchange rate includes external debt stock, FX-denominated and FX-indexed domestic debt stock.
Source: Treasury, CBRT.

Following the financing strategy intended to reduce the liquidity risk, the ratio of public deposits to average monthly debt service ended June 2010 at 125.4 percent (Graph 6.2.2). The average maturity of domestic cash borrowing was longer from the 2009 average, driving the average maturity of total domestic debt stock to 27.9 months in June 2010 (Graph 6.2.3). Furthermore, bond issues yielded a 5 billion USD worth of long-term external debt in June 2010 with an average maturity of 18.4 years (Graph 6.2.3).

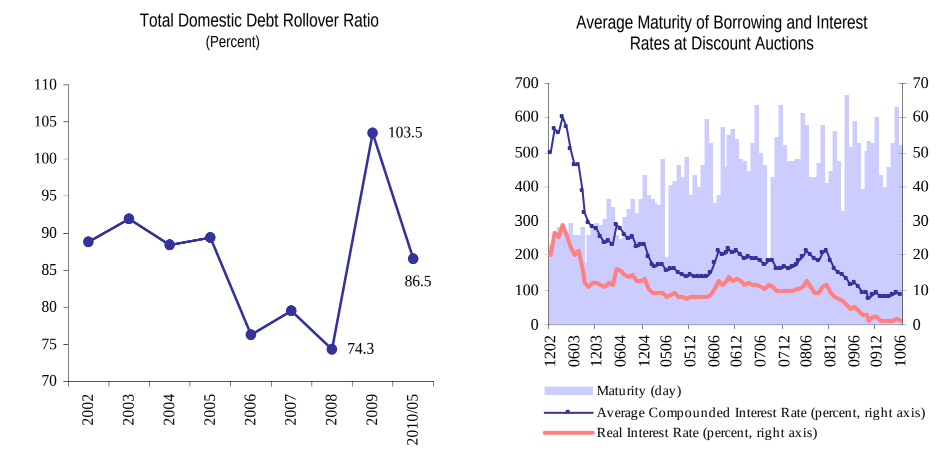
Graph 6.2.3. Maturity of Borrowing from Domestic and External Markets



Source: Treasury, CBRT.

Having fallen rapidly since early 2009, the monthly weighted-average real interest rates realized in discount treasury bill auctions declined to 1 percent in July 2010 (Graph 6.2.4). Despite the increased domestic borrowing requirement, the drop in domestic borrowing costs to recent historic lows has substantially eased concerns about public debt sustainability.

Graph 6.2.4. Domestic Borrowing



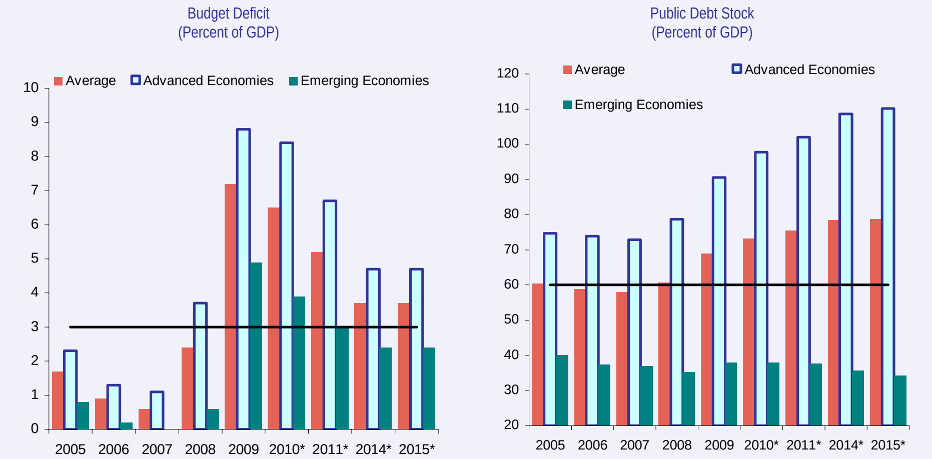
Source: Treasury, CBRT.

Hovering below 100 percent since 2002, total domestic debt rollover ratio declined to 74.2 percent in 2008. As the high budget deficit was mainly financed by domestic borrowing, domestic debt rollover ratio climbed to 103.5 percent in 2009. Despite having fallen to 86.5 percent during the first five months of 2010, domestic debt rollover ratio is expected to increase slightly by the second half of 2010 (Graph 6.2.4).

Box 6.1 Developments in Budget Deficit and Public Debt Stock: An International Comparison

The substantial fiscal stimulus measures and financial rescue plans implemented during the global crisis, particularly across advanced economies, caused budget deficits and public debts to expand globally. The ratio of budget deficits-to-GDP weighted by purchasing power parities was up from nearly 1 percent in 2007 to 8.8 percent in 2009 in advanced economies. Meanwhile, in emerging economies with a nearly balanced budget, the ratio of budget deficit-to-GDP rose to around 5 percent (Graph 1). Moreover, the increased need to finance larger deficits led to a sizable increase in debt stocks, especially in advanced economies. In fact, the ratio of advanced economy debt stocks-to-GDP weighted by purchasing power parities was up from 73 percent in 2007 to 91 percent in 2009, and is expected to exceed 110 percent by 2015.[1] Emerging economies are expected to have slightly lower debt stocks compared to pre-crisis levels by 2015 (Graph 1).

Graph 1. Budget Deficit and Public Debt Stock in Advanced and Emerging Economies



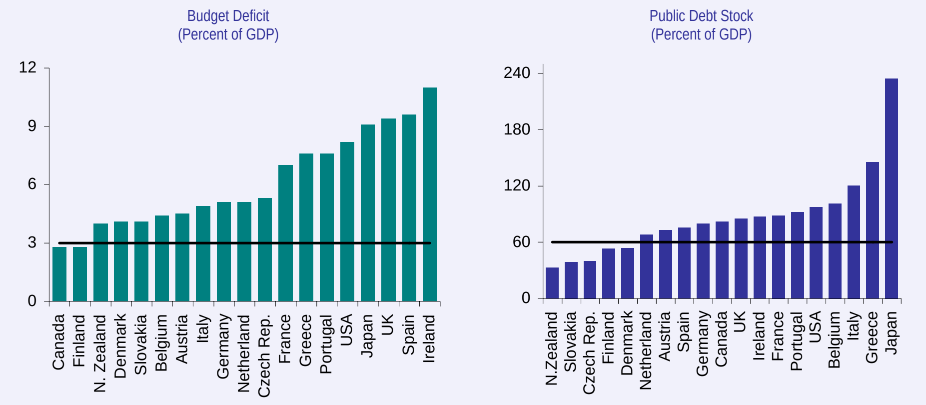
* Forecast.
Source: IMF, Fiscal Monitor, May 2010.

Another important factor that accounted for the notable deterioration of the fiscal balance in advanced economies is the significant loss in potential output driven by the global crisis and the resulting fall in tax revenues. According to OECD forecasts, the global crisis would cause potential output to decrease by about 3 percent in OECD member states in the medium term.[2] Across all OECD countries, the ratio of tax revenues to GDP is expected to drop by 1.2 percent from the 2000-2007 average in 2011.[3]

[1] IMF, Fiscal Monitor, May 2010.
[2] OECD Economic Outlook 85, June 2009.
[3] OECD, Economic Policy Reforms: Going for Growth 2010, March 2010.

The potential output collapse and the related revenue loss hold up the economic recovery to ease the pressures on public finances in advanced economies. By 2011, budget deficits and debt stocks would exceed the Maastricht criteria of 3 and 60 percent of GDP in most advanced economies (Graph 2). The large debt stock in advanced economies heightens concerns over debt sustainability, thereby causing interest rates to soar and bringing the possibility of adversely affecting the already fragile global growth dynamics.

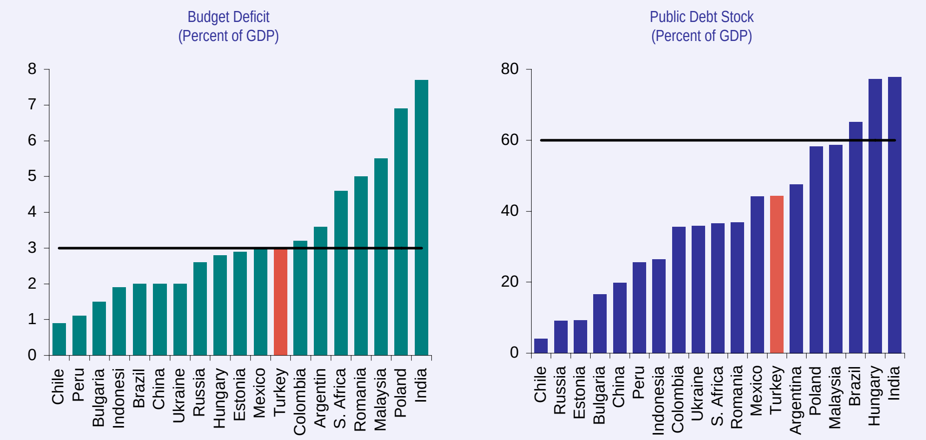
Graph 2. Budget Deficit and Public Debt Stock Forecasts for 2011 in Advanced Economies



Source: IMF, Fiscal Monitor, May 2010.

The fiscal outlook is more favorable among emerging economies, including Turkey. As emerging economies entered the global economic crisis with relatively smaller budget deficits and debt stocks, adopted more modest fiscal stimulus measures, and recovered more swiftly, their fiscal outlook is more stabilized. In a majority of emerging economies, the ratios of budget deficits and debt stocks to GDP are likely to fall below the Maastricht criteria by 2011 (Graph 3).

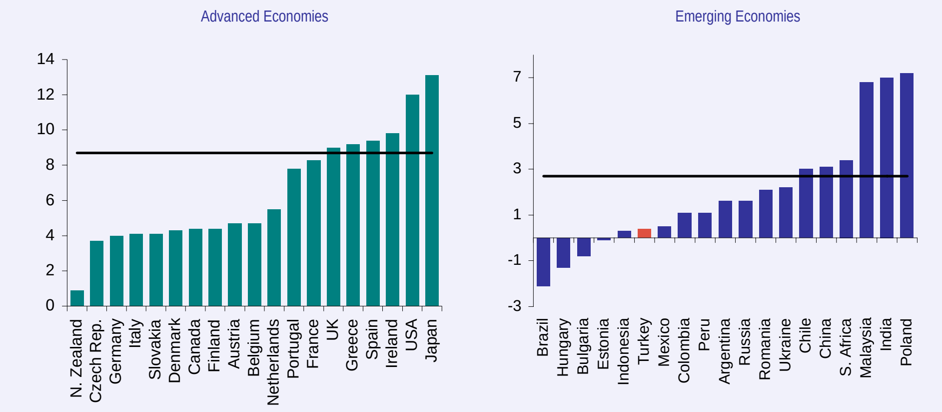
Graph 3. Budget Deficit and Public Debt Stock Forecasts for 2011 in Emerging Economies



Source: IMF, Fiscal Monitor, May 2010.

The high post-crisis debt stocks may require a comprehensive fiscal adjustment especially for advanced economies. According to IMF forecasts, lowering the debt stock-to-GDP ratio back to 60 percent for advanced economies by 2030 would require increasing the cyclically adjusted primary balance-to-GDP ratio by 8.7 percentage points from 2010 to 2020. For emerging economies, the fiscal adjustment to stabilize the debt stock-to-GDP ratio around 40 percent by 2030 (a threshold beyond which fiscal risks are often considered to rise in emerging economies) averages 2.7 percentage points of GDP from 2010 to 2020.[4] Similarly, the fiscal adjustment to stabilize the debt stock-to-GDP ratio around 40 percent by 2030 in Turkey is 0.4 percent of GDP, well below the emerging market average (Graph 4).

Graph 4. Required Fiscal Adjustment During 2010-2020 to Achieve Debt Target in 2030
(Cyclically Adjusted Primary Surplus As a Percent of GDP)



Source: IMF, Fiscal Monitor, May 2010.

To sum up, when compared with advanced economies, emerging economies, including Turkey, face less requirement for fiscal adjustment. This, together with the soundness of the financial system, explains the relative improvement in Turkey's sovereign risk in the post-crisis period. In the upcoming period, the adoption of structural and institutional reforms to further strengthen fiscal discipline and the establishment of the required legal and institutional framework for fiscal rule implementation would ensure that Turkey continues to differ positively from other emerging economies, and support the lowering of long-term interest rates even further.

[4] According to IMF's debt sustainability analysis (Fiscal Monitor, May 2010), in order to stabilize the debt stock to GDP ratio around 60 and 40 percent, respectively, in advanced and emerging economies by 2030, advanced economies are required to improve the cyclically adjusted primary balance from a deficit of 4.9 percent of GDP in 2010 to a surplus of 3.8 percent of GDP in 2020 and maintain this level from 2020 to 2030, whereas emerging economies are required to improve the cyclically adjusted primary balance from a deficit of 1.4 percent of GDP to a surplus of 1.2 of GDP and maintain this level for all respective periods.

7. Medium-Term Projections

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

7.1. Current State of the Economy, Short-Term Outlook and Assumptions

The first-quarter data on GDP were largely consistent with the outlook presented in the April Inflation Report. The weak global economy continued to weigh on the economic activity and employment in external demand-oriented sectors, while government spending made a much smaller contribution to GDP. Excluding the public sector, domestic demand showed a stable recovery, as expected.

The consumer price index fell quarter-on-quarter in the first quarter of 2010 for the first time since its inception, while inflation dropped by 1.9 percentage point from the April Inflation Report forecast. Lower-than expected food prices accounted for about 1.3 percentage points of the decline in inflation.

The annual rate of increase in unprocessed food prices fell sharply during the second quarter. Fruit and vegetable prices dropped earlier and more rapidly than expected amid rising supply. Moreover, the renewed import regulations for meat brought meat prices down as of the end of April. As a result, food inflation sunk below forecasts during the second quarter.

Prices for communication services had a major impact on services inflation during the second quarter. The lowered ceiling for postpaid rates and the prepaid plans now quoted in Turkish liras increased the competition among mobile network operators and pushed services inflation down by about 1 percentage point. Similarly, the rate of increase in prices of core goods decelerated considerably. Hence, core inflation indicators, and therefore underlying inflation, slowed down remarkably during the second quarter.

In April, the price of Brent crude oil was assumed to average around 85 USD per barrel in 2010. Yet, in view of the recent changes in international crude oil prices, Brent crude oil prices are expected to average 80 USD per barrel in 2010 (Table 7.1.1).

Table 7.1.1. Sources of Revisions to Inflation Forecasts

	April 2010 IR				July 2010 IR			
Output Gap	2009Q4:-6.0 2010Q1:-4.7 2010Q2: -3.1				2009Q4:-6.0 2010Q1:-4.7 2010Q2: -3.4			
Food Prices	2010: 9% 2011: 7% 2012: 7%				2010: 7.5% 2011: 7% 2012: 7%			
Administered Prices and Taxes	Adding 1.9 percentage points to 2010 inflation				Adding 1.9 percentage points to 2010 inflation			
Oil Prices	2010: 85 USD/bbl 2011: 90 USD/bbl 2012: 90 USD/bbl				2010: 80 USD/bbl 2011: 85 USD/bbl 2012: 90 USD/bbl			
Euro Area Growth Forecasts[1]	2010		2011		2010		2011	
	CF	*WEO*	*CF*	*WEO*	*CF*	*WEO*	*CF*	*WEO*
	1.2	1.0	1.5	1.5	1.1	1.0	1.4	1.3

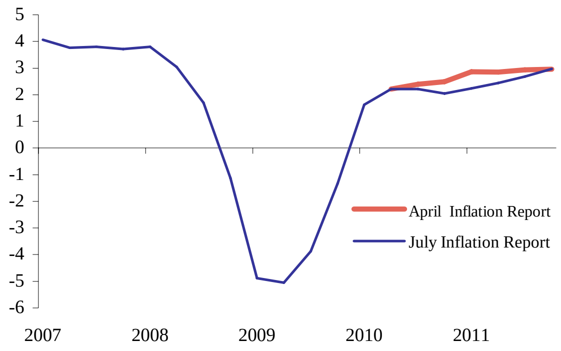
[1] Consensus Forecasts, April and July 2010 Bulletins (average annual growth, percent); WEO, April and July 2010 issues.

Assuming that the second-quarter drop in fruit and vegetable prices reflects a temporarily increased supply, annual inflation may rise in this subcategory over the second half of 2010. Furthermore, given the renewed import regulations for meat, meat prices are unlikely to rise in coming months. Therefore, our forecasts are based on the assumption that meat prices remain flat. Accordingly, we revised our food inflation assumptions down from 9 to 7.5 percent for end-2010. Our assumptions for 2011 and 2012 are left unchanged at 7 percent (Table 7.1.1).

Private consumption and investment demand is likely to grow further in the upcoming period, albeit more slowly. Moreover, the uncertainty caused by Europe’s sovereign debt crisis since May and the sharp deprecation in the euro led to a weaker outlook for external demand during the second quarter, compared with the April Inflation Report. In this respect, our output gap forecasts, the starting point for our medium-term forecasts, are revised slightly downwards by the second quarter, and the contribution of aggregate demand conditions to disinflation is expected to be slightly higher than estimated in the previous Report (Table 7.1.1).

As stated in the April Inflation Report, the global growth outlook remains important for the assumptions underlying medium-term forecasts, due to its implications on aggregate demand conditions over the medium term and on international commodity prices. There has not been a major revision to the global growth forecasts since April. However, euro area growth forecasts have been revised slightly downwards, reflecting the change in the outlook owing to the problems in Greece, Portugal, and Spain spreading throughout the financial systems of the euro area—Turkey’s largest export destination. In this respect, the export-weighted global economic activity index constructed by the CBRT reveals weaker external demand than that envisaged in April (Graph 7.1.1).

Graph 7.1.1. Export-Weighted Global Economic Activity*
(Annual Percentage Change)



* For the methodology, see Inflation Report 2010-II, Box 2.1 “Foreign Demand Index for Turkey”.
Source: CBRT, Bloomberg, Consensus Forecasts, April and July 2010 Bulletins.

When assessing the external demand outlook, it is important to consider our trading partner’s headline growth forecasts as well as the composition of growth. In this respect, it is noteworthy that the latest Consensus Forecasts release indicates a noticeable change in the composition of the euro area 2011 growth forecasts. Specifically, with the depreciation of the euro amid financial distress and weaker growth outlook, the export outlook for the euro area has improved, particularly in Germany and Italy, whereas forecasts for the contribution of final domestic demand to GDP growth are revised down (Table 7.1.2). The fact that the euro area private consumption and investment forecasts are revised downwards has the potential to affect Turkey’s external demand prospects adversely. In other words, despite the absence of a major revision to the euro area growth forecasts, the change in the composition of GDP growth indicates a weaker external demand outlook for Turkey compared to the previous Report.

Table 7.1.2. Revisions of Euro Area 2011 Growth Forecasts
(Percent)

	Growth	Private Consumption	Public Consumption	Investment	Exports	Imports
April 2010	1.5	1.0	1.1	2.6	4.9	4.8
July 2010	1.4	0.7	0.5	2.1	5.3	4.4

Source: Consensus Forecasts, April and July 2010 Bulletins.

Against this background, we now envisage weaker external demand conditions compared to the previous Report, while domestic demand continues to recover as anticipated. Therefore, the revised forecasts envisage that the resource utilization would stay at low levels and the contribution of aggregate demand conditions to disinflation would increase slightly.

The global fragility induced by the financial distress in the euro area as well as the emerging slowdown in the Chinese economy led to an increase in downside risks to global growth. As a direct result, metal and oil prices in international spot and futures markets are down from the April Inflation Report as of July. Accordingly, our crude oil price assumptions underlying the medium-term forecasts are revised down from 85 to 80 USD per barrel for 2010 and from 90 to 85 USD per barrel for 2011, and left unchanged for 2012 (Table 7.1.1).

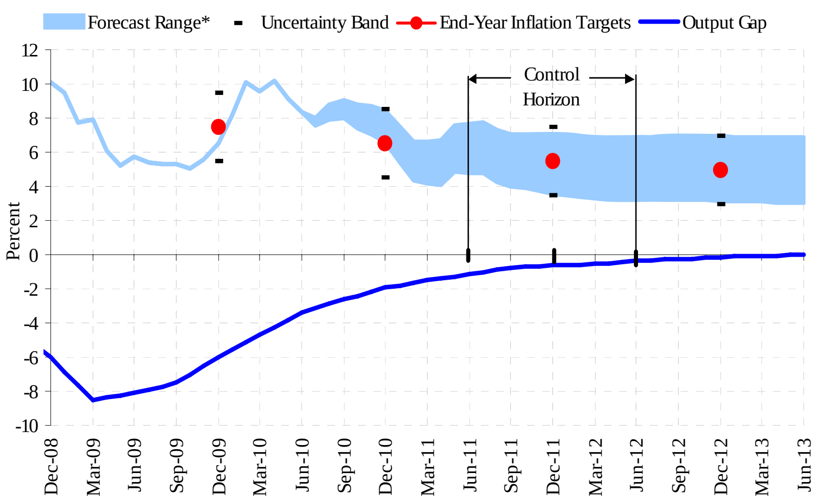
Another global reflection of the fiscal problems in Europe has been the decline in investor risk appetites. Increasing risk premiums, particularly for the highly-indebted European countries, have generally spilled over into emerging markets. Heightened risk premiums could be mainly attributed to concerns regarding debt sustainability, which in turn, could jeopardize financial stability. The rise in Turkey’s risk premium has been relatively limited, owing to comparatively low debt ratios and sound debt sustainability indicators.

Despite the increased risk premium during the second quarter, both the fall in inflation and the growing expectation that policy rates would remain low for quite some time caused market rates to decrease further, and the yield curve to flatten out (Graph 5.1.7). Credit markets continued to recover in the second quarter, while lending standards eased further. The gap between commercial loan rates and deposit rates remained narrow, and the increase in SME loans steadied. Therefore, we have built our forecasts on a macroeconomic outlook of financial easing.

7.2. Medium-Term Outlook

Against this background, assuming that the measures outlined in our exit strategy are completed to a large extent during rest of the year, and that policy rates are kept constant at current levels for some time followed by limited increases in 2011, with policy rates staying at single digits throughout the 3-year forecast horizon, the medium-term forecasts suggest that, with 70 percent probability, inflation will be between 6.5 and 8.5 percent with a mid-point of 7.5 percent at end-2010, and between 3.6 and 7.0 percent with a mid-point of 5.3 percent by the end of 2011. Furthermore, inflation is expected to decline to 5.0 percent by the end of 2012 (Graph 7.2.1).

Graph 7.2.1. Inflation and Output Gap Forecasts



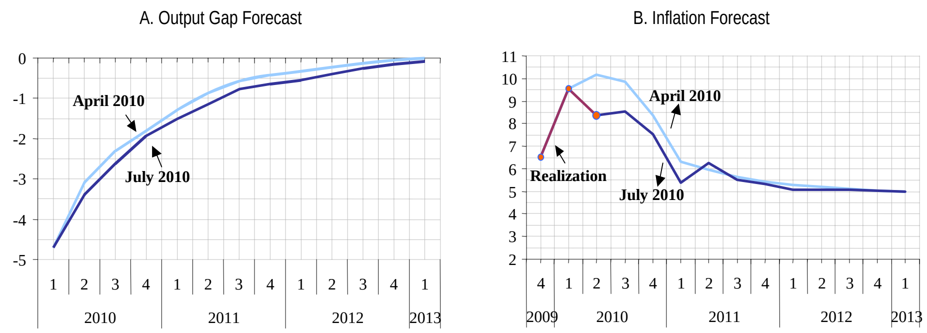
* The shaded region indicates the 70 percent confidence interval for the forecast.

In sum, the end-2010 inflation forecast has been revised down by 0.9 percentage points from April, owing to the downward revisions to food and oil price assumptions, and the recent slowdown in underlying inflation (Graph 7.2.2B). Inflation is expected to remain volatile above the target in the short run, drop to 7.5 percent at end-2010, fall further in 2011 and achieve the medium-term target of 5 percent in early 2012 (Graph 7.2.1).

Our output gap forecasts based on the above assumptions are shown in Graph 7.2.1. Due to the dampening effect of the euro area debt crisis on aggregate demand, output gap forecasts are revised slightly down from the previous Reporting period (Graph 7.2.2A). However, the downward revision to monetary policy is expected to partially compensate for the adverse impact of the weak external demand. Put differently, despite the relatively weak outlook for external demand, estimates for the pace of economic recovery are left unchanged. Our revised forecast indicates that the monetary tightening required to keep inflation in line with medium-term targets would start later and would be more limited compared to the previous forecast.

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 future policy rates underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

Graph 7.2.2. Comparison of April and July 2010 Inflation Report Forecasts



Source: CBRT.

Source: TURKSTAT, CBRT.

Although underlying inflation is expected to remain consistent with the medium-term targets, and follow a stable path, the exact path of inflation would largely depend on base effects over the year ahead. Therefore, a clear understanding of these effects would help economic agents better interpret the developments in inflation, and enable the management of expectations:

Given the extreme volatility in unprocessed food prices and the tax incentives in 2009, inflation is expected to remain volatile over the remainder of 2010. Owing to the base effects resulting from the tax hike on tobacco in 2009 and the tax cuts on durable goods in March and April 2009, which began to run out in June 2009, inflation is likely to fall markedly in July 2010. Inflation is expected to rise in August due to the sharp drop a year ago, and decline substantially in the final quarter with the reversal of base effects from food prices.

The fact that the 1.9 percentage point contribution from tax hikes in early 2010 has largely disappeared, will affect inflation in the first two months of 2011. Although annual inflation may rise during the second quarter of 2011 amid very low base effects from food inflation, inflation is likely to fall gradually in subsequent periods to stabilize around 5 percent by early 2012.

Comparison of CBRT Forecasts with Inflation Expectations

It is critical that economic agents, with the awareness of temporary factors, focus on medium-term inflation trends, and therefore, take the inflation targets as a benchmark for 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. Our inflation forecasts for end-2010 are largely consistent with current inflation expectations. However, longer term inflation expectations, particularly 24-month ahead inflation expectations, are significantly above the revised inflation forecasts (Table 7.2.1).

Table 7.2.1. CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations[1]	Inflation Target[2]
2010 year-end	7.5	7.7	6.5
12-month ahead	6.0	7.2	5.9
24-month ahead	5.1	6.9	5.2

[1] July 2010, Second survey period results.
2 Calculated by linear interpolation of year-end inflation targets for 2010, 2011 and 2012.
Source: CBRT.

7.3. Risks and Monetary Policy

By influencing commodity prices and external demand conditions, global economic activity would continue to be the main factor driving inflation dynamics and the monetary policy outlook. In this respect, the timing and the extent of monetary tightening to be implemented during 2011 under the baseline scenario may change depending on the course of the economic activity.

Recently, rising concerns regarding debt sustainability in several euro area countries and the spillover effects to the financial system have led to renewed turmoil across financial markets, underscoring the downside risks to the global economic recovery. Furthermore, ongoing problems in credit, real estate and labor markets across advanced economies, with little policy options left in case of another disruption to global economic activity, suggest that the downside risks regarding the pace of global growth are likely to persist for some time. Should the global economy face a longer-than-anticipated period of anemic growth, which would consequently delay the domestic recovery significantly, the monetary tightening envisaged in 2011 under the baseline scenario may be postponed towards the end of 2011. Moreover, an outcome whereby global economic problems intensify and contribute to a contraction of domestic economic activity, may trigger a new easing cycle. By contrast, monetary tightening may be implemented in an earlier period during 2011, should the recovery in economic activity turn out to be faster than expected.

Despite the increased downside risks pertaining to external demand, domestic demand remains strong. Although problems regarding the global economy have the potential to restrain domestic demand through confidence and financing channels, countercyclical monetary policy and the ongoing improvement in employment conditions are likely to support the recovery in domestic demand. On the other hand, given the relative improvement in the creditworthiness of Turkey during the post-crisis period, a possible strengthening in capital inflows in the forthcoming period stands out as another factor that may lead to a faster recovery in the domestic demand in contrast to external demand. Should the divergence in the growth rates between domestic and external demand continue in the forthcoming period, it would be necessary to utilize other policy instruments such as reserve requirement ratios and liquidity management facilities more effectively. Accordingly, if the composition of strong domestic demand and weak external demand continue as envisaged, and if this pattern of growth co-exists with rapid credit expansion and a deterioration in the current account balance, consequently leading to financial stability concerns, than the CBRT may bring forward the measures outlined in the exit strategy that are expected to be implemented until the end of 2010.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. Since the second half of 2009, economic activity has been stronger than envisaged in the MTP, leading to a better-than-expected performance in budget revenues. Using this fiscal space mostly to reduce the government debt would facilitate demand management and reduce any need for indirect tax hikes, therefore providing more flexibility regarding the conduct of countercyclical monetary policy. In this respect, should the fiscal discipline be implemented through institutional and structural improvements, such as enacting and establishing the fiscal rule, it would be possible to keep policy rates at single-digit levels over the medium term.

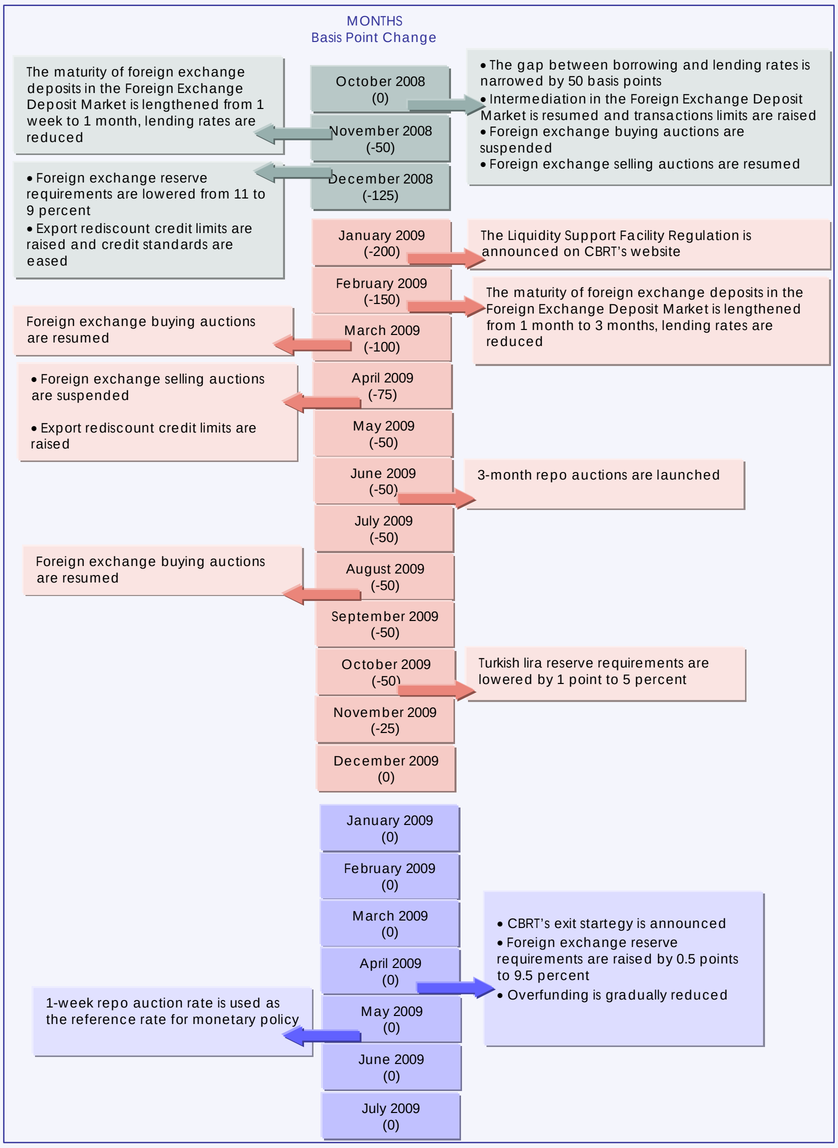
Since the last quarter of 2008, the CBT, without conflicting with its primary objective of maintaining price stability, has focused on containing the adverse effects of the global crisis on the domestic economy—which has been achieved to a large extent. Monetary policy will continue to focus on price stability in the period ahead. Strengthening the commitment to fiscal discipline and the structural reform agenda would support the improvement of Turkey's sovereign risk, and thus facilitate macroeconomic and price stability. In this respect, timely implementation of the structural reforms envisaged by the MTP and the EU accession process remains to be of utmost importance.

Box 7.1 Monetary Policy Stance During September 2008 - July 2010

The financial turmoil that initiated with the meltdown in the US sub-prime mortgage market during the third quarter of 2007 deepened further by the fourth quarter of 2008, and spread across the globe. Concurrently, monetary and fiscal policy authorities called for coordinated action to tackle with the financial crisis and to stimulate the economy. Following the deepening of the crisis, central banks in advanced economies launched unconventional monetary policy measures to restore the smooth functioning of credit markets, while those in emerging economies slashed policy rates aggressively to contain the effects of the global crisis on their economies. Meanwhile, the CBRT not only sought to maintain price stability but also adopted measures to contain the adverse effects of the crisis on economic activity and financial stability. This Box analyzes the monetary policy decisions taken after the outburst of the crisis and the underlying rationale.

The heightened global uncertainty immediately after the collapse of Lehman Brothers in September 2008 prompted the CBRT to pursue a prudent monetary policy. Therefore, the CBRT left policy rates unchanged in September and October 2008, but adopted a series of measures to reduce the crisis-induced uncertainty surrounding money markets and to counter the Turkish lira and foreign currency squeeze in markets. Accordingly, the CBRT started to overfund the markets in October 2008, and narrowed the gap between borrowing and lending rates by lowering the lending rate by 50 basis points. In addition, the CBRT suspended foreign exchange buying auctions on October 16, 2008 and, in the face of non-competitive pricing in the foreign exchange market, conducted foreign exchange selling auctions on October 24 and 27, 2008. In October 2008, the CBRT resumed its intermediary role in its Foreign Exchange Deposit Market, raised transactions limits, extended the respective maturities and cut lending rates for transactions for which the CBRT is a party. On December 5, 2008, the CBRT reduced the foreign exchange reserve requirement ratio and injected an additional foreign currency liquidity to the markets. The CBRT also raised export re-discount credit limits and provided an easier access to these credits (Table 1).

Table 1: Policy Decisions and Liquidity Measures between October 2008 and July 2010



The economy plunged into a deeper contraction in November 2008, which was confirmed by indices and data releases in December. Amid growing concerns over a prolonged and deeper crisis in international credit markets and the world economy in January 2009, the outlook for external demand deteriorated further during the first quarter of 2009, while global growth forecasts were revised down in March. The global crisis had a more severe impact on the labor market during the first quarter, while domestic demand fell rapidly.

Meanwhile, the CBRT envisaged that global credit problems would dampen domestic and external demand for a long time and therefore downside risks to inflation would become more pronounced. In this respect, the CBRT, without conflicting with the primary objective of maintaining price stability, has pursued policies focusing on economic activity and financial stability, and moved rate-cut decisions forward in order to help alleviate the additional tightening in financial conditions. Thus, the CBRT adopted a front-loaded monetary policy and launched the monetary expansion process in November 2008. Unlike many emerging economies, Turkey's sound financial system in addition to its relatively less deteriorated risk premium amid the global crisis enabled the CBRT to cut policy rates more aggressively, by a cumulative 625 basis points from November 2008 to March 2009. In early March, with the deepening of the global economic crisis, foreign exchange markets lost depth, leading to non-competitive pricing behavior. Accordingly, the CBRT resumed daily foreign exchange selling auctions, which continued until April 2, 2009 (Table 1).

The second quarter of 2009 was marked by growing signs that the worst of the crisis was over, yet the post-crisis economic recovery would be slow and gradual. In this period, domestic demand recovered largely due to fiscal measures, while external demand remained weak. The lack of a major growth in the demand for goods without tax incentives, ongoing de-stocking, absence of a solid recovery in the labor market and the growing sense that it would take a long while for employment conditions to improve, all signaled that weak demand conditions are yet to end. Thus, aggregate demand conditions continued to support disinflation during the second quarter, prompting the CBRT to take further measures to contain the adverse effects of the global financial crisis. Accordingly, the CBRT launched 3-month repo auctions on June 19, 2009 to ensure the smooth functioning of the credit market (Table 1).

The policy rate cuts and other countercyclical measures had a major impact on money and credit markets by the second quarter of 2009, and kept inflation from undershooting the year-end target. The CBRT emphasized that the partially prevalent additional tightening in financial conditions reflected ongoing downside risks and that monetary policy would require downward flexibility for quite some time. Accordingly, the CBRT continued to cut policy rates gradually from April to June 2009, totaling 175 basis points (Table 1).

Fiscal measures had a waning impact on domestic demand during the third quarter of 2009, while external demand remained sluggish. Moreover, data releases on inflation and economic activity since the launch of the rate-cut cycle vindicated the CBRT's monetary strategy, and thereby reinforced the impact of the policy decisions on expectations. As a result, the CBRT lowered policy rates by a total of 150 basis points in the third quarter (Table 1). The policy rate cuts and the improved risk sentiment, and more importantly, the CBRT's communication policy[1] played a key role in bringing market rates down, leading to an increase in loan supply and consumer loans. In view of the favorable developments in the credit market and the moderate economic recovery during the fourth quarter, the CBRT slowed the pace of monetary easing, and lowered policy rates by 50 and 25 basis points, respectively, in October and November.

December 2009 was marked by growing expectations of a moderate economic recovery. Yet, the continued uncertainty about aggregate demand as well as the belief that it would take a long while for employment conditions to fully recover indicated that domestic resource utilization would remain low for a prolonged period and inflation would hover around low levels in the medium term. Accordingly, although inflation was heading towards a base effect-driven jump, in view of the ongoing problems in the global economy and the uncertainty about the pace of economic recovery, the CBRT left policy rates unchanged in December 2009, pausing the monetary easing cycle that had been effective for over a year. Furthermore, in order to ensure that the temporary increase in inflation would not pose a threat to inflation expectations and pricing behaviors, the CBRT followed an effective expectations management strategy with a stronger emphasis on the positive outlook for core inflation indicators.

In sum, the CBRT cut borrowing rates by a total of 1025 basis points from November 2008 to November 2009 (Table 1), bringing Turkey's policy rate closer to the average of inflation-targeting emerging economies.

Higher energy and food prices and tax adjustments caused inflation to increase dramatically in the fourth quarter of 2009. Having envisioned that the rise in inflation would be temporary, the CBRT maintained an effective communication strategy assuring that inflation was in line with medium-term targets, and focused on limiting the deterioration in inflation expectations and pricing behaviors.

[1] Specifically, the well-established medium-term perspective on monetary policy presented in the July 2009 Inflation Report accelerated the downtrend in market rates.

The imbalance between domestic and external demand increased remarkably during and after February. While domestic demand was on a gradual and stable rise, external demand remained uncertain. Besides, the increase in inflation led to higher inflation expectations and heightened concerns about deterioration in pricing behaviors. Against this background, the CBRT stated that it would revise its monetary policy stance in case higher expectations would lead to a deterioration in pricing behaviors, and hinted at an exit from crisis measures. In fact, on April 14, 2010, as money and credit markets started to normalize, the CBRT announced an exit strategy that embodies the withdrawal of crisis measures and normalization process of the monetary policy (Table 1).[2]

Unlike other emerging economies, Turkey entered the global crisis with a strong and well-regulated banking system and a flexible and efficient liquidity management tailored to previous crisis experience. Therefore, having only minor deterioration in its balance sheet, the CBRT was not forced to launch radical measures. Thus, the CBRT was able to design a clearer and easier exit strategy than many other central banks. Firstly, as global markets returned to normal, the CBRT raised the foreign exchange reserve requirement ratio by 0.5 percentage points in April to bring foreign exchange liquidity facilities orderly and gradually back to pre-crisis levels (Table 1). In May, the CBRT decided to use the 1-week repo rate as the benchmark for policy rates (Table 1).

Domestic demand remained relatively stable, while the uncertainties surrounding external demand were back on the rise in May 2010 due to the financial turmoil in the euro area. Moreover, lower unprocessed food prices and easing commodity prices contributed to a positive inflation outlook, which added to the optimism about inflation, and therefore reduced risks pertaining to pricing behavior. This outlook confirmed the CBRT's prediction that it would be necessary to maintain the current policy rate for some time and keep rates at low levels for a long period. Accordingly, the CBRT maintained its monetary policy stance during May-July 2010 and continued to keep policy rates fixed at low levels.

In conclusion, the CBRT's post-crisis, front-loaded rate-cut strategy intended to bring policy rates down to historic lows and keep rates at these levels for a long time, has been confirmed by data releases. Without conflicting with the objective of maintaining price stability, the CBRT has focused on containing the adverse effects of the global crisis on the economy, which has been achieved to a large extent. Monetary policy will continue to focus on price stability in the period ahead.

[2] For the full text, see: "Monetary Policy Exit Strategy", http://www.tcmb.gov.tr/yeni/announce/2010/ANO2010-12.pdf

Graphs

1. Overview

2. International Economic Developments

3. Inflation Developments

Tables

Boxes in Previous Inflation Reports

Abbreviations

BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CCS	Cross Currency Swaps
CDS	Credit Default Swap
CEEMEA	Central Eastern Europe, Middle East and Africa
CF	Consensus Forecasts
CUR	Capacity Utilization Rate
ECB	European Central Bank
EMBI	Emerging Markets Bonds Index
EU	European Union
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
IFS	International Financial Statistics
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
OPEC	Organization of the Petroleum Exporting Countries
PMI	Purchasing Managers Index
SCT	Special Consumption Tax
SEE	State Economic Enterprises
SME	Small and Medium-Sized Enterprises
SSA	Social Security Agency
TL	Turkish Lira
TURKSTAT	Turkish Statistical Institution
UK	United Kingdom
US	United States
USA	United States of America
VAT	Value Added Tax
WEO	World Economic Outlook

2010 Calendar of MPC Meetings, Inflation Reports and Financial Stability Reports		
Monetary Policy Meeting	Inflation Report (in Turkish)	Financial Stability Report (in Turkish)
January 14, 2010 (Thursday) February 16, 2010 (Tuesday)	January 26, 2010 (Tuesday)	
March 18, 2010 (Thursday)		
April 13, 2010 (Tuesday)	April 29, 2010 (Thursday)	
May 18, 2010 (Tuesday)		May 26, 2010 (Wednesday)
June 17, 2010 (Thursday)		
July 15, 2010 (Thursday)	July 27, 2010 (Thursday)	
August 19, 2010 (Thursday)		
September 16, 2010 (Thursday)		
October 14, 2010 (Thursday)	October 26, 2010 (Thursday)	
November 11, 2010 (Thursday)		
December 16, 2010 (Thursday)		December 7, 2010 (Tuesday)