1. Overview

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

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

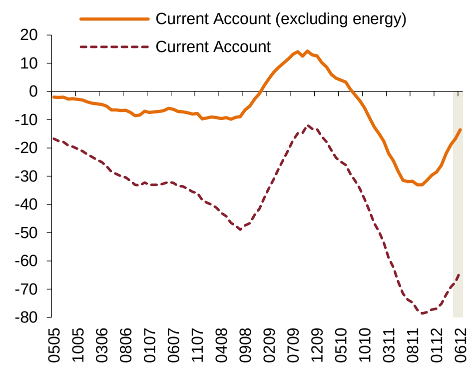
Ongoing fragilities and imbalances regarding the global economy keep the risk appetite highly volatile. Four years after the outbreak of the global crisis, advanced economies are still going through deleveraging. Problems in the Euro Area, uncertainties regarding the US economy and China as well as supply-side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

1.1. Monetary Policy Implementation and Monetary Conditions

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

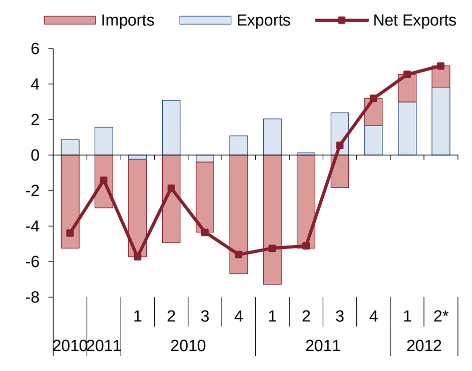
Data released for the first half of the year have shown that policies pursued were successful in delivering the intended results. The composition of growth has displayed a healthier outlook, while the balancing process became more significant. In fact, during this period, current account has continued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

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



*Estimate for June.
Source: TurkStat,CBRT.

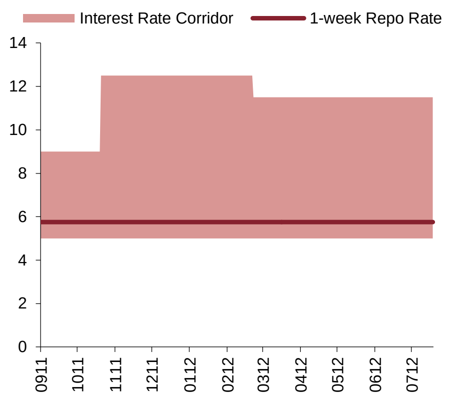
Chart 1.1.2.
Contribution of Net External Demand to Annual GDP Growth (Percent)



* Estimate.
Source: TurkStat, CBRT.

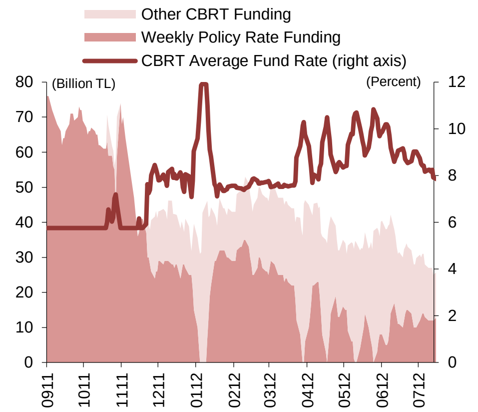
Having started to attain the desired outcomes regarding macro financial risks, monetary policy shifted the emphasis to price stability as of October 2011. In this respect, the CBRT implemented a strong monetary tightening by widening the interest rate corridor upwards and effectively using liquidity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

Chart 1.1.3.
CBRT Policy Rate and the Interest Rate Corridor
(Percent)



Source: CBRT.

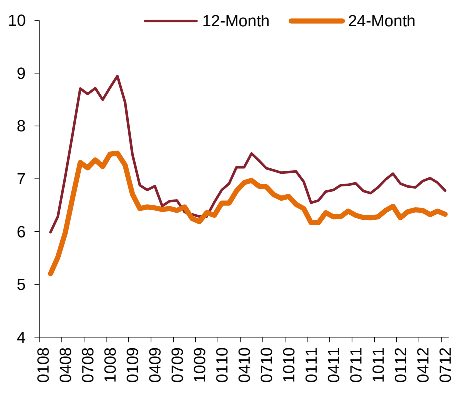
Chart 1.1.4.
CBRT Funding and the Average Funding Rate
(Percent)



Source: CBRT.

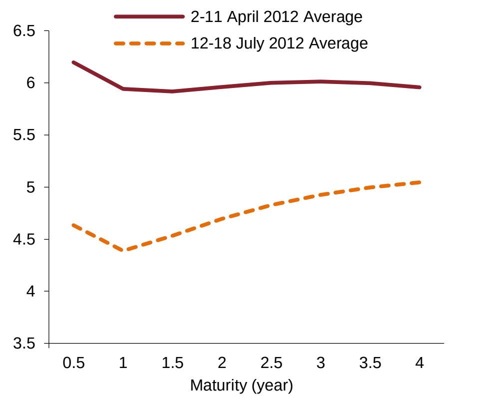
In line with the improvement in global risk appetite, the Monetary Policy Committee (the Committee) kept short-term interest rates relatively stable during the early months of the year. Additional monetary tightening was implemented in April and May with an aim to contain the adverse effects of temporary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

Chart 1.1.5.
Inflation Expectations*
(Percent)



* 12-month and 24-month ahead inflation expectations from CBRT Survey of Expectations
Source: CBRT.

Chart 1.1.6.
1-year Forward Inflation Compensation*
(Percent)



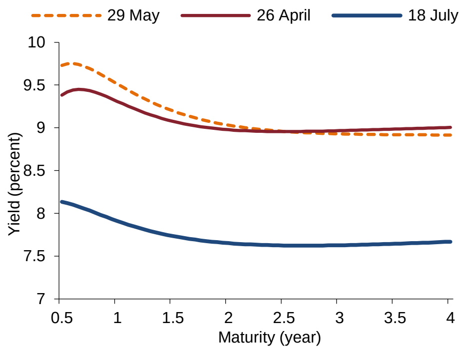
* Forward inflation compensation of the nominal and CPI-indexed bonds traded at the ISE.
Source: CBRT.

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

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

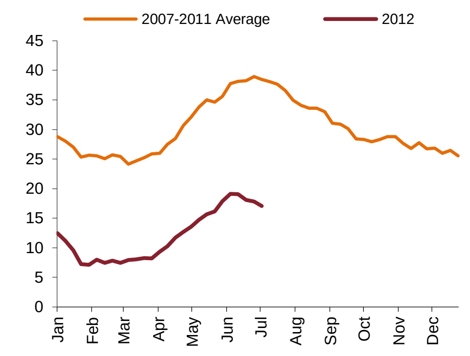
On the other hand, credit conditions have been relatively tighter. The pick-up in credit growth in the second quarter can be attributed to seasonal factors rather than an acceleration in the course of growth. In this period, the pace of growth in credit was much slower compared to the average growth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

Chart 1.1.7.
Yield Curve*



* Calculated from the compounded returns on bonds quoted in ISE Bonds and Bills Market by using Extended Nelson Siegel (ENS) method.
Source: ISE, CBRT.

Chart 1.1.8.
Comparison of 2012 Consumer Loan Growth with Previous Years (13-Week Annualized Moving Average, Adjusted for Exchange Rate, Percent)



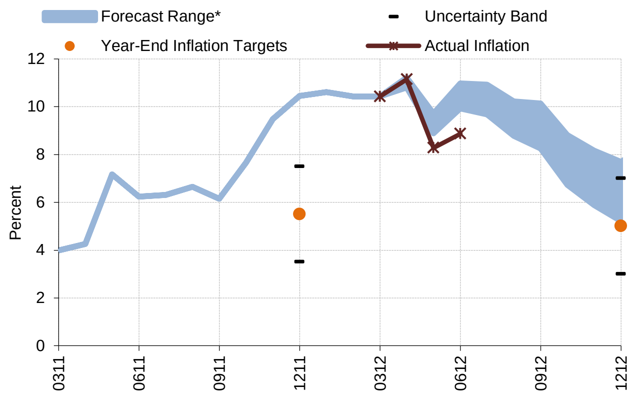
Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

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

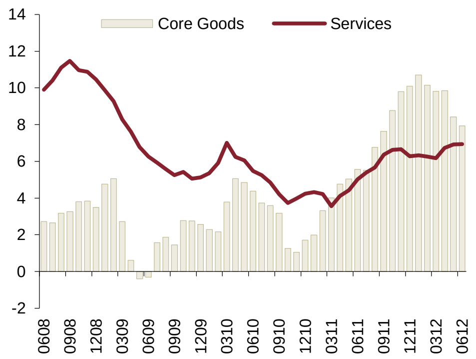
Chart 1.2.1.
April Inflation Forecasts and Realizations
(Percent)



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

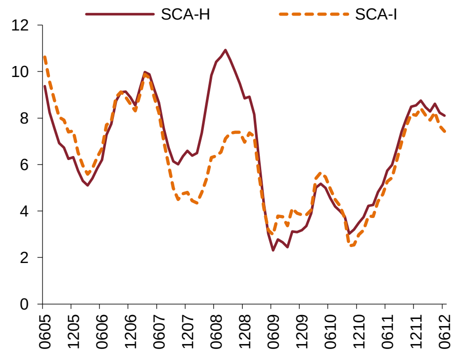
As the cumulative pass-through effect of exchange rate movements in 2011 faded, the core inflation has continued to fall. After a slight pick-up, prices of services followed a mild course (Chart 1.2.2). Against these developments, core inflation indicators maintained a downward trend (Chart 1.2.3).

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



Source: TurkStat, CBRT.

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

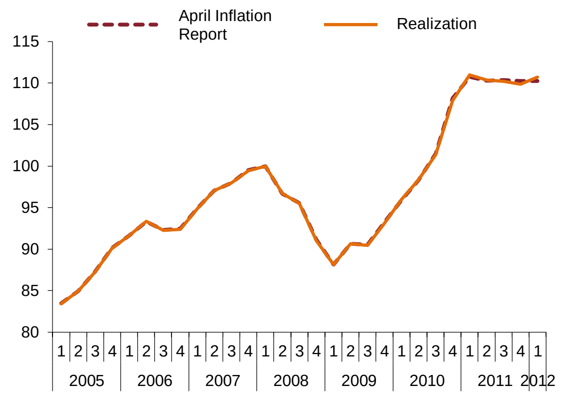


Source: TurkStat.

Supply and Demand

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

Chart 1.2.4.
Final Domestic Demand in 2012Q1: Estimate and Realization
(Seasonally Adjusted, 2008Q1=100)

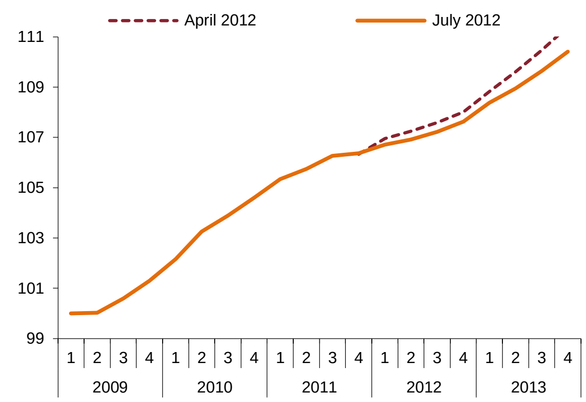


Source: TurkStat, CBRT.

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

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

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



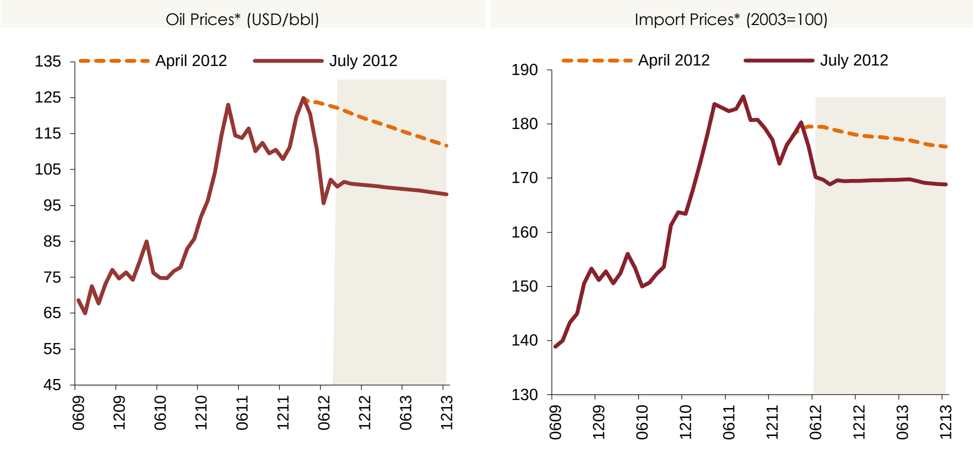
* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

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

Energy, Imports and Food Prices

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

Chart 1.2.6.
Oil and Import Price Assumptions



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

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

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

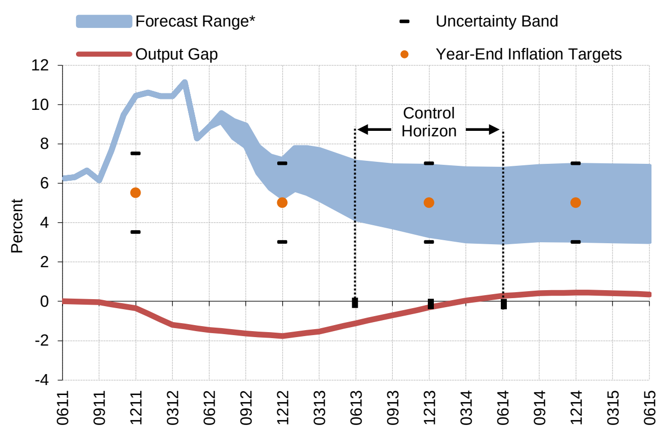
Fiscal Policy and Tax Adjustments

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

1.3. Inflation and Monetary Policy Outlook

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

Chart 1.3.1.
Inflation and Output Gap Forecasts



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

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

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

1.4. Risks and Monetary Policy

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

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

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

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

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

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

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

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

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