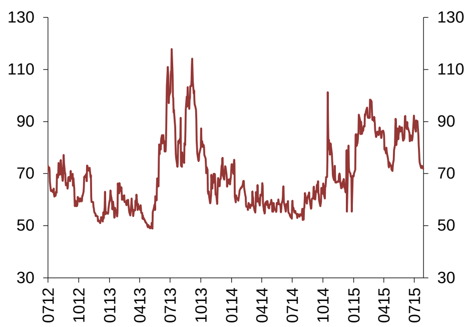
1. Overview

Global financial markets remained volatile in the second quarter of 2015, which was attributed to the continued divergence among global monetary policies, the uncertainty surrounding the Fed's normalization plans and developments regarding the Greek debt crisis in the EU. In this period, the volatility in long-term rates surged significantly, especially across advanced economies (Chart 1.1), which also affected emerging market rates. Thus, portfolio flows to emerging markets weakened (Chart 1.2). The global economic slowdown of 2014 continued into the first quarter of 2015 largely due to emerging economies. Despite signs of economic recovery in Europe, geopolitical tensions continued to restrain Turkey's external demand.

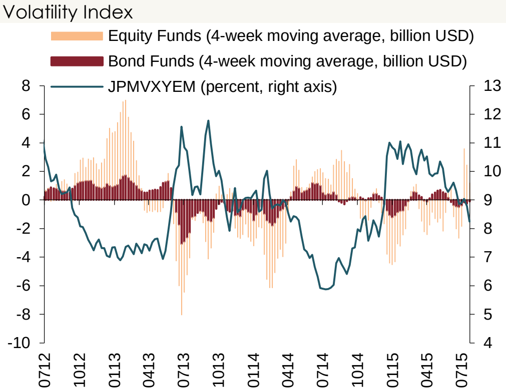
The volatility across global markets had implications for the Turkish economy as well, causing fluctuations in financial indicators amid domestic uncertainty. In this period of heightened long-term interest rate volatility in advanced economies and added interest rate sensitivity in emerging economies, the interest rate corridor and the tight liquidity policy implemented by the CBRT played a major role in shielding the economy against global shocks. Moreover, the CBRT's structural and cyclical measures supporting FX liquidity, core liabilities and long-term borrowing strengthened the economy's resilience.

Chart 1.1.
US Interest Rate Volatility
(Basis Points)



Source: Bloomberg.

Chart 1.2.
Portfolio Flows to Emerging Economies and JPMVXYEM Volatility Index



Source: EPFR, Bloomberg.

The growth in economic activity during the first quarter of 2015 was mainly driven by consumption spending. In this period, exports of goods and services increased quarter-on-quarter whereas imports decreased, thus helping net exports to contribute positively to quarterly growth. Indicators for the second quarter suggest that economic activity continues to grow moderately. The global economic slowdown and geopolitical problems cause external demand to remain weak while domestic demand provides a moderate support to growth. Therefore, economic activity is expected to follow a moderate and gradual growth path in the upcoming period. Although inflation decreased on lower food prices in the second quarter of 2015, the accompanying depreciation of the Turkish lira caused core goods inflation to rise, delaying the desired improvement in the inflation outlook. The prospective partial improvement in food prices and the cautious monetary policy stance will help to minimize the deterioration in the inflation outlook. Inflation is expected to reach the target over the medium term.

1.1. Monetary Policy and Financial Conditions

In view of the uncertainty over global markets and the volatility in food and energy prices, the CBRT maintained its cautious monetary policy stance in the second quarter of 2015. In this period, the CBRT kept interest rates unchanged, but continued with its tight liquidity policy to contain risks to core goods inflation and inflation expectations. To meet the recently growing liquidity need, the weight of marginal funding was increased, which in turn increased the CBRT average funding rate (Chart 1.1.1). The CBRT average funding rate has been hovering around 8.5 percent since mid-June (Chart 1.1.2). The BIST overnight repo rates, on the other hand, remained close to the upper band of the interest rate corridor as in the previous reporting period.

Chart 1.1.1.
CBRT Funding
(2-Week Moving Average, Billion TL)

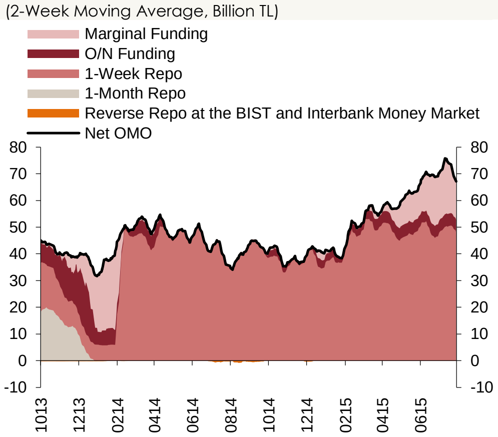
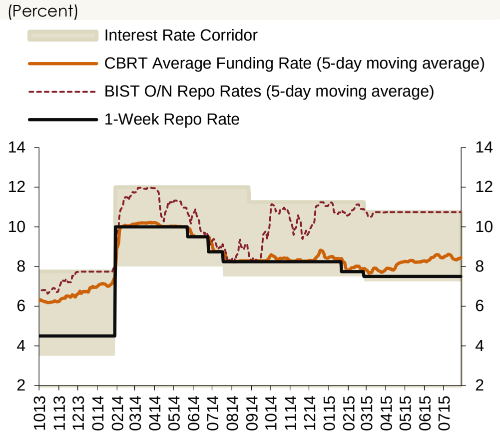


Chart 1.1.2.
CBRT Rates and BIST Repo Rates
(Percent)



Source: BIST, CBRT.

The Turkish lira liquidity need of the banking system is met by both CBRT funds and short-term funds obtained from various markets. Among the non-CBRT funds with up to one-week maturity, funds from the swap market constitute the largest share, which is followed by transactions with banks and with other intermediaries at the BIST Repo and Reverse Repo Market (Chart 1.1.3). The weighted-average market funding rate calculated by using the transaction volumes and interest rates at these markets closely follows the overnight rate at the BIST Interbank Money Market determined by the CBRT's interest rate and liquidity policies (Chart 1.1.4). The effective funding rate measured by using the respective weights of CBRT and non-CBRT funds in total funds hovers around 9.3 percent as of July, surpassing the CBRT average rate of about 8.5 percent and reflecting the recent increases in the CBRT average funding rate.

Chart 1.1.3.
Non-CBRT Funding
(2-Week Moving Average, Billion TL)

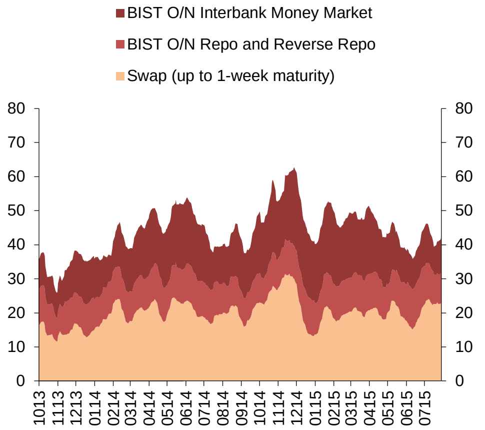
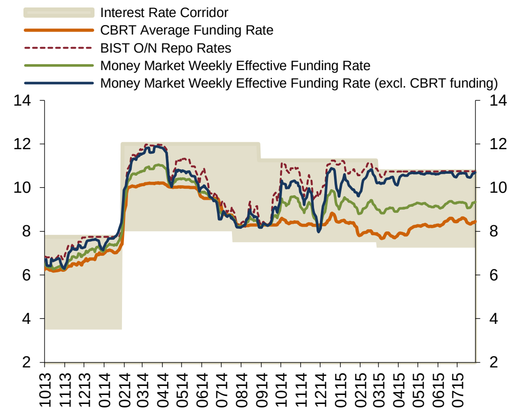


Chart 1.1.4.
Bank's Funding Costs at the Money Markets
(5-Day Moving Average, Percent)



Source: BIST, CBRT.

Thanks to the cautious monetary policy stance, the yield curve remained nearly flat. Although the yield curve has remained basically unchanged since the publication of the previous Inflation Report, there was a slight increase in the market rates with more than two-year maturity (Chart 1.1.5). Thus, the spread between the overnight repo rates at the BIST Interbank Money Market and 5-year market rates has narrowed somewhat (Chart 1.1.6). The CBRT reiterated that inflation expectations, pricing behavior and other factors that affect inflation will be monitored closely and the cautious monetary policy stance will be maintained by keeping a flat yield curve until there is a significant improvement in the inflation outlook.

Chart 1.1.5.
Yield Curve
(Percent)

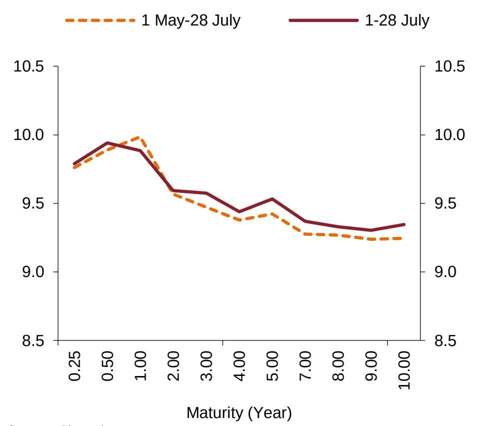
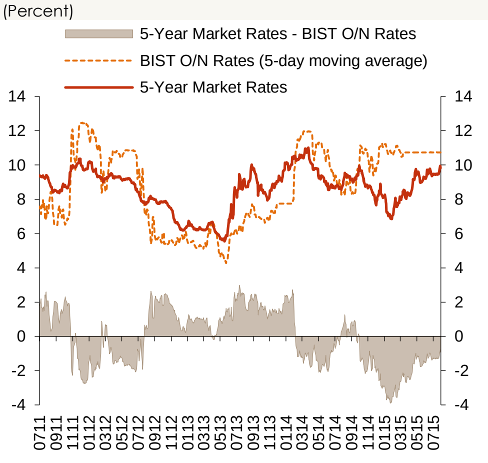


Chart 1.1.6.
Market Rates
(Percent)



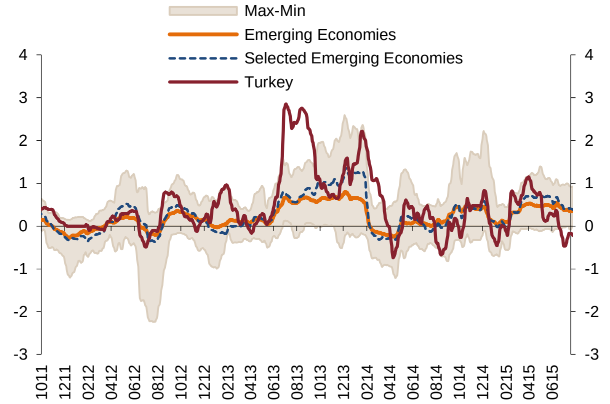
Source: Bloomberg.

The wide interest rate corridor and the CBRT's tight liquidity policy reduce the economy's sensitivity to global shocks, thus supporting financial stability and facilitating the attainment of the price stability objective. In the post-crisis period, the unconventional policies of advanced economies and the ongoing uncertainties over global monetary policies caused long-term interest rates in these economies to fluctuate. In addition, emerging market rates have become extremely sensitive to global monetary policy developments. To contain repercussions on the Turkish economy, the CBRT designed a monetary policy framework that is composed of a wide interest rate corridor and an active liquidity policy. The CBRT's wide interest rate corridor and the tight liquidity policy have strengthened the resilience of the Turkish economy against global shocks and have proven to be effective in pursuing the primary objective of maintaining price stability. The wide interest rate corridor enables short-term rates to temporarily exceed long-term rates when faced with shocks and allows the yield curve to be kept nearly flat or inverted. Accordingly, TL long-term rates remain more stable and the economy becomes less sensitive to global long-term interest rate shocks. Moreover, a flat or inverted yield curve constitutes an effective monetary policy stance that supports disinflation. In fact, following the strong monetary tightening of early 2014, the sensitivity of domestic markets to global interest rates weakened markedly and core inflation indicators have improved significantly (Chart 1.1.7).

Chart 1.1.7

Regression Coefficients of 10-Year Treasury Bond Rates of Emerging Economies on 10-Year US Treasury Bond Rates*

(Weekly Changes, 60-Day Moving Window,5-Day Moving Average)



* Emerging economies include Brazil, Chile, Hungary, Poland, Peru, South Africa, Mexico, Malaysia, Colombia, China, South Kore, India, Israel, Romania, Indonesia, Czech Republic, Thailand and Philippines. Selected emerging economies are Brazil, South Africa, India and Indonesia.
Source: Bloomberg.

In addition to the interest rate corridor and the tight liquidity policy, the CBRT continues to make efficient use of the policy tools it has developed in response to the global financial volatility. These measures taken with regard to the financial system are highly important in encouraging prudential borrowing and minimizing macrofinancial risks amid domestic and external uncertainty. The remuneration of Turkish lira required reserves at different rates depending on core liabilities has been effective as of January 2015. As of 8 May 2015, the remuneration rate has been raised by 50 basis points. Similar to the FX sales, increasing the partial remuneration for required reserves reduces the reserves maintained via the ROM, thus raising the system's funding need from the CBRT. Moreover, when the Turkish lira depreciates, reserves maintained via the ROM decrease automatically due to the valuation effect, which helps to stabilize the FX liquidity. Additionally, the rise in FX required reserves ratios to extend the maturity of non-core liabilities appears to have contributed to the recent slowdown in the growth of the loan-to-deposit ratio (Chart 1.1.8). Furthermore, the share of short-term non-deposit FX liabilities declined more evidently in the second quarter after the FX required reserves ratios were changed to stimulate long-term borrowing (Chart 1.1.9).

Chart 1.1.8.
Loans/Deposits
(Percent)

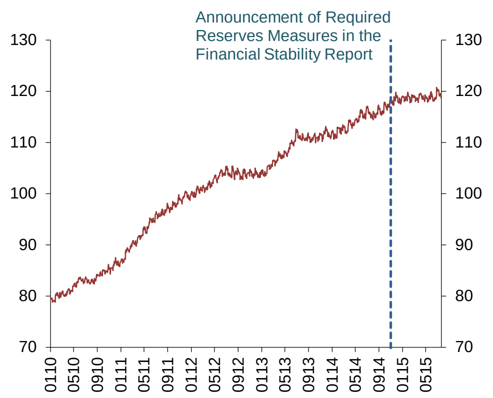
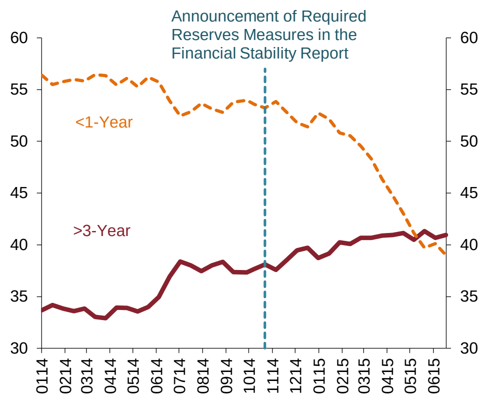


Chart 1.1.9.
Non-Deposit FX Liabilities by Maturity
(Percent)



Source: CBRT.

In the second quarter, the CBRT continued with the flexible FX selling auctions where the amount of FX to be sold is determined on a daily basis; and, as per the changes made to the ROC on 13 February 2015 and 10 March 2015, the CBRT supported the FX liquidity in the market by allowing withdrawals from the FX reserves under ROM. Moreover, some new changes were made in addition to the adjustments of the first quarter regarding the rates applied to banks' FX borrowings from the CBRT. Accordingly, the rates applied to banks' one-week borrowings from the CBRT, which was 10 percent before 9 October 2014, were lowered to 3 and 1.25 percent for USD and euro, respectively. Although banks have not resorted to this facility yet, the adjustments made to the rates and upper limits of one-week FX deposits serve as a buffer for the banking sector restoring the confidence in financial markets.

As another measure related to the FX liquidity, the USD-denominated required reserves, reserve options and free reserves held at the CBRT have been remunerated as of 5 May 2015. The remuneration rate to be applied is set on a daily basis by taking global and local financial market conditions into account. In addition, the annual commission rate of 0.02 basis points that had been applied since 1 February 2015 on euro-denominated accounts of banks and financing companies at the CBRT was reduced to a yearly 0.005 basis points as of 1 July 2015, and to zero as of 27 July 2015 due to the recent developments in the Euro area.

Thanks to the tight monetary policy stance and the macroprudential measures, loan growth continues to stay at reasonable levels. Adjusted for exchange rate changes, loans provided to the non-financial sector increased modestly by 18.1 percent year-on-year in the second quarter of 2015. A comparison of consumer and commercial loans shows that commercial loans continue to grow at a higher rate than consumer loans, partly due to BRSA regulations. The annualized growth rate of commercial loans dropped to 15.1 percent at the end of the second quarter of 2015, whereas this rate was 21.6 percent for commercial loans adjusted for exchange rate. Likewise, comparing their growth trend to averages in past years, commercial loans are close to the average whereas consumer loans are significantly below the average (Charts 1.1.10 and 1.1.11). Due to the moderate economic activity and the recent tightening in financial conditions, loan growth is likely to slow somewhat in the forthcoming period.

Chart 1.1.10.
Consumer Loan Growth
(13-Week Moving Average, Annualized, Percent)

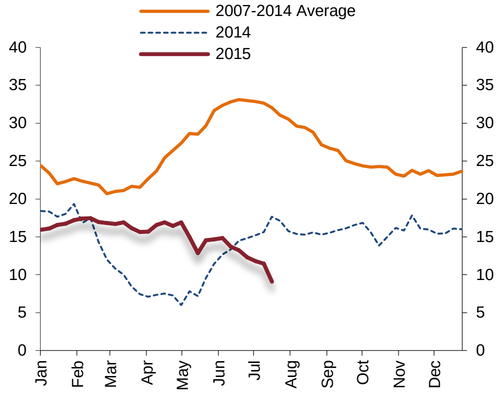
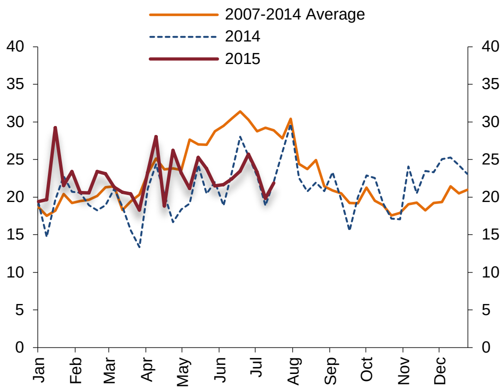


Chart 1.1.11.
Commercial Loan Growth
(13-Week Moving Average, Annualized, Percent)



Source: CBRT.

1.2. Macroeconomic Developments and Main Assumptions

Inflation

In the second quarter of 2015, annual consumer inflation declined by about 0.4 points from end of the first quarter to 7.20 percent, nearing the forecasts of the April Inflation Report (Charts 1.2.1 and 1.2.2). This improvement in inflation was mainly attributed to the declining food inflation, while core goods inflation increased mostly due to exchange rate developments. In this period, the contribution of the food category to annual inflation was down to about 2.3 points amid the correction in food prices. Yet, the depreciation of the Turkish lira limited the decline in inflation.

Chart 1.2.1.
April Inflation Forecasts and Realizations*
(Percent)

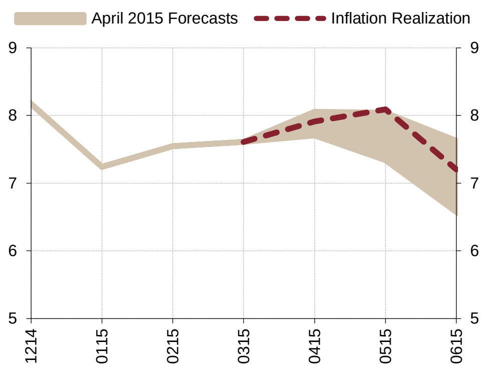
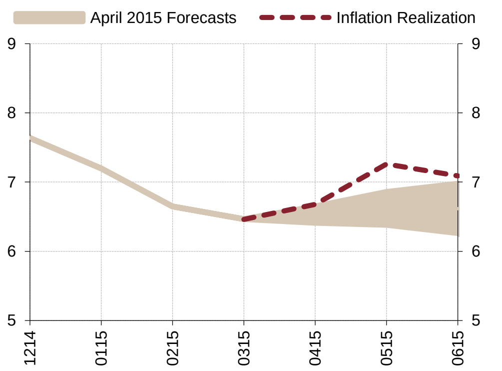


Chart 1.2.2.
April Inflation Forecasts and Realizations Excluding Unprocessed Food and Tobacco* (Percent)



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

The ongoing cautious monetary policy along with prudent fiscal and macroprudential policies are having a favorable impact on inflation, especially inflation excluding energy and food (core goods inflation indicators). However, the lagged effects of the recent exchange rate developments delay the improvement in the inflation outlook. In fact, compared to the first quarter, the underlying core inflation indicators deteriorated notably in the second quarter, largely due to exchange-rate-driven cost pressures (Chart 1.2.3). The cautious monetary policy stance and the moderate course of domestic demand continued to limit the spillover from cost pressures into prices.

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

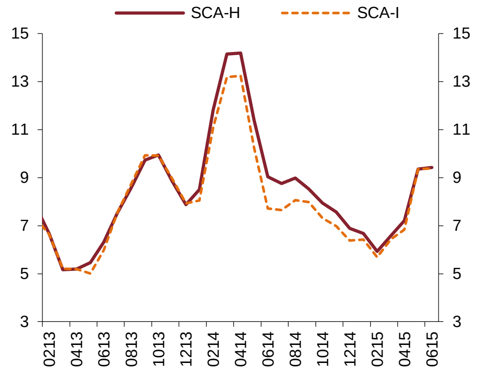
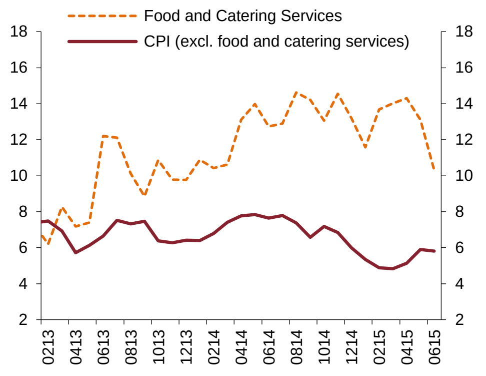


Chart 1.2.4.
Food and Non-Food Prices
(Annual Percent Change)



Source: TURKSTAT, CBRT.

As projected in the April Inflation Report, food prices were corrected remarkably amid the weather conditions that accommodated supply in the second quarter. Annual inflation in the prices of food, which makes up around 25 percent of the consumption basket, fell to 9.28 percent in June. Similarly, annual inflation in food and catering services posted a significant decline in this period. Also, consumer inflation excluding food and catering services increased by 1 point to 5.82 percent in the inter-reporting period due to these cost pressures (Chart 1.2.4).

To sum up, food prices pulled inflation down in the second quarter; yet the depreciation of the Turkish lira restricted this decline, inhibiting the desired improvement in the inflation outlook. Owing to the expected partial recovery in food prices accompanied by the cautious monetary policy stance, the deterioration in the inflation outlook is projected to remain limited and inflation is expected to reach the target in the medium term.

Supply and Demand

According to the GDP data of the first quarter of 2015, economic activity proved more robust compared to the outlook presented in the April Inflation Report, and the GDP rose by 1.3 and 2.3 percent on a quarterly and annual basis, respectively (Chart 1.2.5). An analysis of national income components on the production side indicates that all sectors, excluding construction, exhibited increases in the first quarter compared to the previous quarter's averages. In this period, the contributions of agriculture and net taxes stood out, while those of industry and services remained on a mild uptrend (Chart 1.2.6). Seasonally adjusted data on the expenditures side reveal that final domestic demand increased owing to the rise in consumption expenditures in the first quarter. Investment expenditures contracted in both the public and the private sectors on a quarterly basis. Meanwhile, exports posted an increase, but imports declined on a quarterly basis in the first quarter. On the other hand, the import quantity index excluding gold posted a steady rise in line with the uptrend in domestic demand in this period, while exports thereof declined amid the weak course of the external demand.

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

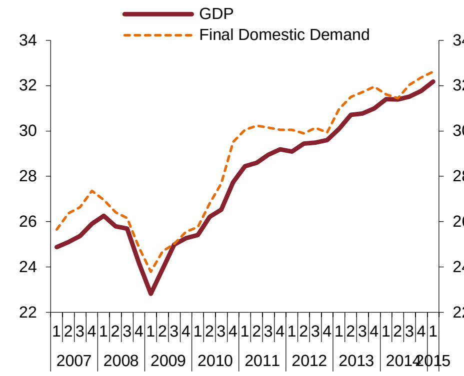
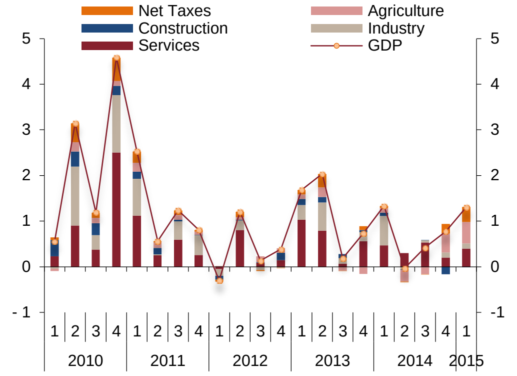


Chart 1.2.6.
Contributions to Quarterly Growth from Production Side
(Seasonally Adjusted, Percentage Points)

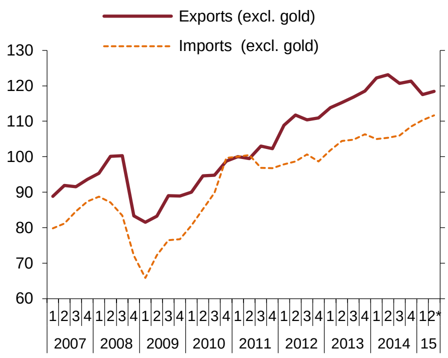


Source: TURKSTAT.

Data on the second quarter of 2015 suggest that the economic activity continues to expand at a moderate pace. Industrial production rose by 1.0 percent in the April-May period compared to the previous quarter. Combined with the other indicators for June, the industrial production is expected to record a quarterly increase in the second quarter. Sales, production, and import indicators regarding domestic demand show that the final domestic demand will continue with an uptrend stemming from consumption demand. Investment indicators, on the other hand, signal that the weak outlook will remain in the second quarter. The export quantity index excluding gold increased at a modest rate in the April-May period following the contraction in the first quarter, while imports excluding gold maintained their upward trend suggesting that the contribution of external demand to economic growth may be limited in the second quarter (Chart 1.2.7).

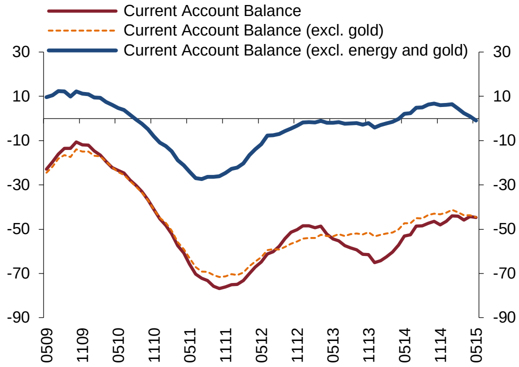
The recovery in economic activity is projected to continue in the upcoming period, yet risks to growth exist. Downside risks regarding external demand persist due to geopolitical developments and troubles in Europe. Moreover, domestic uncertainties, the weak course of the confidence indices, and volatility in financial markets driven by global monetary policies stand out as potential risk factors that could limit the contribution of final private demand to growth. Despite the existence of these factors keeping the downside risks alive, the robust employment performance following the global crisis along with low oil prices generate room for domestic demand and economic policies by improving the current account balance and the inflation outlook. In addition, the expected correction in the agricultural value added may support growth on the production side. Against this background, the second half of 2015 is projected to witness a sustained moderate growth and disinflationary demand conditions. In line with the favorable developments in the terms of trade coupled with the slowdown in consumer loans, the current account balance is anticipated to recover further in the upcoming period; yet the weak course of external demand may limit this recovery to some extent (Chart 1.2.8).

Chart 1.2.7.
Export and Import Quantity Indices
(Seasonally Adjusted, 2011Q1=100)



*As of May.
Source: TURKSTAT, CBRT.

Chart 1.2.8.
Current Account Balance
(12-Month Cumulative, Billion USD)



Source: CBRT.

Oil, Import and Food Prices

In the second quarter of 2015, oil prices stood slightly above the path projected in the previous report, while USD-denominated import prices remained below projections (Charts 1.2.9 and 1.2.10). On an annual basis, average oil price assumption was lowered by 2 percent for 2015, and by around 6 percent for 2016 (Table 7.1.1). Accordingly, assumptions for annual percentage changes in average import prices were revised downwards by 1.7 points for 2015 and 1.4 points for 2016. Developments in food prices show that unprocessed food prices exhibited a notable correction in the second quarter of 2015 and the contribution of food prices to inflation declined significantly. Due to the projections that this correction will continue and the effects of measures taken by related institutions will materialize, the food inflation assumption for end-2015 was revised downwards from 9 percent to 8 percent.

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

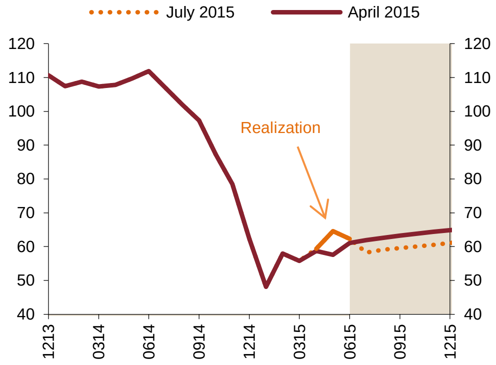
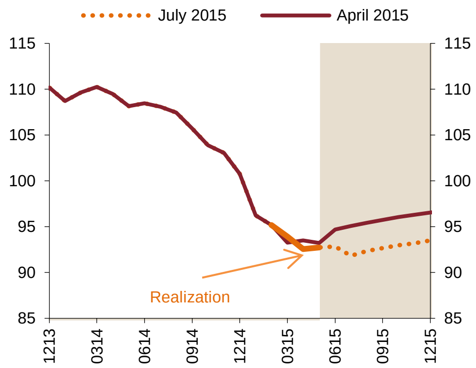


Chart 1.2.10. Revisions in Import Prices*
(USD, 2010=100)



* Shaded region denotes the forecast.
Source: TURKSTAT, Bloomberg, CBRT.

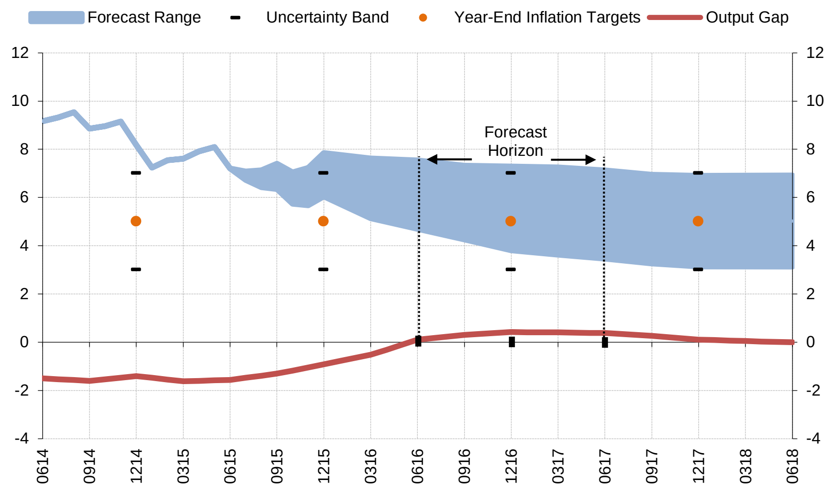
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices will not exceed the inflation targets and be consistent with automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a cautious fiscal policy will be implemented and the primary expenditures to the GDP ratio will decrease gradually.

1.3. Inflation and the Monetary Policy Outlook

Medium-term forecasts are based on the framework that a cautious monetary policy stance will be maintained by keeping the yield curve flat until there is a significant improvement in the inflation outlook. Moreover, the annual loan growth rate is envisioned to hover further around the recent reasonable levels in 2015, also on the back of the macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.0 percent and 7.8 percent (with a mid-point of 6.9 percent) at end-2015 and between 3.7 percent and 7.3 percent (with a mid-point of 5.5 percent) at end-2016. Inflation is projected to stabilize around 5 percent in the medium term (Chart 1.3.1).

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



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

In the second quarter of 2015, exchange rate movements delayed the recovery in the underlying core inflation, causing the year-end inflation forecast to be raised by 0.5 points. On the other hand, the improvement in import and food prices in the inter-reporting period reduced the year-end inflation forecast by 0.1 points and 0.3 points, respectively. As a result, import and food prices are estimated to offset the adverse effects of core inflation indicators in the second half of the year. Accordingly, the end-2015 inflation forecast, which was set as 6.8 percent in the April Inflation Report, was revised upwards by 0.1 points. The end-2016 inflation forecast, which was 5.5 percent in the previous Report, was kept unchanged. It is assessed that the downward revision in the average oil price assumption will pull down the end-2016 inflation by around 0.1 points; yet this effect will be compensated by the effect coming from the rise in inflation forecast for end-2015, leaving the end-2016 inflation forecast intact (Chart 1.3.1).

Base effects will continue to determine the course of inflation for the rest of 2015. Accordingly, inflation is envisaged to decline until September, and increase slightly in September due to base effects. Then, following a fluctuating course, inflation is estimated to reach 6.9 percent in the year-end.

1.4. Risks and the Monetary Policy

Loan growth remains reasonable in response to the tight monetary policy stance and macroprudential measures. Commercial loans have recently been following a robust course of growth, while growth of consumer loans excluding housing lost pace. Additionally, commercial loans grow faster than consumer loans in line with the desired loan composition. Also owing to the recent partial tightening in financial conditions, total credit growth is expected to slow somewhat in the second half of the year. This loan outlook not only limits medium-term inflationary pressures, but also contributes to the improvement in the current account balance.

External demand remains weak while domestic demand contributes to growth moderately. Although the recovery in the European economy affects the external demand positively, ongoing geopolitical developments and the slowdown in global trade restrict the growth of exports. Meanwhile, cumulative energy imports will continue to decline if oil prices continue to remain low. As a result, favorable developments in the terms of trade and the mild course of consumer loans support the recovery in the current account balance, yet the relatively weak export outlook limits this recovery. Domestic demand, on the other hand, exhibits a mild increase driven mainly by consumption. Meanwhile, the weak course of confidence indices coupled with domestic and external uncertainties are the risk factors that may restrict the contribution of the final private demand to growth. In this context, it is projected that the rebound in economic activity will be gradual, and the aggregate demand conditions will continue to support disinflation.

Unprocessed food inflation had been quite unfavorable in the first quarter, causing inflation to remain elevated. However, recently, there has been a notable correction in food prices, which has affected inflation favorably. Similarly, the current decline in oil prices supports disinflation. On the other hand, exchange rate movements have been especially influential in the prices of core goods, delaying the recovery in the core goods inflation. Together with the uncertainty in global markets and volatility in energy and food prices, this warrants the cautious stance in monetary policy to be maintained. It is assessed that the partial recovery in food prices accompanied by the cautious monetary policy stance will limit the deterioration in the inflation outlook and inflation will reach the target in the medium term.

Future monetary policy decisions will be conditional on the pace of improvements in the inflation outlook. Inflation expectations, pricing behavior and other factors affecting inflation will be monitored closely and the cautious monetary policy stance will be maintained by keeping the yield curve flat, until there is a significant improvement in the inflation outlook.

Risks to global markets remain significant. Reduced predictability of the global economy and increased uncertainties amid the divergence among the monetary policies of advanced economies cause global markets to remain highly data-sensitive. Against this background, risk appetite and capital flows continue to be volatile. It was underlined by the CBRT that structural measures to enhance the resilience of the financial system are as important as the stabilizing cyclical policies. Accordingly, recent measures implemented to support the FX liquidity, core liabilities, and long-term borrowing have enhanced the resilience of the economy against global shocks. It is stated that additional measures along these lines may be adopted if deemed necessary.

Following the global crisis, long-term rates in emerging economies have grown excessively sensitive to global monetary policy, the US monetary policy in particular. The wide interest rate corridor and the tight liquidity policy implemented by the CBRT increased the resilience of the domestic economy against global shocks during this period. In the upcoming period, volatility in long-term interest rates may decline permanently by forward guidance during the normalization of global monetary policies. According to this baseline scenario, the need for a wide interest rate corridor may diminish over time. In that case, the operational framework of the CBRT's interest rate policy may be simplified gradually.

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

Sustained fiscal discipline has become a fundamental element in reducing the sensitivity of the Turkish economy against external shocks in recent years. In the current environment of highly uncertain global markets, the value added from maintaining and further advancing these achievements is significant. Any measure that would ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping interest rates of long-term government securities at low levels.