

## 7. Medium-Term Forecasts

This chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook for the upcoming 3-year horizon.

### 7.1. Current State, Short-Term Outlook and Assumptions

#### Financial Conditions

Recently, the persisting deceleration trend in global economic activity and the ongoing low levels of inflation have led the central banks of advanced economies to continue with accommodative policies. The Fed stated that policy rate increases would be slower, while the ECB and the Bank of Japan announced new easing measures. Against this background, capital inflows to emerging economies accelerated, while market rates fell and emerging market currencies appreciated.

Developments in global conditions had impacts on the Turkish economy as well. The yield curve shifted downwards across all maturities due to the stronger perception that accommodative policy stances adopted by the central banks of advanced economies would be maintained. The shift in the yield curve was also supported by waning global uncertainties, the improvement of global financial conditions, the favorable course of domestic macroeconomic indicators, the fall in market and survey-based inflation expectations and reductions in the marginal funding rate. Hence, given better inflation outlook, the ongoing mild and steady growth trend in economic activity and global developments, the CBRT continued to remain tight against the inflation outlook, stabilizing for the foreign exchange liquidity and supportive of financial stability, while also taking steps to simplify the monetary policy framework.

#### Inflation

In the first quarter of 2016, consumer inflation fell by 1.35 points quarter-on-quarter to 7.46 percent, and stood below the January Inflation Report forecasts. The lower-than-expected inflation was mainly driven by the salient plunge in unprocessed food prices. Moreover, low import prices coupled with the diminishing effects of the cumulative depreciation of the Turkish lira on annual inflation also led to a limited decline in annual inflation in core goods and energy in this period. On the other hand, adjustments to administered prices, high levels of inflation expectations and wage developments restricted the fall in inflation.

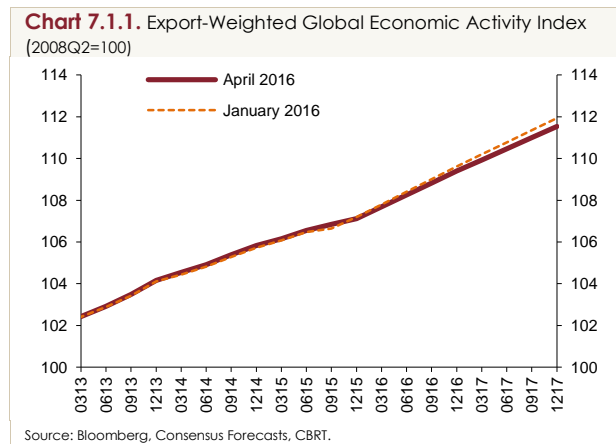
#### Demand Conditions

In the fourth quarter of 2015, economic activity was consistent with the outlook presented in the January Inflation Report, and the GDP grew by 0.7 and 5.7 percent in quarterly and year-on-year terms, respectively. Accordingly, the output gap assumption for the fourth quarter of 2015 was revised upward slightly (Table 7.1.1 and Chart 7.2.3). Having gained momentum in the first three quarters of 2015, the agricultural value added lost pace in the last quarter. Meanwhile, the value added of

industrial and services sectors experienced some acceleration in the last quarter. On the spending front, private spending saw a quarter-on-quarter increase in the last quarter, and private investment expenditures posted a mild increase in the last quarter following a decline in the third quarter. All in all, final domestic demand, which was fueled mostly by private consumption expenditures, proved to be the main driver of growth in 2015, while net exports contributed negatively to growth, despite the positive contribution in the last quarter.

Data on the first quarter of 2016 indicate that economic activity continues to grow at a steady pace. Industrial production posted an increase by 1.6 percent in the January-February period compared to the previous quarter. According to sales, production and import indicators regarding domestic demand, final domestic demand also displayed a moderate and stable growth. Supported by the strong external demand, the export quantity index excluding gold increased in the January-February period, yet geopolitical developments pose downside risks to exports. Against this backdrop, despite a slight narrowing in the first quarter of the year, the output gap still remains disinflationary (Table 7.1.1 and Chart 7.2.3).

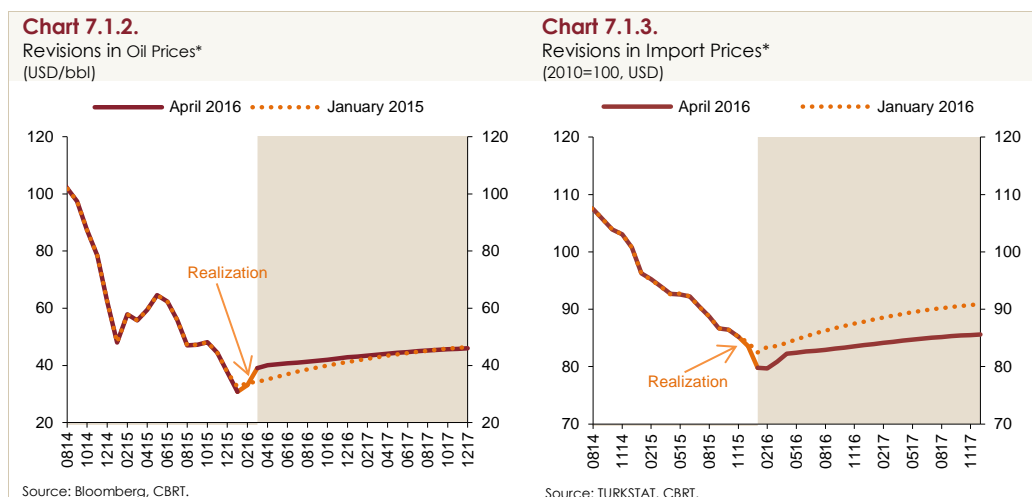
Economic activity and the aggregate demand are projected to grow a little stronger in the upcoming period in year-on-year terms. The support offered by the developments in employment and wages to consumption expenditures through the income channel as well as waning domestic uncertainties and expected financial recovery to be led by external conditions are likely to invigorate investment spending, which will be influential in growth. Meanwhile, downside risks to growth are mostly attributed to external demand. Geopolitical tensions and attenuating global growth have a retarding impact on exports, while downside risks to tourism revenues have recently grown evident. On the other hand, exports are stimulated by the rising demand from the EU amid Turkey's increased market share in the region. Given all these developments, the annual growth rate of the export-weighted global production index revised by January growth forecasts edged down slightly compared to the January Inflation Report figures (Chart 7.1.1).



### Oil, Import and Food Prices

Oil prices picked up in the inter-reporting period, whereas the downtrend in international commodity prices continued into the first quarter of 2016. Thus, compared to the January Inflation Report, assumptions for crude oil prices were revised upwards, while those for USD-denominated import

prices were revised downwards (Table 7.1.1). With regard to annual averages, the crude oil price assumption was raised from 37 USD to 40 USD for 2016. Also, assumptions for annual percentage changes in average import prices were revised downwards by 3.4 points for 2016. Food inflation saw a marked decline due to unprocessed food prices in the first quarter of 2016. However, given the high volatility in food prices, assumptions for food inflation were preserved as 9 percent for 2016 and 8 percent for 2017.



### Fiscal Policy and Tax Adjustments

The medium-term forecasts are based on an outlook that adjustments to taxes and administered prices will be consistent with inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2016-2018 period. Reverberations of the minimum wage rise at the start of 2016 on producer costs, aggregate demand and inflation are closely monitored.

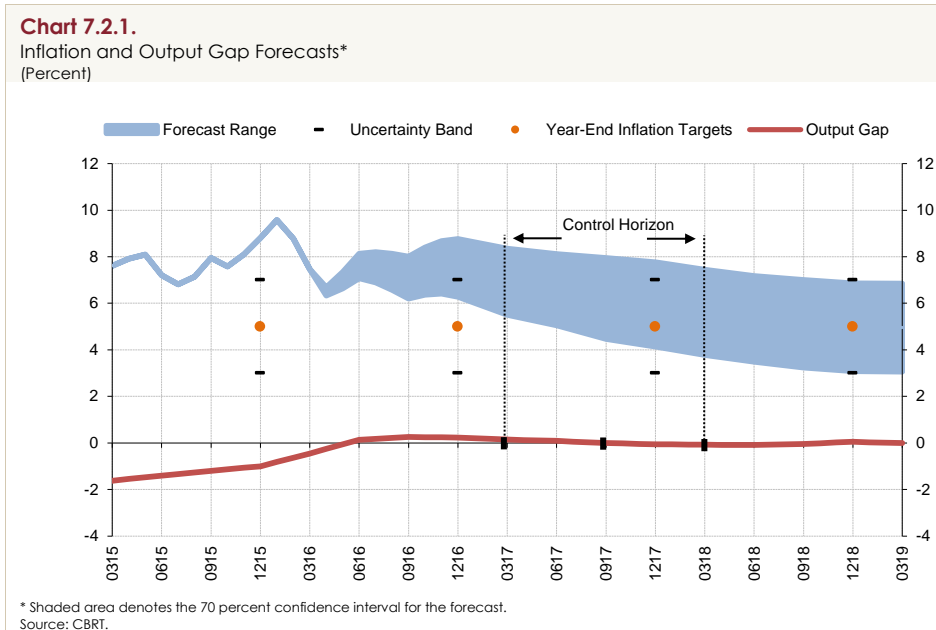
**Table 7.1.1. Revisions in Assumptions**

		January 2016	April 2016
Output Gap	2015Q4	-1.1	-1.0
	2016Q1	-0.6	-0.5
Food Prices (Year-end Percent Change)	2016	9.0	9.0
	2017	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2016	-5.5	-8.9
	2017	5.1	3.2
Oil Prices (Average, USD)	2016	37	40
	2017	44	45
Export-Weighted Global Production Index (Average Annual Percent Change)	2016	2.2 (2.0*)	1.8
	2017	2.3 (2.2*)	2.0

\* Forecasts after revisions on country basis.

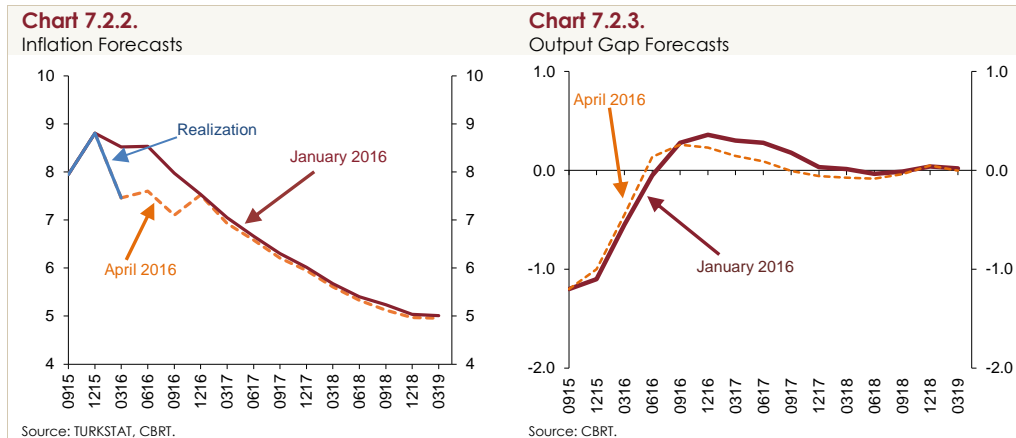
## 7.2. Medium-Term Forecasts

In view of the above economic conditions, policy stance and assumptions, inflation forecasts for the upcoming period are left unchanged from the previous Report. Given a decisive policy stance that focuses on reducing inflation, the 5-percent target is expected to be achieved gradually; inflation is likely to stabilize around 5 percent as of 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. Accordingly, inflation is expected to be, with 70 percent probability, between 6.3 percent and 8.7 percent (with a mid-point of 7.5 percent) at end-2016 and between 4.2 percent and 7.8 percent (with a mid-point of 6 percent) at end-2017 (Chart 7.2.1).

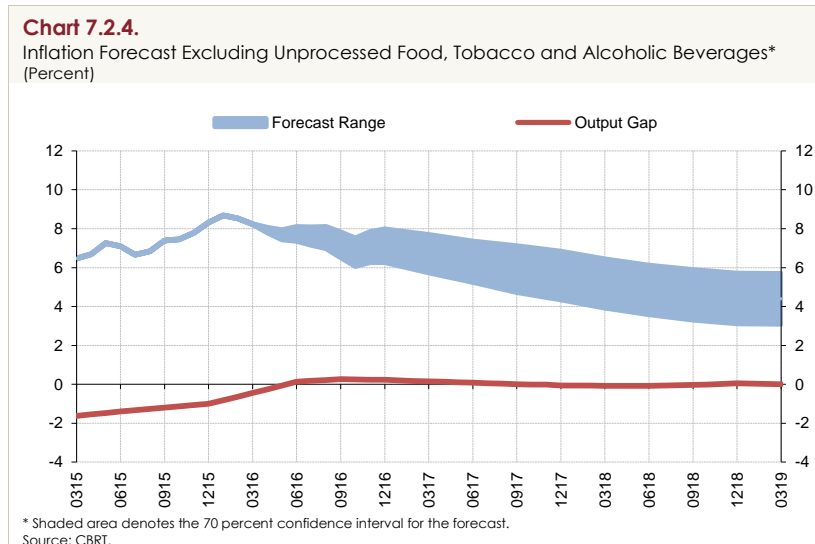


The Turkish lira maintained a steady pattern following the January Inflation Report, while oil prices inched up marginally and the USD-denominated import prices edged down slightly. Accordingly, TL-denominated import prices had no impact on inflation forecasts. Food prices are expected to drive consumer inflation down further in the short term. Rising later, mostly because of base effects, inflation is expected to follow a volatile course in the second half of 2016 and reach 7.5 percent at the end of the year. Given the unpredictability of food prices, assumptions for food inflation are preserved, yet it should be noted that food inflation poses downside risks to the year-end inflation forecast.

Excluding food price realizations, medium-term inflation forecasts have remained unchanged since the January Inflation Report (Chart 7.2.2). Output gap forecasts were subject to only a limited revision, and output gap values pertaining to this period were revised slightly upwards. (Chart 7.2.3). Likewise, the output gap forecasts for the rest of 2016 were revised slightly upwards compared to the previous reporting period.



Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food and tobacco, are among major factors that cause a deviation in inflation forecasts. Hence, inflation forecasts excluding unprocessed food and tobacco prices are also announced. Accordingly, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are presented in Chart 7.2.4. The inflation indicator as measured above is expected to decline gradually to 4.5 percent.



### Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents take the inflation target as a benchmark in their plans and contracts and focus on the underlying trend of medium-term inflation, rather than on temporary price fluctuations. Likewise, it is crucial that the CBRT's current inflation forecasts be compared with inflation expectations of other economic agents to serve as a reference guide. It should be noted that year-end, 12-month-ahead and 24-month-ahead inflation expectations of the Survey of Expectations'

respondents are above the CBRT's baseline scenario forecasts (Table 7.2.1). Despite a slight fall, 12-month-ahead inflation expectations hover above CBRT projections, which necessitates close monitoring of expectations and the pricing behavior.

**Table 7.2.2.**  
CBRT Inflation Forecasts and Expectations

	<b>CBRT Forecast</b>	<b>CBRT Survey of Expectations*</b>	<b>Inflation Target</b>
2016 Year-end	7.5	7.9	5.0
12-month-ahead	6.8	7.8	5.0
24-month-ahead	5.5	7.1	5.0

\* April 2016 survey period results.  
Source: CBRT.