

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

In the first quarter of 2014, the implementation of a gradual exit from quantitative easing in the US economy led to capital outflows from emerging economies with relatively weaker growth performance. The FCI for Turkey indicates tightness in financial conditions in the first quarter of the year (Chart 5.1). However, financial conditions are expected to ease slightly in the upcoming period amid improved global risk appetite, reduced domestic uncertainties and the reversal of the depreciation of the Turkish lira as of end-March.

Inflation

Consumer inflation increased to 8.4 percent in the first quarter of 2014, slightly overshooting the January Inflation Report forecasts. This was attributed to the depreciation of the Turkish lira, which particularly affected the core inflation indicators with relatively higher pass-through. Likewise, core inflation indicators also increased upon the uptrend in prices of services.

In the first quarter of the year, supply-side constraints due to unfavorable weather conditions and increases in the international prices of some products adversely affected the course of food prices. This negative development, which affected all the subcategories of food prices except for fresh fruits and vegetables, also led to an increase in inflation. Accordingly, the end-2014 assumption for the rate of increase in food prices, which was set as 8 percent in the January Inflation Report, was revised up to 9 percent. This revision brought the end-2014 inflation forecast up by about 0.3 percentage points.

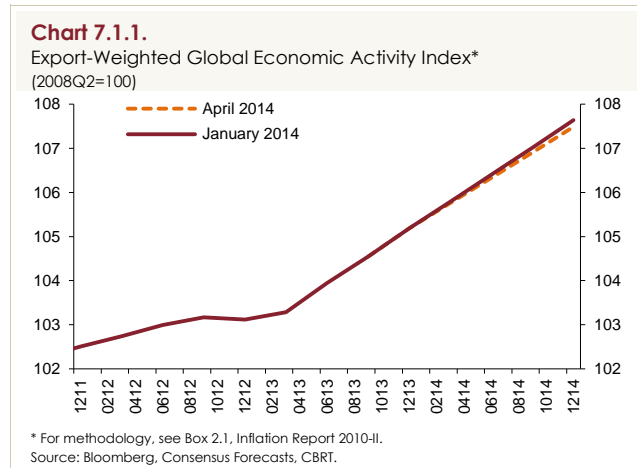
Table 7.1.1. Revisions to Assumptions

		April 2014	January 2014
Output Gap	2013Q4	-1.50	-1.50
	2014Q1	-1.40	-1.40
Food Prices (Year-end Percent Change)	2014	9.0	8.0
	2015-2016	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2014	0.5	0.0
	2015	0.1	-
Oil Prices (Average, USD)	2014	106	105
	2015	102	-
Export-Weighted Global Production Index (Average Annual Percent Change)	2014	2.3	2.4
	2015	2.6	-

Demand Conditions

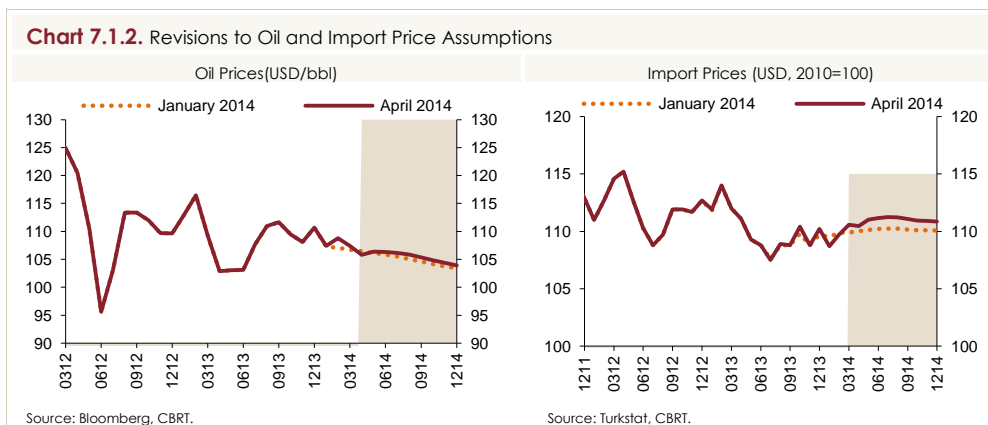
In the last quarter of 2013, economic activity was largely consistent with the outlook presented in the January Inflation Report. Accordingly, the output gap was kept unchanged for 2013 (Table 7.1.1). Seasonally adjusted data signaled a modest growth in economic activity in the second half of 2013. In the last quarter of the year, final domestic demand accelerated slightly amid rising public sector demand. Meanwhile, private consumption remained mild. The higher rate of quarterly growth of exports relative to imports in this period favorably affected the balancing of demand components.

Leading indicators for the first quarter of 2014 signal a slowdown in private sector demand. In the first half of the year, domestic demand is expected to follow a weak course amid domestic uncertainties and tightness in financial conditions. Meanwhile, net exports and public sector demand will support the domestic economic activity. On the external demand front, the export-weighted global economic activity index remained broadly unchanged from the previous reporting period, while expectations for recovery were maintained (Chart 7.1.1).



Import Prices

In the last quarter of the year, oil and import prices proved mostly consistent with the January Inflation Report forecasts (Chart 7.1.2). However, the assumption for the average oil price and the import price was revised slightly upwards for 2014 (Table 7.1.1). This revision brought the end-2014 inflation forecast up by 0.1 percentage points.



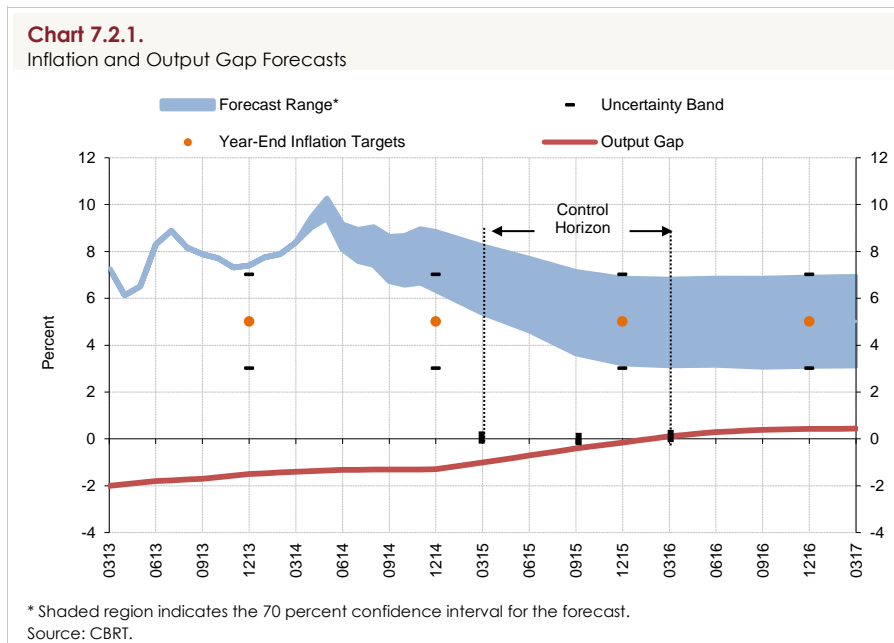
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with the inflation targets and automatic pricing mechanisms. Thus, the end-2014 inflation forecast has been subject to no revision stemming from the fiscal policy.

The medium-term fiscal policy stance is based on the MTP projections covering the 2014-2016 period. Accordingly, it is assumed that the cautious fiscal stance will be preserved and primary expenditures will be kept under control.

7.2. Medium-Term Outlook

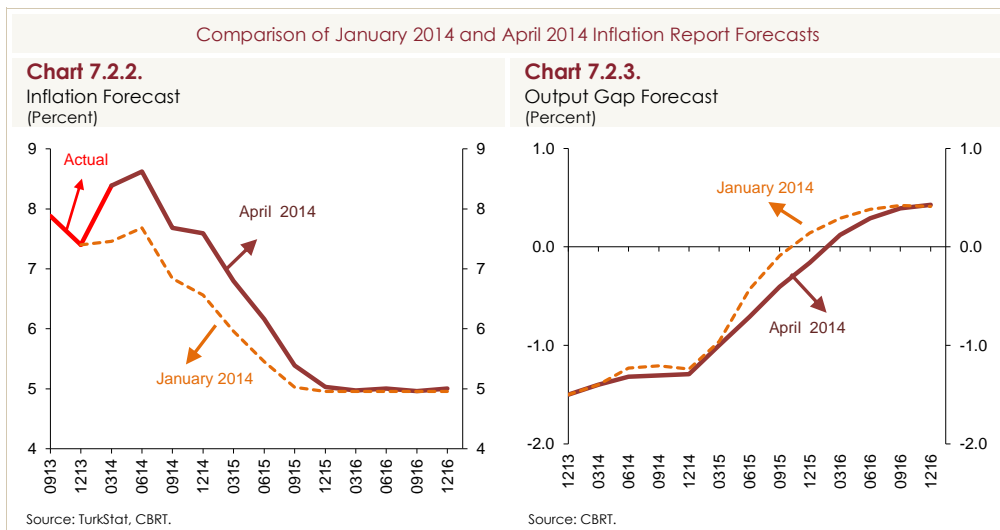
Medium-term forecasts are based on the assumption that the tight stance of the monetary policy will be maintained until the inflation outlook recovers significantly and the improvement in the risk premium indicators is sustained. Moreover, it is assumed that the annual loan growth rate will near 15 percent by the end of 2014 on the back of the adopted macro prudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.4 percent and 8.8 percent (with a mid-point of 7.6 percent) at end-2014 and between 3.2 percent and 6.8 percent (with a mid-point of 5 percent) at end-2015. Inflation is expected to stabilize around 5 percent in the medium term (Chart 7.2.1).



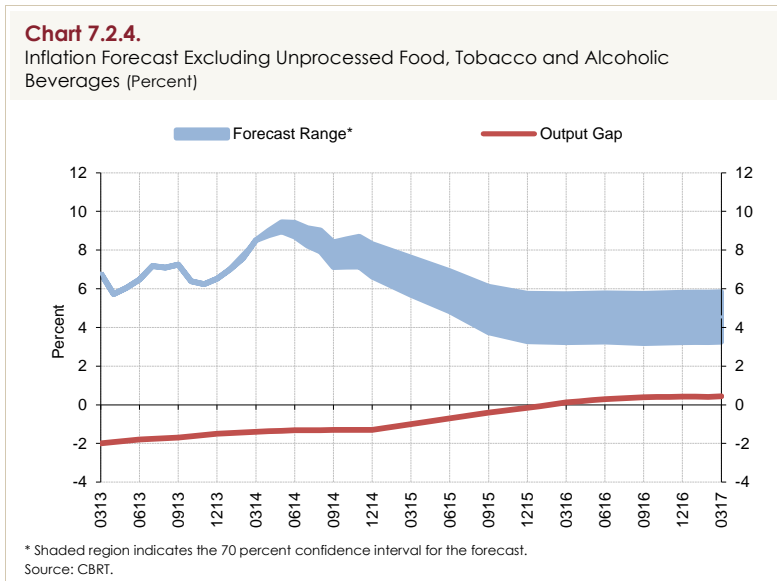
Annual inflation is expected to remain elevated for a while due to high food prices and the lagged effects of the depreciation of the Turkish lira, and considerably exceed the 5-percent target at year-end. On the back of reduced cost pressures from exchange rates, the favorable impact of the lagged effects of monetary tightening on inflation and the weakness of private demand conditions, inflation is envisaged to fall by the second half of the year to 7.6 percent at the year-end (Chart 7.2.1).

The end-2014 inflation forecast was revised upwards by 1 percentage point from the January Inflation Report. Of this revision, 0.3 percentage points stemmed from the higher-than-anticipated depreciation of the Turkish lira, and 0.1 percentage points from the slight upward revisions to import and oil price assumptions for 2014. The upward revision to food price inflation also drove the year-end forecast up by 0.3 percentage points. The relatively deteriorated pricing behavior compared with the previous reporting period is expected to add about 0.3 percentage points to year-end inflation via its effect on the underlying inflation trend.

Chart 7.2.3 presents revisions to the output gap forecasts, which were kept unchanged for the second half of 2013. Leading indicators signal a weaker private final domestic demand. Moreover, financial conditions are considerably tighter compared to the previous reporting period. Accordingly, domestic demand conditions are expected to have a slightly higher restraining effect on inflation in the near term. In this context, output gap forecasts have been reduced marginally for the second quarter of 2014 and onwards (Chart 7.2.3).



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 publicly 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 start a gradual fall by the second half of 2014 and stabilize around 4.5 percent in the medium term.



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 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. Accordingly, 12-month and 24-month-ahead inflation expectations of the Survey of Expectations' respondents are above the CBRT's baseline scenario forecasts (Table 7.2.1). Furthermore, the increase in inflation expectations in the inter-reporting period necessitates close monitoring of expectations.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2014 Year-end	7.6	8.1	5.0
12-month-ahead	6.6	7.2	5.0
24-month-ahead	5.0	6.6	5.0

* April 2014 survey period results.

** Calculated by linear interpolation of year-end inflation targets for 2014-2016.

Source: CBRT.

