7. Medium-Term Forecasts

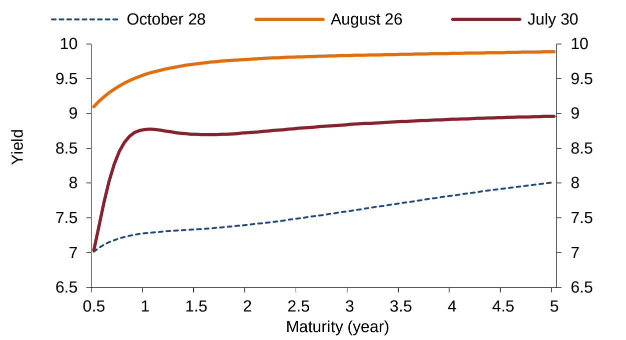
This chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Conditions

The yield curve shifted upwards in August due to heightened global uncertainty. However, the yield curve shifted back in October and declined across all maturities in the inter-reporting period (Chart 7.1.1). This was due to the limited correction in the global risk perception, the decline in Turkey's sovereign risk and the higher effectiveness of the CBRT's monetary policy strategy to alleviate interest rate uncertainty on short-term interest rates. During this period, the CBRT continued with a cautious stance to contain the adverse effects of the uncertainties regarding global monetary policy on the domestic economy.

Chart 7.1.1.
Yield Curve*
(Percent)



* Calculated from the compounded returns on bonds quoted in BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

Inflation

In the third quarter of 2013, annual consumer inflation went down to 7.9 percent, yet exceeded the July Inflation Report forecasts. This was attributed to the depreciation of the Turkish lira and the surge in unprocessed food prices. As a result, core inflation indicators increased as well.

The quarter-on-quarter decline in inflation is mainly attributed to the favorable course of unprocessed food prices. Having risen by around 13 percentage points in the second quarter, unprocessed food prices went down by about 10 percentage points in the third quarter of the year. In view of the possibly more limited slowdown in unprocessed food prices in the last quarter, the year-end food inflation forecast remained unchanged from the July Inflation Report at 7 percent.

Table 7.1.1.
Revisions to Assumptions

		July 2013	October 2013
Output Gap	2013Q2	-2.00	-1.80
	2013Q3	-2.10	-1.90
Food Price Inflation (Year-end Percent Change)	2013-2015	7.0	7.0
Import Prices (Average Annual Percent Change, USD)	2013	-1.3	-1.5
	2014	-1.7	-0.3
Oil Prices (Annual Average, USD)	2013	107	109
	2014	102	105
Export-Weighted Global Production Index (Average Annual Percent Change)	2013	1.2	1.2
	2014	2.4	2.3

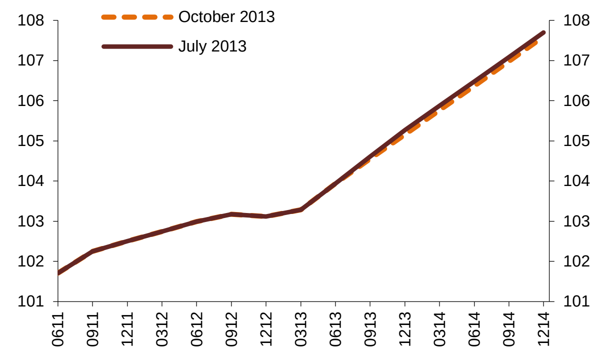
Demand Conditions

In the second quarter of 2013, economic activity was slightly more favorable than the outlook presented in the July Inflation Report. Domestic demand followed an almost flat course. In the meantime, imports surged, while exports increased only slightly due to weak global demand. The favorable course of the economic activity was driven by changes in inventories.

The third-quarter data indicate a relatively milder increase in the economic activity in this quarter. Production of consumption goods registered a quarter-on-quarter decline in the July-August period, while imports thereof remained on an upward trend. On the other hand, indicators signal a weaker outlook for investment than for consumption demand. Exports followed a horizontal course, while imports declined notably in this period. Hence, net exports are expected to contribute less negatively to growth in the third quarter of the year. The export-weighted global economic activity index remained broadly unchanged in the inter-reporting period (Chart 7.1.2).

The recovery of the final domestic demand is expected to continue with a mild course in the second half of the year. Accordingly, output gap forecasts for end-2013 were revised slightly upwards. On the other hand, downside risks to recovery mounted due to recent financial developments. Hence, output gap forecasts for end-2014 were revised downwards. In the period ahead, domestic demand developments are expected to support disinflation and the improvement of the current account deficit.

Chart 7.1.2.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)

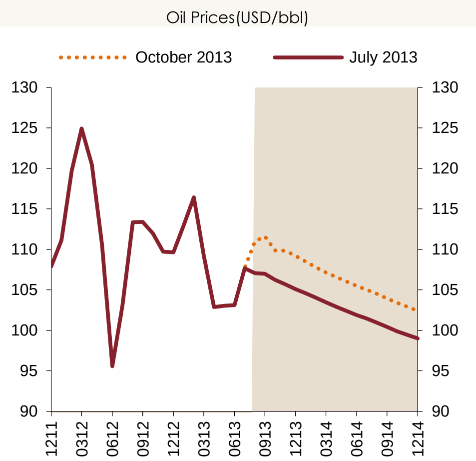


* For methodology, see Box 2.1, Inflation Report 2010-II.
Source: Bloomberg, Consensus Forecasts, CBRT.

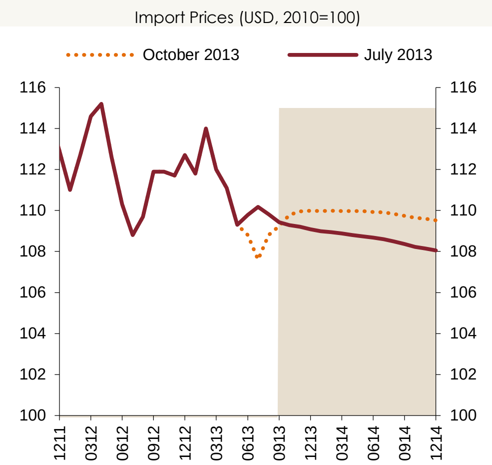
Import Prices

In the third quarter of the year, import prices remained below the July Inflation Report assumptions, while oil prices were slightly above forecasts (Chart 7.1.3). Accordingly, the average oil price assumption for 2013, which was set as 107 USD in the July Inflation Report, was revised upwards to USD 109 in line with the average futures price in the first three weeks of October (Table 7.1.1).

Chart 7.1.3.
Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.



Source: TurkStat, CBRT.

Fiscal Policy and Tax Adjustments

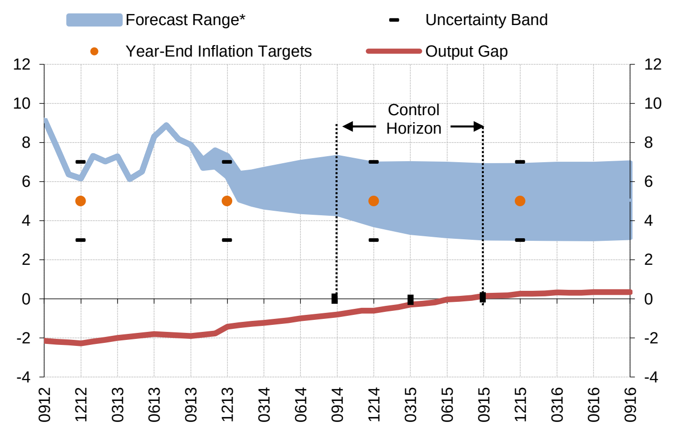
Medium-term projections are based on the assumption that no additional tax adjustments will be introduced to tobacco and energy products in the rest of the year. Meanwhile, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms. Thus, there has been no revision to the end-2013 inflation forecast stemming from the fiscal policy.

The medium-term stance of the fiscal policy is based on the recently revised MTP projections. Accordingly, it is assumed that the fiscal discipline will be maintained in the forthcoming period and the ratio of primary expenditures to GDP will decline gradually starting from the next year.

7.2. Medium-Term Outlook

Medium-term forecasts are based on an outlook where predictability of the monetary policy continues to be raised gradually. Furthermore, it is assumed that the liquidity policy will mostly be tight owing to the sustained cautious stance, and the annual growth rate of credit will fall to 15 percent by mid-2014 on the back of the adopted macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.3 percent and 7.3 percent (with a mid-point of 6.8 percent) at end-2013 and between 3.8 percent and 6.8 percent (with a mid-point of 5.3 percent) at end-2014. Inflation is expected to stabilize around 5 percent in the medium-term (Chart 7.2.1).

Chart 7.2.1.
Inflation and Output Gap Forecasts
(Percent)



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

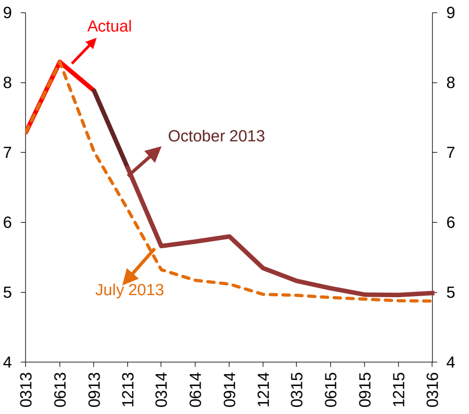
In sum, inflation forecasts for end-2013 and end-2014 were revised upwards by 0.6 and 0.3 percentage points, respectively, in the inter-reporting period (Chart 7.2.2). 0.4 percentage points of the revision to end-2013 inflation forecast was caused by exchange rate developments, while 0.1 percentage points stemmed from the rise in the average oil price assumption. Moreover, the output gap forecast, which was revised upwards on the better-than-expected growth outlook for 2013 than presented in the July Inflation Report, is expected to add 0.1 percentage points to the year-end inflation forecast. Developments in the exchange rate and oil prices were influential in the revision to the end-2014 inflation forecast. Taking into account the output gap forecasts, these cost-side factors are expected to push the end-2014 inflation forecast by 0.3 percentage points.

Although inflation is estimated to fluctuate in the short term due to the base effect on energy prices, it is expected to remain on a downward track (Chart 7.2.1). As the effects of the tobacco price hike in January 2013 on annual inflation taper off, inflation is expected to plunge in early 2014, and near the target-consistent levels by the last quarter of 2014.

Chart 7.2.3 presents revisions to the output gap forecasts. The second quarter data on national income are more favorable than the July Inflation Report forecasts. Hence, the output gap forecast for the second half of 2013 was revised upwards (Table 7.1.1). However, given the recent data, the output gap forecasts for 2014 were revised slightly downwards (Chart 7.2.3).

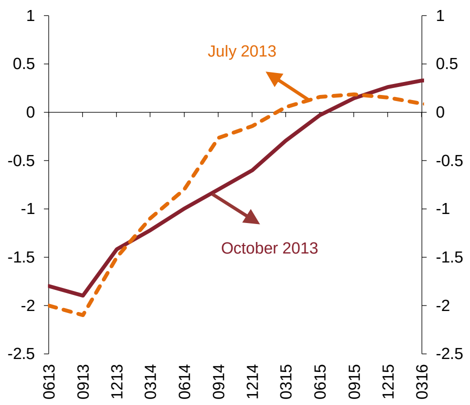
Comparison of July 2013 and October 2013 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast
(Percent)



Source: TurkStat, CBRT.

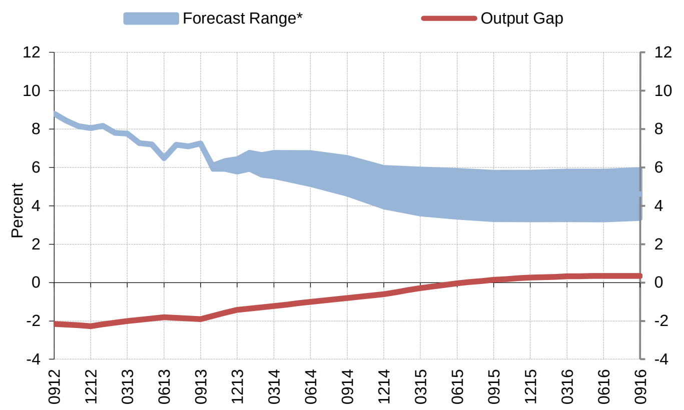
Chart 7.2.3.
Output Gap Forecast
(Percent)



Source: CBRT.

Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food and tobacco are among major factors to 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 decline in the last quarter mainly due to the base effect on energy prices. Inflation excluding unprocessed food, tobacco and alcoholic beverages is expected to stabilize around 4.5 percent in the medium term.

Chart 7.2.4.
Inflation Forecast Excluding Unprocessed Food, Tobacco and Alcoholic Beverages



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

Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents should take the inflation target as a benchmark in their pricing plans and contracts and focus on the underlying medium-term inflation, rather than temporary price fluctuations. Hence, 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's Inflation Forecasts and Expectations

	CBRT's Forecast	CBRT Survey of Expectations*	Inflation Target**
2013 Year-end	6,8	7,4	5,0
12-month ahead	5,6	6,6	5,0
24-month ahead	5,0	6,2	5,0

* October 2013, second survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2013- 2015.
Source: CBRT.

7.3. Risks and Monetary Policy

Financial markets have recently experienced heightened uncertainty mainly due to global monetary policies. This heightened uncertainty prompted re-pricing of all financial assets, including exchange rates, and the weight of emerging economies in global portfolio investments posted a decline. During this period, despite an absence of problems in external borrowing in the financial and non-financial sectors, portfolio items saw capital outflows and financial assets were re-priced in Turkey. Against this background, monetary policies adopted a cautious stance with a view to balancing macro financial risks and restraining the deterioration of the inflation outlook. In addition, predictability of the monetary policy was enhanced in order to contain the effects of global volatilities on the Turkish economy.

Both advanced and emerging economies might be favorably affected should uncertainties regarding global monetary policies diminish in the upcoming months. In that case, capital flows towards emerging economies are likely to re-accelerate. Materialization of such a scenario may prompt the CBRT to take steps towards accumulating foreign exchange reserves.

The probable aggravation of uncertainties regarding global monetary policies may bear consequences on global liquidity, capital flows and the pricing of financial assets. In that case, capital flows towards emerging economies are likely to remain weak, and this may pose a risk to the inflation outlook. Should such a scenario materialize, the CBRT may start implementing additional monetary tightening for longer periods to enhance price stability.

Other important factors that pose risks to inflation forecasts are food and energy prices. Assumptions regarding food prices were kept unchanged in the Inflation Report. However, the lower-than-anticipated correction in unprocessed food prices in the third quarter caused unprocessed food prices, which remained above historical averages in the first three quarters of the year, to pose an upside risk to the inflation outlook. Should unprocessed food prices remain elevated throughout the fourth quarter, the year-end inflation may materialize above our inflation forecast of 6.8 percent in the baseline scenario. Energy prices are assumed to maintain their relatively favorable course the rest of the year. However, cumulative effects of the depreciation of the Turkish lira and the international oil price developments pose an upside risk on administered energy prices, albeit limited.

Effects of rising core inflation indicators on the pricing behavior due to the recent volatility in exchange rates appear as an upside risk factor and are monitored closely. On the other hand, the mild course of the international commodity prices excluding oil and the limited recovery in economic activity are the leading downside risk factors on inflation.

In formulating its monetary policy strategy, the CBRT closely monitors developments on fiscal policy and tax adjustments with regard to their effects on the inflation outlook. Inflation forecasts presented in the baseline scenario take the framework outlined in the MTP as given. Accordingly, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices in the forthcoming period. A revision of the monetary policy stance may be considered, should the fiscal stance deviate significantly from this framework, and consequently, have an adverse effect on the medium-term inflation outlook.

Maintaining acautious stance in fiscal and financial sector policies is critical to maintainingthe resilience of our economy against global imbalances. Strengthening structural reforms that will ensure the sustainability of the fiscal discipline and reduce the savings deficit will support macroeconomic stability in the medium term. Steps taken in this regard will also provide more room for maneuvering the monetary policy and improve social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, implementation of the structural reforms outlined by the MTP remains to be of utmost importance.