3. Medium-Term Projections

3.1 Current State, Short-Term Outlook and Assumptions

Changes in Key Forecast Variables

Economic activity has been growing stronger on the back of demand, mainly domestic demand. In the fourth quarter, the services sector was the main driver of annual growth, while the industrial sector's contribution to annual growth was negative due to weaker external demand. Final domestic demand played a pivotal role in the last quarter of 2022, particularly through private consumption expenditures. In the first quarter of 2023, domestic demand remained strong despite the earthquake-induced effects. External demand also recovered compared to the previous quarter.

CPI and B-index inflation, which were 50.51% and 52.11% in the first quarter of 2023, respectively, continued to decline as expected, but remained above the forecast range presented in the previous Inflation Report. The decrease in energy and commodity prices, coupled with easing supply constraints, supported the fall in annual inflation. The stable course of the Turkish lira and the effects of the policy measures taken in the scope of the Liraization Strategy have also been influential in the downtrend in annual inflation. Accordingly, cost effects on domestic prices were in line with forecasts, except for services sectors where food prices are an input. Meanwhile, the rise in unprocessed food prices exceeded forecasts due to temporary supply-side effects in food markets. Amid wage revisions, accelerating public expenditures and loans due to the earthquakes led to stronger-than-expected monetary effects and in the first quarter of the year, aggregate demand conditions recovered more strongly than envisaged in the previous reporting period. The earthquake-induced supply-demand mismatches particularly in the housing market and disaster relief materials also played a role in the first-quarter inflation exceeding the forecasts presented in the previous Inflation Report (Table 3.1.1).

Table 3.1.1: Changes in Key Forecast Variables*

	2023-I
Consumer Inflation (Quarter-end, Annual % Change)	50.5 (45.6)
B Index Inflation (Quarter-end, Annual % Change)	52.1 (48.0)

* Figures in parentheses are from the previous Inflation Report.

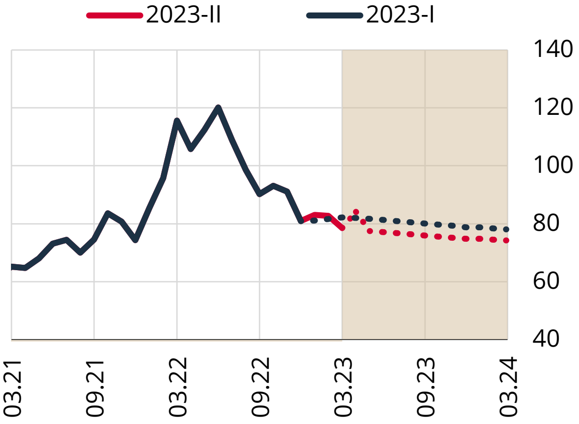
Assumptions on Exogenous Variables

Expectations for global growth and the outlook for external demand have improved compared to the previous reporting period, while uncertainty especially over the US growth has increased again. The recovery in global supply conditions and the easing of pandemic measures in China support global growth expectations and raise forecast averages. Although central banks of advanced economies continue to raise policy rates, regional financial fluctuations stemming from the banking sector have fueled expectations that current interest rate levels cannot be maintained on the market.

It is expected that the decline in global inflation will be gradual and the high levels will continue in 2023. Global growth, which has been recovering in a more widespread and more balanced manner than was expected compared to regional growth, accelerates the improvement trend in global supply conditions, re-balances supply-demand mismatches, leads to lower import prices through retreats in commodity prices and freight costs, and supports the deceleration in global inflation. Meanwhile, geopolitical risks may lead to temporary divergence and volatility in energy prices.

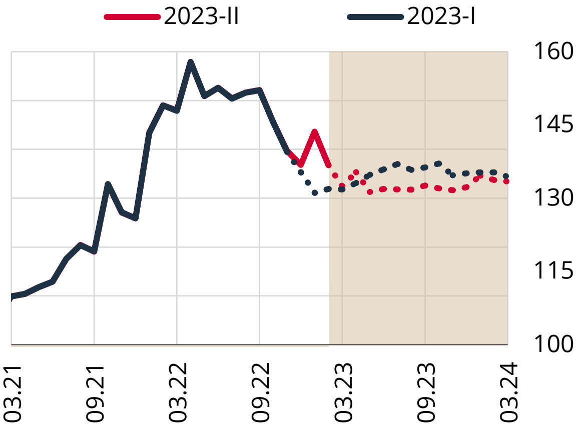
Commodity prices continue to decrease owing to accelerating improvement in global supply conditions. The favorable trend in stocks, particularly in Europe, and mild weather conditions have been influential in the decline in natural gas and coal prices. Oil prices continued to decline, albeit with some volatility due to the revision in production plans (Chart 3.1.1). As for import prices, the limited rise observed in January due to gold and energy prices remained temporary, and the downtrend was maintained. Assumptions for oil and import prices presented in the previous Report have been revised downwards based on our forecasts of a faster-than-expected easing in supply constraints in the upcoming period (Chart 3.1.2).

Chart 3.1.1: Revisions in Oil Price Assumptions* (USD/bbl)



Source: Bloomberg, CBRT.
* Shaded area denotes the forecast period.

Chart 3.1.2: Revisions in Import Price Assumptions* (Index, 2015=100)



Source: CBRT, TURKSTAT.
* Shaded area denotes the forecast period.

Assumptions for food prices for 2023 have been revised upwards. Annual inflation in food and non-alcoholic beverages decreased to 67.9% at the end of the first quarter. In this period, despite the ongoing decline in global food prices, the uptrend in food prices continued due to supply shortages and supply problems in Turkey. The rise in prices of red meat, eggs and related products was mainly driven by temporary supply-side factors. While expectations for an agricultural drought have put pressure on food prices, these risks have eased thanks to the increase in precipitation in recent months. Moreover, cost-side factors on food prices have weakened owing to the favorable outlook particularly in energy prices. On the other hand, measures towards ensuring price stability in the food market are expected to strengthen. Thus, it has been assumed that food inflation would display a significant decline in the upcoming period and become more aligned with the global food prices outlook, come down to 27.9% at the end of 2023 and 11.5% at the end of 2024 (Table 3.1.2).

Table 3.1.2: Revisions in Assumptions*

	2023	2024
Export-Weighted Global Production Index (Annual Average % Change)	1.6 (1.3)	2.4 (2.5)
Oil Prices (Average, USD)	78.1 (80.8)	73.6 (77.3)
Import Prices (USD, Annual Average % Change)	-9.8 (-8.5)	0.4 (2.3)
Food Prices (Year-End % Change)	27.9 (22.0)	11.5 (11.5)

* Numbers in parentheses are from the previous Inflation Report.

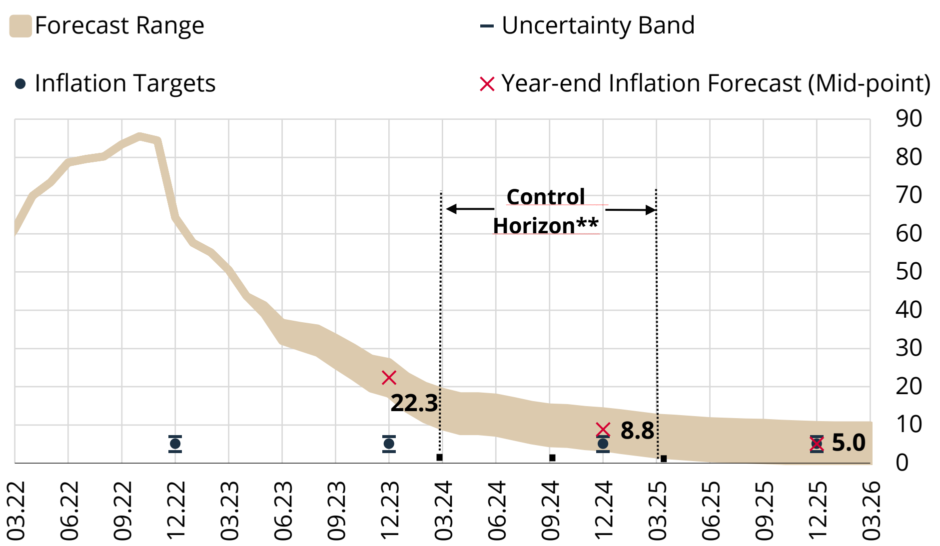
3.2 Medium-Term Outlook

Inflation is projected to be 22.3% at the end of 2023, to fall to 8.8% at the end of 2024 and sustain the downtrend by receding to 5.0% by the end of 2025. Key assumptions underlying the forecasts are based on the downtrend in commodity prices. Moreover, it was assumed that the stronger-than-expected recovery in global growth would be more evenly distributed, and thus, supply constraints and import prices would display a faster normalization compared to the previous reporting period. Assumptions were based on an outlook where the decline in commodity prices as well as tourism revenues and external demand conditions that are expected to be stronger in the second half of the year, will have a favorable impact on the current account deficit. In addition to the favorable course of the current account deficit, the framework envisages that the stability of the Turkish lira will be preserved through the effective utilization of the Liraization Strategy with its targeted loan, liquidity and diversified reserve management and the elements of the liraization targets. Accordingly, the improvement in expectations, which will be rapidly adapted to the decline in the inflation rate, is expected to support the disinflation process.

While revising inflation forecasts, the intermediate target nature of the forecasts was taken into account, and the forecasts are based on an outlook in which monetary policy as well as the policy instruments regarding all structural issues related to pricing behavior are used in line with the projected decline in inflation. *The forecasts were built upon a monetary outlook* in which financial conditions as well as the growth rate, composition and purpose of loans as a result of the reinforced implementation of the targeted loan policy would be consistent with the projected disinflationary process. A framework was envisaged in which integrated economic policies will be effectively implemented to strengthen this process. Other factors assumed to affect prices were transparency and competition in prices would be enhanced, measures towards ensuring price stability in food markets would be prioritized, the rate of increase in rents would decline, the public fiscal balance would be kept at a level consistent with disinflation, and incentives in administered prices, particularly in energy prices, would be reflected on prices.

Accordingly, with 70% probability, inflation is expected to be between 18.1% and 26.5% (with a mid-point of 22.3%) at end-2023; between 4.0% and 13.6% (with a mid-point of 8.8%) at end-2024; and come down to the medium-term target of 5% at the end of 2025 and stabilize thereafter (Chart 3.2.1).

Chart 3.2.1: Inflation Forecasts (%)



Source: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.
** The control horizon denotes the period elapsed between a change in monetary policy and the final impact observed on inflation.

Table 3.2.1: Revisions in Year-End Inflation Forecasts 2023 and Sources of Revisions

	2023
2023-I IR Forecast (%)	22.3
2023-II IR Forecast (%)	22.3
Forecast Revision as Compared to the 2023- I	0.0
Sources of Forecast Revision (% Points)	
Import Prices	-2.3
Output Gap	0.2
Food Prices	1.5
Forecast Deviation and Inflation Trend	0.6

Source: CBRT.

The end-2023 inflation forecast was kept unchanged at 22.3%. Compared to the previous reporting period, the revision due to import prices lowered the inflation forecast by 2.3 percentage points. Administered prices are assumed to reverse the increase in the first quarter, mainly due to the assumptions for natural gas and electricity tariffs, thus, the end-year inflation forecast has not been affected through this channel. Stronger-than-expected demand conditions pushed inflation forecasts up by 0.2 points. Food prices raised inflation forecasts by 1.5 points due to realizations. The positive impact of the deviation from the forecast will be offset by the correction in the underlying trend amid continued stability in the Turkish lira, and the impact of financial conditions and holistic policies that will support the disinflation process. The combined effect of the deviation and the underlying trend led to a 0.6 percentage point rise in forecasts (Table 3.2.1).

Forecasts are based on an outlook in which global economic activity recovers and global inflation remains high despite a slight slowdown. Leading indicators suggest that the slowdown in the global economic activity outlook continues, albeit at a more favorable pace than in the previous reporting period. Growth forecasts for Türkiye's top export partners for 2023 have been revised slightly upwards compared to the previous reporting period due to stronger-than-expected growth in Europe. The downside risks to global economic activity posed by concerns over energy supply have been easing. Leading indicators for global growth and its distribution suggest that supply conditions have been improving. There are also factors that are stabilizing global demand, which proved to be more resilient than expected despite the vulnerabilities in banking sectors of advanced economies.

It was assumed that the monetary policy stance would contribute to real and financial conditions so as to support the disinflation process. The decisions were based on a framework in which instruments to support the effectiveness of the monetary transmission mechanism will be used decisively in line with the main principles and objectives stated in the Monetary Policy and Liraization Strategy for 2023 and effects of imbalances that may be caused by the earthquake disaster will be minimized. Accordingly, short-term interest rates as well as targeted loan and liquidity policies will boost production and export capacity, and directly support the disinflationary process through the supply channel. Meanwhile, these policies will indirectly support the disinflationary process through FX markets to the extent that these policies support export capacity. It will be ensured that the growth rate, composition and utilization areas of loans remain consistent with targeted loan policies and the disinflation process. Moreover, it is expected that the diversified reserve and liquidity management will contribute to healthy price formation in FX markets and support the disinflationary process through expectations and cost channels via long-term interest rates.

The targets set for liraization are expected to contribute to the stability in exchange rates and affect pricing behavior favorably. The 60% liraization target set for deposits in the first half of 2023 stated in the Monetary Policy and Liraization Strategy for 2023 and the conversion rate targets introduced in April are expected to lead to a permanent rise in the banking sector's Turkish lira share in both assets and liabilities. Meanwhile, thanks to the liraization process, the stable course of exchange rates is expected to continue and the recent improvement in pricing behavior is expected to accelerate. In addition, credit developments, which are closely monitored to be consistent with economic activity, are expected to support a balanced monetary growth and the decline in the underlying trend of inflation during the liraization process.

Policies aimed at supporting the rise in export capacity are expected to make a greater contribution to maintaining the stable course of FX markets and the disinflationary process. Favorable financing resources to be provided to productive sectors through targeted loan policies are expected to support both the production and investment environment and increase the share of technological investments in total investments, thereby raising labor productivity and contributing further to the current account balance in the upcoming period. Moreover, the recovery in external demand mainly stemming from Türkiye's major trade partners and the moderate course of energy and commodity prices in line with expectations are expected to have a favorable impact on the current account balance. In the rest of the year, the current account balance is envisaged to support the supply in FX markets and contribute to the stable course of exchange rates.

In line with inflation expectations, the gradual decline in the underlying trend of inflation is projected to continue. Continued stability in exchange rates, easing adverse effects of supply constraints, and the moderate course of energy and commodity prices have been reducing cost pressures. The contribution of the diversification of reserve resources as well as the liraization process to the stability in the FX market and the improvement in expectations is higher compared to previous years.

Forecasts are based on an outlook in which holistic economic policies are implemented to strengthen monetary transmission and the disinflation process. The domestic food inflation is assumed to better reflect the downtrend in global food and agricultural input prices as a result of a more effective supply management in food markets. Forecasts reflect an external balance outlook in which the normalization in gold imports observed in high-frequency data will continue throughout the year, consumption import demand will partly decline, while travel revenues will increase, and exports will remain strong. It was assumed that the effectiveness of the steps taken to increase price transparency and competition will increase, measures to mitigate the effects of supply shocks on house prices and rents will strengthen, and wage revisions will be consistent with the disinflation process.

3.3 Key Risks to Inflation Forecasts and Possible Impact Channels

The possibility of vulnerabilities in the banking sector of advanced economies turning into broader financial risks may have both positive and negative effects on current forecasts. Although unlikely, a financial risk-driven contraction in advanced economies may affect prices positively by accelerating the decline in commodity prices, while it could affect prices negatively through exchange rate volatility.

Global inflation remains high despite some slowdown. Headline inflation in advanced economies declined in the current reporting period. However, the persisting rigidity in the core inflation rate continues to exert pressure on monetary policies and global financial conditions.

The improvement in global supply conditions, energy price-driven risks not materializing in Europe in winter and China's opening up policy have led to an improvement in expectations for the global growth outlook for 2023 compared to the previous reporting period. Improved expectations for global growth pose an upside risk to forecasts through the external demand channel. Meanwhile, despite the improvement in the global growth outlook, industrial commodity prices have recently declined owing to easing supply constraints and partly due to the vulnerabilities in financial markets. The continued moderate course of commodity prices poses downside risks to inflation forecasts through the import prices channel.

The likelihood that strong domestic demand will continue poses upside risks to inflation forecasts through the current account balance. The impact of strong domestic demand on imports keeps the risks on the current account balance in place. Moreover, the effects of supply-demand imbalances caused by the earthquake on inflation through the current account balance channel are closely monitored. Meanwhile, the recent acceleration in gold imports has been one of the main drivers of the rise in the current account deficit. The course of imports of consumption goods will be monitored as a risk factor for forecasts. However, the role that Türkiye can play in regional energy distribution and the increase in the share of domestic energy resources involve supportive effects on the current account balance.

The growth rate of credits and the appropriate utilization of the accessed funds in economic activity are important for achieving sustainable price stability. Credit developments, particularly personal loans, which increase consumption demand and are not consistent with the objective of increasing the supply potential, pose upside risks to forecasts.

Administered prices as well as general and minimum wage adjustments that exceed the projected path pose risks to pricing behavior. It is critical that the decline in the underlying trend of inflation and inflation expectations remain consistent with forecast assumptions. The coordination and complementarity of monetary and fiscal policies will have a significant impact on inflation throughout 2023. Moreover, maintaining fiscal discipline despite the earthquake-induced increase in public expenditures and acting prudently in moderating wage increases are important for anchoring pricing behavior.