7. Medium-Term Projections

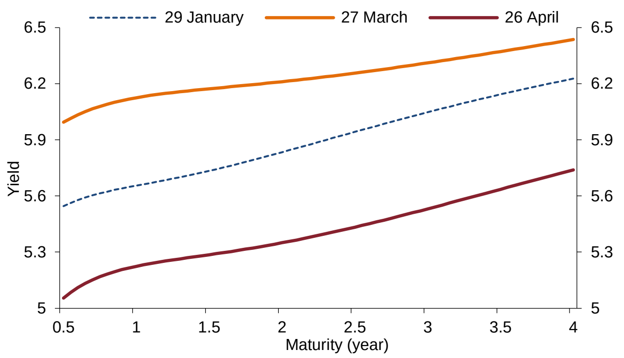
This Chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Conditions

In the first quarter of the year, market rates followed a fluctuating course amid the volatility in the risk appetite. Following the publication of the January Inflation Report, yield curve shifted upwards on deteriorated risk appetite due to heightened uncertainty in the Euro Area. On the other hand, capital inflows accelerated amid the quantitative easing package announced by BoJ. Furthermore, the lowering of short-term policy rates by the CBRT as well as favorable developments regarding risk perceptions about Turkey also supported the fall in market rates. As a result, yield curve displayed a limited decline across all maturities in the inter-reporting period (Chart 7.1.1).

Chart 7.1.1.
Yield Curve*



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

Inflation

Annual consumer inflation went up to 7.29 percent in the first quarter of 2013, thus surpassing the projections presented in the January Inflation Report. This was mainly attributed to increases in unprocessed food prices, which were below seasonal averages as well as price hikes to alcoholic beverages and tobacco products. The reduced support from exchange rate to disinflation and the relatively robust domestic demand restricted the deceleration in core inflation in this period. Meanwhile, the underlying trend of service prices increased, albeit modestly. Amid higher-than-expected realization of core inflation indicators, the initial point of the inflation forecast was slightly revised upwards, thus adding 0.2 points to year-end inflation forecast.

Unprocessed food prices remained above the January Inflation Report forecasts in the first quarter of 2013. This was mainly driven by the higher-than-envisioned rises in the seasonally adjusted unprocessed food prices, which slumped in the last quarter of 2012. In the first quarter of the year, fresh fruit and vegetable prices registered a record-high first-quarter rise by 42 percent. Nonetheless, taking into account of the volatility in unprocessed food prices, the year-end food price inflation assumption was kept unchanged at 7 percent from the January Inflation Report.

Table 7.1.1.
Revisions to 2013 Assumptions

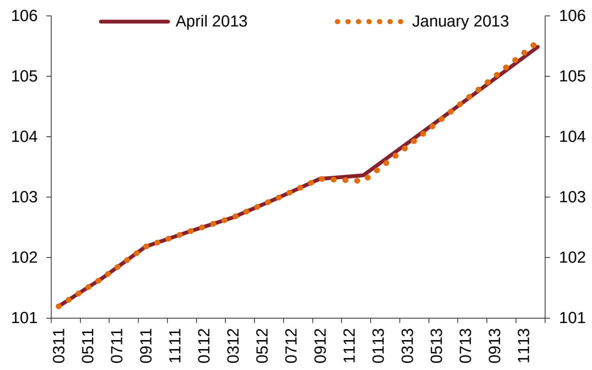
		April 2013	January 2013
Output Gap	2012Q4	-2.27	-2.17
	2013Q1	-2.00	-1.96
Food Price Inflation (Year-end Percent Change)	2013-2015	7.0	7.0
Import Prices (Average Annual Percent Change, USD)	2013	-1.4	-0.2
Oil Prices (Annual Average, USD)	2013	103	108
Export-Weighted Global Production Index (Average Annual Percent Change)	2013	1.6	1.7

Demand Conditions

In the last quarter of 2012, the economic activity presented a slightly weaker outlook than presented in the January Inflation Report. This was caused by the contraction in private demand for investment and consumption. Net exports remained robust, thereby fuelling the economic growth.

The first quarter data for 2013 signal for recovery of the economic activity. The production and imports of consumption and investment goods in January and February as well as hovering of total loans above the previous year's average indicate that domestic demand has started to recover. However, global growth is expected to stay weak. The ongoing global economic uncertainties, albeit at a slower pace, remains to be a critical factor to restrict economic recovery. Accordingly, output gap forecast for end-2013 was revised down slightly, while forecast remained virtually unchanged throughout the year.

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

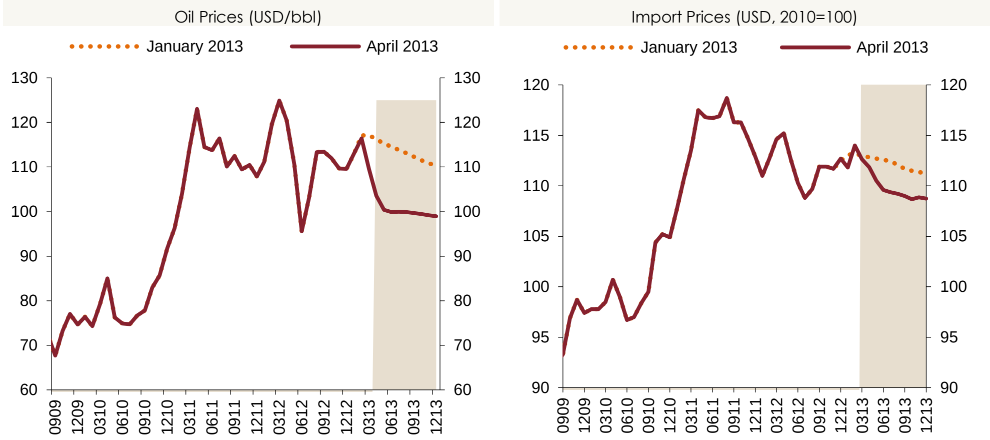


* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

Import Prices

In the first quarter of 2013, international oil prices remained broadly in line with the January Inflation Report assumptions (Chart 7.1.3). However, oil prices declined in April on account of the US employment data signaling no permanent recovery, expectations for an extended period of contraction in the Euro Area in 2013, the lingering of US crude oil inventories and the expectation for the current production level to be maintained in OPEC countries. Accordingly, the average oil price assumption, which was determined to be USD 108 in the January Inflation Report, was revised down to USD 103 in line with forward oil prices in April 2013 (Chart 7.1.1). These revisions pulled down the year-end inflation forecast by 0.2 points.

Chart 7.1.3.
Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.
Source: TurkStat, CBRT.

Fiscal Policy and Tax Adjustments

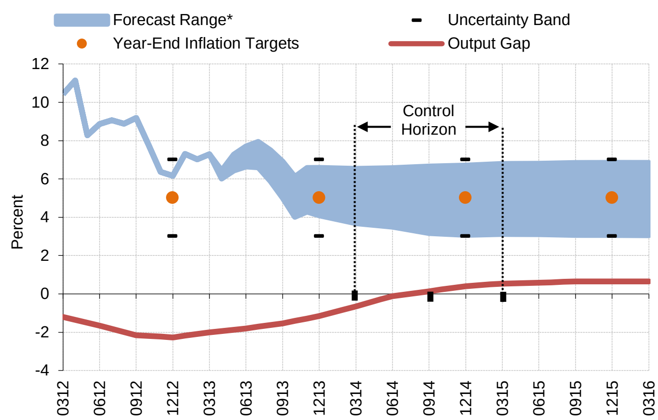
Medium-term projections are based on the outlook that tobacco and energy products will be exposed to no additional tax adjustments in the remaining of the year. Furthermore, projections are based on the outlook that other tax adjustments and administered prices are assumed to be consistent with the inflation targets and the automatic pricing mechanisms.

The fiscal stance is based on MTP projections. Accordingly, fiscal discipline is assumed to be maintained and primary expenditures to GDP ratio is expected to remain broadly unchanged in the forthcoming period. Hence, there has been no change in end-2013 inflation forecast stemming from the fiscal policy.

7.2. Medium-Term Outlook

Medium-term forecasts are based on the outlook where potential risks due to the recent surge in capital inflows are contained. In other words, assumptions are based on the outlook where policy rates are kept low and macro prudential measures remain in place. In this respect, annual loan growth rate is assumed to hover around 15 percent. Accordingly, inflation is expected to be, with 70 percent probability, between 4.1 percent and 6.5 percent (with a mid-point of 5.3 percent) at end-2013; and between 3.1 percent and 6.7 percent (with a mid-point of 4.9 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



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

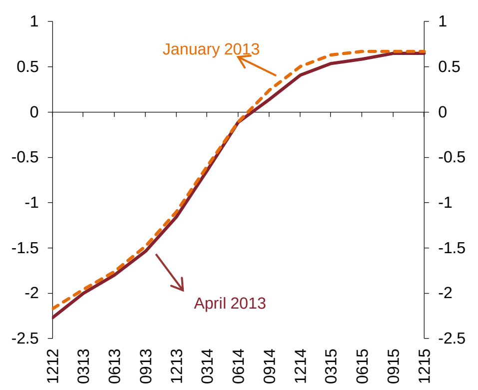
Inflation is expected to slump in April due to the base effect driven by high energy prices in the last year. Inflation is expected to increase over the following quarter also due to base effect in energy prices. This increase is expected to be temporary, thus inflation is expected to head downwards as of August, reaching down to 5.3 percent at the year-end (Chart 7.2.1).

Chart 7.2.2 presents revisions to output gap forecasts. Output gap forecasts are slightly revised downwards in the inter-reporting period due to the weaker-than-expected national accounts data for the last quarter of 2012 (Table 7.1.1). However, the recent data signal a mild recovery in the first quarter. Hence, output gap forecasts are kept virtually unchanged for the remaining of the year (Chart 7.2.2).

Inflation remained above January Inflation Report forecasts due to soaring unprocessed food prices in the first quarter. In the inter-reporting period, the year-end food price inflation forecast remained constant, while food price inflation is revised slightly upwards for the short term, thereby causing an upward revision to inflation in the short term (Chart 7.2.3). Meanwhile, global economic slowdown and the commodity price outlook contain upside risks to inflation. Hence, the year-end inflation forecast was kept unchanged at 5.3 percent as presented in the January Inflation Report forecasts.

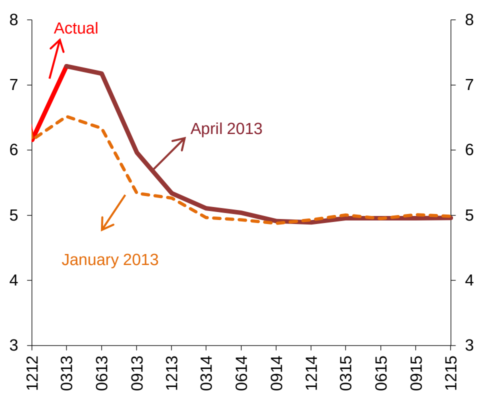
Comparison of January 2013 and April 2013 Inflation Report Forecasts

Chart 7.2.2.
Output Gap Forecast



Source: CBRT.

Chart 7.2.3.
Inflation Forecast

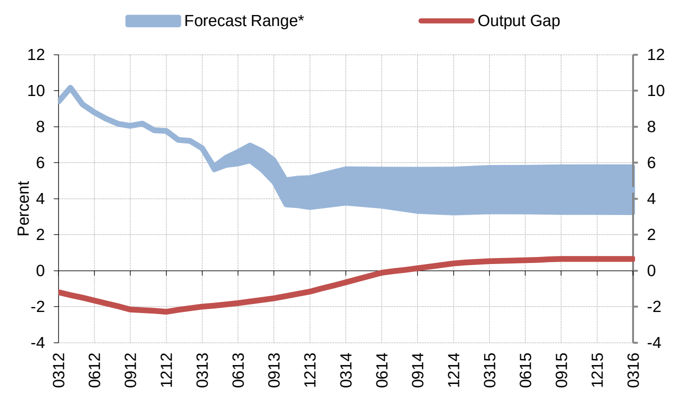


Source: TurkStat, CBRT.

The currently robust pace of credit growth necessitates further use of macro prudential measures. In view of the effect of domestic demand and credits on the pricing behavior, it is critical that credit growth should stay close to the reference value determined by the CBRT for the year-end inflation realization to be close to the target as envisaged. Accordingly, forecasts are based on a policy stance where macro prudential measures are sustained on one hand, and policy rates are kept low against accelerating capital flows on the other hand.

Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food and tobacco are among major factors to cause deviation in inflation forecasts. Hence, inflation forecasts excluding unprocessed food and tobacco are publicly announced. Accordingly, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are presented in Chart 7.2.4. Except for the envisioned rise in the second quarter of 2013 due to base effect, inflation indicator as measured above is expected to follow a downward course throughout the year. Inflation is expected fall rapidly as of the second half of the year. 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: TurkStat, CBRT.

Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents, being aware of the temporary factors, should focus on the underlying medium-term inflation, and therefore, take the inflation target as a benchmark in their pricing plans and contracts. In this respect, to serve as a reference guide, the CBRT's current inflation forecasts should be compared to inflation expectations of other economic agents. Accordingly, year-end inflation expectations as well as 12-month and 24-month ahead inflation expectations of the Survey of Expectations' respondents are slightly above our baseline scenario forecasts (Table 7.2.1). Furthermore, the year-end inflation expectation increased by 0.3 points in the inter-reporting period, thus requiring close monitoring of expectations.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2013 Year-end	5.3	6.6	5.0
12-month ahead	5.1	6.1	5.0
24-month ahead	5.0	5.9	5.0

* April 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

Developments in the first quarter of the year highlight the ongoing fragility in the global economy. During this period, data regarding global economy did not diplay a stable outlook, whereas economic policy uncertainty in advanced economies has continued. The policy framework designed by the CBRT and the instruments developed in this respect provide a flexible framework to contain the adverse impact of the global shocks on the domestic economy.

Capital inflows have re-accelerated in the recent period. Improved perceptions regarding Turkish economy and the monetary expansion package announced by the Bank of Japan suggest that portfolio flows may continue to exhibit a strong pattern in the forthcoming period. The possibility of further inflows of capital as well as weak global demand has the potential to increase macro financial risks through a deterioration in external balance. Should this scenario materialize, the CBRT will continue to keep short term interest rates at low levels, while tightening through reserve requirements and ROM.

On the other hand, the ongoing uncertainty regarding Euro Area suggests that risk appetite may continue to be volatile. Given the quantitative easing packages implemented by advanced economies, the impact of the fluctuations in the risk appetite on capital flows may even increase in the forthcoming period. Although the ROM plays a stabilizing role against possible shocks, ongoing uncertainties regarding the global economy and the volatility in capital flows necessitate the monetary policy to remain flexible in both directions. Therefore, the impact of the recent measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely, and the funding amount will be adjusted in either direction as needed.

On the other hand, monetary policy may normalize in advanced economies, should the measures taken towards the solution of problems regarding the global economy be completed sooner and more decisively than envisaged. Materialization of such a risk may require a tightening using all policy instruments, since it would lead to a faster than expected rise in aggregate demand and import prices.

The baseline forecasts in the Report suggest that keeping inflation close to the target without a deterioration in the external balance would require a mild increase in the domestic demand along with a reasonable growth rate of credit. However, it is likely that the domestic demand and credit may display a stronger course than envisaged. Recently, the gradual easing in financial conditions indicates upside risks regarding credit growth. The CBRT will closely monitor the developments in the domestic demand and credit, and take the necessary measures to prevent a deterioration in the pricing behavior using the instruments at its disposal.

The assumption regarding food prices was kept unchanged in the baseline scenario. However, the volatile course of unprocessed continues to pose risks regarding inflation outlook. The CBRT will not respond to volatility in unprocessed food prices, yet will deliver the necessary tightening should this lead to a persistent increase and a deterioration in the pricing behavior. On the other hand, the recent slowdown in global demand and developments regarding commodity prices offset the upside risks arising from food prices.

The CBRT monitors fiscal policy developments and tax adjustments closely, with regard to their effects on the inflation outlook. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. In this respect, it is assumed that fiscal discipline will be sustained and there will be no unanticipated hikes to administered prices. A revision in 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.

Prudent fiscal and financial sector policies are crucial for preserving the resilience of our economy against existing global imbalances. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the savings deficit would support macroeconomic stability in the medium term. This will also provide more flexibility for monetary policy and improve social welfare by keeping interest rates of long-term government securities persistently at low levels. In this respect, implementation of the structural reforms envisaged by the MTP remains to be of utmost importance.