3. Medium-Term Projections

3.1 Current State, Short-Term Outlook and Assumptions

Changes in Key Forecast Variables

Economic activity lost momentum in the third quarter of 2022 due to the weakening in foreign demand. The main driver of annual growth in the third quarter was the services sector, while the contribution of the industrial sector to growth remained limited due to weak foreign demand. In the last quarter of the year, domestic demand was relatively strong but external demand conditions weakened, which indicates that the slowdown in growth continued.

Having ended the fourth quarter of 2022 at 64.3% and 57.7%, respectively, CPI and B index inflation remained within the forecast range presented in the October Inflation Report. Inflation continued to decline in the fourth quarter driven by the fall in energy and commodity prices, easing supply constraints, the stable course of the Turkish lira, and the policy measures taken as part of the Liraization Strategy. In this period, the Turkish lira maintained its stable course on the back of the effects of policy measures introduced as part of the Liraization Strategy. In addition, data for the last quarter of the year suggest that aggregate demand conditions somewhat lost strength due to weakening foreign demand, as projected in the October Inflation Report. Against this background, inflation was in line with the October Inflation Report projections in the last quarter of the year (Table 3.1.1).

Table 3.1.1: Changes in Key Forecast Variables*

	2022-III	2022-IV
Consumer Inflation (Quarter-end, Annual % Change)	83.5 (83.4)	64.3 (65.2)
B Index Inflation (Quarter-end, Annual % Change)	74.6 (74.6)	57.7 (58.1)

* Numbers in parentheses are from the October Inflation Report.

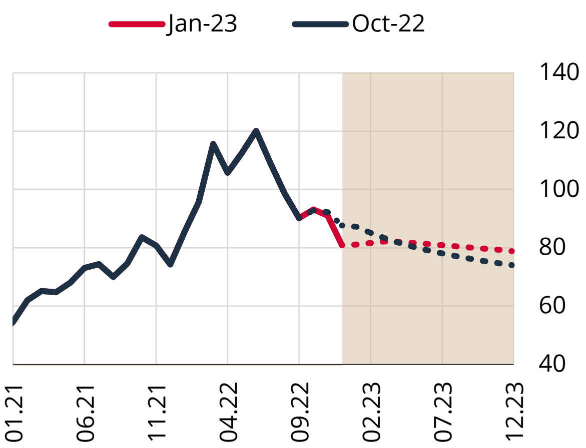
Assumptions on Exogenous Variables

Tightening steps of central banks had an impact on the global demand outlook, and geopolitical risks continued to restrict economic activity. On the other hand, easing of pandemic measures in China had positive implications for the global demand outlook. The Export-Weighted Global Growth Index was revised downwards for 2023 compared to the previous reporting period due to tightening global financial conditions and geopolitical risks (Table 3.1.2).

The elevated levels of global inflation and the tight financial conditions are expected to continue for most of the year 2023. With supply-demand mismatches starting to decrease on the back of the ongoing improvement in supply conditions, the decline in global freight costs, the fall in commodity prices, and the state support for preventing price increases, global inflation is expected to cease its upward trend but still remain elevated. On the other hand, there have also emerged expectations in the markets that the rate-hike cycles will end soon. Accordingly, the global risk appetite is projected to increase slightly.

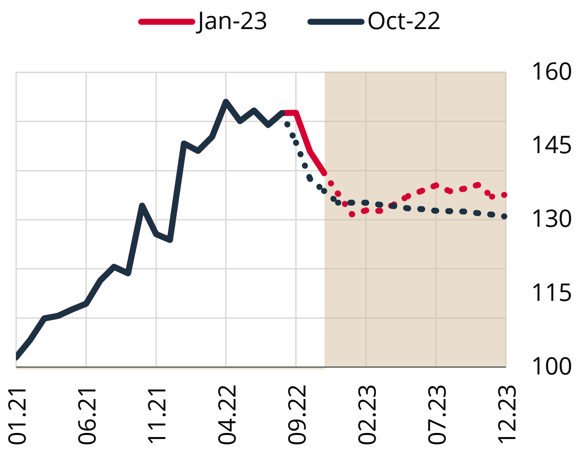
Commodity prices maintain their downward trend in line with the improvement in supply conditions and the weak global demand conditions. Also supported by favorable weather conditions in Europe, the weak demand suppressed natural gas prices and also caused oil prices to decline. Nevertheless, oil price expectations for 2023 have been revised slightly upwards for the end of 2023 based on the projection that geopolitical risks will continue to dominate the global oil supply (Chart 3.1.1). Although similar dynamics are also at play for the general level of import prices, industrial commodity prices were revised slightly upwards taking into account the demand-side effects of easing pandemic measures in China (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.

Food price assumptions for 2023 have been kept unchanged. Annual inflation in food and non-alcoholic beverages dropped to 77.9% by the end of 2022. This decline was driven by the supply-boosting effect of the grain corridor as well as reduced volatility in exchange rates and the fall in freight costs. It is assumed that food prices will continue to decrease in the upcoming period and food inflation will end the year 2023 at 22% (Table 3.1.2).

Table 3.1.2: Revisions in Assumptions*

	2022	2023	2024
Export-Weighted Global Production Index (Annual Average % Change)	3.3 (3.0)	1.3 (1.8)	2.5 (-)
Oil Prices (Average, USD)	99.8 (100.5)	80.8 (79.3)	77.3 (-)
Import Prices (USD, Annual Average % Change)	26.7 (25.2)	-8.5 (-9.2)	2.3 (-)
Food Prices (Year-End % Change)	77.9 (75.0)	22.0 (22.0)	11.5 (-)

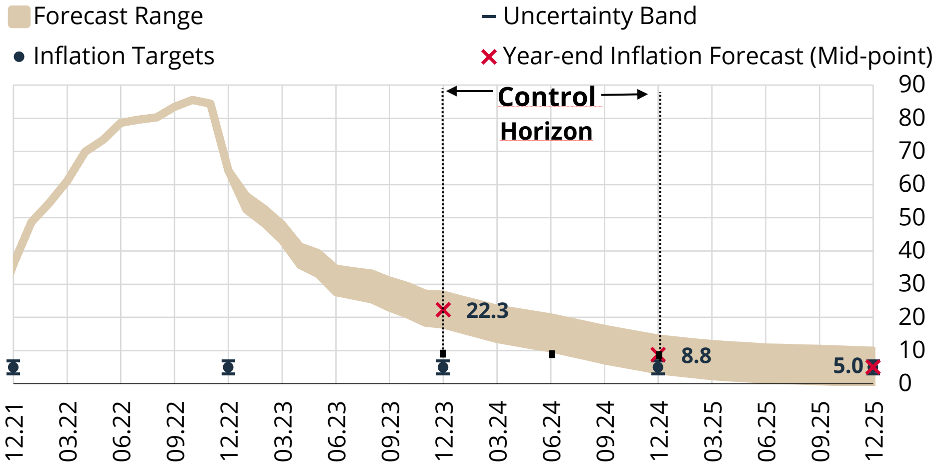
* Numbers in parentheses are from the October Inflation Report.

3.2 Medium-Term Outlook

The monetary policy stance is determined in line with the primary objective of achieving sustainable price stability, taking into account the continuity of supply, the growth, composition and purpose of loans, the components of the current account balance, and healthy price formations in the foreign exchange market. In this framework, as a result of the evaluations based on the increased risks regarding global demand, the policy rate was lowered to 9% in November. Moreover, the effectiveness of the monetary transmission mechanism continued to be supported by reinforcing the macroprudential policy set for collateral and liquidity management, and loans. Meanwhile, in order to increase the Turkish lira's weight in the financial system, the liraization target for deposits was set at 60% for the first half of 2023, and some changes were made in the securities maintenance practice in February. The decisions were based on an outlook in which policies will be pursued decisively in line with the main principles and objectives stated in Monetary Policy and Liraization Strategy for 2023.

Inflation is projected to be 22.3% at the end of 2023, fall to 8.8% at the end of 2024 and sustain the downtrend by receding to 5.0% by the end of 2025. Inflation Report forecasts, which are intermediate targets, have been maintained at the levels of the previous Report. The key assumptions underlying inflation and other forecasts are consistent with the projections of the previous Report. It is projected that the slowdown in the global economic activity will continue in the first half of 2023, and the recently observed moderate course in commodity prices, particularly in energy prices, is expected to continue in the upcoming period. The policy mix implemented under the Liraization Strategy is expected to support the structural demand for the Turkish lira. In addition, the forecasts have been based on an outlook in which targeted loan and interest rate policies will establish monetary stability, reinforce monetary transmission, continue to support potential supply via the financing cost channel and contribute positively to the supply/demand balance. Accordingly, the improvement in the pricing behavior and inflation expectations observed during the forecast period is projected to continue. Accordingly, with a 70% probability, inflation is expected to be between 17.8% and 26.9% (with a mid-point of 22.3%) at end-2023, between 4.0% and 13.7% (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.

Year-end inflation forecasts for end-2023 and end-2024 have been kept unchanged at 22.3% and 8.8%, respectively. End-2022 CPI and B-index inflation were 64.3 and 57.7%, respectively, within the forecast range presented in the previous Report. The moderate course in energy and commodity prices continues as projected in the previous Report. Moreover, no significant revision has been made to assumptions for 2023 and onwards. Accordingly, taking into account the effects of the current policy stance and strengthened macroprudential measures, inflation forecasts for 2023 and 2024 have been maintained.

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

	2023
2022-IV (October 2022) Forecast (%)	22.3
2023-I (January 2023) Forecast (%)	22.3
Forecast Revision as Compared to the 2022-IV	0.0
Sources of Forecast Revision (% Points)	
Import Prices	+0.1
Administered Prices	-0.2
Unit Labor Costs	+1.5
Underlying Inflation Trend and Expectations	-1.4

Source: CBRT.

The year-end inflation forecast for 2023 has been kept unchanged at 22.3%. Compared to the previous reporting period, the update stemming from the import prices increased the inflation forecast by 0.1 points. Administered prices, mainly due to assumptions for natural gas and electricity tariffs, have driven year-end inflation expectations down by 0.2 points. Meanwhile, unit labor costs increased expectations by 1.5 points due to wage increases in 2023. The improvement already observed and likely to be observed in the underlying trend of inflation and expectations led to a 1.4 point-decline in forecasts (Table 3.2.1).

Forecasts are based on an outlook in which global economic activity slows down, global inflation remains elevated albeit at a slightly slower pace, and global financial conditions slightly improve compared to the previous reporting period. Leading indicators point to a continued slowdown in global economic activity. However, year-end growth forecasts for 2022 for Türkiye's top export destinations were revised slightly upwards compared to the October Inflation Report as realizations for the third quarter were stronger than implied by leading indicators. However, the slowing effects of geopolitical developments, risks to energy supply, and financial conditions on global economic activity have started to become more pronounced. Accordingly, global growth forecasts for 2023 have been revised downwards compared to the previous reporting period. The decrease in supply chain disruptions and the recent moderate course of international commodity prices moving in tandem with global demand developments are expected to continue in the upcoming period.

At a time marked by elevated likelihood of a global recession and geopolitical risks, supporting supply potential by reducing domestic financial costs is important with respect to the monetary policy strategy. Reducing domestic financing costs stands out as an important factor to contain the adverse effects of these risks on industrial production and employment as well as on structural gains achieved in production and investment capacity. With the decisions taken towards this aim, the effectiveness of the monetary policy transmission mechanism has been strengthened. As a result, it is predicted that the share of investment and export credits in commercial loans will further increase in the upcoming period. Moreover, favorable financing costs and targeted loan policies are expected to contribute to the sustainability of the strength of the supply potential in the medium term.

The targets introduced for Liraization are expected to contribute to the stability in exchange rates and affect pricing behavior positively. The 60% target set for Turkish lira deposits in the first half of 2023 is expected to boost the weight of Turkish lira in the banking sector's liabilities. Meanwhile, in tandem with the liraization process, the stable course in exchange rates is expected to continue and the recent improvement in pricing behavior is expected to accelerate. In addition, efforts are being made to keep credit developments in line with economic activity, which is expected to contribute more efficiently to monetary stability during the liraization process and to support the decline in the underlying trend of inflation.

Policies to boost investment, employment, production and export capacity as well as the improvement in the current account balance are expected to contribute further to maintaining the stable course in FX markets and the disinflation process. The projected slowdown in external demand increases risks to the current account balance. On the other hand, the moderate course of energy and commodity prices, which are in line with expectations, is expected to have a favorable impact on the current account balance. In the upcoming period, targeted loan policies are expected to make a greater contribution to the current account balance by supporting the production and investment environment and also raising labor productivity by increasing the share of technological investments in total investments. Targeted loan policies are also important for maintaining the structural gains achieved in exports and investment capacity.

It is projected that the gradual decline in inflation expectations and the underlying trend of inflation will continue. Stable exchange rates, waning adverse effects of supply constraints, and continued moderate energy and commodity prices reduce cost pressures. With the liraization process, exchange rates and credit markets are expected to stabilize and the improvement in the current account balance is expected to contribute to disinflation via the expectations channel.

3.3. Key Risks to Inflation Forecasts and Possible Impact Channels

Underlying trend indicators of producer prices suggest that the weakening trend in cost pressures continues. Recently, supply chain disruptions have been easing and transportation costs have been decreasing. Moreover, the global demand outlook and effective policies implemented by Turkey regarding the supply sustainability of critical products help international commodity and natural gas prices follow a more moderate course. These developments have been containing cost pressures. However, drought keeps upside risks to food prices and inflation alive. Meanwhile, China's opening-up policy and geopolitical developments pose upside risks to commodity prices.

The effects of volatility and tightening in financial conditions, geopolitical risks and concerns over the pandemic continue to create uncertainty and increases downside risks to the global growth outlook for 2023. This outlook poses downside risks to inflation via import prices and the demand channel.

The possibility of a faster-than-expected decline in external demand and an earlier-than-expected increase in domestic demand pose upside risks to inflation via the current account balance. Nevertheless, there are three factors potentially offsetting the risks to the current account balance. The first is the role that Türkiye can play in regional energy distribution, as was the case in grain supply, and the increase in the share of domestic energy sources. The second is that thanks to the supportive nature of the policy mix for supply continuity, Türkiye can substitute for the potential energy-based production losses in Europe, as has been the case for some time. The third factor is that a deeper-than-anticipated slowdown in global demand could support the current account balance through domestic demand and global commodity prices.

The continued deceleration trend in economic activity poses a downside risk to inflation. Meanwhile, the course of the share of sustainable components in growth composition will be closely monitored. There will be a strong correlation between the effectiveness of targeted loan policies and the disinflation process.

The recent improvement in supply constraints and transportation costs and the moderate course of commodity prices have eased the pressure on global inflation. However, the possibility of a slower-than-expected improvement in core indicators continues to weigh on financial conditions.

In the current Report period, global financial conditions have relatively improved and the risk appetite has partially recovered. Türkiye's risk premium also declined significantly. This outlook alleviates pressures on exchange rates and has a downward impact on forecasts.

In the upcoming period, economic conditions and problems in advanced economies are more likely to diverge. Therefore, policy uncertainties may pose additional risks to global economic activity and financial conditions. All possible scenarios are closely monitored.

Price hikes beyond those implied by upward adjustments in the general wage level also pose risks to the overall pricing behavior. It is crucial that the decline in the underlying 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.