7. Medium-Term Projections

This Chapter gives information about the CBRT's recent monetary policy strategy and the related policy decisions. Furthermore, it 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 three-year horizon.

7.1. Recent Monetary Policy Decisions

The CBRT, with a view to minimizing the risks against price stability and financial stability, has been implementing a policy mix of low policy rate, wide interest rate corridor and high reserve requirement ratios since November 2010, given the global and domestic economic climate.

Lagged effects of cumulative increases in import prices led to a gradual and envisioned increase in core inflation indicators in the second quarter. MPC stated that this increase was due to a relative price change in tradable goods rather than a deterioration in the general pricing behavior, and hence, secondary effects are yet to be observed. In this context, considering the slowdown in economic activity and the uncertainties in the global economy, policy rate and TL required reserve ratios were kept constant since the previous reporting period. Moreover, invigorating the emphasis on global risks at the July meeting, the MPC stated that all policy instruments may be eased should problems in advanced economies intensify and lead to contraction in domestic economic activity.

The mounting concerns in the second quarter regarding sovereign debt problems across some European countries as well as global economic growth adversely affected the risk appetite and capital flows to emerging economies, also including Turkey. In view of these developments, the daily amount to be purchased via FX auctions was reduced to USD 30 million from USD 50 million in May and in June. Towards the end of July, FX buying auctions were suspended in order to monitor the effects of the decisions taken by the EU pertaining to solve the sovereign debt problems.

Lastly, in July, in order to extend the maturity structure of the banking sector liabilities, foreign exchange required reserve ratios were decreased for long-term liabilities, while they were kept unchanged for liabilities with maturities less than one-year.

7.2. Current State of the Economy, Short-Term Outlook and Assumptions

First-quarter GDP data were consistent with our projections in the April 2011 Inflation Report, and economic activity in this period remained robust, despite a quarter-on-quarter slow down. Domestic demand, and in particular the private sector demand, continued to be the main driver of economic growth in this period. Against the weak course of exports, imports continued to boost, leading to further negative contribution of net external demand to growth. Thus, the divergence between the paces of recovery in domestic and external demand became more pronounced in this period. Employment conditions continued to improve displaying a better outlook compared to the previous reporting period, and unemployment rate returned to its pre-crisis level in the first quarter of 2011.

Consumer prices, which went up by 1.83 percent in the second quarter of 2011, increased by 6.24 percent on annual basis. This increase is consistent with the April Inflation Report projection that the base effects stemming from food price movements will determine the course of inflation, and in this respect, the annual inflation will increase in the second quarter of 2011. Furthermore, lagged effects of the cumulative increases in TL-denominated import prices were also influential in second-quarter rise in inflation. While the annual rate of increases in core inflation indicators went up in this period, the seasonally adjusted trends indicated a slowdown.

Food prices recorded a rise in the second quarter in line with the projections in the April Inflation Report. This rise is attributable to the increase in unprocessed food prices, mainly fresh fruits and vegetables. Moreover, processed food prices also posted hikes owing to the price increases in fats and oils parallel to the domestic and international price developments. In short, 1.3 points of the quarter-on-quarter increase of 2.25 points in consumer inflation in the second quarter stemmed from food inflation.

The surge in producer prices amid the rises in imported input prices continued in the second quarter of 2011 as well. Despite the relatively flat course of international oil prices compared to the end of the first quarter, domestic fuel prices went up due to the depreciation of the Turkish lira. Reverberations of the high course of international commodity prices besides the depreciation of the Turkish lira on core goods prices continued in this quarter.

Table 7.2.1.
Revisions to 2011 Assumptions

	April 2011	July 2011
Food Price Inflation (Year-end Percent Change)	7.5	7.5
Processed Food	7.0	7.0
Unprocessed Food	8.0	8.0
Import Prices (Average Annual Percent Change)	16.2	15.4
Oil Prices (Average Annual, USD)	115	115
Export-Weighted Global Production Index (Average Annual Percent Change)	2.60	2.51

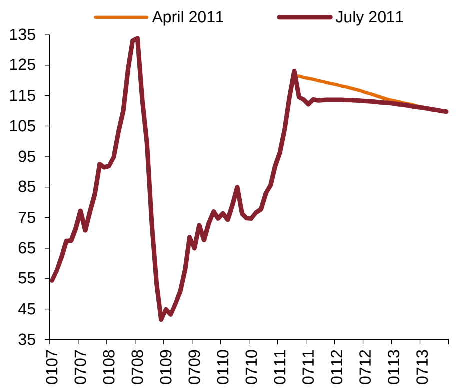
Given the high volatility in unprocessed food prices and the developments in agricultural commodity prices, food inflation projection for 2011 was maintained as 7.5 percent. Accordingly, the assumption for unprocessed and processed food inflation at end-2011 is maintained at 8 percent and 7 percent, respectively (Table 7.2.1).

In the April Inflation Report, with reference to future prices for commodities, oil prices were assumed to be 115 USD/bbl for 2011 and onwards, and import prices were assumed to increase by an average 16.2 percent year-on-year. Although crude oil prices remained slightly below 115 USD/bbl in the second quarter, considering the data for the first half of July, crude oil price assumption was kept unchanged at 115 USD/bbl for 2011 and onwards. Other commodity prices remained high, despite a limited decline in the second quarter. In view of the futures prices, import prices are assumed to record an average increase by 15.4 percent in 2011 (Chart 7.2.1) Thus, the contribution of oil and other commodities to inflation forecasts remained unchanged compared to the previous reporting period.

The rise in tariffs on imports of fabrics and apparels at various rates across country groups is supposed to put an upward pressure on clothing prices. This rise is expected to be effective as of the new season, and thus raise inflation in the last quarter.

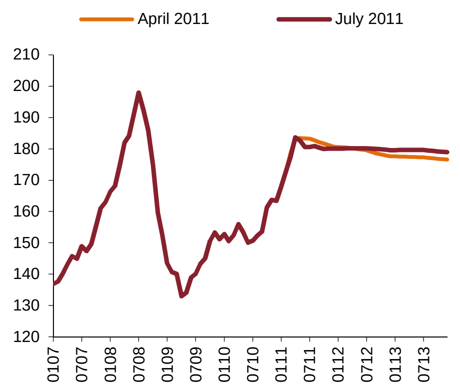
Chart 7.2.1.
Revisions to Oil and Import Price Assumptions

Oil Prices (USD/bbl)



Source: Bloomberg, CBRT.

Import Prices (2003=100)

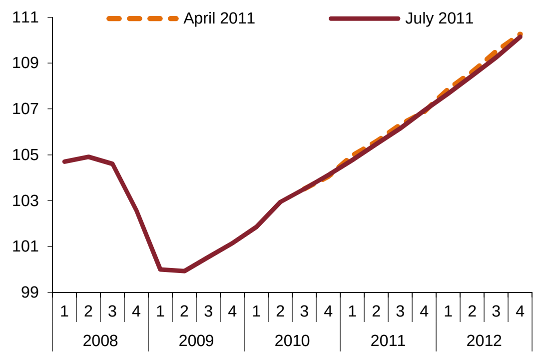


Source: TurkStat, CBRT.

Second-quarter data exhibit a quarter-on-quarter slowdown in the robust increase in domestic demand. Seasonally adjusted industrial production has decreased for four consecutive months starting from February. Given the lagged effects of the policy measures as well as the global slowdown, domestic demand is envisioned to follow a milder course in the second half of the year. Indices constructed by aggregating selected leading economic indicators also point to a similar outlook (Chart 4.1.10).

External demand remains weak. The possibility of a spillover of the Greek debt crisis to other European countries, the slowdown in the U.S. economic recovery and the weak course of the Japanese economy in the aftermath of the earthquake led to a contraction in the global economic activity in the second quarter. An overall outlook for 2011 suggests that despite the decline in growth expectations for the U.S. economy, growth forecasts for the euro area, our main trading partner, were slightly revised upwards. In this context, projections for export-weighted global growth index for Turkey posted no significant change. Therefore, baseline scenario forecasts were based on the assumption that external demand would recover slowly and gradually, and no significant revision was made for the external demand outlook compared to the previous reporting period (Chart 7.2.2).

Chart 7.2.2.
Export-Weighted Global Economic Activity Index*
(2009Q1=100)



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

In sum, while inflation rose in the second quarter as envisaged, economic activity lost pace due to poor external demand outlook. In this respect, starting point of the output gap was slightly revised downwards. Medium-term outlook for factors affecting inflation remained unchanged.

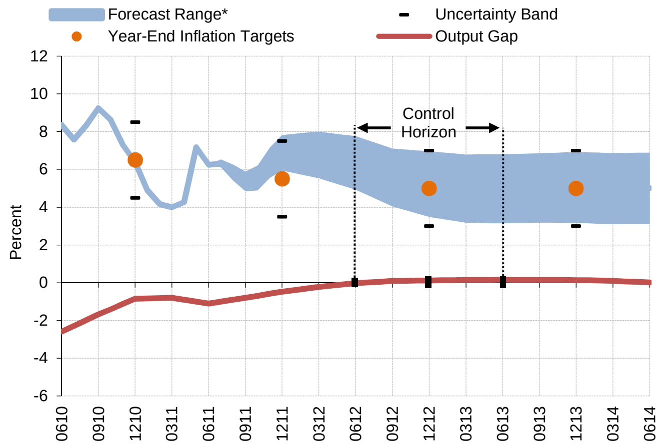
In building medium-term inflation forecasts within the inflation targeting regime, the CBRT uses not only policy rates, but also, required reserve ratios and other liquidity management tools. In this process, the impact of the policy mix on monetary and financial conditions are observed mainly through the credit channel. Thus, while presenting inflation forecasts, certain assumptions on credit growth are also made. In this context, medium-term projections are based on the assumption that the rate of increase in credits would largely slow down in the upcoming period due to the tightening effects of the ongoing monetary and fiscal policies besides the reverberations of the measures on consumer loans taken by the BRSA.

Lastly, inflation forecasts are based on the assumption that a majority of the revenues obtained within the law on restructuring of the public claims would be used to lower public debt, and hence, fiscal policy would be tightened in the upcoming period. Forecasts are based on an outlook of a limited fall in the ratio of primary expenditures to GDP besides an ongoing rise in the ratio of public debt to GDP and insignificant changes in risk premiums. Moreover, tax adjustments are expected to be consistent with inflation targets and automatic pricing mechanisms.

7.3. Medium-Term Outlook

Against this background and assuming that credit growth rate declines to 25 percent at end-2011 and the policy rate will be kept unchanged until the year end, inflation will be, with 70 percent probability, between 5.9 and 7.9 percent with a mid-point of 6.9 percent at end-2011, and between 3.5 and 6.9 percent with a mid-point of 5.2 percent at end- 2012. Inflation is expected to stabilize around 5 percent in the medium term (Chart 7.3.1).

Chart 7.3.1.
Inflation and Output Gap Forecasts*



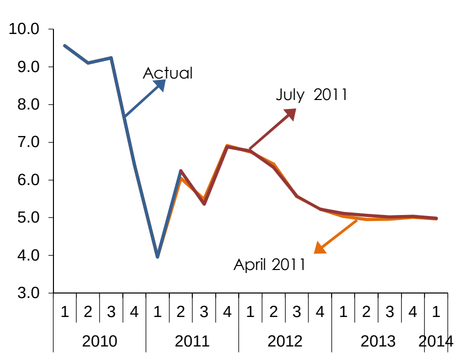
* Shaded region indicates the 70 percent confidence interval for the forecast.

Inflation forecast path was not subject to a notable change compared to the April Inflation Report since no significant revisions were made to the assumptions underlying our forecasts (Chart 7.3.2). Revised forecasts suggest that keeping inflation in line with targets over the medium term requires a measured and vigorous credit growth. In order to give a better perspective to this end, annual rate of credit growth underlying inflation forecasts is provided. It should be emphasized that these credit growth rates are not strict targets for the CBRT. The nominal credit growth consistent with the medium-term inflation target may vary across years depending on the course of inflation, economic growth and the composition of the aggregate demand.

Even though underlying inflation is expected to follow a stable trend in line with the medium-term targets, base effects are likely to have a substantial impact on inflation during the second quarter. A correct understanding of these effects will help public to better interpret inflation developments, and thus, improve expectations management. Inflation is expected to be driven mainly by base effects due to food prices in 2011, and accordingly, annual inflation is expected to decline in the third quarter, and rise in the last quarter. Year-end inflation is expected to slightly overshoot the target due to tariff adjustments on clothing imports and the cumulative effects of the rises in import prices. Through the end of 2012, inflation is expected to reach the medium-term target of 5 percent due to fading of these temporary effects as well as the tightening effect of the adopted policies (Chart 7.3.2).

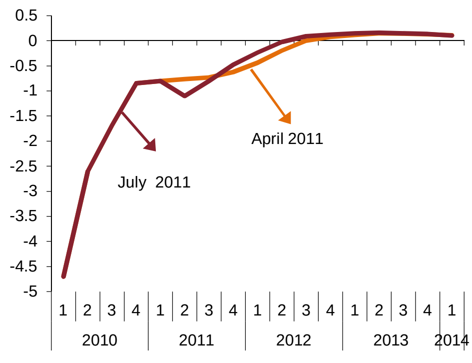
Comparison of April 2011 and July 2011 Inflation Report Forecasts

Chart 7.3.2.
Inflation Forecast



Source: TurkStat, CBRT.

Chart 7.3.3.
Output Gap Forecast

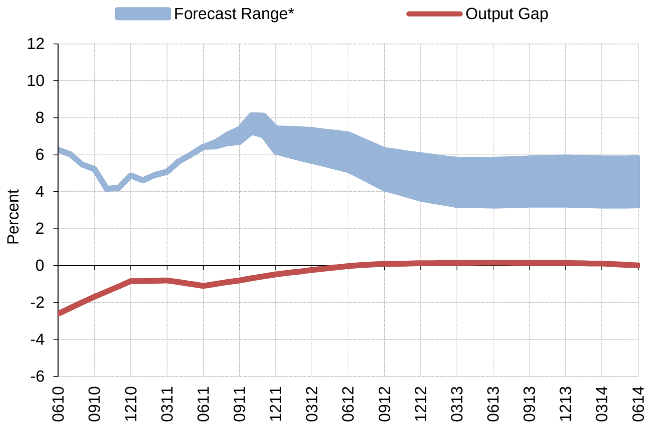


Source: CBRT.

Output gap, which shows the effects of aggregate demand conditions on inflation, is revised downwards for the second quarter of 2011, compared to the previous reporting period. However, forecasts are based on the assumption that this decline will be temporary amid the normalization in the global economy, and the output gap will return to the path envisaged in the April Inflation Report in the period ahead (Chart 7.3.3).

Unpredictable fluctuations in items that are beyond the control of the monetary policy, such as unprocessed food and tobacco, are among major factors causing deviations in inflation forecasts. Hence, inflation forecasts on unprocessed food and tobacco are also shared with the public. Forecasts are based on the assumption that annual unprocessed food inflation will be 8 percent, while the annual rate of increase in tobacco and alcoholic beverages will remain in line with inflation targets. In this context, our inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are shown in Chart 7.3.4. Accordingly, inflation is expected to rise gradually until the last quarter of 2011, assume a downward path thereafter and stabilize around 5 percent in the medium term (Chart 7.3.4).

Chart 7.3.4.
Inflation Forecast Excluding Unprocessed Food, Tobacco and Alcoholic Beverages



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

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

Comparison of CBRT Forecasts with Inflation Expectations

It is critical that economic agents, being aware of the temporary factors, should focus on the medium-term inflation trend, and therefore, take the inflation target as a benchmark in their pricing plans and contracts. In this respect, to serve as a reference guide, CBRT's current inflation forecasts should be compared to inflation expectations of other economic agents. Year-end inflation expectations as well as 12-month and 24-month ahead inflation expectations of the Survey of Expectations respondents are above our baseline scenario forecasts (Table 7.3.1).

Table 7.3.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2011 Year-end	6.9	7.3	5.5
12-Month Ahead	6.1	6.9	5.2
24-Month Ahead	5.1	6.3	5.0

* July 2011, second survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2011- 2013.
Source: CBRT.

7.4. Risks and Monetary Policy

Under current circumstances, risk factors and the associated monetary policy measures are assessed within a framework where both price stability and financial stability are observed. Accordingly, risk factors are not only assessed with respect to their impact on the level; but also, on the composition of the aggregate demand since the level of the aggregate demand is related to price stability, while its composition is directly related to financial stability. Hence, risk factors regarding global economy are also evaluated against this backdrop.

The baseline scenario, and hence, our inflation forecasts are built on the assumption that the second-quarter slowdown in global economic activity will mainly be temporary, given the forecasts by international institutions. However, developments since the previous reporting period have intensified downside risks regarding the global economy.

Problems in credit, real estate and labor markets in advanced economies are yet to be fully solved. Moreover, concerns on fiscal dynamics in these economies still persist. In particular, mounting problems regarding sovereign debt in the euro area peripheral economies have intensified downside risks to the global economy. Should the sovereign debt problems regarding some European economies and the concerns on global growth continue to have adverse impact on the risk appetite, the interest rate corridor may be narrowed gradually. Moreover, an outcome whereby global economic problems intensify and domestic economic activity contracts may require an easing in all policy instruments.

Even if debt problems in the euro area are resolved before they turn into a global crisis, it is still likely to experience a prolonged period of weak economic activity in advanced economies coupled with continued economic growth in emerging markets driven by domestic demand. In such a case, there may be a resurge in short-term speculative capital inflows to emerging markets which may render itself as weak external demand and elevated commodity prices with rising capital inflows, feeding into macro financial risks for the domestic economy. Should this scenario materialize, the policy mix of low policy rates and high reserve requirements may be implemented for a long period, in order to contain risks to price stability and financial stability.

Developments in exchange rates and import prices have been adversely affecting core inflation since the last quarter of 2010. The additional tariffs on fabrics and apparels are another leading factor that may lift up core inflation indicators in the coming period. Under current circumstances, the increase in core inflation reflects only the relative price movements while the current level of aggregate demand contains the second round effects of these price movements. However, core inflation is expected to increase in the forthcoming period, posing upside risks to inflation expectations and price-setting behavior. Should such a risk materialize and hamper the attainment of medium-term inflation targets, the CBRT will not hesitate to tighten monetary policy. In such a case, the mix of policy tools to be used for tightening will depend on developments regarding domestic demand, capital flows, current account and credit growth.

The impact of the ongoing tightening measures on credit volume and domestic demand is expected to be more significant during the second half of the year. However, the extent and the timing of the impact may vary depending on the developments beyond the control of the monetary policy. The impact of the ongoing tightening measures on credit volume and domestic demand is expected to be more significant during the second half of the year. However, the extent and the timing of the impact may vary depending on the developments beyond the control of monetary policy. The lagged effects of the policy measures on price stability and financial stability will be closely monitored, and further measures will be taken if deemed necessary.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. Sustaining the fiscal discipline under current circumstances is essential to limit risks posed by the current account deficit driven by the divergence between domestic and external demand. Saving the additional tax revenues acquired both within the law on restructuring of public claims and also owing to strong economic activity would not only reduce risks to price stability and financial stability, but also increase the effectiveness of the new policy mix. In this respect, our forecasts presented in the baseline scenario assume that the additional budget revenues will be saved to a large extent. 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.