3. Medium-Term Projections

3.1 Current State, Short-Term Outlook and Assumptions

Changes in Key Forecast Variables

Having contracted by 0.2% quarterly in the third quarter of 2024, GDP implied a limited loss of momentum in economic activity. Given the national income data for the third quarter, growth rates of previous quarters were revised downwards. On the expenditures side, final domestic demand contributed positively to annual growth in the third quarter, while the positive contribution of net exports increased. The services sector remained the main driver of annual growth, while the downward pressure on industrial sector growth persisted. Against this background, the output gap forecast for the third quarter of 2024 was revised as -1.1% (Table 3.1.1). This revision is partly attributed to the change made in the forecast methodology. Recent production and demand indicators point to a mild course in economic activity for the last quarter. Accordingly, the output gap forecast for the fourth quarter has been kept constant at -1.1% (Table 3.1.1).

Consumer inflation closed 2024 at 44.4%, the midpoint of the forecast range presented in the previous Inflation Report. The disinflation process is on track, yet consumer inflation remains elevated due also to some sectors with strong backward-indexation tendency. Producer inflation, on the other hand, ended 2024 at 28.5%, a lower level than consumer inflation. Accordingly, producer price-driven cost pressures on consumer prices eased significantly in the last quarter of the year. Core goods inflation remained low, and the services group made the largest contribution to the fall in annual inflation. January inflation was driven by strong course of services prices, wage and administered price adjustments and backward-indexation behavior in items with high time-dependent pricing behavior.

Core inflation indicators B and C indices continue to slow down. In the fourth quarter, B inflation declined significantly and closed 2024 at 43.9%. In this quarter, price increases in services and processed food, which constitute the B index, remained mild, while they remained subdued in core goods. The underlying inflation for January posted a temporary rise in line with previous projections.

Table 3.1.1: Changes in Key Forecast Variables*

	2024-III	2024-IV
Output Gap (%)	-1.1 (0.2)	-1.1 (-1.1)
Consumer Inflation** (Annual % Change)	49.4 (49.4)	44.4 (44.0)
B-Index Inflation** (Annual % Change)	48.2 (48.2)	43.9 (43.9)

* Figures in parentheses denote values presented in the previous Inflation Report.
** Denotes inflation in September for 2024-III and December for 2024-IV.

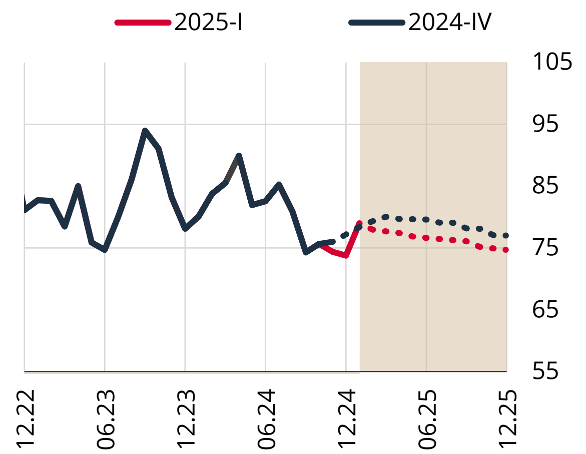
Assumptions for Exogenous Variables

The global recovery remained limited compared to the previous report projections. In the current reporting period, the services sector continued to drive global economic activity, while the manufacturing industry remained weak. Moreover, the divergence in the growth outlooks for Türkiye's main trading partners became more pronounced in this period. Growth forecasts for 2025 were revised downwards for many of our trading partners, more markedly for the euro area, but were kept unchanged for China and raised for the US economy. Accordingly, the global growth forecast based on Türkiye's export weights declined slightly (Table 3.1.2). In this period, heightened uncertainties regarding international trade policies increased downside risks to global growth forecasts.

Compared to the previous reporting period, markets are pricing in more limited rate cuts by major central banks in 2025. A sector-by-sector analysis of global inflation suggests that the divergence between services and core goods inflation persisted, and services prices remained rigid in many countries, limiting disinflation. In addition to the divergence in growth prospects, inflation outlooks across countries have also differed depending on country-specific factors as well as the extent and direction of their exposure to risks to global trade policies. In fact, markets now have a stronger expectation that the Fed, which emphasized upside risks to inflation at its last meeting, will opt for fewer rate cuts in 2025 due to the favorable growth outlook. Similarly, although the end-2025 policy rate priced in for the ECB increased, the negative divergence in the EU's growth outlook limited the expectation of higher rates. On the other hand, the accommodative monetary stance in China, one of the countries likely to be most affected by protectionist trade policies, is expected to continue in the upcoming period.

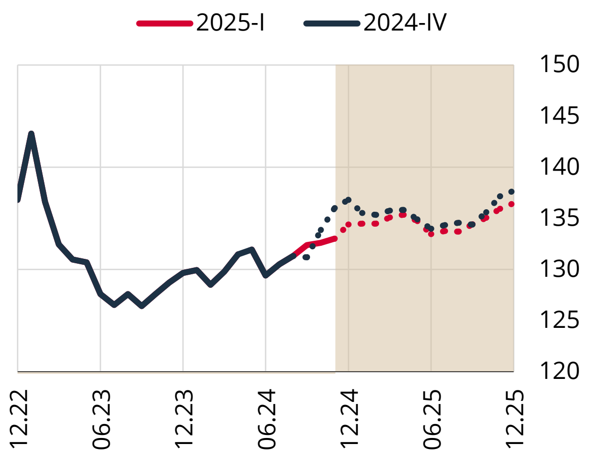
Geopolitical risks, the global growth outlook and supply-side factors continue to affect commodity prices. Oil prices increased in December due to the news flows on geopolitical developments driven by the Russia-Ukraine war. However, uncertainties about the global growth outlook and global trade weigh on oil prices. Accordingly, the oil price assumption for 2025 based on futures prices was revised to USD 76.5 in the current reporting period, down from USD 78.8 in the previous reporting period (Chart 3.1.1). For 2026, the oil price assumption is set at USD 74.0. On the other hand, agricultural commodity prices posted supply-side increases due to climatic conditions. Meanwhile, industrial commodity prices declined due to the weak growth outlook in China. Assumptions for the general level of import prices point to an increase of 2.6% in 2025 and 0.6% in 2026 (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.

The food price assumption for 2024 was revised upwards. Annual food inflation ended 2024 at 43.6%, above the assumptions of the previous report. Price hikes in fresh fruits and vegetables weighed on food prices in the fourth quarter. In October and November 2024, prices of fresh fruits and vegetables surged due to temporary supply conditions. Unprocessed food prices showed some moderation in December and realized close to their historical averages in January. The assumption for food prices for 2025 was revised to 24.5% due to unprocessed food products, and the assumption for 2026 was set at 13.5% (Table 3.1.2)

Table 3.1.2: Revisions in Assumptions*

	2024	2025	2026
Export-Weighted Global Growth Index (Annual Average % Change)	1.9 (2.0)	2.2 (2.4)	2.4 (-)
Oil Prices (Average, USD)	80.7 (81.1)	76.5 (78.8)	74.0 (-)
Import Prices (USD, Annual Average % Change)	0.5 (0.8)	2.6 (2.8)	0.6 (-)
Food Price Inflation (Year-End % Change)	43.6 (41.8)	24.5 (22.5)	13.5 (-)

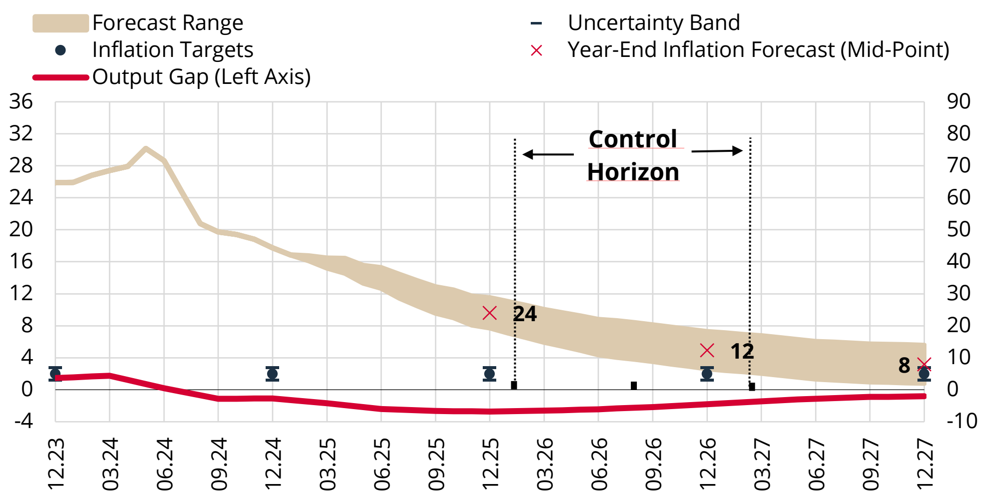
* Figures in parentheses denote values presented in the previous Inflation Report.

The forecasts are based on an outlook in which macroeconomic policies are determined in a coordinated manner focused on disinflation by adopting a medium-term perspective. In January, when time-dependent price adjustments were strong, administered price hikes were influential on inflation. The SCT increase in fuel prices, which came out below the D-PPI, limited this effect. Medium-term forecasts are based on the assumption that the enhanced coordination of fiscal policy will contribute significantly to the disinflation process and that policies regarding government-administered prices, borrowing, and tax and income will be determined to support the disinflation process.

3.2 Medium-Term Outlook

The year-end inflation forecast for 2025 has been revised as 24% while inflation is projected to remain on a downtrend, falling to 12% and 8% at end-2026 and end-2027, respectively. With 70% probability, inflation is projected to be between 19% and 29% (with a mid-point of 24%) at end-2025, between 6% and 18% (with a mid-point of 12%) at end-2026, and fall to single digits to 8% before stabilizing at the medium-term inflation target of 5% (Chart 3.2.1). Forecasts are based on an outlook in which the tight monetary policy stance will be maintained until disinflation is sustained and the price stability is achieved, and in which the coordination among economic policies will strengthen.

Chart 3.2.1: Inflation Forecasts* (%)



Source: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

In December 2024, annual inflation materialized at 44.4%, the midpoint of the forecast range presented in the 2024-IV Inflation Report. Annual consumer inflation in January stood at 42.1%, close to the mid-point of the forecast range presented in the previous report. The underlying inflation rose temporarily in January in line with projections. This rise was driven by services inflation, tax and administered price adjustments, and backward indexation in certain items dominated by time-dependent price increases. Inflation expectations and price-setting behavior continued to improve. However, expectations declined more slowly than envisaged. With the lagged effects of the monetary tightening, the moderation in domestic demand continued to support disinflation.

Due to various factors that are relatively outside the monetary policy domain and the current data flow, the end-2025 inflation forecast has been revised upwards. The mechanical effect that stemmed from the increase in the weight of the services sector, led by rental and education services, in the consumer price index due to the change in consumption patterns, played a role on the revision. Changes in the assumptions for unprocessed food inflation and administered prices were also instrumental in the revision. Having slowed considerably in the last quarter of the year, the inflationary effect of taxes and administered items rose again by early 2025. Factors such as price adjustments for urban transportation items, the increase in taxes and fees by the revaluation rate, the revision of medical examination co-payments in the SSI Communiqué on Healthcare Practices (Section 2.4) pushed consumer inflation higher (Table 3.2.1). It is assessed that the primary effects of these developments will not affect inflation for the next year, while their secondary effects will be offset by maintaining the tight monetary stance. Therefore, the end-2026 inflation forecast is kept at 12%.

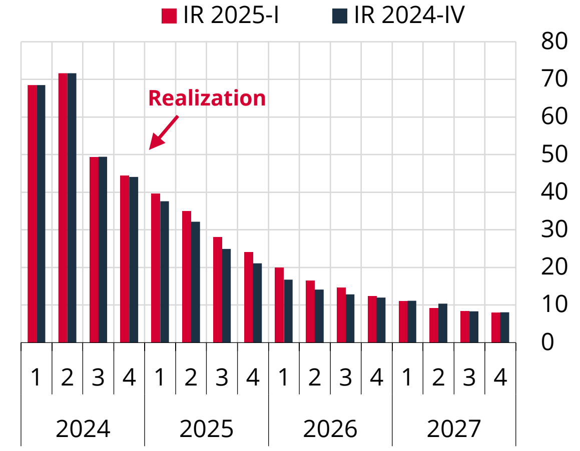
Table 3.2.1: Revisions in Year-End Inflation Forecasts for 2025 and Sources of Revisions

	2025
Inflation Report 2024-IV Forecast (%)	21.0
Inflation Report 2025-I Forecast (**with new CPI weights,** %)	21.8
Inflation Report 2025-I Year-End Forecast (%)	24.0
Forecast Revision Compared to Inflation Report 2024-IV (% Points)	**2.2**
Sources of Forecast Revision (% Points)	
Food Prices	+0.5
Administered Prices	+1.7

Source: CBRT.

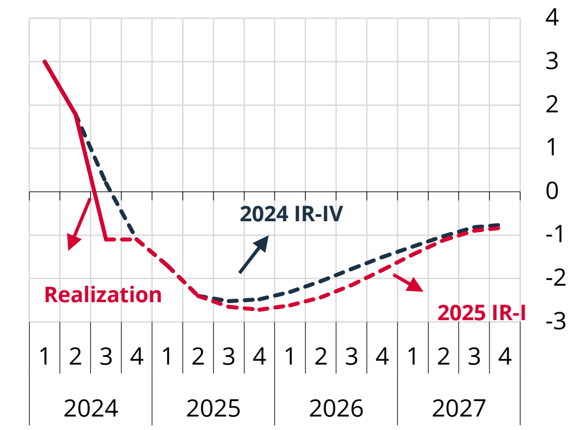
The year-end inflation forecast for 2025 was revised at 24% (Chart 3.2.2). The revision to the CPI consumption basket and weighting structure mechanically pushed the previous end-2025 forecast up by 0.8 points. Revisions to food price assumptions added 0.5 points to the inflation forecast. Various January-specific adjustments to administered prices had an upward effect on the year-end inflation forecast by 1.7 points.

Chart 3.2.2: Inflation Forecast (Quarter-End, Annual, %)



Source: CBRT, TURKSTAT.

Chart 3.2.3: Output Gap Forecast (%)



Source: CBRT.

Forecasts rely on an outlook marked by mounting uncertainties about global financial markets and global economic and trade policies. Increased upside risks to global inflation signal that central banks will pursue a tighter monetary policy. Central banks are expected to stick to rate-cutting processes, but adopt a more cautious stance compared to the previous reporting period. In addition to geopolitical developments and fluctuations in commodity prices, heightened uncertainties regarding fiscal and trade policies continue to cause volatility in the global risk appetite. The tight monetary policy stance that will be maintained until the underlying inflation declines permanently will help contain the possible adverse effects of the volatility in global financial markets on the country risk premium.

Medium-term forecasts are based on an outlook in which the tight monetary policy stance would be maintained until the inflation outlook displays a sustained decline and price stability is achieved, and the coordination among economic policies would be strengthened. The convergence of inflation expectations to the Inflation Report forecasts in the short term and to the inflation targets in the medium term is critical for ensuring a permanent decline in inflation. A monetary policy stance that will ensure the tightness required by the projected disinflation path and a continued decline in headline inflation will support the improvement in inflation expectations in the period ahead. It is expected that on the back of macroprudential policies that support the monetary transmission mechanism, the credit growth will remain consistent with the projected disinflation path. Assumptions rely on a framework in which the monetary transmission mechanism will be supported via additional macroprudential measures and sterilization tools will be used effectively in case of unanticipated developments in credit and deposit markets. Moreover, monetary policy tools will be used effectively in case a significant and persistent deterioration in inflation is foreseen. Lastly, in the forecast period, the continuation of a stronger coordination among fiscal and monetary policies will contribute to disinflation through demand, cost and expectation channels.

The disinflation process is projected to gain strength through moderation in domestic demand, the real appreciation of the Turkish lira and the improvement in inflation expectations. Given the lagged effects of the monetary tightening, the contribution of the output gap outlook to disinflation will continue in the upcoming period (Chart 3.2.3). Thus, inflation will continue to decelerate in items that are highly sensitive to demand conditions. Weaker demand conditions and lower labor costs in the upcoming period as compared to the previous year are likely to add to the slowdown in persistence of services inflation. Moreover, a continued moderation in pressures stemming from producer prices will help core goods inflation to remain low. Despite a temporary rise in the first quarter, the decline in the underlying inflation is expected to strengthen in the remainder of the year. As the weakening in real unit costs becomes more pronounced, the stickiness of services inflation fades and the tight monetary stance is maintained, the underlying inflation is projected to decline to its historical averages.

Thanks to the decline in headline inflation, inflation expectations across all sectors continue to improve, albeit slowly. In the current reporting period, expectations remained above the forecast range, with the pace of improvement in expectations yet to reach the desired levels. The sustained decline in inflation will contribute to the improvement in expectations. Given their indirect effect on expectations, it is critical that taxes and administered items, which were inflationary in January, align with the disinflationary path in the upcoming period. Despite an interruption in January due to time-dependent effects, it is expected that a continued improvement in expectations will enable the underlying inflation to remain on a steady decline in the medium term.

3.3. Key Risks to Inflation Forecasts and Possible Impact Channels

The outlook underlying the medium-term forecasts presented in the previous section is shaped by the assessments and assumptions of the Monetary Policy Committee. However, the inflation outlook may be subject to various risks associated with these factors, leading to a divergence from the monetary policy stance projected in the baseline scenario. The risks that are identified in the baseline scenario and have the potential to change the outlook are listed below and summarized in Table 3.3.1.

The possibility of strengthening protectionism in trade policies increases upside risks to global inflation, and poses downside risks to global growth. The slower-than-expected rate cuts by central banks of advanced and emerging economies may pose upside risks to inflation due to the pressure on capital flows and the Turkish lira. Besides, this outlook may increase uncertainty regarding commodity and import prices. Increased downside risks to global economic activity may affect inflation through commodity prices and external demand.

The broad-based increase in commodity prices compared to the previous reporting period poses upside risks to inflation forecasts. The global growth outlook, supply-side factors, financial conditions and geopolitical risks continue to be influential on commodity prices. In the current reporting period, the US sanctions against Russia and uncertainties regarding global trade policies caused volatility in oil prices to increase. Natural gas prices also increased due to supply security concerns, higher costs of storage and liquefied natural gas transportation, and expectations that climatic conditions would boost demand. Industrial commodity prices declined on account of the weak global demand outlook, while the agricultural commodity index increased further compared to the previous reporting period. The effects of these developments on transportation and input costs are monitored. Geopolitical developments may also affect risk perceptions towards Türkiye through foreign demand and export proceeds.

Although inflation expectations and pricing behavior tend to improve, they remain a risk factor for the disinflation process. Inflation expectations of market participants, firms and consumers play an important role in pricing behavior, portfolio preferences and consumption/credit demand. High inflation expectations may pose an upside risk to the propensity to consume and credit demand. In the current reporting period, expectations of market participants declined further. Although inflation expectations of households and the real sector have been revised downwards noticeably, they remain a risk factor for the disinflation process. Expectations’ level as well as their sensitivity to short-term data are important.

The ongoing stickiness in services prices poses an upside risk to inflation forecasts. The prevailing price-setting behavior in the services sector leads to significant inertia in inflation, a protracted impact of shocks on inflation, and causes price increases in this sector to be inconsistent with the disinflationary path. In the last quarter of the year, price increases in the services sector remained high despite a slight decline due to the developments in demand and labor costs. During this period, the highest price increase was observed in the rent sub-group, while inflation in services, excluding rents, was lower. In the upcoming period, both rents and certain services items with time-dependent price-setting behavior remain risk factors for the inflation forecast.

The course of unprocessed food prices also poses a risk to inflation forecasts. The fresh fruits and vegetables group, which is sensitive to temporary supply conditions, posted a strong rise in the last quarter of the year, becoming the leading factor preventing a more favorable consumer inflation outlook (Zoom-In 2.3). Moreover, agricultural commodity prices, which have been generally volatile, continued to climb in the last quarter of the year. Therefore, the volatile course of food prices, particularly in the unprocessed food group, keeps downside and upside risks to inflation forecasts alive.

Strengthening the coordination of monetary and fiscal policies is of utmost importance for the disinflation process. The incomes policy may affect inflation and expectations through the production cost and demand channels. Adjustments in taxes and administered prices in line with the projected disinflation path will contribute to the disinflation process. Given the possibility of the indirect effects of taxes and administrated items on expectations, their course may affect the disinflation path. Additionally, achieving the budget balance targets envisaged in the MTP by prioritizing expenditure reduction over revenue increase will underpin the disinflation process.

Table 3.3.1: Key Risks to Inflation Forecasts and Possible Impact Channels*

Risks	Evaluation of Risks Compared to the Baseline Scenario and Possible Effects on Inflation (↑ | ↔ | ↓)		Indicators Monitored
Global Risks	• Stronger protectionism in trade policies increases upside risks to inflation and creates downside risks to global growth.	↔	• Global inflation and growth indicators and forecasts • Global economy and trade policies • World uncertainty index • Global risk appetite indicators • Export-weighted global economic activity index
	• The slower-than-expected pace of interest rate cuts by central banks may pose an upside risk to inflation.	↑	
	• Heightened downside risks to global economic activity may have a downward impact on inflation through the commodity prices and external demand channels.	↓	
Geopolitical developments and the course of commodity prices	• Oil and commodity prices are likely to remain volatile due to geopolitical risks and the uncertainty regarding global trade policies.	↔	• Crude oil prices and demand-supply balance • OPEC+ decisions • Indicators for domestic energy market • Administered prices
	• Rising natural gas and agricultural commodity prices keep risks to inflation forecasts alive.	↑	
Inflation expectations	• Despite the improvement in medium-term inflation expectations, the elevated level of expectations keeps upside risks to inflation forecasts alive.	↑	• Key inflation indicators • Indicators for inflation expectations • Sectoral inflation expectations • Distribution of inflation expectations • Inflation uncertainty indicators • Survey and market pricing-based inflation and exchange rate expectations
Inertia in services inflation	• The ongoing stickiness of services prices keeps upside risks to inflation alive.	↑	• Key inflation indicators • Inertia in services inflation
Food prices	• Volatility in unprocessed food prices keeps downside and upside risks to inflation forecasts alive.	↔	• Prices of fresh fruits and vegetables • Marketplace Registration System data • International agricultural commodity prices • Indicators for climate change

Risks to the effectiveness of the coordination between monetary and fiscal policies	• Lack of coordination between monetary and fiscal policies may pose risks to inflation and the moderation in domestic demand. • Introducing reforms in direct taxes and/or tax collection efficiency may reduce the need for indirect taxes, thereby having a downward impact on prices.	↑ ↓	• Adjustments in administered prices and taxes • Developments in tax revenues and public expenditure • MTP and fiscal policy measures • Budget and public debt stock indicators • Structural budget balance forecasts • Share of direct taxes in total taxes • Minimum wage and public wage increases

* Each risk row in the table indicates the possible channel and the direction for the change in inflation forecasts in case the mentioned risk materializes. The signs ↑, ↓ indicate that the risk to the inflation forecast is upside and downside, respectively. The ↔ sign is used when the net impact on the inflation forecast is not completely clear. The indicators through which the risk is monitored are also listed in the right column.