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 three-year horizon.

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

Second-quarter GDP data were more favorable than the outlook presented in the July Inflation Report. Having recorded a slightly limited slowdown than expected, domestic demand was the main driver of economic growth in this period. Meanwhile, external demand remained weak. Seasonally adjusted data suggest that exports followed a flat course, while imports went down quarter-on-quarter. Thus, the contribution of net exports was positive in the second quarter of the year.

The depreciation of the Turkish lira had a major impact on inflation in the third quarter of 2011. Furthermore, the surge in gold prices also raised the consumer inflation. Exchange rate developments particularly affected the prices of core goods, while services prices maintained a mild course. Food prices declined significantly on the base effect. In brief, inflation followed nearly a flat course.

The imported input prices continued to surge in the third quarter of 2011. Despite the quarter-on-quarter decline in international oil prices, domestic fuel, solid fuel and bottled gas prices went up amid the depreciation of the Turkish lira, also weighing further on the prices of core goods in the third quarter. Correspondingly, core price indicators SCA-H and SCA-I remained on the rise in this period (Chart 3.1.15). Alternative core inflation indicators monitored by the CBRT also suggest a higher underlying trend compared to the previous quarter (Chart 3.1.18).

Table 7.1.1.
Revisions to 2011 Assumptions

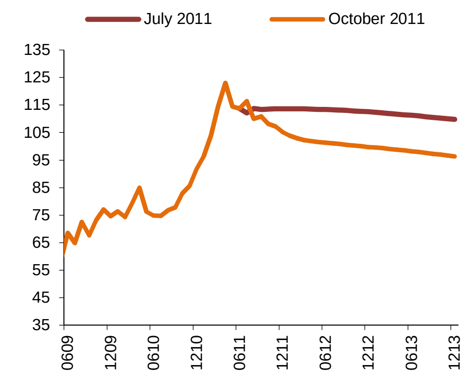
		July 2011	October 2011
Output Gap	2011Q2	-1.1	-0.4
	2011Q3	-0.8	-0.7
	2012 Average	-0.01	-1.08
Food Price Inflation (Year-end Percent Change)	2011-2013	7.5	7.5
Import Prices (Average Annual Percent Change, USD)	2011	15.4	15.2
	2012	0.6	-1.9
Oil Prices (Average Annual, USD)	2011	115	110
	2012	115	100
Export-Weighted Global Production Index (Average Annual Percent Change)	2011	2.51	2.45
	2012	2.88	2.26

In the July Inflation Report, with reference to future prices for commodities, oil prices were assumed to be 115 USD/bbl for 2011 and onwards. Given the lower levels of crude oil prices in the third quarter, crude oil price assumptions are revised as USD 110/bbl for 2011. Import prices were assumed to record an average year-on-year increase by 15.4 percent in 2011 in the July Inflation Report. According to revised projections based on futures prices, import prices are assumed to increase by an average 15.2 percent in 2011. (Chart 7.1.1). In addition, our assumption on food inflation remained unchanged at 7.5 percent for 2011 and onwards (Table 7.1.1).

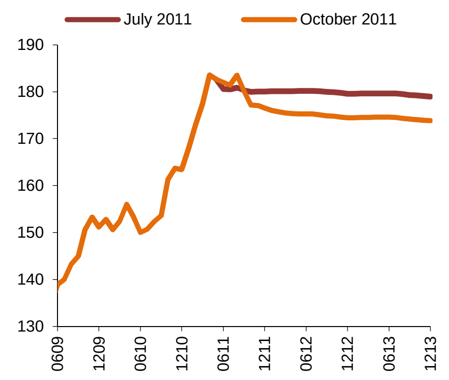
In the July Inflation Report, prices of tobacco products were assumed to increase in line with the inflation target by 5.5 percent, adding nearly 0.3 percentage points to inflation. However, as hikes to tobacco products prices were far above than assumed, they are estimated to contribute to inflation approximately by 0.9 percentage points, thereby adding 0.6 percentage points to the short-term inflation forecast (Table 1.3.1).

In the previous reports, it was stated that natural gas and electricity prices were likely to increase in the second quarter of 2011. Indeed, natural gas and electricity tariffs were subject to hikes starting from October 1, 2011. Accordingly, energy inflation is expected to soar in October, thus contributing to annual inflation by 0.5 percentage points. However, the increase in energy inflation was already included in the inflation forecasts under automatic pricing mechanism, thus leaving the year-end inflation forecast unchanged.

Chart 7.1.1.
Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.



Source: TurkStat, CBRT.

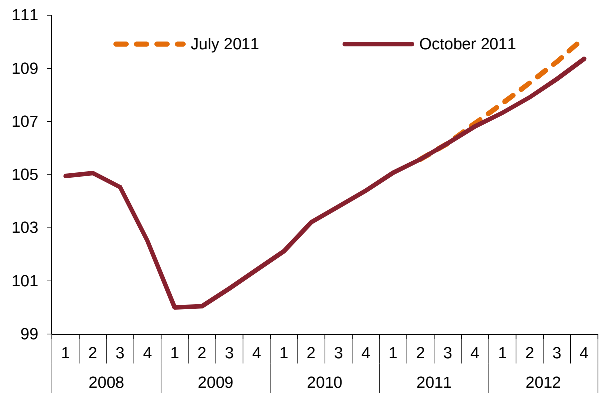
Third-quarter data point to a quarter-on-quarter slowdown in the final domestic demand. Production of consumption goods followed a flat course, while imports of consumption goods declined. Moreover, developments in consumer confidence index also point to a slowdown in the third quarter.

Leading indicators suggest that the observed slowdown in the third quarter will remain temporary, and that the economic activity will assume a mild course of growth. BTS order indicators as well as PMI order and production indicators signal that economic activity will maintain its mild growth without any contraction in the forthcoming period. Aggregated indices of selected leading indicators of economic activity also suggest that the contraction in the third quarter will be temporary (Chart 4.1.10).

Second-quarter data on external demand was worse than the outlook presented in the July Inflation Report. Leading indicators for the U.S. suggest that the mild course of growth in the second quarter of 2011 continued into the third quarter. On the other hand, concerns over the sovereign debt sustainability problems in the euro area countries were further intensified in the third quarter, and the spillover of these problems into the banking sector caused a loss of confidence. Leading indicators for the euro area point to a more pronounced slowdown in growth in the third quarter. This led to a decline in the global risk appetite, and even though remaining relatively limited, adverse effects were already materialized on emerging economies. Thus, in the last quarter, global economic growth decelerated significantly, especially in advanced economies, thus causing a downward revision in global growth forecasts for 2011-2012. Accordingly, projections for export-weighted global growth index for

Turkey were revised downwards. Hence, external demand outlook was also revised downwards given the baseline scenario forecasts assuming a slower recovery in external demand than the previous reporting period, (Chart 7.1.2).

Chart 7.1.2.
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, amid the better-than-envisaged economic activity in the second quarter, the output gap was revised upwards for the short term, and downwards thereafter. While leaving the 2011 year-end inflation forecast virtually unchanged, this revision pulled down the 2012 year-end forecast by 0.2 percentage points.

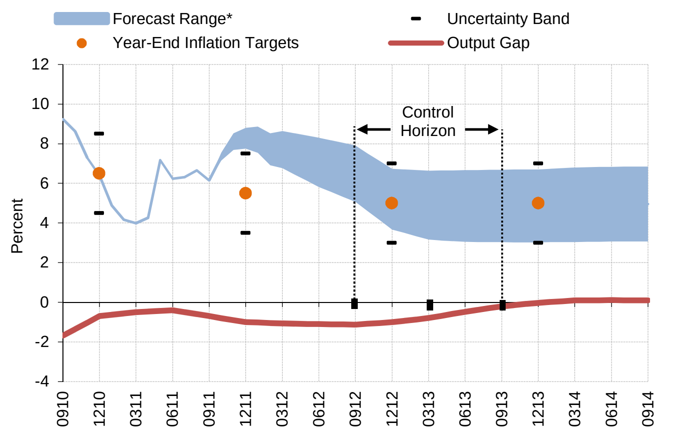
In building medium-term inflation forecasts within the inflation targeting framework, the CBRT uses not only policy rates, but a policy mix also encompassing required reserve ratios and other liquidity management tools. Under this setting, the impact of the policy mix on monetary and financial conditions is observed essentially through the credit channel. Thus, inflation forecasts are based on certain assumptions about credit growth. Accordingly, both the decisions of the CBRT and the arrangements by the BRSA on various loans were influential on the slowdown of credit growth in the third quarter. In this context, annual credit growth rate in the third quarter converged to desirable levels in terms of macroeconomic and financial stability. Correspondingly, the medium-term projections are based on the assumption that the year-end credit growth adjusted for exchange rate would reach nearly 25 percent as envisaged, owing to the tightening effects of the ongoing monetary and fiscal policies in addition to the effects of the BRSA's measures on consumer loans.

Lastly, the fiscal policy outlook is based on the MTP projections revised in October 2011. Accordingly, the baseline scenario envisages that the contribution of the public spending to domestic demand would gradually decline. In other words, the public sector is expected not to exert an inflationary pressure on aggregate demand. In addition, our forecasts are also based on our previous assumption that the risk premium remains virtually unchanged. Moreover, tax adjustments and administered prices are assumed to be consistent with inflation targets and automatic pricing mechanisms.

7.2. Medium-Term Outlook

According to the assumptions and projections in the preceding Chapter, assuming that annual rate of credit growth decelerates gradually, and monetary conditions are tightened significantly in the final quarter in line with the policy measures taken in October, inflation is expected to be, with 70 percent probability, between 7.8 and 8.8 percent with a mid-point of 8.3 percent at the end of 2011, and between 3.7 and 6.7 percent with a mid-point of 5.2 percent at the end of 2012. 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

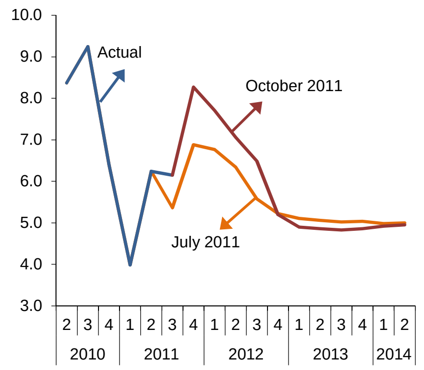


* Shaded region indicates the 70 percent confidence interval for the forecast.

In sum, the year-end forecast for 2011 was significantly revised upwards in the interreporting period (Chart 7.2.2), where this revision was mainly owed to the exchange rate developments and the adjustments in administered prices (Table 1.3.1). It should be highlighted that these factors reflect a temporary change in relative prices rather than a permanent increase in inflation, as the secondary effects will be hindered on the back of the envisioned monetary tightening in the last quarter owing to the CBRT's recent aggressive policy reaction. Moreover, given the weak outlook for the global economy, the course of commodity prices is also expected to support slowdown inflation. Accordingly, inflation is expected to decelerate gradually starting from early 2012, nearing target by the end of 2012 (Chart 7.2.1).

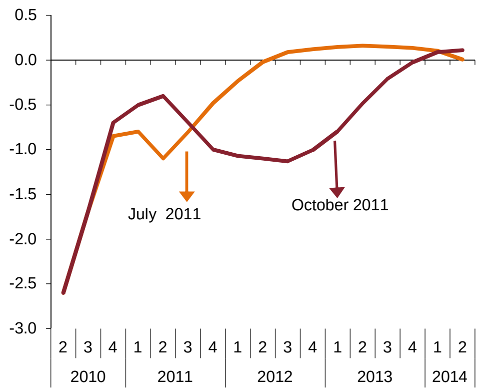
Comparison of July 2011 and October 2011 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast



Source: TurkStat, CBRT.

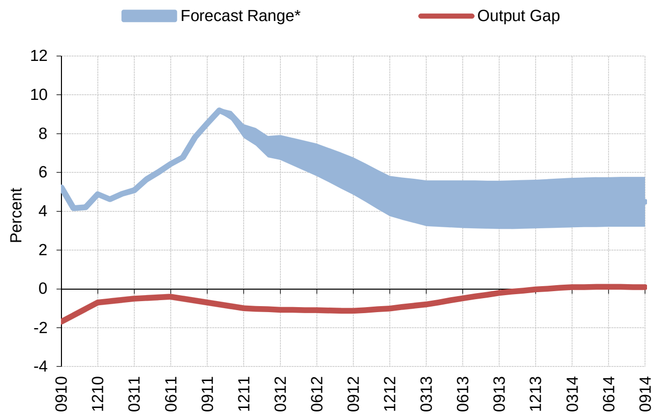
Chart 7.2.3.
Output Gap Forecast



Source: CBRT.

Unpredictable fluctuations in items that are beyond the control of the monetary policy, such as unprocessed food, tobacco and alcoholic beverages, are among major factors causing deviations in inflation forecasts. Hence, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are also publicly shared. Forecasts are based on the assumption that for end-2011, annual unprocessed food inflation will be 6 percent, while the annual rate of increase in the prices of tobacco and alcoholic beverages will be 15.3 percent amid the recent tax adjustments. Accordingly, the inflation forecast excluding unprocessed food, tobacco and alcoholic beverages is depicted in Chart 7.2.4. The inflation indicator, measured as above, is expected to fall gradually as of the last quarter of 2011, and stabilize around 5 percent in the medium term (Chart 7.3.4).

Chart 7.2.4.
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 the CBRT Forecasts with Inflation Expectations

It is critical that economic agents, being aware of the temporary factors, should focus on the course of 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, 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	8.3	8.01	5.5
12-Month Ahead	6.1	6.84	5.1
24-Month Ahead	4.9	6.28	5.0

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

7.3. Risks and Monetary Policy

The fact that inflation will hover above target in the short term poses risks regarding inflation expectations and pricing behavior. As of October, the CBRT has adopted a policy stance aiming to eliminate these risks. These risks will be closely monitored in the upcoming period as well, and necessary measures will be taken to avoid deterioration in the inflation outlook.

The medium-term outlook of the Report assumes that global economic activity will stay weak for a long period with no further worsening in the current circumstances. Nevertheless, uncertainties regarding the global economy remain crucial. In particular, escalating problems of the euro area economies regarding sovereign debt continue to pose downside risks on the global economy. Concerns regarding the debt sustainability problems in the EU were further intensified in the interreporting period, and perceptions about a possible spillover of these problems to the banking sector in the region were heightened. The probability for a failure to solve the banking sector problems in the euro area as well as the further deepening of the global problems via a possible spread constitute a major risk factor. In order to maintain stability in the domestic markets, the CBRT will continue to take the required measures promptly by closely monitoring the global developments in line with the strategy formulated at the interim meeting of August 4, 2011.

The CBRT will continue to monitor fiscal policy developments closely while formulating monetary policy. The baseline scenario forecasts of the Report are based on the MTP framework, therefore fiscal discipline is assumed to be maintained. 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.

In the period ahead, monetary policy will continue to focus on achieving price stability on a permanent basis, while observing financial stability. To this end, the impact of the macroprudential measures taken by the CBRT and other relevant institutions on the inflation outlook will be assessed carefully. Maintaining fiscal discipline in the medium term and strengthening the structural reform agenda will contribute to the relative improvement of Turkey's sovereign risk, thereby supporting macroeconomic stability and price stability. Maintaining fiscal discipline will also provide room for monetary policy maneuver, and support the social welfare by keeping interest rates permanently at low levels. In this respect, steps to be taken in order to implement the structural reforms envisaged by the recently announced MTP remains to be of utmost importance.