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 for the upcoming three-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Financial Conditions

In the third quarter of 2016, monetary policy developments in advanced economies caused volatility in global financial markets. Having surged markedly after the July Inflation Report, portfolio flows into emerging economies have recently started to slow down again. In this period, Turkey attracted fewer portfolio flows compared to other emerging economies, while the Turkish lira depreciated against the US dollar and the country risk premium inched up.

The CBRT continued with monetary policy simplification by lowering the marginal funding rate to 8.25 percent by consecutive reductions of 25 basis points in July, August and September. The reduced tightness in monetary conditions amid the CBRT's policy actions as well as macroprudential measures support overall financial conditions. In fact, consumer loans have started to recover in recent weeks. In view of the reduced tightness in financial conditions besides the possible spillovers of the developments in the exchange rate and other cost factors on the inflation outlook, the simplification process was postponed in October, and the marginal funding rate was kept constant at 8.25 percent.

Inflation

Consumer inflation ended the third quarter at 7.28 percent, remaining close to the lower bound of the July Inflation Report forecast. The fall in inflation was mostly driven by prices of unprocessed food. On the other hand, annual inflation in tobacco and energy increased. Thus, inflation excluding unprocessed food and tobacco posted a smaller decline, and ended up near the upper bound of the July Inflation Report forecast. The inflation outlook remained benign amid waning cumulative exchange rate effects, weakening demand conditions and modest import prices in September.

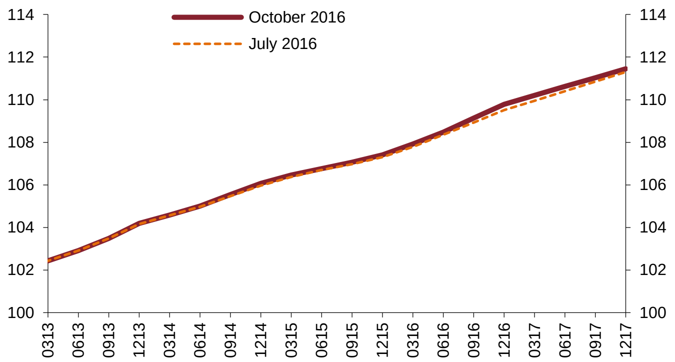
Demand Conditions

Economic activity was broadly in line with the predictions of the July Inflation Report. In the second quarter, the GDP grew by 0.3 and 3.1 percent quarter-on-quarter and year-on-year terms, respectively. The main driver of annual growth was final domestic demand, whereas net exports provided more negative contribution to growth due to the tourism slump. Final domestic demand contributed to growth both through public and private consumer spending, while investments remained subdued. On the production front, the value added of industrial and services sectors was limited due to tourism-driven indirect effects.

Current indicators of the third quarter of 2016 hint at a quarterly contraction in economic activity. The expected slowdown in economic activity caused by the tourism sector deepened due to the domestic turmoil in July, which had adverse impacts on both production and the domestic demand. On the other hand, economic indicators for August and September indicate that the adverse effects of the mid-July developments are counterbalanced. Accordingly, the output gap estimate for the third quarter is likely to widen compared to the previous quarter and put downward pressure on inflation (Table 7.1.1, Chart 7.2.3).

In view of waning uncertainties in the upcoming period, producer and consumer confidence will be re-built, demand-stimulating policies will support consumption expenditures and negative contribution of net exports will fall, which will all contribute to economic recovery. External demand was not revised notably amid the global growth outlook. In fact, the annual growth rate of the export-weighted global production index, which is updated according to current growth forecasts of Turkey's export partners, remained almost unchanged in the inter-reporting period (Chart 7.1.1).

Chart 7.1.1. Export-Weighted Global Economic Activity Index
(2008Q2=100)



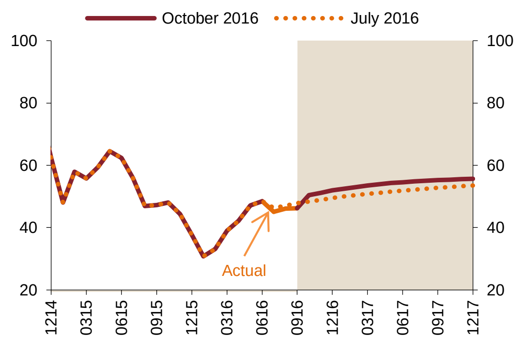
Source: CBRT, Bloomberg, Consensus Forecasts.

Oil, Import and Food Prices

Owing to the recent developments, assumptions for crude oil prices for the upcoming period were revised upwards compared to the July Inflation Report, while assumptions for USD-denominated import prices saw a minor downward revision (Table 7.1.1, Charts 7.1.2 and 7.1.3). However, in terms of Turkish lira, import prices were subject to a considerable upward revision compared to the previous reporting period. The crude oil price assumption in annual averages was kept unchanged at 44 USD for 2016, and increased to 54 USD for 2017.

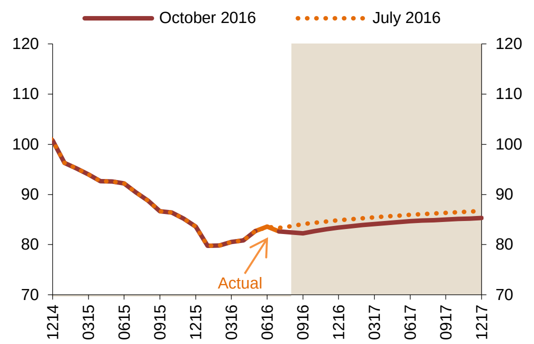
In the third quarter of 2016, food inflation remained far below the level envisaged in the July Inflation Report due to unprocessed food inflation. Taking into account the current trend of unprocessed food inflation as well as the decrease in the demand for food stemming from the fall in tourism revenues, food inflation, which was assumed to be 8 percent by end-2016 in the July Inflation Report, was revised downwards to 6 percent. The weak food demand owing to the tourism sector is expected to restrict food inflation in 2017 as well. Moreover, the measures taken by the Food Committee are expected to cause the food price inflation to remain below its historical average. Accordingly, the assumption for food price inflation was revised downwards from 8 percent to 7 percent for end-2017.

Chart 7.1.2.
Revisions in Oil Prices
(USD/bbl)



Source: Bloomberg, CBRT.

Chart 7.1.3.
Revisions in Import Prices
(2010=100)



Source: CBRT, TURKSTAT.

Fiscal Policy and Tax Adjustments

Medium-term forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with the inflation target and automatic pricing mechanisms. The medium-term fiscal policy stance depends on the MTP projections covering the 2017-2019 period.

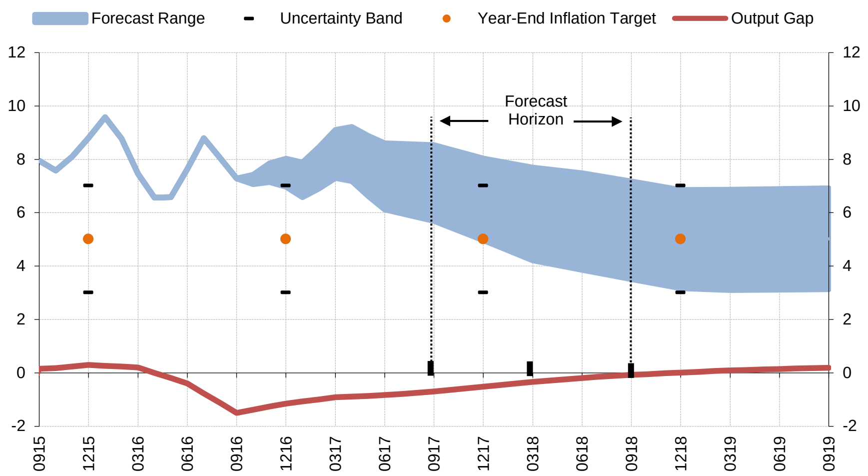
Table 7.1.1. Revisions in Assumptions

		July 2016	October 2016
Output Gap	2016Q2	-0.2	-0.4
	2016Q3	-0.3	-1.5
Food Prices	2016	8.0	6.0
(Year-end Percent Change)	2017	8.0	7.0
Import Prices	2016	-8.5	-9.2
(Average Annual Percent Change, USD)	2017	4.0	3.2
Oil Prices	2016	44	44
(Average, USD)	2017	52	54
Export-Weighted Global Production Index	2016	1.7	1.7
(Average Annual Percent Change)	2017	1.8	1.8

7.2. Medium-Term Forecasts

Given a cautious policy stance that focuses on bringing inflation down, inflation is estimated to converge gradually to the 5-percent target. Accordingly, inflation is likely to stabilize around 5 percent in 2018 after falling to 7.5 percent in 2016 and 6.5 percent in 2017. Hence, inflation is expected to be, with 70 percent probability, between 7 percent and 8 percent (with a mid-point of 7.5 percent) at end-2016 and between 5 percent and 8 percent (with a mid-point of 6.5 percent) at end-2017 (Chart 7.2.1).

Chart 7.2.1.
Inflation and Output Gap Forecasts*
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: CBRT.

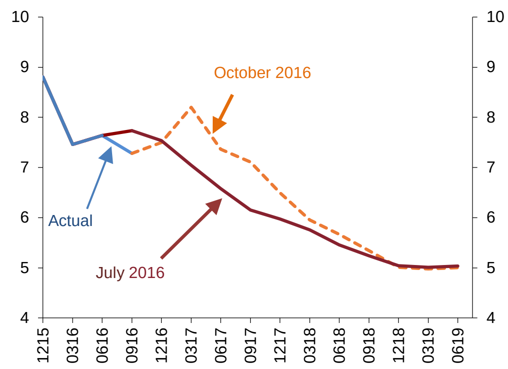
The Turkish lira fluctuated following the July Inflation Report, while oil prices increased. In the upcoming period, TL-denominated import prices are estimated to be higher compared to the previous reporting period. On the other hand, the latest domestic developments are envisaged to curb domestic demand particularly in the short term. Accordingly, output gap forecasts were revised downwards (Chart 7.2.3). In this respect, the year-end consumer inflation forecast for 2016 remained unchanged as downside factors on inflation were counterbalanced by upside factors. On the other hand, the consumer inflation forecast for end-2017 was revised upwards by 0.5 points as the upside effects driven by import prices outweighed the downward revision in the output gap and food inflation (Chart 7.2.2).

A detailed analysis of forecasts accounting for the changes in factors affecting inflation indicates that the upward revision in the TL-denominated import prices and tax adjustments in fuel are expected to push the end-2016 inflation forecast in the July Inflation Report upwards by 0.4 points and 0.3 points, respectively. However, 0.2 and 0.5 points of this effect will be offset by the downward revision in the output gap and the fall in food inflation, correspondingly.

A more detailed analysis of 2017 forecasts suggests that the upward revision in the TL-denominated import prices will add around 1 point to the year-end inflation forecast compared to the previous Report. On the other hand, downward revisions in the output gap and food inflation are likely to pull the end-2017 inflation forecast down by 0.3 and 0.2 points, respectively. Accordingly, the consumer inflation forecast for end-2017, which was set as 6 percent in the July Inflation Report, was revised to 6.5 percent.

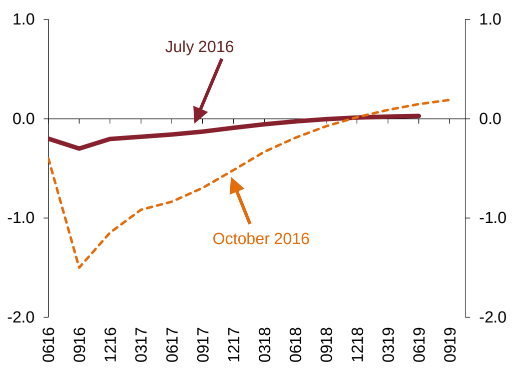
According to the inflation forecast path presented in Chart 7.2.1, consumer inflation is projected to follow a flat course in October and converge to the 7.5 percent year-end forecast after a slight increase in November. Following an expected increase due in particular to the base effects from unprocessed food inflation in the first quarter of 2017, inflation is likely to fall in the second quarter of the year and see 6.5 percent at end-2017 with a gradual decline.

Chart 7.2.2.
Inflation Forecasts
(Percent)



Source: TURKSTAT, CBRT.

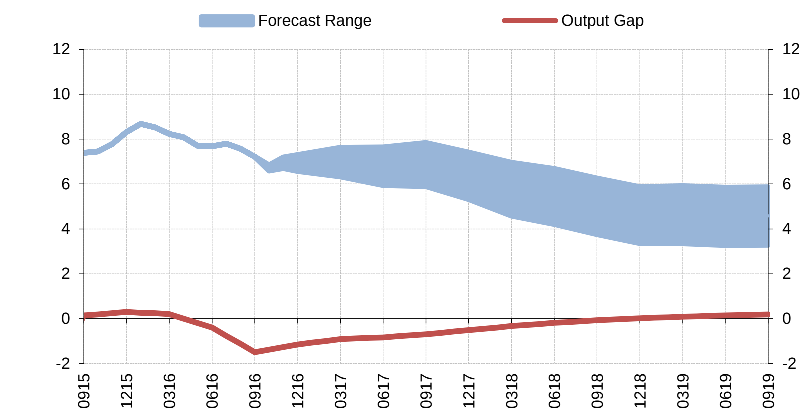
Chart 7.2.3.
Output Gap Forecasts
(Percent)



Source: CBRT.

Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food and tobacco, are among major factors that cause a deviation in inflation forecasts. Hence, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are also announced and presented in Chart 7.2.4. The inflation indicator as measured above is expected to decline gradually to 4.6 percent.

Chart 7.2.4.
Inflation Forecast Excluding Unprocessed Food, Tobacco and Alcoholic Beverages*
(Percent)



* Shaded area denotes the 70 percent confidence interval for the forecast.
Source: CBRT.

Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents take the inflation target as a benchmark in their plans and contracts and focus on the underlying trend of medium-term inflation rather than on temporary price fluctuations. Likewise, it is crucial that the CBRT's current inflation forecasts be compared with inflation expectations of other economic agents to serve as a reference guide. Accordingly, the year-end, 12-month-ahead and 24-month-ahead inflation expectations of the Survey of Expectations' respondents are above the CBRT's baseline scenario forecasts, which necessitates close monitoring of expectations and the pricing behavior (Table 7.2.1).

Table 7.2.2.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target
2016 Year-end	7.5	7.8	5.0
12-month-ahead	6.9	7.6	5.0
24-month-ahead	5.2	7.0	5.0

* As of October 2016.
Source: CBRT.

7.3. Risks and Monetary Policy

Overall financial conditions remain buoyed by reduced tightness in monetary conditions, thanks to the CBRT's policy actions, and macroprudential measures. The gradual fall in the marginal funding rate has partially passed through to loan and deposit rates. Supported also by the recently enforced macroprudential measures, consumer loans showed some recovery in the last couple of months. On the other hand, due to global and geopolitical developments that had effects on domestic financial markets, loan conditions still remain tight. As the end-September downgrade of Turkey's sovereign credit rating to non-investment grade was largely anticipated by markets, the reaction of financial markets remained limited. Even though this downgrade weighs on external funding costs, loan conditions are supported by liquidity measures, macroprudential arrangements and other incentives. On the other hand, the CBRT may introduce accommodative adjustments to required reserves and other liquidity instruments in case of a higher-than-expected tightness in financial conditions.

The latest data indicate a remarkable economic slowdown in the third quarter. Accommodative incentives and measures are projected to stimulate a rebound in domestic demand starting from the last quarter. Accordingly, the Turkish economy is expected to grow mildly in the remainder of 2016 and throughout 2017. However, economic activity is exposed to downside risks stemming from tourism revenues, the global economic outlook, uncertainties regarding the monetary policies of advanced economies and geopolitical developments. The CBRT will continue to closely monitor the impacts of the developments in economic activity on price stability and financial stability.

In the third quarter of the year, inflation recorded a decline on the back of improvements in unprocessed food and core inflation indicators. While the lagged effects of the cumulative exchange rate developments on annual inflation continued to wane, slowing aggregate demand supported disinflation and the underlying trend of core inflation displayed some recovery. However, the tax rise in fuel products restrained the improvement in inflation through energy and transport prices. Although the developments in TL-denominated import prices are expected to push inflation upwards, the mild course of aggregate demand is projected to support the gradual decline in core inflation. Moreover, forecasts are based on the assumption that the year-end food inflation in 2016 and 2017 will be lower than the projections of the previous Report amid the tourism-induced slowdown in food demand and the actions taken by the Food Committee.

Inflation forecasts accommodate both upside and downside risks. Inflation may settle on a lower-than-expected path, should economic activity recover at a slower-than-envisioned pace in the upcoming period. On the other hand, uncertainties regarding oil prices and global markets pose an upside risk to inflation through the cost channel. Meanwhile, the volatility in food prices pose risks in both directions for 2017. The CBRT will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.

Leading indicators for the third quarter of 2016 point to a mild improvement in global economic activity. However, the historically low levels of global growth and the trade volume lead to sustained environment of low interest rates in advanced economies. Accordingly, the risk appetite towards emerging economies has followed a robust course in recent months. On the other hand, uncertainties regarding global monetary policies cause fluctuations in portfolio inflows. In fact, amid strengthened perceptions about the Fed’s possible rate hike coupled with the uncertainties regarding the monetary policies of other advanced economies, portfolio flows towards emerging economies have recently trended downwards after a surge following the previous reporting period.

Against this background, the marginal funding rate, which was lowered gradually under the simplification process as of March 2016, was kept constant in October. The completion of the simplification will ensure funding via a single rate, thereby bringing short-term market rates closer to the CBRT funding rate. Simplification is believed to contribute to the effectiveness of the transmission mechanism by providing a more reliable assessment of the monetary policy stance. Therefore, simplification of the monetary policy will be finalized within a reasonable schedule. The direction and timing of simplification will depend on developments affecting the inflation outlook and financial stability.

Despite experiencing significant external shocks in recent years, the adopted policy framework proved successful in containing the deterioration in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience in inflation targeting showed that combatting inflation requires joint efforts. Thus, to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties under a holistic approach by also taking structural factors into account. In this respect, actions taken by the Food Committee set an invaluable precedent. In the upcoming period, the CBRT will bolster these efforts by undertaking extensive studies to raise awareness regarding structural issues in inflation dynamics.

Developments in fiscal policy and tax adjustments are monitored closely with regard to their effects on the inflation outlook. The baseline monetary policy stance is formulated under the assumption that fiscal discipline will be maintained and there will be no unanticipated hikes in administered prices. A revision of the monetary policy stance may be considered, should the fiscal policy deviate significantly from this framework, and consequently have an adverse effect on the medium-term inflation outlook.

In recent years, sustaining fiscal discipline has contributed significantly to lowering the sensitivity of the Turkish economy against external shocks. In the current environment of highly uncertain global markets, the gains from maintaining and further advancing these achievements are significant. Any measure to provide permanent fiscal discipline and reduce the savings deficit will support macroeconomic stability and contribute positively to social welfare by keeping the interest rates of long-term government securities at low levels.