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 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Financial Conditions

The second quarter of 2016 was marked by the UK's Brexit referendum that gripped global financial markets. The decision to exit caused the global trade volume to shrink, while also heightening risks to growth and deflation across advanced economies. As a result, expectations grew stronger that a further rate hike by the Fed would be postponed until late 2016 or 2017, while the ECB, the Bank of Japan and the Bank of England have adopted new measures to prop up their economies. Moreover, the MOVE index, which measures volatility in US bond prices at different maturities, dipped after the Brexit referendum while the G7 currency volatility soared mainly due to strong movements in the pound sterling.

Meanwhile, financial and economic conditions vary among emerging economies. The growth outlook is weak across emerging economies, especially in Russia and China. The EMBI and the CDS indices, which had been rising before the Brexit referendum, started declining afterwards and emerging market currencies depreciated on average against the US dollar. Unlike the first quarter of 2016, capital flows into emerging economies turned negative due to equity outflows, yet still remain more robust than in 2015 and 2014.

In sum, the favorable course of the macroeconomic indicators, the low course of oil prices despite the latest increases, the simplification of the monetary policy as per the CBRT's road map, higher effectiveness and predictability of the liquidity policy, the ongoing improvement in the current account deficit and the extending maturity of FX liabilities all contribute to accommodative financial conditions. However, the recent domestic turmoil might lead to a temporary tightening in financial conditions. Therefore, forecasts are based on an outlook that financial conditions remain tight.

Inflation

Consumer inflation edged up by 0.18 points quarter-on-quarter and hit 7.64 percent in year-on-year terms in the second quarter of 2016. After contributing to a more benign inflation outlook in the first quarter of the year, unprocessed food prices stopped improving in the second quarter, which, along with rising oil prices, caused inflation to soar. On the other hand, annual inflation across core goods and services, which constitute core inflation, decreased. Given the relatively stable course of the Turkish lira, the cumulative exchange rate effects on annual inflation continued to diminish through the core goods channel. Meanwhile, import prices, particularly for oil, soared in this period. Therefore, inflation increased in food and energy but fell across core items in the second quarter.

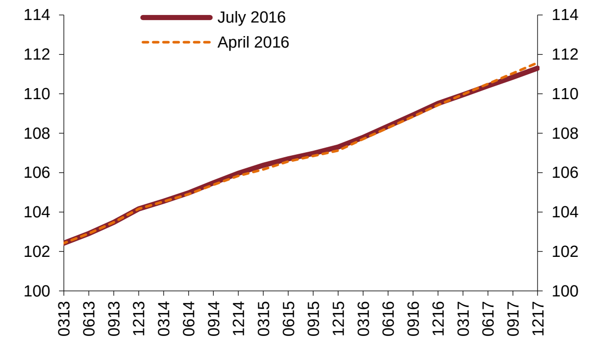
Demand Conditions

Economic activity was broadly in line with the April Inflation Report forecasts in the first quarter. The GDP grew by 0.8 percent quarter-on-quarter and 4.8 percent year-on-year. Thus, the assumption for the output gap was kept unchanged for the first quarter of 2016 (Table 7.1.1 and Chart 7.2.3). The quarterly growth was spurred by agriculture and industry, while construction and services produced a smaller contribution. On the spending side, private consumption recorded the largest quarterly increase since the last quarter of 2010 and became the main driver of quarterly growth. On the other hand, investment demand and net exports put downward pressure on growth.

The second-quarter data signal no additional improvement in economic activity. Industrial production fell below the previous quarter's average by 0.4 percent during April-May. Sales, production, and import indicators regarding domestic demand suggest a quarterly pickup in final domestic demand, which, however, might be smaller than in the first quarter. Moreover, according to April-May data on external trade, external demand may provide limited contribution to growth. Accordingly, despite having narrowed slightly compared to the previous quarter, the output gap continues to put downward pressure on inflation (Table 7.1.1 and Chart 7.2.3).

Domestic demand may expand further in the upcoming period, particularly on account of consumption, and external demand is likely to recover on the back of the moderate growth expected in Turkey's export markets. External demand is adjusted down due to the weakening global growth. In fact, the annual growth rate of the export-weighted global production index revised by July forecasts posted a limited decline compared to the April Inflation Report (Chart 7.1.1).

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

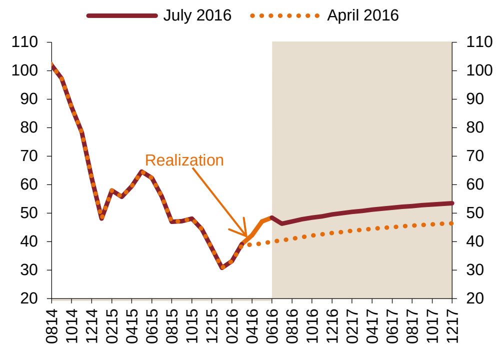


Source: Bloomberg, Consensus Forecasts, CBRT.

Oil, Import and Food Prices

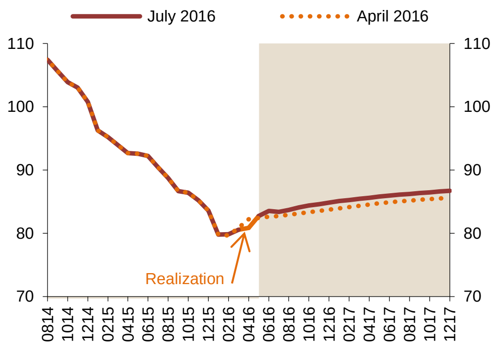
Oil prices surged in the inter-reporting period, rendering import prices relatively less supportive of the inflation outlook in the second quarter. Thus, assumptions for crude oil prices and USD-denominated import prices were revised upwards compared to the April Inflation Report (Table 7.1.1). With regard to annual averages, the crude oil price assumption was increased from 40 USD to 44 USD for 2016. Also, assumptions for annual percentage changes in average import prices were revised slightly upwards for 2016. The first-quarter decline in food inflation came to a halt in the second quarter due to rising unprocessed food prices, which are expected to increase further in July. Still, thanks to the measures taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee and the decline in food demand owing to the tourism sector, food price inflation for end-2016 is expected to be lower compared to the previous reporting period. Accordingly, the assumption for food inflation was revised downwards to 8 percent for 2016, and kept unchanged at 8 percent for 2017.

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



Source: Bloomberg, CBRT.

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



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 2016-2018 period. The effects of the minimum wage rise in early 2016 on production costs, aggregate demand and inflation are being closely monitored.

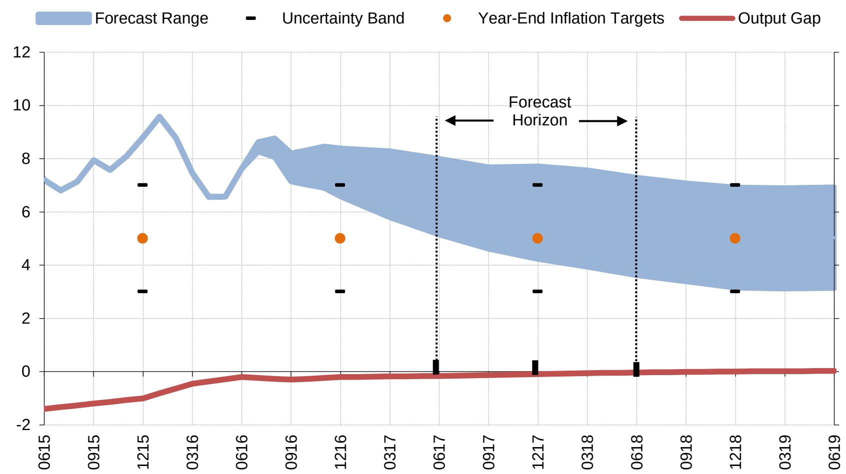
Table 7.1.1. Revisions in Assumptions

		April 2016	July 2016
Output Gap	2016Q1	-0.5	-0.5
	2016Q2	0.1	-0.2
Food Prices (Year-end Percent Change)	2016	9.0	8.0
	2017	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2016	-8.9	-8.5
	2017	3.2	4.0
Oil Prices (Average, USD)	2016	40	44
	2017	45	52
Export-Weighted Global Production Index (Average Annual Percent Change)	2016	1.8	1.7
	2017	2.0	1.8

7.2. Medium-Term Forecasts

In view of the economic conditions, policy stance and assumptions, inflation forecasts for the upcoming period are unchanged from the previous Report. Given a decisive 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 starting from 2018 after falling to 7.5 percent in 2016 and to 6 percent in 2017. Hence, inflation is expected to be, with 70 percent probability, between 6.6 percent and 8.4 percent (with a mid-point of 7.5 percent) at end-2016 and between 4.3 percent and 7.7 percent (with a mid-point of 6 percent) at end-2017 (Chart 7.2.1).

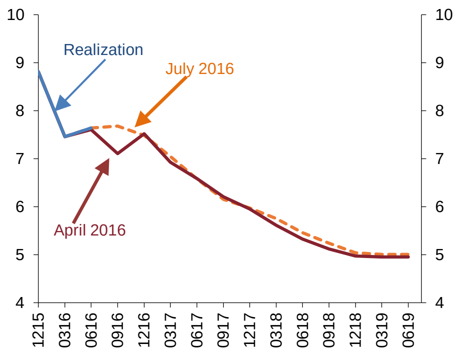
Chart 7.2.1.
Inflation and Output Gap Forecasts*
(Percent)



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

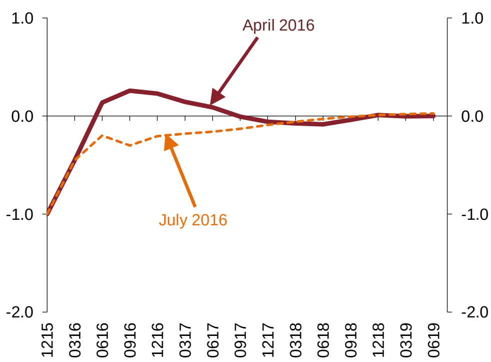
The Turkish lira followed a fluctuating course following the April Inflation Report, while oil prices inched up and import prices remained close to the projections. Although TL-denominated import prices are estimated to be higher compared to the previous reporting period, the pass-through to inflation will be restricted. The recent upward movement in unprocessed food prices and adjustments in tobacco prices will push inflation significantly upwards in July. On the other hand, food prices are projected to see a downward correction in the upcoming period. In addition, depending on the short-term developments in economic activity, core inflation is likely to settle on a more modest path across the year compared to the previous reporting period. The rise in tobacco prices is expected to push the end-2016 inflation forecast upwards compared to the April projections, yet the improvement in headline inflation and the course of economic activity are expected to compensate for this increase. Thus, the consumer inflation forecast for end-2016 is unchanged (Chart 7.2.2). The recent domestic developments pose downside risks to demand, particularly over the short-term. Therefore, output gap forecasts are revised downwards (Chart 7.2.3).

Chart 7.2.2.
Inflation Forecasts
(Percent)



Source: TURKSTAT, CBRT.

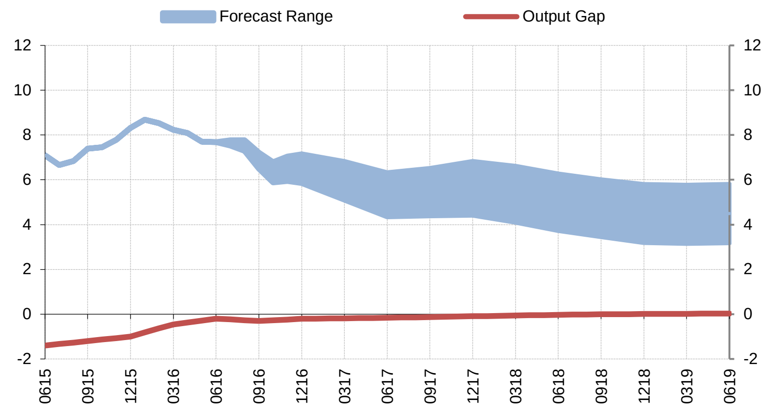
Chart 7.2.3.
Output Gap Forecasts
(Percent)



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 and tobacco prices are also reported. Accordingly, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are presented in Chart 7.2.4. The inflation indicator as measured above is expected to decline gradually to 4.5 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	6.6	7.6	5.0
24-month-ahead	5.5	7.0	5.0

* July 2016 survey period results.
Source: CBRT.

7.3. Risks and Monetary Policy

Financial conditions continue to be tight despite the recent rise in the global risk appetite, which eased conditions slightly. Financial conditions are likely to remain tight in the short term owing to domestic developments and weaker capital flows. Accordingly, credit growth rates are not expected to recover notably. The moderate course of credits is driven not only by demand but also by supply-side factors. Recent surveys show that credit standards did not display any easing. Domestic developments have recently led to fluctuations in markets. Liquidity measures taken by MPC have partially limited the volatility in markets. It is projected that the effects of the fluctuations in markets will prove temporary and Turkey will sustain its resilience through its sound economic fundamentals. On the other hand, to balance the short-term effects of the tightness in financial conditions, the CBRT may make downside adjustments to required reserves, if deemed necessary.

Economic activity maintains a moderate and stable course of growth. Consumption spending fuels domestic demand, while investments remain relatively sluggish. Despite the adverse effects of geopolitical developments on external demand, exports of goods to EU countries remain strong. Restored relations with Russia may support external demand in the last quarter. Accordingly, exports are expected to provide further support to growth in the upcoming period. Meanwhile, the steady increase in employment and wage developments boost domestic demand through the income channel. In this respect, economic activity is expected to grow moderately across the year.

Recent terrorist attacks and domestic developments pose a downside risk to economic activity especially through the tourism sector. Thus, the economy may witness a slowdown in the second and third quarters in which tourism revenues register a high share within economic activity. In fact, leading indicators of the second quarter point to a quarter-on-quarter deceleration, which may also continue through the third quarter. On the other hand, the economy is expected to maintain a steady course of growth amid structural arrangements and investment incentives. Against this background, risks to economic activity are likely to be balanced in the medium term.

The current account deficit may widen slightly in the short term even though external balances continue to recover. The current account balance is being positively affected by the lagged effects of the decline in energy prices. Moreover, the moderate course of credits and the increasing share of commercial credits in credit composition also support the improvement in the current account balance. However, the fact that the current economic growth is fueled by domestic demand and that the tourism sector is experiencing a slowdown signals a possible deceleration in the recovery of the current account balance in the upcoming period. Yet, the current account deficit is estimated to hover at reasonable and predictable levels across the year.

Even though inflation is projected to rise in the short term, core inflation is expected to settle on a milder track across the year. The recent hikes in unprocessed food prices and the tobacco price adjustments will cause an upsurge in July inflation. Yet, food prices may see a downward correction in the upcoming periods. Owing to the measures taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee accompanied by the seasonal decline in food demand caused by the tourism sector, the year-end food price inflation is expected to prove lower compared to the previous reporting period. In addition, owing to the expected deceleration in economic activity in the short term, core inflation is anticipated to exhibit a milder course compared to the previous reporting period across the year. Meanwhile, the minimum wage hike is estimated to have a limited effect on core inflation on the back of state support. Accordingly, inflation forecasts for the baseline scenario were unchanged.

Inflation forecasts accommodate both upside and downside risks. Recent exchange rate developments pose an upside risk to inflation through the cost channel. Moreover, the possible adjustments to administered prices and taxes to compensate for the effect of the recent rise in budget expenditures on fiscal balances may push inflation upwards towards the end of the year. On the other hand, the latest domestic developments constitute downside risks to demand and inflation through the confidence channel and the tourism sector. The CBRT will closely monitor the developments affecting inflation and take necessary policy measures to achieve price stability.

Despite experiencing significant external shocks in recent years, the adopted policy framework was successful in containing the deterioration in inflation and inflation expectations. However, price stability is yet to be achieved. Ten years of experience with the inflation targeting regime showed that combatting inflation requires joint efforts. Thus, in order to reduce inflation to the 5-percent target permanently, all institutions must fulfill their duties by taking structural factors into account. In this respect, actions taken by the Food and Agricultural Products Markets Monitoring and Evaluation Committee set an invaluable precedent. In the upcoming period, the CBRT will contribute to these efforts by undertaking extensive studies to examine structural issues in inflation dynamics.

Global financial markets and capital flows remain highly volatile. Despite the recent slight rise in the risk appetite, persisting concerns over global growth and uncertainties in global monetary policies feed into volatility. The tight monetary policy stance, the cautious macroprudential policy and the effective use of the policy tools announced in the road map of August 2015 enhanced the resilience of the economy against external shocks to a certain extent. However, adverse domestic developments may cause fluctuations in markets if accompanied by global volatilities and this may place extra pressure on financial conditions. In such circumstances, the CBRT will closely monitor the developments in both global and domestic markets and take necessary stabilizing measures by utilizing its large variety of tools.

The recent monetary policy decisions of the CBRT should be evaluated under the scope of the simplification process. The ultimate aim of the simplification is to achieve a narrow and symmetrical corridor and provide funding via a single rate. The simplification is believed to contribute to the effectiveness of the transmission mechanism. Therefore, simplification of the monetary policy will be finalized within a reasonable schedule. The pace and timing of simplification will depend on the developments regarding inflation and financial stability.

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, sustained fiscal discipline has become essential in reducing 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 reduction in 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.