7. Medium-Term Forecasts

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

In the third quarter of 2014, financial conditions and the global risk appetite followed a volatile course due to international developments. The uncertainty about the Fed's exit from monetary easing and the concerns over global growth, which were particularly more significant in the second quarter, caused markets to fluctuate. Moreover, rising geopolitical risks were other factors that fueled market volatility. Yet, the fall in raw material prices, oil prices in particular, may have a favorable impact on the risk premiums of countries, such as Turkey, that are dependent on external energy. Additionally, further compliance with the current tight fiscal stance as set out in the MTP is expected to have positive implications for Turkey's risk premium.

Inflation

Annual consumer inflation fell by 0.3 points quarter-on-quarter to 8.86 percent in the third quarter of 2014. This fall was mostly attributed to developments in prices of energy and core goods. Energy prices remained relatively flat in the third quarter. Durable goods have been exposed to lessened inflationary pressures amid waning lagged effects of exchange rate changes, whereas inflation continued to rise in the other core goods category, where exchange rate pass-through is observed with more lag. On the other hand, due to adverse weather conditions and the cumulative effects of the Turkish lira depreciation, domestic food inflation continued to diverge markedly from international food inflation in the third quarter, with food prices continuing to be the subcategory making the greatest contribution to inflation. Meanwhile, prices of services remained on the rise, particularly across subcategories closely linked to food prices. Despite these deteriorations, prices of core goods improved in quarterly terms amid the better outlook for core inflation.

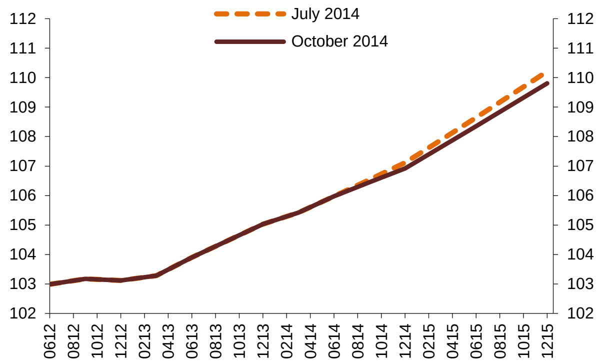
Demand Conditions

In the second quarter of 2014, the GDP grew by 2.1 percent year-on-year, following a slower course than envisioned in the July Inflation Report. Final domestic demand declined at a pace similar to the first quarter due to falling private demand and reduced public spending. In the second quarter, as a result of global growth developments, exports performed weaker than expected. Yet, net exports continued to make a positive contribution to growth in the second quarter. Against this backdrop, the output gap was revised slightly downward (Table 7.1.1).

On the production side, during July-August, the industrial production index expanded by 1.1 percent from the second-quarter average. However, the fall in agricultural output and the slowdown in the construction sector are expected to restrain growth. Thus, in the third quarter, economic activity is likely to grow more moderately than in the second quarter. Data on the expenditures side suggest that a steady improvement in consumer and investor confidence is yet to appear, slowing the pace of recovery in domestic demand.

Indicators for external demand show that the global economic slowdown and the ongoing uncertainty about global monetary policies and geopolitical tensions may curb external demand. The export-weighted global economic activity index has declined slightly in the inter-reporting period. Therefore, exports are expected to provide less contribution to growth in the upcoming period (Chart 7.1.1).

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

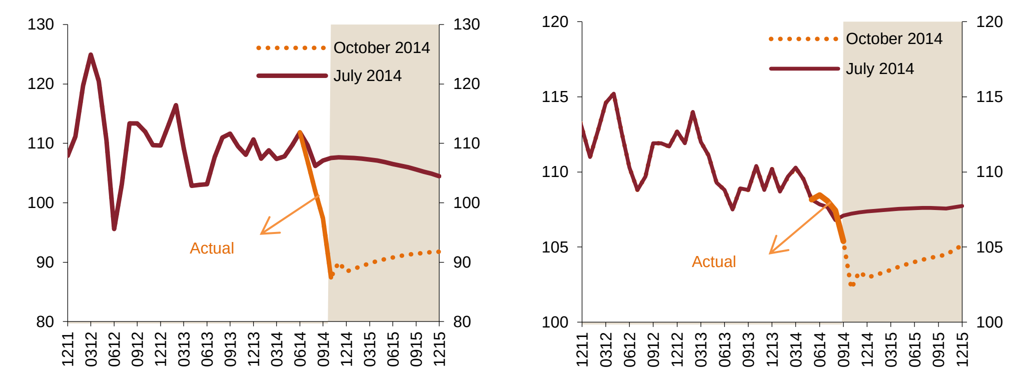


* For methodology, see Box 2.1, Inflation Report 2010-II.
Source: Bloomberg, Consensus Forecasts, CBRT.

Import Prices

In the third quarter, oil and import prices lagged behind the July Inflation Report forecasts (Chart 7.1.2). Accordingly, the assumption for the average oil and import prices for 2014 was revised downwards (Table 7.1.1). This revision drives the end-2014 and 2015 forecasts by 0.3 and 0.2 points lower, respectively, from the previous Report.

Chart 7.1.2. Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.
Source: Turkstat, CBRT.

Fiscal Policy and Tax Adjustments

Medium-term forecasts are based on the assumption that tax adjustments and administered prices are consistent with inflation targets and automatic pricing mechanisms. Higher-than-envisioned price hikes to electricity and natural gas by 9 percent in early October caused an upward revision of the end-2014 inflation forecast by 0.2 percentage points. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a tight fiscal stance will be implemented and the primary expenditures to GDP ratio will decrease gradually.

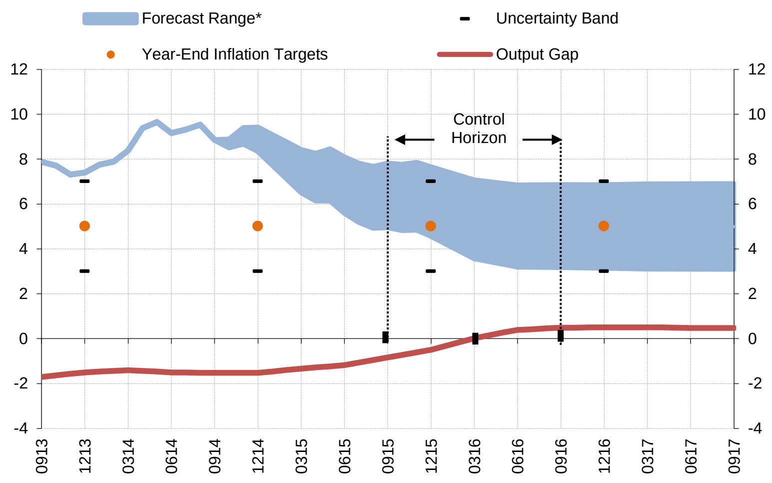
Table 7.1.1. Revisions to Assumptions

		October 2014	July 2014
Output Gap	2014Q2	-1.50	-1.30
	2014Q3	-1.50	-1.30
Food Prices (Year-end Percent Change)	2014	12.5	9.0
	2015	9.0	8.0
	2016	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2014	-2.7	-1.8
	2015	-3.3	-0.3
Oil Prices (Average, USD)	2014	102	108
	2015	92	106
Export-Weighted Global Production Index (Average Annual Percent Change)	2014	1.9	2.0
	2015	2.4	2.6

7.2. Medium-Term Outlook

Medium-term forecasts are based on the assumption that the tight monetary policy stance will be maintained by keeping the yield curve flat. A further assumption is that the annual loan growth rate will near 15 percent by the end of 2014 and stabilize around these reasonable levels on the back of the macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 8.4 percent and 9.4 percent (with a mid-point of 8.9 percent) at end-2014 and between 4.6 percent and 7.6 percent (with a mid-point of 6.1 percent) at end-2015. Inflation is projected to stabilize around 5 percent in the medium term (Chart 7.2.1).

Chart 7.2.1.
Inflation and Output Gap Forecasts (Percent)



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

Inflation is envisioned to considerably exceed the 5-percent target by the year-end, and decrease significantly as of the start of 2015 and fall to 6.1 percent at end-2015. This decline is driven by lower futures prices for commodities, oil prices in particular, and projections that cumulative exchange rate effects will continue to taper off, and food price inflation will recede to past years' average. Moreover, demand conditions and the announced tight fiscal policy stance will likely support the decline in inflation in this period. The fluctuating course in 2015 inflation forecasts stem from the base effects.

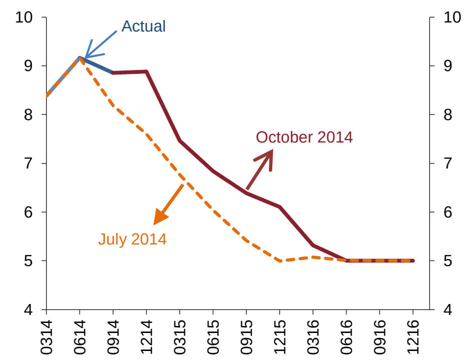
The end-2014 inflation forecast of 7.6 percent in the July Inflation Report was raised to 8.9 percent due to developments in the inter-reporting period. The upward revision in food inflation forecasts, the higher-than-expected hikes in electricity and natural gas tariffs and the deterioration in pricing behaviors, particularly across the services sector, drove the year-end forecast higher from the July Inflation Report; yet, downward revisions to the output gap and import prices have partially compensated for these effects.

Raising the year-end food price inflation forecast from 9 percent in the July Inflation Report to 12.5 percent brought year-end inflation forecasts up by 0.8 points (Table 7.1.1). Additionally, early October price hikes in electricity and natural gas of 9 percent, which were slightly higher than the assumptions in the July Inflation Report, drove the year-end inflation forecast up by 0.2 points, while the deterioration in pricing behavior added 0.7 points to the year-end inflation forecast. The downward revision in import prices offset 0.3 points of the total upward effects of 1.7 points, while the downward revision in the output gap since the second quarter of 2014 cancelled out 0.1 point of these effects. Accordingly, the end-2014 inflation forecast was revised up by 1.3 points from the previous Report.

On the other hand, the end-2015 inflation forecast was raised from 5 percent in the previous Report by 1.1 points to 6.1 percent. 0.3 points of this revision was driven by the end-2015 food inflation forecast that rose from 8 to 9 percent. Moreover, the marked upward revision to the end-2014 inflation adds 1.2 points to the end-2015 forecast due to persistence in inflation. Yet, as the second-quarter GDP data and external demand outlook are more negative than in the previous Report, the downward revision in the output gap restrains the upward impact from food prices and underlying inflation by 0.2 points (Chart 7.2.3). Meanwhile, the fact that the forecast path for import prices is revised down from the previous Report as of end-2014 compensates for 0.2 points of the upward impact on 2015 inflation forecasts.

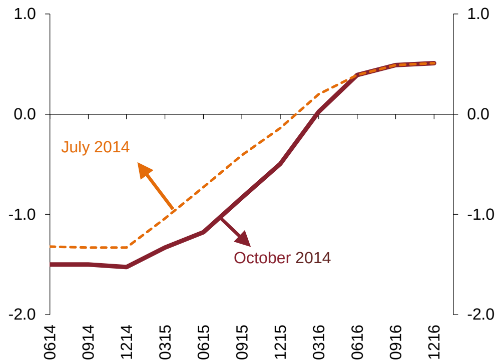
Comparison of July 2014 and October 2014 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast
(Percent)



Source: TurkStat, CBRT.

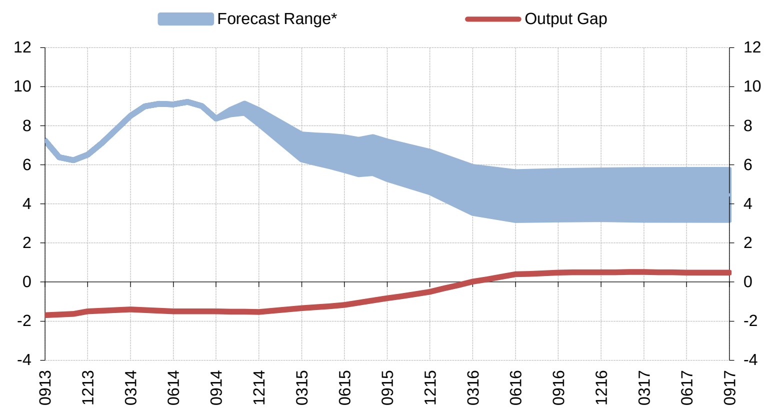
Chart 7.2.3.
Output Gap Forecast
(Percent)



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 publicly announced. 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 pick up slightly by the final quarter of 2014 on the back of price hikes in electricity and natural gas and then fall gradually throughout 2015 and stabilize around 4.5 percent in the medium term.

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



* Shaded region indicates 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 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, 12-month and 24-month-ahead inflation expectations of the Survey of Expectations' respondents are above the CBRT's baseline scenario forecasts (Table 7.2.1). Furthermore, the increase in inflation expectations in the inter-reporting period necessitates close monitoring of expectations and pricing behavior.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2014 Year-end	8.9	9.2	5.0
12-month-ahead	6.3	7.5	5.0
24-month-ahead	5.0	6.8	5.0

* October 2014 survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2014- 2016.
Source: CBRT.