7. Medium-Term Projections

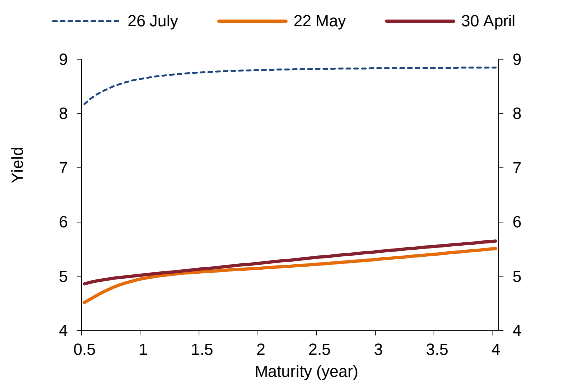
This chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Conditions

Having followed a downward course in May across all maturities on policy rate reductions and the credit rating upgrade, the yield curve shifted upwards due to heightened global uncertainty at the end of the month (Chart 7.1.1). During this period, the CBRT implemented additional monetary tightening and FX sale auctions amid mounting volatility in exchange rates as well as the robust pace of credit growth. In its July meeting, the MPC delivered a limited additional monetary tightening to support financial stability and curb upside risks on the pricing behavior. Accordingly, the upper band of the interest rate corridor was raised by 75 basis points. The MPC re-iterated that additional monetary tightening would be implemented when deemed necessary. Furthermore, some additional arrangements were introduced to reinforce the effect of the interest rate corridor and the liquidity policy during additional monetary tightening periods.

Chart 7.1.1.
Yield Curve*



* Calculated from the compounded returns on bonds quoted in BIST Bonds and Bills Market by using ENS method.
Source: BIST, CBRT.

Inflation

In the second quarter of 2013, annual consumer inflation went up to 8.3 percent, thus exceeding the April Inflation Report forecasts. This was attributed to higher-than-envisioned increases in unprocessed food prices, which continued in the second quarter of the year. Annual inflation in core goods maintained its downward course in this period, whereas services inflation displayed a more-than-anticipated rise, adding 0.1 points to the year-end inflation forecast. The restricted recovery of the economic activity continued to provide support to the inflation outlook and core inflation indicators presented a mild outlook amid sluggish cost-side pressures.

Unprocessed food prices continued to increase from the year-end; in the second quarter of the year, seasonally adjusted unprocessed food prices increased mainly on the upward movement in fresh fruit and vegetable prices. Nevertheless, in view of the volatility in unprocessed food prices, the year-end food inflation forecast remained unchanged from the April Inflation Report at 7 percent.

Table 7.1.1.
Revisions to 2013 Assumptions

		April 2013	July 2013
Output Gap	2013Q1	-2.0	-2.0
	2013Q2	-1.8	-2.0
Food Price Inflation (Year-end Percent Change)	2013-2015	7.0	7.0
Import Prices (Average Annual Percent Change, USD)	2013	-1.4	-1.3
	2014	-	-1.7
Oil Prices (Annual Average, USD)	2013	103	107
	2014	98	102
Export-Weighted Global Production Index (Average Annual Percent Change)	2013	1.6	1.2
	2014	2.5	2.4

Demand Conditions

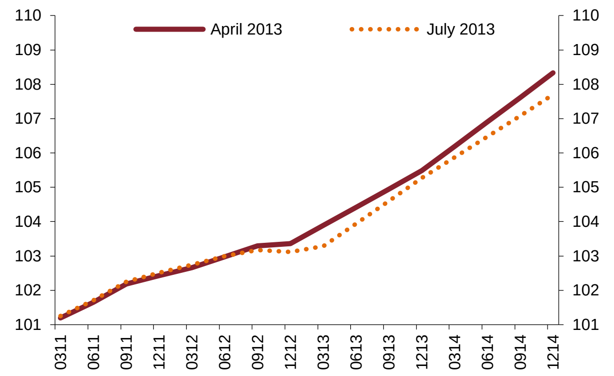
In the first quarter of 2013, economic activity remained mainly in line with the outlook presented in the April Inflation Report. The quarter-on-quarter GDP growth in the first quarter was largely driven by the final domestic demand. In the meantime, exports followed a horizontal course due to weak external demand, while imports surged. Second quarter data indicate that consumption demand continues to increase moderately.

Fluctuations in financial markets amid changes in global liquidity conditions may cause domestic demand to follow a weaker course in the second quarter than envisioned in the previous reporting period. In fact, expectations for domestic orders were slightly distorted recently compared to the second quarter.

In the second quarter of 2013, external demand remained weak. In this period, economic activity in the Euro Area continued to slow down, while global growth forecasts were revised downwards. Accordingly, the export-weighted global growth index was revised slightly downwards (Chart 7.1.2)

In view of the developments in domestic and external demand, forecasts are based on an outlook where the contribution of aggregate demand conditions to disinflation increased slightly in the inter-reporting period. Despite the revision, the inflation forecast for end-2013 was kept unchanged given lagged effects of the economic activity on inflation, while 2014 year-end inflation forecast was lowered by 0.1 percentage points.

Chart 7.1.2.
Export-Weighted Global Economic Activity Index*
(2008Q2=100)

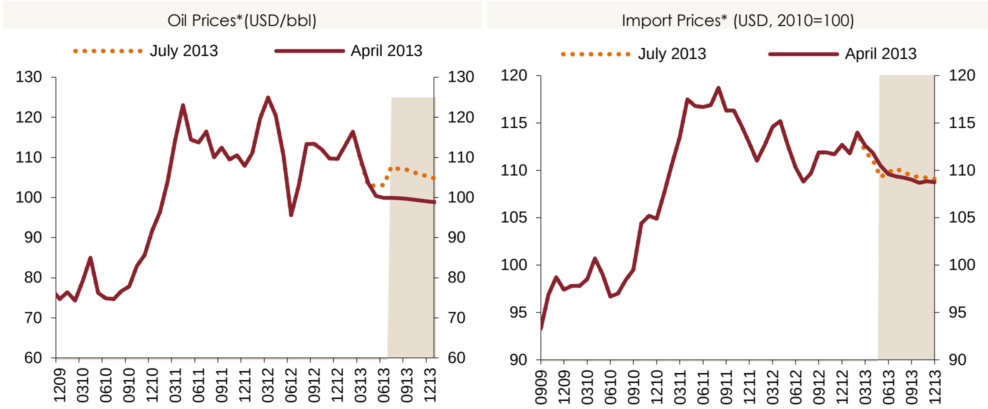


* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

Import Prices

In the second quarter of the year, import prices remained in line with the April Inflation Report assumptions, while oil prices were slightly above forecasts (Chart 7.1.3). Accordingly, the average oil price assumption for 2013, which was set as USD 103 in the April Inflation Report, was revised upwards to USD 107 in line with the average futures price in the first three weeks of July (Table 7.1.1). The depreciation of the TL due to global developments in this period led to an increase in TL-denominated import prices in the inter-reporting period. These developments added 0.8 and 0.2 points to year-end inflation forecasts for 2013 and 2014, respectively.

Chart 7.1.3.
Revisions to Oil and Import Price Assumptions



* Shaded region denotes the forecast period.
Source: Bloomberg, CBRT.

* Shaded region denotes the forecast period.
Source: TurkStat, CBRT.

Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that no additional tax adjustments will be introduced to tobacco and energy products the rest of the year. Meanwhile, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and automatic pricing mechanisms.

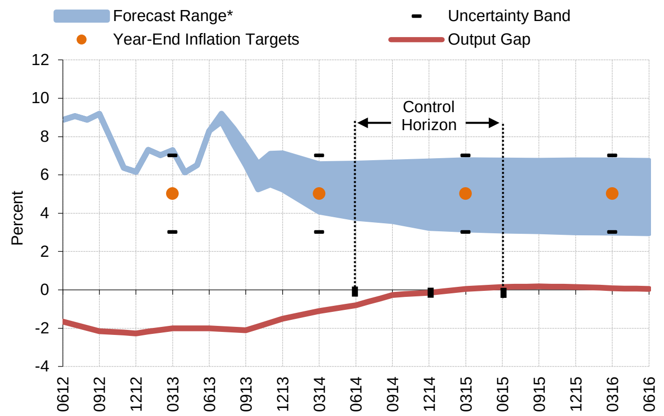
MTP projections are taken as given regarding the fiscal policy stance. Accordingly, it is assumed that fiscal discipline will be preserved and the ratio of budget expenditures to GDP will not display a notable change compared to the first half of the year. Thus, there has been no revision to the end-2013 inflation forecast stemming from the fiscal policy.

7.2. Medium-Term Outlook

Medium-term forecasts envisage an outlook where the cautious and flexible stance of the monetary policy is preserved on account of the recently-elevated uncertainties regarding global monetary policies and weakening capital flows. Accordingly, it is assumed that the liquidity policy will be tight, the interest rate corridor will be actively used when necessary, and the annual growth of credit will fall to 15 percent by mid-2014. Accordingly, inflation is expected to be, with 70 percent probability, between 5.2 percent and 7.2

percent (with a mid-point of 6.2 percent) at end-2013and between 3.3 percent and 6.7 percent (with a mid-point of 5.0 percent) at end-2014. 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.
Source: CBRT.

In sum, the end-2013 inflation forecast was revised upwards in the inter-reporting period mainly due to developments in the exchange rate and oil prices. These cost-side factors added 0.8 and 0.2 points to 2013 and 2014 year-end inflation forecasts, respectively. In addition, services inflation also contributed 0.1 percentage points to 2013 year-end inflation forecast (Chart 7.2.2). Thus, the 2013 year-end inflation forecast was revised upwards by 0.9 percentage points in the inter-reporting period. Given the downward revision in output gap assumption, the inflation forecast for end-2014 was revised upwards merely by 0.1 percentage points.

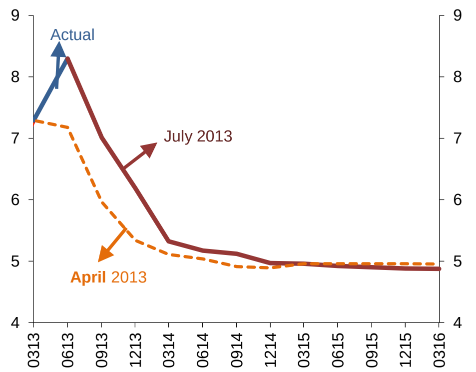
Inflation is estimated to fluctuate in the short term due to the base effect in energy prices. Accordingly, annual inflation is expected to go up in July before trending downwards from August onwards (Chart 7.2.1). Although inflation is likely to overshoot the 5-percent target at the year-end, it is expected to plunge in early 2014 as the effects of the hike in tobacco prices on annual inflation taper off in January 2013. In sum, inflation is expected to settle on a target-consistent path by early 2014.

Chart 7.2.3 presents revisions to output gap forecasts. The first-quarter data on national accounts were compatible with the April Inflation Report forecasts. Hence, the output gap remained unchanged in the first quarter

(Table 7.1.1). However, in view of the recently announced data, output gap forecasts were revised downwards as of the second quarter (Chart 7.2.3).

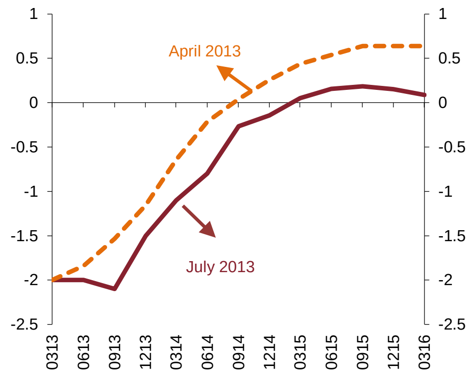
Comparison of April 2013 and July 2013 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast



Source: CBRT.

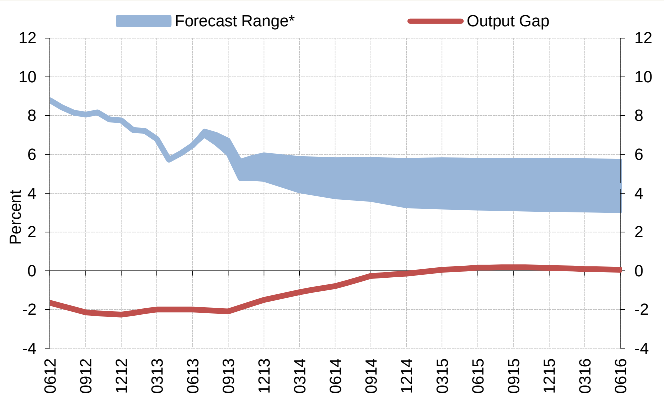
Chart 7.2.3.
Output Gap Forecast



Source: TurkStat, CBRT.

Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food and tobacco are among major factors to cause a deviation in inflation forecasts. Hence, inflation forecasts excluding unprocessed food and tobacco 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 decline in the rest of the year mainly due to base effect on energy prices. Inflation excluding unprocessed food, tobacco and alcoholic beverages is expected to stabilize around 4.5 percent in the medium term.

Chart 7.2.4.
Inflation Forecast Excluding Unprocessed Food, Tobacco and Alcoholic Beverages



* 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 should take the inflation target as a benchmark in their pricing plans and contracts and focus on the underlying medium-term inflation, rather than temporary price fluctuations. Likewise, it is crucial that the CBRT's current inflation forecasts be compared to 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 raising of inflation expectations in the inter-reporting period warrants close monitoring of expectations.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2013 Year-end	6.2	7.2	5.0
12-month ahead	5.2	6.4	5.0
24-month ahead	4.9	6.1	5.0

* July 2013, second survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2013- 2015.
Source: CBRT.

7.3. Risks and Monetary Policy

Ongoing fragility in the global economy and heightened uncertainty of global monetary policies necessitate a flexible monetary policy framework. Accordingly, global liquidity conditions will play an important role on the future course of monetary policy. The current monetary policy and the instruments designed by the CBRT provide a flexible framework to contain the adverse effects of the global shocks on the domestic economy.

Currently, the data on global economic activity do not exhibit a stable pattern. Risk appetite and capital flows may remain volatile, should uncertainties regarding economic policies of advanced economies persist. This situation may pose risks to the inflation outlook and financial stability. In order to contain the excessive volatility in the exchange rate, the CBRT will effectively use the interest rate corridor and other policy instruments should such a risk materialize.

Meanwhile, the possibility for a delay in the global economic recovery, which therefore requires maintaining quantitative easing policies in advanced economies for an extended period remains as downside risks. In that case, capital flows to emerging economies are likely to re-accelerate. Materialization of such a scenario may prompt the CBRT to lower short-term money market rates by easing liquidity conditions, while the adverse impact of rapid capital inflows on financial stability is alleviated through required reserves and the reserve options mechanism.

Recently, the medium-term inflation expectations have displayed a slight deterioration as several factors have simultaneously exerted pressure on inflation. Increases in unprocessed food prices, higher oil prices, and exchange rate volatility may continue to have an adverse impact on inflation in the short term. Although these effects are expected to be temporary, it is also possible that unprocessed food prices are corrected with a delay or financial markets may continue to be volatile. Accordingly, the CBRT will maintain its cautious stance until inflation outlook is consistent with the medium-term targets and will opt for further monetary tightening by closely monitoring the pricing behavior.

In formulating its monetary policy strategy, the CBRT monitors developments on fiscal policy and tax adjustments closely with regard to their effects on the inflation outlook. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. Hence, it is assumed that fiscal discipline will be maintained and there will be no unanticipated hikes to administered prices in the forthcoming period. 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.

Sustaining the cautious stance in fiscal and financial sector policies is critical to maintaining the resilience of our economy against global imbalances. As for the medium term, strengthening structural reforms that ensure the sustainability of the fiscal discipline on a permanent basis and reduce the savings deficit will support macroeconomic stability. Steps taken in this regard will also provide more room for maneuvering in the monetary policy and improve social welfare by keeping interest rates of long-term government securities permanently at low levels. In this respect, fulfilling the structural reforms envisaged by the MTP remains to be of utmost importance.