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 second quarter of 2014, the decisions made by major central banks to support global liquidity and prospects for a continuation in accommodative monetary policy alleviated global uncertainties, thereby causing a notably lesser volatility in risk premium as well as bills and bonds, stocks and foreign exchange markets. Against this background, capital inflows towards emerging economies grew robust in the second quarter of the year. In this period, Turkey's financial indicators followed a similar path to those of other emerging economies. The CBRT's tight monetary policy stance and macroprudential measures contributed to the balancing process and improved domestic financial indicators.

Inflation

In the second quarter of 2014, CPI inflation reached 9.16 percent by posting a quarter-on-quarter increase of 0.8 percentage points. This was driven by the increase of food and core goods prices. In particular, food prices followed a quite negative course due to drought and the reverberations of the exchange rate. Annual inflation slowed in durable goods, which are among the sub-items of core goods, while other core goods remained on the rise due to lagged effects of the exchange rate pass-through. On the services front, the underlying trend followed a negative outlook, while annual inflation edged down mostly due to the base effect. Accordingly, the rise in annual inflation in core inflation indicators ended in the second quarter.

On the other hand, in the second quarter of the year, pricing behavior and inflation expectations witnessed an improvement after the deterioration in the first quarter. Moreover, domestic manufacturing industry prices remained flat after a long period amid appreciation of the Turkish lira and the mild course of import prices. Hence, except for the ongoing supply-side restraints on food prices, cost-side pressures on inflation eased slightly in the second quarter.

Table 7.1.1. Revisions to Assumptions

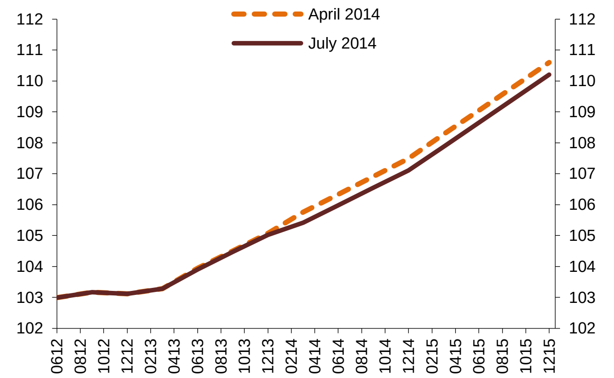
		July 2014	April 2014
Output Gap	2014Q1	-1.40	-1.40
	2014Q2	-1.30	-1.30
Food Prices (Year-end Percent Change)	2014	9.0	9.0
	2015-2016	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2014	-1.8	0.5
	2015	-0.3	0.1
Oil Prices (Average, USD)	2014	108	106
	2015	106	102
Export-Weighted Global Production Index (Average Annual Percent Change)	2014	2.0	2.3
	2015	2.6	2.6

Demand Conditions

In the first quarter of 2014, economic activity proved largely consistent with the outlook presented in the April Inflation Report. Accordingly, the output gap was kept unchanged for the first quarter of 2014 (Table 7.1.1). In this period, the weak course in private sector demand was compensated by the public sector demand, which led the final domestic demand to follow a flat course. Exports of goods and services recorded a robust increase on the back of gold exports, whereas imports of goods and services registered a quarterly decline, thereby causing a further balancing of the demand components. An analysis of second-quarter leading indicators from the production side suggests that the industrial production index stayed close to the average of the previous quarter in the April-May period. Meanwhile, readings on the expenditures side indicate that amid the recovery in financial conditions and confidence indices, the decline in private sector demand halted particularly at the consumption side and the mild growth in economic activity continued. Accordingly, the outlook presented in the April Inflation Report continued in the second quarter of 2014 and the output gap was kept unchanged (Table 7.1.1).

Domestic demand, which remained mild amid domestic uncertainties and the tightening in financial conditions in the first half of the year, is expected to settle into a track of gradual recovery in the second half due to relatively eased financial conditions. Meanwhile, amid the rebound in the global economy, exports are estimated to further contribute to growth. However, lingering uncertainties on the strength of recovery in the global economy, global monetary policies and geopolitical developments pose a downside risk to growth. Indicators of external demand suggest that the export-weighted global economic activity index remained unchanged from the previous reporting period, while expectations for recovery were maintained(Chart 7.1.1).

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

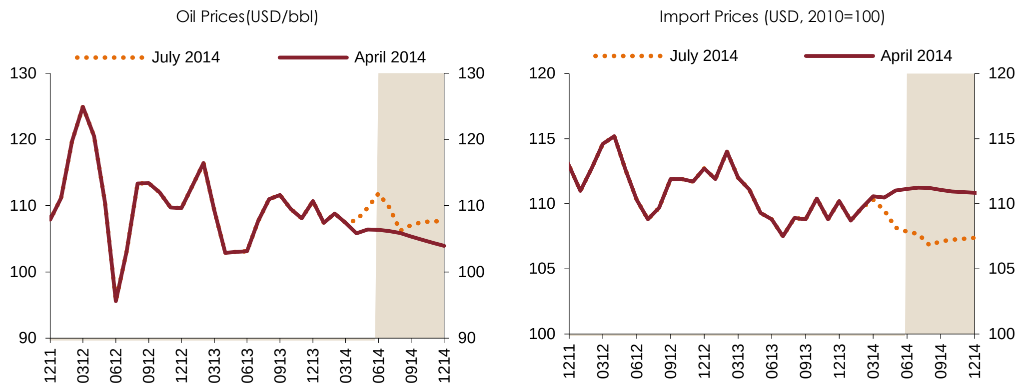


* For methodology, see Box 2.1, Inflation Report 2010-II.
Source: Bloomberg, Consensus Forecasts, CBRT.

Import Prices

In the second quarter of the year, oil prices slightly exceeded the April Inflation Report forecasts, while import prices lagged behind the predictions (Chart 7.1.2). Thus, the assumption for the average oil price for 2014 was revised upwards, while that of import prices was revised downwards (Table 7.1.1). Under the current outlook, the effects of oil and import prices on inflation offset each other. Hence, the contribution of external prices to year-end inflation forecast was kept constant.

Chart 7.1.2. Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.

Source: Turkstat, CBRT.

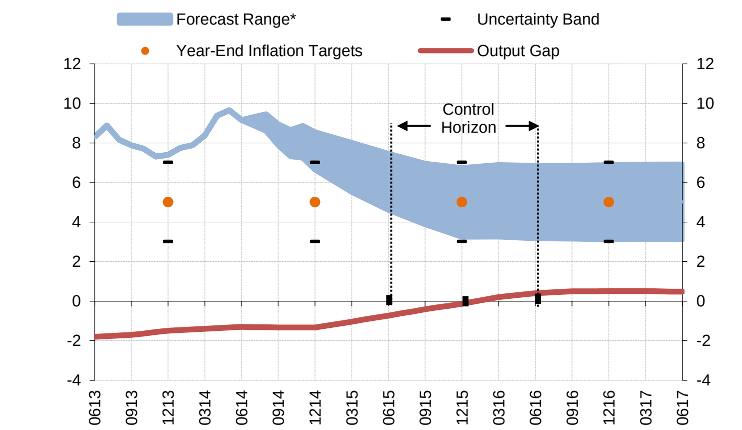
Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that tax adjustments and administered prices are consistent with the inflation targets and automatic pricing mechanisms. Thus, the end-2014 inflation forecast was subject to no revision stemming from the fiscal policy. The medium-term fiscal policy stance is based on the MTP projections covering the 2014-2016 period. Accordingly, the cautious fiscal stance will probably be preserved and primary expenditures will likely be kept under control.

7.2. Medium-Term Outlook

Medium-term forecasts are based on the assumption that the tight stance of the monetary policy will be maintained by keeping the yield curve almost flat and the improvement in global liquidity conditions will be sustained. Moreover, the annual loan growth rate will near 15 percent by the end of 2014 on the back of the adopted macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 6.7 percent and 8.5 percent (with a mid-point of 7.6 percent) at end-2014 and between 3.3 percent and 6.7 percent (with a mid-point of 5 percent) at end-2015. 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 (Percent)



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

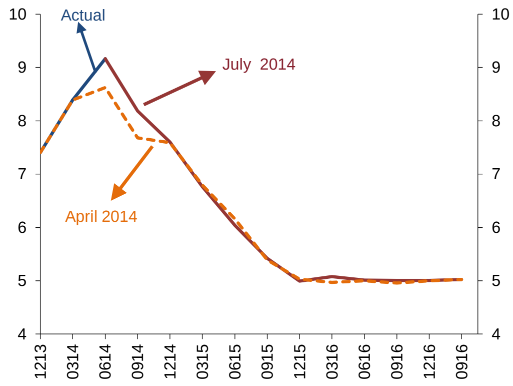
The year-end inflation is projected to realize remarkably above the 5-percent target due to the lagged effects of exchange-rate-driven cost pressures and the unfavorable course of food prices.

Inflation is expected to fall to 7.6 percent at year-end on the back of the mild course of import prices, the gradual weakening of the cumulative effects of the exchange rate and the moderate course of final domestic demand conditions (Chart 7.2.1). The second-quarter CPI inflation that remained above the April Inflation Report projections was mainly led by the negative course of food prices, which are expected to wane towards the year-end amid the effective use of external trade policies (Chart 7.2.2).

Chart 7.2.3 presents revisions to the output gap forecasts. Accordingly, the output gap is projected to be consistent with the outlook presented in the April Inflation Report. Output gap forecasts for the first half of 2014 were kept unchanged. In the second half of 2014, parallel to the recovery in financial conditions and confidence indices, the fall in private sector demand halted particularly at the consumption side, which is expected to have a mild effect on the output gap. However, lingering uncertainties over the strength of the recovery in the global economy, global monetary policies and geopolitical developments pose a downside risk to growth. Hence, the output gap is expected to be consistent with the path projected in the April Inflation Report (Chart 7.2.3).

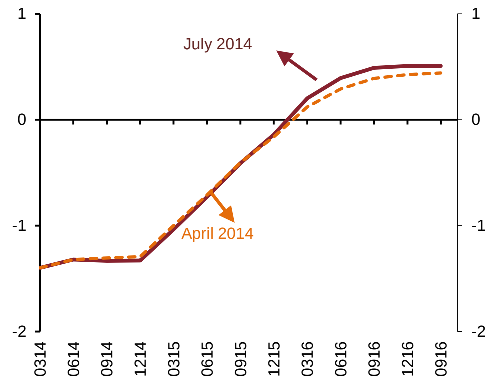
Comparison of April 2014 and July 2014 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast
(Percent)



Source: TurkStat, CBRT.

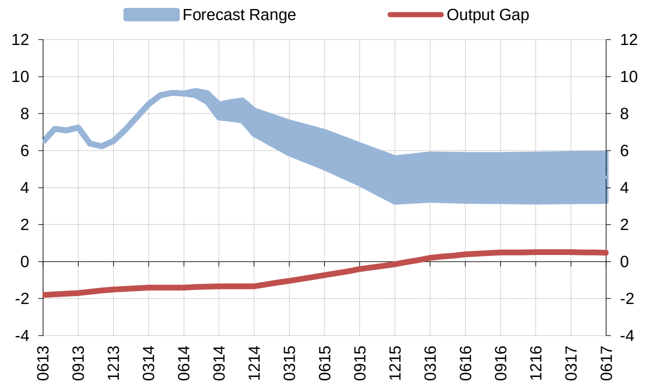
Chart 7.2.3.
Output Gap Forecast
(Percent)



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 start a gradual fall by the second half of 2014 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.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2014 Year-end	7.6	8.3	5.0
12-month-ahead	6.3	7.3	5.0
24-month-ahead	5.0	6.7	5.0

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