

## 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 next three-year horizon.

### 7.1 Current State, Short-Term Outlook and Assumptions

#### Financial Conditions

Financial markets were volatile in the first quarter of the year. The global financial market volatility since early February also had repercussions on Turkey's risk premium, portfolio flows and exchange rates. These developments implied tighter financial conditions for the first quarter, despite broadly unchanged domestic loan standards.

The CBRT announced at the January and March MPC meetings that the tight monetary policy stance will be maintained decisively until the inflation outlook displays a significant improvement, and further monetary tightening will be delivered if needed. At the April MPC meeting, the CBRT decided to implement a measured monetary tightening to contain inflationary risks and raised the LLW lending rate by 75 basis points.

#### Inflation

Although consumer inflation was down by 1.69 percent from end-2017 to 10.23 percent in the first quarter of 2018, core inflation indicators fell only marginally, and economic units showed high tendency toward price hikes. Producer-price-driven cost pressures still weigh on consumer inflation, while demand conditions remain strong.

#### Demand Conditions

Recent data indicate an even stronger quarterly growth in the final quarter of 2017. The main drivers of growth in this period were private and public consumption, while expanding exports also contributed remarkably to growth.

Leading indicators point to solid economic activity in the first quarter of 2018, albeit less marked than a quarter ago, thanks to private consumption and machinery and equipment investments. The upward revision in the national income data of 2017 and the first-quarter outlook prompted an upward revision to output gap forecasts (Table 7.1.1, Chart 7.2.3).

Amid a buoyant global economic outlook, the assumption for the annual growth rate of the export-weighted global production index, a measure for Turkey's external demand, is also revised upwards from the previous reporting period (Table 7.1.1).

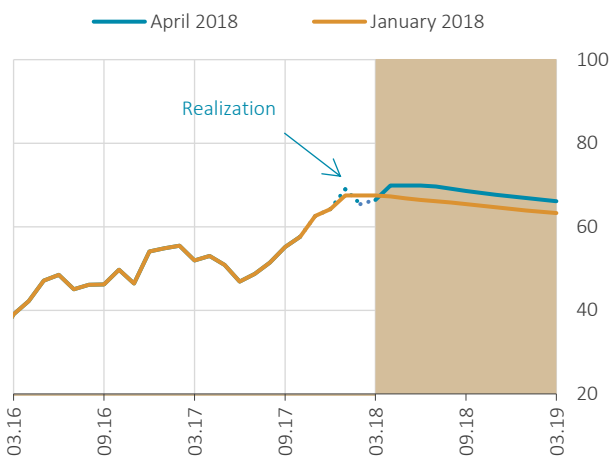
#### Oil, Import and Food Prices

Recent increases in crude oil prices on both spot and futures markets drove assumptions for crude oil prices in the January Inflation Report upwards from 66 USD to 68 USD for 2018 and from 62 USD to 65 USD for 2019 (Table 7.1.1, Chart 7.1.1). Meanwhile, the assumption for the average annual growth rate of USD-denominated import prices was revised downwards for 2018 due to the notable fall in the import unit value index announced by TURKSTAT in February (Chart 7.1.2). However, the projected rates of quarterly change in import prices did not change significantly for the remainder of 2018, indicating that risks driven by import prices have not faded since the previous reporting period.

Ending the first quarter of 2018 at 10.4 percent, food inflation was quite close to the January Inflation Report forecast of 10.3 percent. Processed food prices climbed due to higher raw milk purchase prices and the imposition of SCT on non-alcoholic beverages. On the other hand, unprocessed food prices dropped amid favorable weather conditions, driving food inflation lower over the quarter. In view of the

measures on the agenda of the Food Committee, the assumption for food inflation is kept unchanged at 7 percent for both end-2018 and end-2019 (Table 7.1.1).

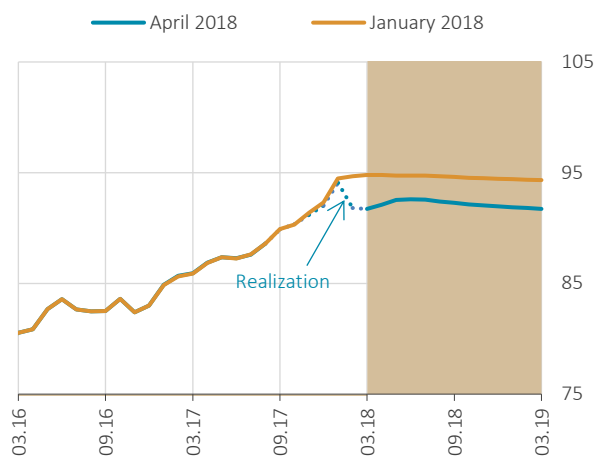
**Chart 7.1.1: Revisions in Oil Price Assumptions\***  
(USD/bbl)



Source: Bloomberg, CBRT.

\* Shaded area denotes the forecast period.

**Chart 7.1.2: Revisions in Import Price Assumptions\***  
(2010=100)



Source: CBRT, TURKSTAT.

\* Shaded area denotes the forecast period.

### Fiscal Policy and Tax Adjustments

Medium-term projections are based on the assumption that fiscal discipline will be maintained, and administered prices and taxes will not be subject to any unanticipated increase. Forecasts are based on the assumption that adjustments to taxes and administered prices will be consistent with MTP projections and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2018-2020 period.

**Table 7.1.1: Revisions in Assumptions**

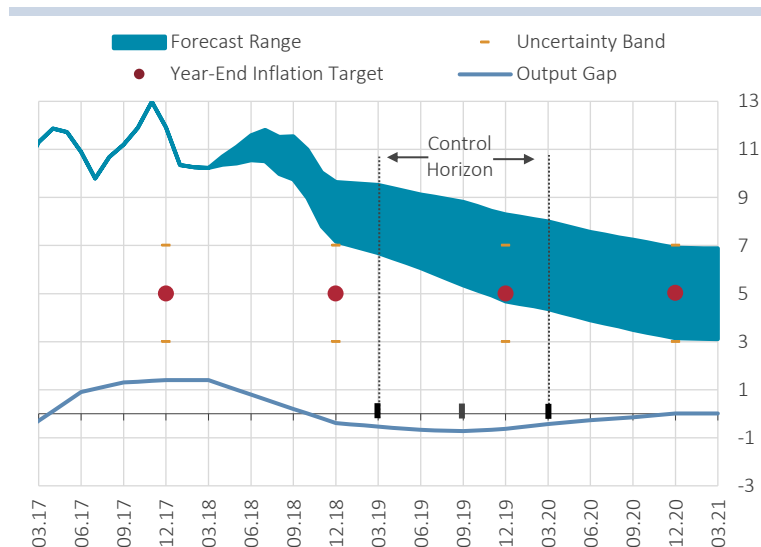
		January 2018	April 2018
Output Gap	2017Q4	1.0	1.4
	2018Q1	0.8	1.4
Food Inflation (year-end % change)	2018	7.0	7.0
	2019	7.0	7.0
Import Prices (USD, annual average % change)	2018	7.4	4.8
	2019	-0.5	-1.0
Oil Prices (average, USD)	2018	66	68
	2019	62	65
Export-Weighted Global Production Index (annual average % change)	2018	2.7	2.9
	2019	2.5	2.7

## 7.2 Medium-Term Forecasts

Given a tight policy stance that focuses on bringing inflation down, inflation is projected to converge gradually to the 5-percent target, falling to 8.4 percent and 6.5 percent at the end of 2018 and end-2019, respectively, and stabilizing around 5 percent over the medium term. Thus, with a 70 percent probability, inflation is expected to be between 7.2 percent and 9.6 percent (with a mid-point of 8.4 percent) at end-

2018 and between 4.7 percent and 8.3 percent (with a mid-point of 6.5 percent) at end-2019 (Chart 7.2.1).

Chart 7.2.1: Inflation and Output Gap Forecasts\* (%)



Source: CBRT, TURKSTAT.

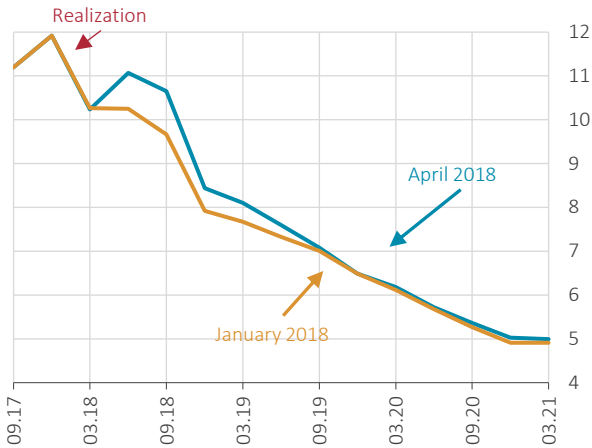
\* Shaded area denotes the 70 percent confidence interval for the forecast.

Although consumer inflation has been in line with January Inflation Report projections as of the first quarter of 2018, developments in exchange rates and oil prices have increased upside risks on the near-term inflation outlook, especially after mid-March. Besides cost pressures, aggregate demand conditions also drive inflation higher due to the robust course of the economic activity. In fact, data released for the last two quarters prompted an upward revision to output gap forecasts over the inter-reporting period, particularly for the first quarter of 2018 (Chart 7.2.3). The forecasts are based on the assumption that the tight monetary policy stance, which was strengthened by the measured rate hike in April, will be maintained decisively to contain the risks to inflation. Moreover, amid the expected slowdown in public spending growth in line with MTP targets as well as the tighter financial conditions and monetary policy, growth will converge to its potential while the output gap will no longer put upward pressure on inflation starting mid-2018.

Accordingly, the year-end consumer inflation forecast for 2018, which was announced as 7.9 percent in the January Inflation Report, was revised up to 8.4 percent (Chart 7.2.2). Of the upward revision to the end-2018 inflation forecast, 0.4 points stemmed from the adjustment in TL-denominated import price assumption due to oil prices and exchange rate developments. Furthermore, the output gap forecast was revised upwards in the inter-reporting period due to the strong domestic demand, which added 0.1 points to end-2018 inflation forecast.

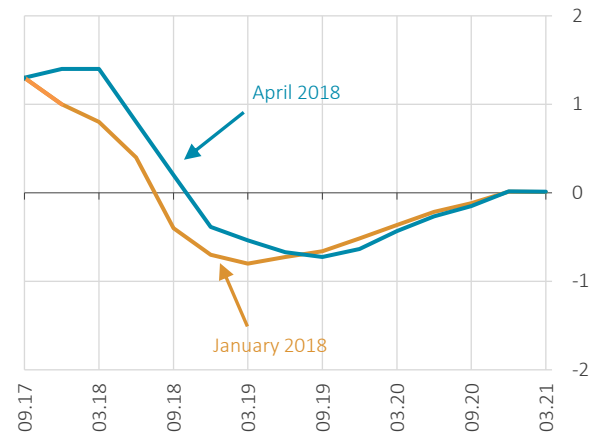
On the other hand, the year-end inflation forecast for 2019 remained unchanged at 6.5 percent, given an outlook that the tight monetary policy stance will be maintained decisively.

Chart 7.2.2: Inflation Forecast and Realization (%)



Source: CBRT, TURKSTAT.

Chart 7.2.3: Output Gap Forecast (%)

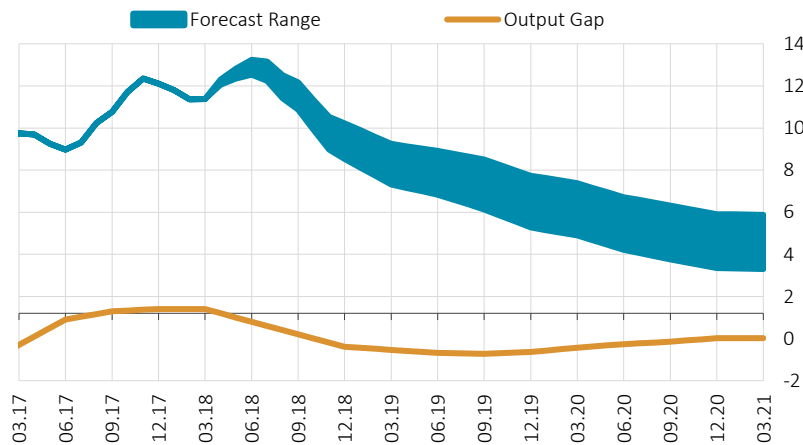


Source: CBRT.

Annual consumer inflation is projected to fluctuate in the short term due to the lagged effects of exchange rate and oil price developments as well as base effects, while risks are judged to be on the upside. Inflation is expected to return to its downward trajectory on the back of recent monetary policy decisions and measures (Chart 7.2.1). Under the assumption that there will be no additional increase in risk premium due to global and domestic developments, the disinflation process will continue in 2018 on the back of the decisive implementation of the tight monetary policy and convergence of economic activity and loan growth to a milder growth path. In this period, it is important that tax adjustments and administered prices are set in a way to support the disinflation process as part of the stronger coordination between monetary and fiscal policies.

Unpredictable price fluctuations in items beyond the monetary policy domain, such as unprocessed food, alcoholic beverages and tobacco products, are among major factors that cause a deviation in inflation forecasts. Therefore, inflation forecasts excluding unprocessed food, alcoholic beverages and tobacco products are also publicly announced. Thus, Chart 7.2.4 shows inflation forecasts excluding unprocessed food, alcoholic beverages and tobacco products. Similar to headline consumer inflation, the CPI excluding unprocessed food, alcoholic beverages and tobacco products is expected to remain elevated across the first half of 2018, decelerate by mid-year and decline gradually to 4.6 percent in the medium term.

Chart 7.2.4: Output Gap and Inflation Excluding Unprocessed Food, Alcoholic Beverages and Tobacco Products\* (%)



Source: CBRT, TURKSTAT.

\* Shaded area denotes the 70 percent confidence interval for the forecast.

## 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. Currently, the year-end, 12-month-ahead and 24-month-ahead inflation expectations of the CBRT Survey of Expectations' respondents are above the baseline scenario forecasts (Table 7.2.1). The hovering of inflation expectations above CBRT forecasts and the exceeding of 24-month-ahead inflation expectations beyond the uncertainty band necessitate the tight monetary policy stance to be sustained. In fact, the CBRT implemented a measured tightening in April to reduce the risks posed by high inflation and inflation expectations to pricing behavior.

**Table 7.2.1: CBRT Inflation Forecasts and Expectations (%)**

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target
2018 Year-end	8.4	10.1	5.0
12-month-ahead	7.9	9.6	5.0
24-month-ahead	6.0	8.6	5.0

Source: CBRT.

\* As of April 2018.

