

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

In the first quarter of 2015, exchange rates and capital flows in global financial markets followed a notably volatile course. The vague atmosphere regarding the Fed's policy rate hike and lingering concerns over the recovery in the Euro Area, the slower-than-estimated growth of emerging economies and some geopolitical developments caused fluctuations in risk indices. The expected normalization process in the Fed's monetary policy on the one hand, and the sustained quantitative easing policies in the Euro Area and Japan on the other, caused the US dollar to appreciate remarkably against many currencies. Meanwhile, the low course of crude oil prices underpinned the inflation and external balance outlook in Turkey and contributed to Turkey's risk perception by keeping it almost flat in an environment of high global uncertainties. Accordingly, domestic financial variables also followed a flat course in the first quarter of 2015.

Inflation

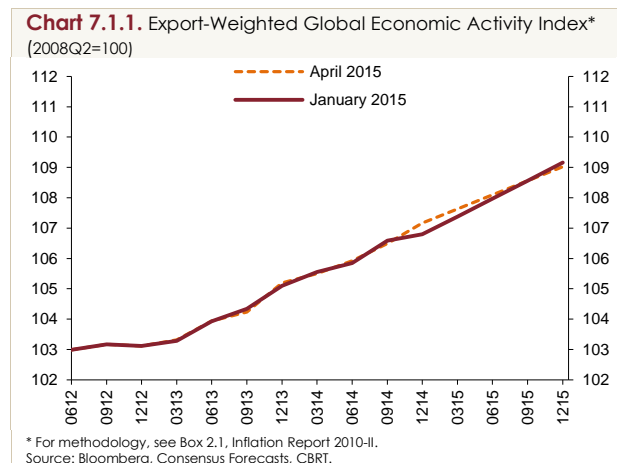
Annual consumer inflation posted a quarter-on-quarter decline by around 0.6 points to 7.61 percent in the first quarter of 2015. Inflation realizations in the first three quarters stood slightly above the previous report's forecasts. The fall in inflation was mainly driven by the base effect in core goods prices, while the persisting effect of unfavorable supply conditions on food prices and its reflection on the prices of catering services appeared as the leading factor that affected inflation adversely. Due to the upward movement of international oil prices as of February, the reducing effect of oil prices on inflation was limited to some extent. Moreover, the slowdown in import prices in USD coupled with the sluggish outlook in aggregate demand caused a more restricted pass-through from the depreciated Turkish lira to inflation. In spite of the favorable outlook in core goods prices, inflation expectations and the headline inflation have not displayed an evident improvement, which delays the slowdown in services inflation.

Demand Conditions

In the last quarter of 2014, the GDP increased by 2.6 percent year-on-year, bringing the annual GDP growth to 2.9 percent in 2014. Owing also to the upward revisions in the data of the preceding periods, the output gap for the last two quarters of 2014 was revised upwards as well (Table 7.1.1 and Chart 7.2.3). On the demand front, the aggregate demand composition changed in favor of domestic demand in the last quarter. Contrary to the positive contribution in the first three quarters, net exports added negatively to annual growth in the last quarter, while the contribution of final domestic demand proved remarkably higher than the previous two quarters particularly due to private consumption.

Data released for the first quarter of 2015 indicate a weak outlook in economic activity. In fact, industrial production in the January-February period has remained unchanged since the last quarter of 2014, and survey indicators signal a low level in production in March. Current indicators point to a decline both in domestic and external demand in the first quarter, the fall in external demand being stronger. Accordingly, economic activity was projected to increase at a slower rate in the first quarter, and the output gap assumption for this period was revised downwards in line with this outlook (Table 7.1.1).

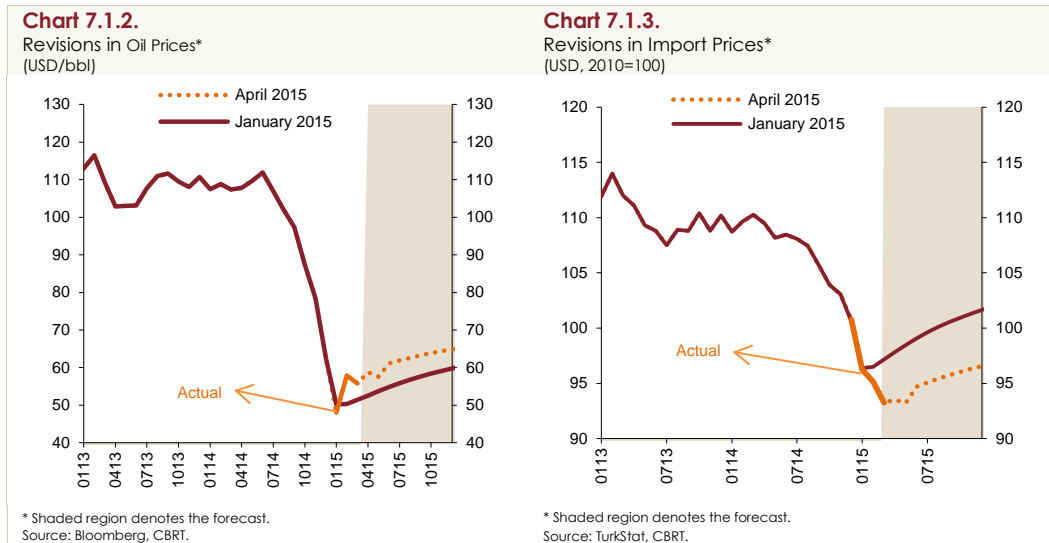
External demand waned due to the slowdown in global economic activity and geopolitical developments in the second quarter of 2014. Exports excluding gold edged up in the last quarter of 2014, but plunged in the first quarter of 2015. Downside risks to external demand that may stem from geopolitical developments remain crucial, while the signals of a rebound in Europe may become a factor to underpin external demand in the upcoming period. In fact, the export-weighted global economic activity index has displayed a limited rebound in the inter-reporting period (Chart 7.1.1). Against this background, domestic demand is expected to exhibit a more robust course than external demand in 2015.



Oil, Import and Food Prices

In the first quarter, oil prices exceeded the envisioned path, whereas import prices in USD stood below the path projected in the January Inflation Report (Charts 7.1.2 and 7.1.3). Accordingly, the assumptions for average oil prices were revised upwards by nearly 9 percent and 5 percent for 2015 and 2016, respectively (Table 7.1.1). On the other hand, assumptions for import prices were subject to a downward revision.

The upward revision in oil prices, which played a major role in the higher-than-projected inflation in the first quarter of 2015 compared to the forecasts of the January Inflation Report, is believed to be more influential for the rest of the year in comparison to the downward revision in import prices. In food prices, given the possibility of a correction, especially due to unprocessed food prices, end-2015 inflation forecast was maintained as 9 percent.



Fiscal Policy and Tax Adjustments

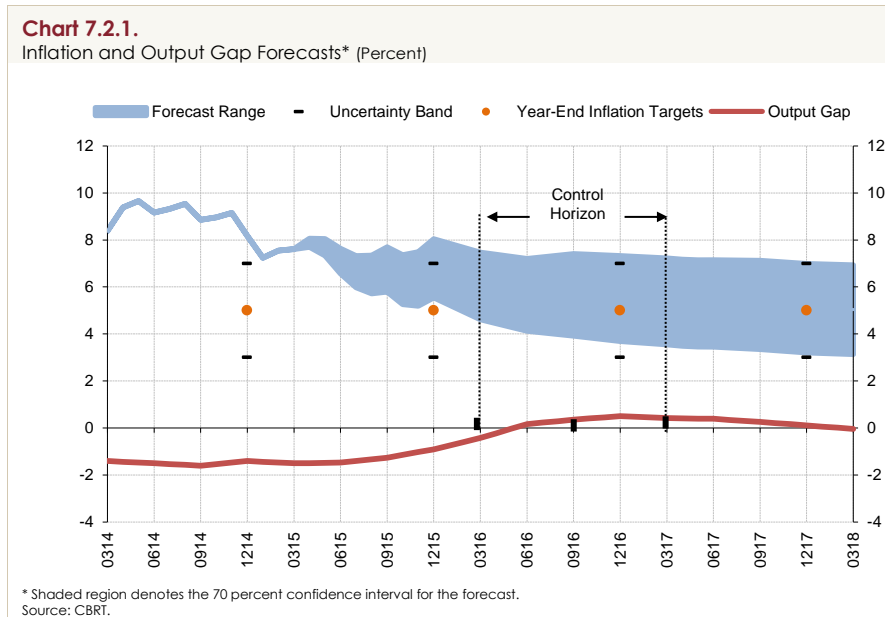
Medium-term forecasts are based on the assumption that tax adjustments and administered prices are consistent with inflation targets and automatic pricing mechanisms. The medium-term fiscal policy stance is based on the MTP projections covering the 2015-2017 period. Accordingly, it is assumed that a tight fiscal stance will be implemented and the primary expenditures to GDP ratio will taper off during this period.

Table 7.1.1. Revisions in Assumptions

		January 2015	April 2015
Output Gap	2014Q4	-1.55	-1.40
	2015Q1	-1.50	-1.70
Food Prices (Year-end Percent Change)	2015	9.0	9.0
	2016-17	8.0	8.0
Import Prices (Average Annual Percent Change, USD)	2015	-7.3	-11.1
	2016	4.5	2.7
Oil Prices (Average, USD)	2015	55	60
	2016	64	67
Export-Weighted Global Production Index (Average Annual Percent Change)	2014	1.9	2.0
	2015	2.0	1.9

7.2. Medium-Term Forecasts

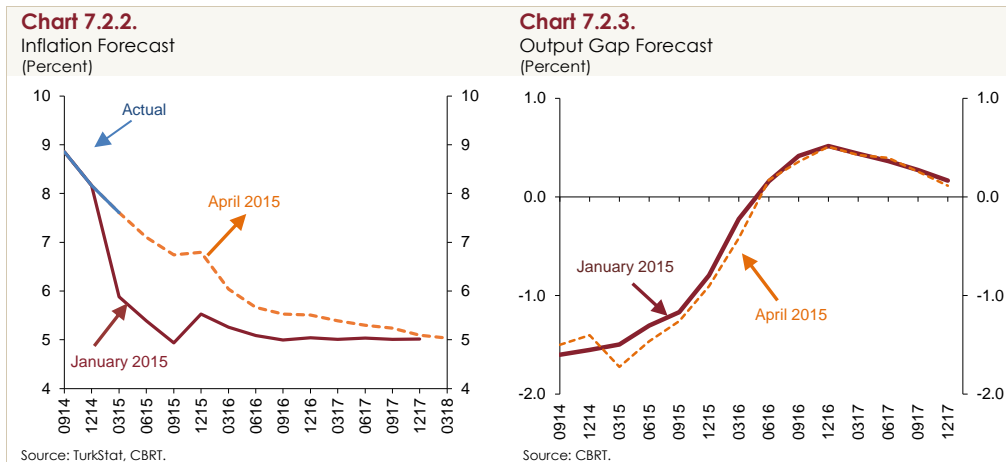
Medium-term forecasts are based on the assumption that a cautious approach will be adopted for a remarkable recovery in the inflation outlook and the tight monetary policy stance will be maintained to keep the yield curve nearly flat. It is further assumed that the annual loan growth rate will continue to post plausible readings in 2015 on the back of the adopted macroprudential measures. Accordingly, inflation is expected to be, with 70 percent probability, between 5.6 percent and 8.0 percent (with a mid-point of 6.8 percent) at end-2015 and between 3.7 percent and 7.3 percent (with a mid-point of 5.5 percent) at end-2016. Inflation is projected to stabilize around 5 percent in the medium term (Chart 7.2.1).



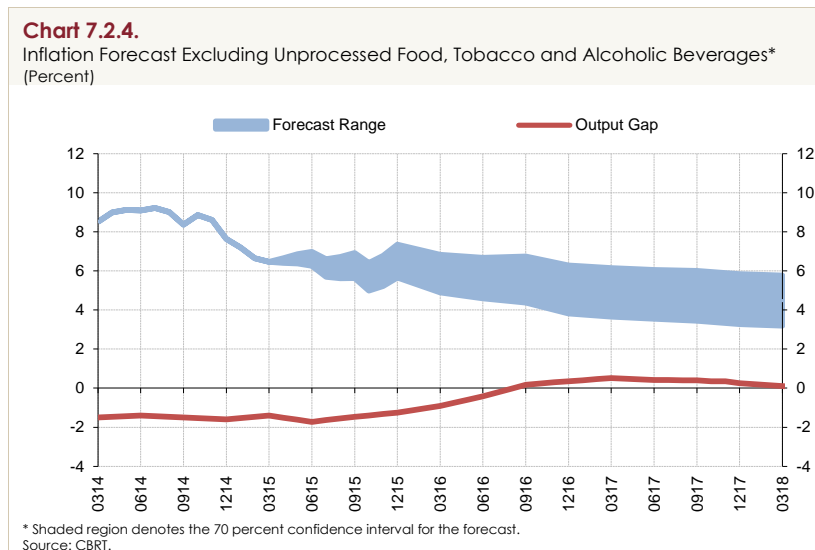
The end-2015 inflation forecast, which was 5.5 percent in the January Inflation Report, was revised upwards by 1.3 points. This revision stemmed from the higher oil prices and the TL import prices than envisioned in the January Inflation Report. Accordingly, the revision in oil prices and movements in TL import prices are expected to add 0.4 and 1 points, respectively to the year-end inflation forecast. On the other hand, downward revisions in the economic activity and the output gap pulled the year-end inflation forecast for 2015 down by 0.1 points. Moreover, year-end inflation forecast for 2016 was pushed upwards from 5 percent to 5.5 percent in the inter-reporting period. 0.3 points of this revision are attributed to the lagged effects of the developments in TL-denominated import prices, and 0.2 points thereof are due to the upward revision in the oil prices for 2016.

Base effects will remain influential on the course of inflation for the remainder of 2015. More specifically, base effects are projected to pull annual inflation upwards starting from August. Accordingly, annual inflation is envisioned to recede until the third quarter, and edge up to 6.8 percent in the fourth quarter.

Revised output gap forecasts are displayed in Chart 7.2.3. As the national income realizations in the third and fourth quarters of 2014 proved more favorable than the previous reporting period, output gap values pertaining to this period were revised slightly upwards. Meanwhile, the data regarding the first quarter of 2015 besides leading indicators show that factors affecting domestic demand remained weaker in the first quarter compared to the previous quarter. Thus, output gap forecasts for 2015 were revised slightly downwards compared to the January Inflation Report, being more apparent in the first two quarters of 2015. As stated above, this revision is anticipated to pull the end-2015 inflation forecast down by 0.1 points.



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 fall gradually around to 4.5 percent.



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 modest increase in inflation expectations in the inter-reporting period necessitates close monitoring of expectations and the pricing behavior.

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2015 Year-end	6.8	7.3	5.0
12-month-ahead	5.9	6.9	5.0
24-month-ahead	5.3	6.6	5.0

* April 2015 survey period results.

** Calculated by linear interpolation of year-end inflation targets for 2015-2016.

Source: CBRT.