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

Global financial markets grew volatile and uncertain as of end-2014, and this continued in the second quarter of 2015. The vagueness regarding the Fed's policy rate hike was prominent in this quarter, and interest rates followed a volatile course vis-à-vis the perception of the data released for the US economy within the quarter. The uncertainty over the Fed policy fueling market volatility was somewhat removed through official statements. However, sovereign debt restructuring issues in Greece have led to deteriorated risk sentiment in global markets as of the second half of 2015. In addition, the slower-than-estimated growth in emerging economies and certain geopolitical developments kept the global risk appetite subdued and the risk premiums of emerging economies pursued a volatile course. The US dollar, which appreciated remarkably against many currencies in the previous reporting period, saw a lower but fluctuating course in the second quarter upon stronger expectations that the Fed will maintain its accommodative monetary policy stance for a while.

In this period, the CBRT kept the overnight borrowing and lending rates and one-week repo rates intact, but raised the average funding rate by changing the liquidity composition to curb the possible risks to the core inflation outlook (Chart 5.1.12). Against this background, financial conditions were tightened slightly compared to the previous quarter (Chart 5.2).

Inflation

The annual consumer inflation declined further from 7.61 percent in the first quarter to 7.20 percent in the second quarter of 2015. Inflation realizations in the second quarter stood around the mid-point of the forecast range projected in the April Inflation Report. Inflation declined due to food prices in the second quarter, yet the depreciation of the Turkish lira restricted this fall, leaving the inflation outlook with figures to recover further. The annual core goods inflation, which is sensitive to the depreciation in the exchange rate, registered an increase in May and June. Although import prices excluding energy followed a mild course, the recent exchange rate developments delayed the improvement in core goods inflation. However, mild aggregate demand conditions are expected to cause the pass-through from exchange rate to inflation excluding energy to remain limited. Meanwhile, services inflation posted a slight rise in the second quarter in line with high inflation expectations and surging labor costs.

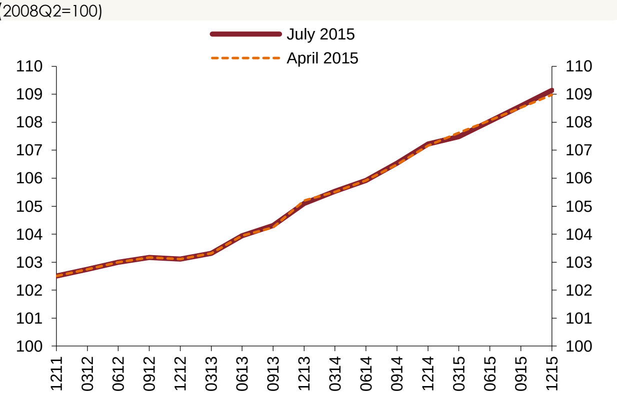
Demand Conditions

Having followed a stronger-than-anticipated course since the previous reporting period, the GDP increased by 2.3 percent year-on-year in the first quarter of 2015. Accordingly, the output gap was revised slightly upwards for the first quarter of 2015 (Table 7.1.1 and Chart 7.2.3). On the demand front, the negative contribution of net exports to growth increased in the first quarter from the previous quarter, while the positive contribution of final domestic demand recorded an increase compared to the previous two quarters, particularly due to private consumption.

Data released for the second quarter of 2015 indicate that domestic demand, which started to recover in the second quarter of 2014, may continue to improve further mainly owing to consumption. Both the production and imports of consumption goods increased in the April-May period. Moreover, sales of automobiles, which underpinned the growth of private consumption in the first quarter, remained robust in the second quarter. However, the sluggish consumer confidence as well as labor market developments and investment indicators signal a less favorable outlook for economic activity than consumption. Thus, the output gap assumption for this period remained unchanged (Table 7.1.1).

External demand maintained its weak course in the first quarter of 2015 amid the geopolitical developments and the slowdown in global economic activity that started in the second half of 2014. Although this period witnessed an increase in the exports of goods and services after three consecutive quarters, this increase stemmed largely from gold exports. The worsening in the balancing of goods excluding gold since the second half of 2014 continued into the first quarter of 2015, yet the data pertaining to May suggest a limited rise in exports. In fact, the export-weighted global economic activity index has remained virtually unchanged since the previous reporting period (Chart 7.1.1).

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



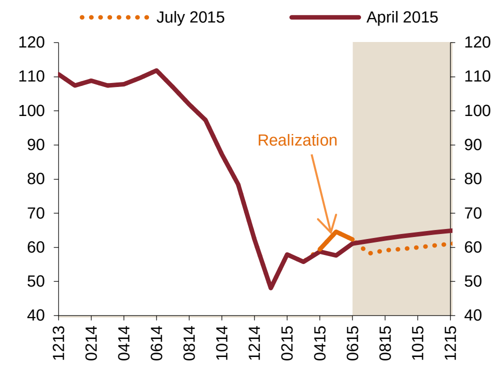
* For methodology, see Box 2.1, Inflation Report 2010-II.
Source: Bloomberg, Consensus Forecasts, CBRT.

Oil, Import and Food Prices

In the second quarter, oil prices slightly exceeded the envisioned path, whereas import prices in USD stood a little below the path projected in the previous Report (Charts 7.1.2 and 7.1.3). Assumptions for average oil prices were revised downwards by nearly 2 and 6 percent for 2015 and 2016, respectively (Table 7.1.1). Parallel to this downgrade, assumptions for an annual percentage change in average import prices were pulled down by 1.7 points for 2015 and 1.4 points for 2016.

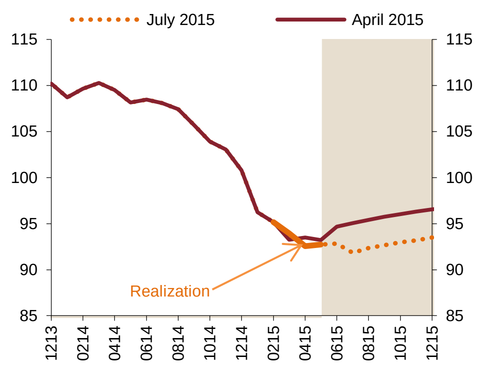
Unprocessed food prices saw a notable correction in the second quarter of 2015. Given the projections that this correction will continue and the effects of the measures taken by competent authorities will manifest, food inflation assumption for end-2015 was revised downwards from 9 percent to 8 percent.

Chart 7.1.2.
Revisions in Oil Prices*
(USD/bbl)



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

Chart 7.1.3.
Revisions in Import Prices*
(USD, 2010=100)



* Shaded region denotes the forecast.
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. 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.

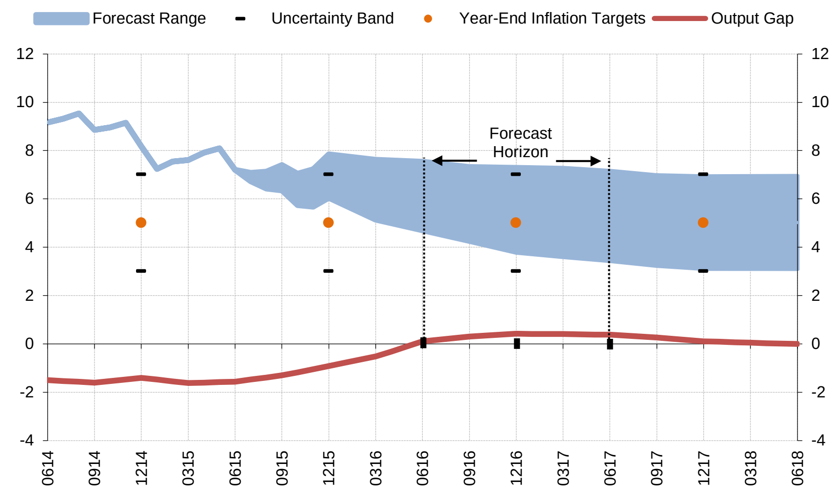
Table 7.1.1. Revisions in Assumptions

		April 2015	July 2015
Output Gap	2015Q1 2015Q2	-1.70 -1.50	-1.60 -1.60
Food Prices (Year-end Percent Change)	2015 2016-17	9.0 8.0	8.0 8.0
Import Prices (Average Annual Percent Change, USD)	2015 2016	-11.1 2.7	-12.8 1.3
Oil Prices (Average, USD)	2015 2016	60 67	59 63
Export-Weighted Global Production Index (Average Annual Percent Change)	2014 2015	1.9 -	1.9 2.4

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 6.0 percent and 7.8 percent (with a mid-point of 6.9 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).

Chart 7.2.1.
Inflation and Output Gap Forecasts*
(Percent)



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

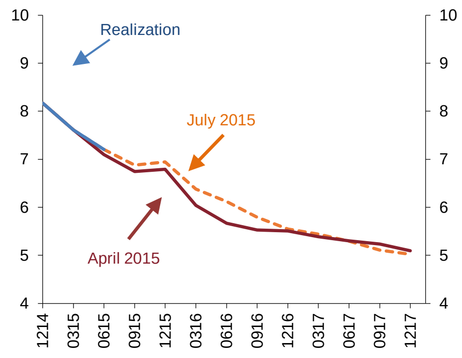
Exchange rate movements delayed the improvement in core goods inflation, pushing the end-2015 inflation forecast upwards by 0.5 points in the second quarter. On the other hand, the recovery in import and food prices compared to the previous Report pulled the year-end inflation forecast for end-2015 down by 0.1 and 0.3 points, respectively. As a result, import and food prices are expected to largely compensate for the adverse effects of core goods inflation developments in the second quarter. Accordingly, the end-2015 inflation forecast, which was given as 6.8 percent in the April Inflation Report, was revised upwards by 0.1 points.

The inflation forecast for end-2016, which was 5.5 percent in the April Inflation Report, was kept intact. The downward revision in the average import price assumption for 2016 will likely pull the end-2016 inflation down by around 0.1 points, yet this will be offset by the rise in the end-2015 inflation forecast. Therefore, the inflation forecast for end-2016 was kept unchanged.

Base effects will remain influential in the course of inflation for the remainder of 2015. Inflation is expected to trend downwards until September, yet go slightly upwards in September due to base effects and reach 6.9 percent in the year-end following a fluctuating course.

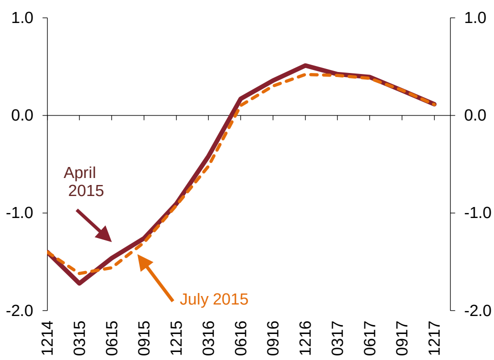
Revised output gap forecasts are displayed in Chart 7.2.3. As the national income realizations in the first quarter of 2015 proved more favorable than envisioned in the previous reporting period, output gap values pertaining to this period were revised slightly upwards. Meanwhile, national income forecasts for 2015 were kept virtually unchanged in the inter-reporting period given the second-quarter data and the leading indicators. Accordingly, output gap forecasts for 2015 were revised slightly downwards compared to the April Inflation Report. Thus, the output gap is expected to keep the end-2015 inflation forecast intact compared to the previous reporting period.

Chart 7.2.2.
Inflation Forecasts



Source: TURKSTAT, CBRT.

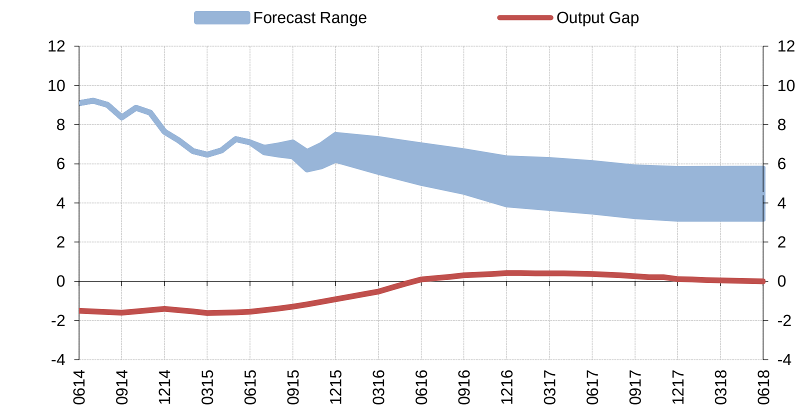
Chart 7.2.3.
Output Gap Forecasts



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 fall gradually around to 4.5 percent.

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



* Shaded region denotes 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 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	6.9	7.7	5.0
12-month-ahead	6.0	7.1	5.0
24-month-ahead	5.2	6.7	5.0

'* July 2015 survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2015- 2016.
Source: CBRT.