7. Medium-Term Forecasts

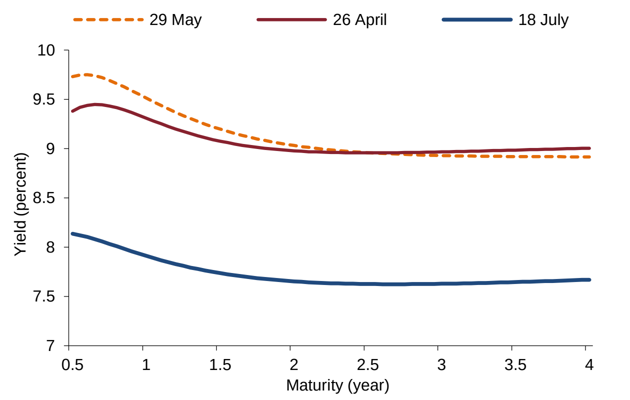
This Chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Policy and Conditions

In the inter-reporting period, the CBRT continued with its tight monetary stance. With a view to preventing the possible adverse effects of a higher-than-targeted inflation on the pricing behavior, additional tightening was implemented more frequently as per the decisions taken in the April meeting of the MPC. Accordingly, the weighted average interest rate for the liquidity the CBRT provides to the market was raised in May and early June (Chart 5.1.12). Starting from June, due to the favorable developments in inflation and the balancing between domestic and external demand, the average cost of the funds provided by the CBRT was reduced. In the meantime, O/N repo rates at the ISE trended downwards (Chart 5.1.13).

Chart 7.1.1.
Yield Curve



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

Short-term market rates which went up in May, has decreased remarkably since June. This is attributed to the suspension of the monetary tightening as well as the upgraded sovereign risk owing to the improvement in the global risk appetite and the better-than-expected macroeconomic outlook. As of the first half of July, the yield curve declined across all maturities compared to the April Inflation Report (Chart 7.1.1).

It was stated in the MPC meeting of July 19, 2012 that as inflation will continue to hover at high levels for an extended period, thus posing risks to the pricing behavior, the cautious stance will be maintained. In this respect, also considering the prevailing uncertainties regarding the global economy, the MPC has stated that it would be appropriate to preserve the flexibility of the monetary policy. It was reiterated that the impact of the measures undertaken on credit, domestic demand, and inflation expectations will be monitored closely and the funding amount will be adjusted in either direction, as needed.

Inflation

Annual consumer inflation in the second quarter of 2012 remained below the forecast presented in the April Inflation Report with 8.87 percent (Chart 1.2.1). This was driven by the more-than-expected decline in unprocessed food and energy prices. Annual inflation in core goods maintained its downward trend in this period, while services inflation increased modestly. Meanwhile, amid the alleviation of demand and cost-side pressures, core inflation indicators trended downwards.

The favorable course of unprocessed food prices in the first quarter strengthened further in the second quarter. Thus, the contribution of unprocessed food prices to inflation in the second quarter lagged behind the level envisaged in the April Inflation Report. Meanwhile, processed food prices recorded a higher-than-expected increase. However, the contribution of food prices to inflation declined relative to the previous reporting period. Against this background, food inflation assumption for end-2012 was revised downwards from 7.5 percent to 7 percent (Table 7.1.1). This revision reduced the inflation forecast for end-2012 by about 0.15 percentage points. Moreover, envisioning that the slowdown in the global economy will contain rises in agricultural commodity prices in the medium term, food inflation assumption for 2013 has been revised downwards by 0.5 percentage points.

Table 7.1.1.
Revisions to 2012 Assumptions

		April 2012	July 2012
Output Gap	2012Q1	-1.20	-1.20
	2012Q2	-1.45	-1.45
Food Price Inflation (Year-end Percent Change)	2012-2013	7.5	7.0
Import Prices (Average Annual Percent Change, USD)	2012	-0.7	-3.9
	2013	-0.7	-1.8
Oil Prices (Annual Average, USD)	2012	120	110
	2013	115	100
Export-Weighted Global Production Index (Average Annual Percent Change)	2012	1.4	1.1
	2013	2.4	2.1

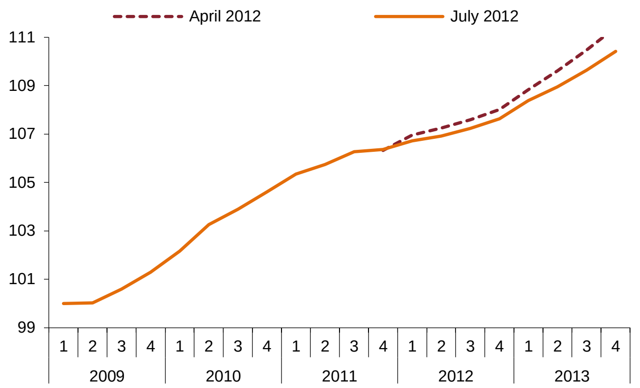
Demand Conditions

In the first quarter of 2012, economic activity remained consistent with the projections presented in the April Inflation Report. Final domestic demand grew moderately, while net external demand fuelled annual growth, thus resulting in a further balancing of the demand composition in the second quarter. Although the national accounts data regarding the first quarter of 2012 point to a persisting deceleration since the first quarter of 2011, indicators for the second quarter suggest that this negative course will not be permanent. In fact, industrial production boomed on a quarterly basis in the April-May period. This strong recovery is attributed to the compensation of the poor figures of the first quarter, resulting in a mild course in the underlying trend of the economic activity.

The deterioration of the global growth outlook in the inter-reporting period led to a slightly downward revision of the export-weighted global production index (Chart 7.1.2). Nevertheless, both the cumulative effects of the counterbalancing policies and market diversification in external markets contained the effect of the slowdown in global growth on exports.

Against this background, output gap forecasts for the first quarter of 2012 have remained unchanged since the publication of the April Inflation Report (Table 7.1.1).

Chart 7.1.2.
Export-Weighted Global Economic Activity Index*
(2009Q1=100)

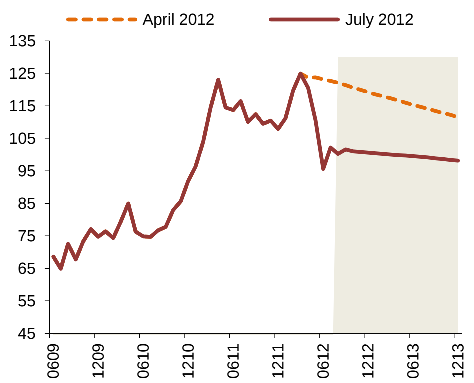


* For methodology, see Inflation Report 2010-II, Box 2.1 "Foreign Demand Index for Turkey".
Source: Bloomberg, Consensus Forecasts, CBRT.

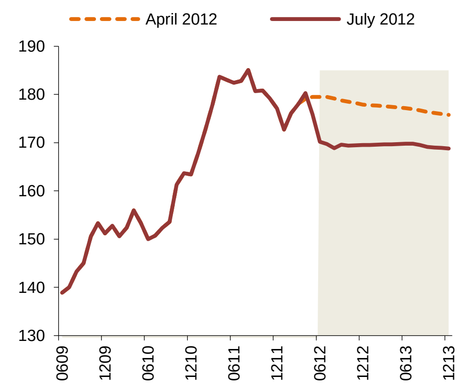
Import Prices

In the second quarter of 2012, oil prices remained below projections presented in the April Inflation Report due to the deterioration in the global growth outlook besides demand-side developments. Accordingly, the assumption for average oil price was reduced from USD 120 to USD 110 for 2012. This revision was mainly led by the decline in forecast for average oil price from USD 114 in the first half to USD 105 in the second-half of the year. As for 2013, average oil price is assumed to be USD 100 (Table 7.1.1 and Chart 7.1.3).

Chart 7.1.3.
Revisions to Oil and Import Price Assumptions



Source: Bloomberg, CBRT.



Source: TurkStat, CBRT.

Import prices in general also displayed a favorable course similar to oil prices. Current projections based on futures prices assume that USDdenominated import prices will go down by a year-on-year 3.9 percent in 2012. Thus, our assumptions for import prices in 2012 were revised notably downwards in the inter-reporting period (Chart 7.1.3). This revision in addition to the developments in the exchange rate lowered the inflation forecast for end-2012 by 0.15 percentage points.

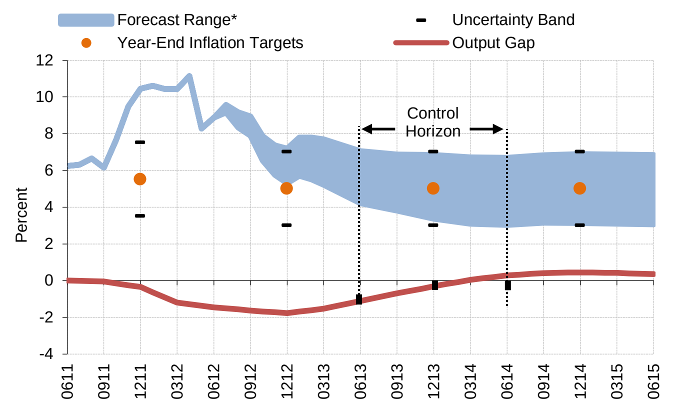
Fiscal Policy and Tax Adjustments

Regarding the fiscal outlook, medium-term inflation forecasts take the revised projections of the MTP as given. Accordingly, the ratio of primary expenditures to GDP is assumed to remain broadly unchanged in the second half of the year. As per the arrangements introduced to taxes imposed on tobacco products in the last quarter of 2011, tobacco prices are envisaged to remain unchanged throughout 2012, and increase at the beginning of 2013 at rates implied by the tax adjustments announced in October 2011. Furthermore, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and the automatic pricing mechanisms.

7.2. Medium-Term Outlook

Forecasts are based on the assumption that monetary policy will maintain its cautious and flexible stance, and annual loan growth rate will be around 14 percent by the end of the year as in the previous Report. Accordingly, inflation is expected to be, with 70 percent probability, between 5.3 and 7.1 percent (with a mid-point of 6.2 percent) at the end of 2012, and between 3.4 and 6.8 percent (with a mid-point of 5.1 percent) at the end of 2013. 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.

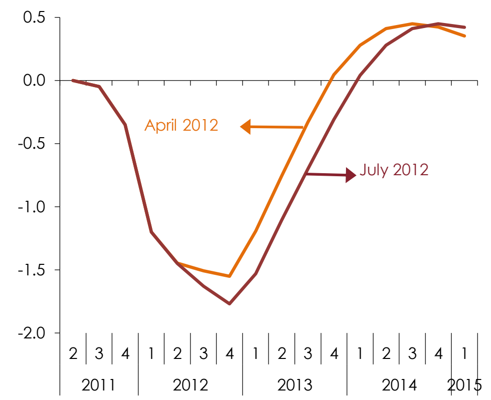
Overall, the year-end inflation forecast is lowered by 0.3 percentage points owing to positive developments in factors affecting inflation (Chart 7.2.2). Revised forecasts indicate that inflation will resume a downward trend following a slight increase in July. The fall in inflation will become more evident in the last quarter of the year as the base effect stemming from tax adjustments in administered products will be removed and inflation will reach 6.2 percent in end-2012.

Comparison of April 2012 and July 2012 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast

Source: TurkStat, CBRT.

Chart 7.2.3.
Output Gap Forecast

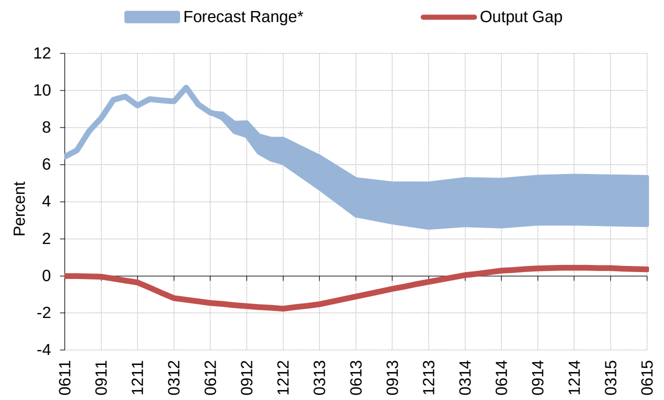


Source: CBRT.

As the latest data releases were largely consistent with the projections presented in the April Inflation Report, output gap forecasts for the second quarter of 2012 remained unchanged. Meanwhile, owing to the weak course of the global economy, forecasts are based on the outlook assuming that aggregate demand conditions will provide a slightly increased support to disinflation as of the second quarter of 2012 (Chart 7.2.3).

Unpredictable fluctuations in the prices of items that are beyond the domain of the monetary policy, such as unprocessed food, tobacco and alcoholic beverages, are among major factors causing deviations in inflation forecasts. Hence, inflation forecasts excluding unprocessed food, tobacco and alcoholic beverages are publicly announced. Forecasts are based on the assumption that year-end unprocessed food inflation will be 6.0 percent and the prices of tobacco and alcoholic beverages will remain constant throughout the year. 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 maintain its downward trend it has assumed since May 2012 and stabilize around 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.

It should be emphasized that any new data or information regarding the inflation outlook may lead to a change in the monetary policy stance. Therefore, assumptions regarding the monetary policy outlook underlying the inflation forecast should not be perceived as a commitment on behalf of the CBRT.

Comparison of the CBRT's Forecasts with Inflation Expectations

It is critical that economic agents, being aware of the temporary factors, should focus on the underlying medium-term inflation, and therefore, take the inflation target as a benchmark in their pricing plans and contracts. In this respect, to serve as a reference guide, CBRT's current inflation forecasts should be compared to inflation expectations of other economic agents. Accordingly, year-end inflation expectations as well as 12-month and 24-month ahead inflation expectations of the Survey of Expectations' respondents are slightly above our baseline scenario forecasts (Table 7.2.1).

Table 7.2.1.
CBRT Inflation Forecasts and Expectations

	CBRT Forecast	CBRT Survey of Expectations*	Inflation Target**
2012 Year-end	6.25	6.98	5.0
12-month ahead	5.53	6.78	5.0
24-month ahead	4.90	6.33	5.0

* July 2012, second survey period results.
** Calculated by linear interpolation of year-end inflation targets for 2012- 2014.
Source: CBRT.

7.3. Risks and Monetary Policy

Ongoing uncertainty regarding the global economy requires the maintenance of a flexible approach in monetary policy. The perception that leading central banks will keep interest rates at low levels for a prolonged period encourages the search for yield. On the other hand, despite the steps taken for the resolution of problems regarding the Euro Area, risk appetite remains highly sensitive to news due to ongoing fragilities in the financial system, elevated levels of sovereign borrowing costs and weakening growth outlook. Therefore, it is highly likely that short-term capital inflows will continue to be volatile in the forthcoming period. Under these conditions, it is important to preserve the flexibility of monetary policy in either direction.

A further weakening in global economic outlook may prompt central banks of the advanced economies to implement additional monetary easing. Such an event would feed into macro financial risks for emerging economies like Turkey. A resurge in short-term capital inflows may slow down the balancing process through rapid credit growth and appreciation pressures on domestic currency. Should such a risk materialize, the CBRT may keep short-term rates at low levels while delivering tightening through reserve requirements, including the mechanism it has developed for reserve requirements by increasing the coefficients which define the amount of foreign exchange to be held per unit of Turkish lira reserve requirements.

It is also likely that problems in the Euro Area may further intensify, given the ongoing deleveraging process in banking, household and public sector balance sheets and possible delays in the institutional mechanisms to resolve the related problems. Should such a risk materialize, the immediate reaction could be to implement an active liquidity policy via the interest rate corridor to be followed by measures to relieve the tension in the banking system through the use of reserve requirements as well as other liquidity instruments.

On the other hand, aggregate demand and commodity prices may increase faster than expected should the measures taken towards the solution of problems regarding the global economy are completed sooner and more decisively than envisaged. Materialization of such a risk would possibly require a tightening using all policy instruments, as it would mean increased pressures on the medium-term inflation outlook.

Another risk factor in the forthcoming period is the uncertainty regarding commodity prices. Although the weak course of the global economy largely contains the upside risks to commodity prices, ongoing geopolitical and supply-side problems pose upside risks to energy prices in the short term. Moreover, recent hikes in agricultural commodity prices pose risks to processed food prices. Should such risks materialize, the CBRT will not react to temporary price movements, yet will not tolerate any deterioration in expectations.

Unprocessed food prices pose downside risk to inflation outlook over 2012 as also highlighted in the April Inflation Report. A rather cautious approach was adopted in the current Report, assuming a reversal in the favorable trend observed during the first half of the year. Year-end inflation may be lower than projected in the baseline scenario should unprocessed food prices follow a more favorable course than expected.

Inflation will continue to stay above the target for some time, necessitating a cautious stance regarding pricing behavior. Although the monetary tightening implemented since last October and the moderate aggregate demand outlook reduce the likelihood of the materialization of second round effects, pricing behavior will be monitored closely in the forthcoming period.

The CBRT monitors fiscal policy developments closely while formulating its monetary policy. The baseline scenario forecasts of the Report are based on the MTP framework. Therefore, neither a deterioration in the budget balance nor an increase in administered prices is assumed. 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.

Maintaining the prudent fiscal policy implemented in recent years is crucial for preserving the resilience of our economy against existing global uncertainties. Strengthening the structural reform agenda that would ensure the sustainability of the fiscal discipline and reduce the saving deficit would support the relative improvement of Turkey's sovereign risk, and thus facilitate price stability and financial stability in the medium term. This will also provide more flexibility for monetary policy and contribute to social welfare by keeping interest rates of long-term government securities at low levels. In this respect, steps towards implementation of the structural reforms envisaged by the MTP remain to be of utmost importance.