7. Medium-Term Projections

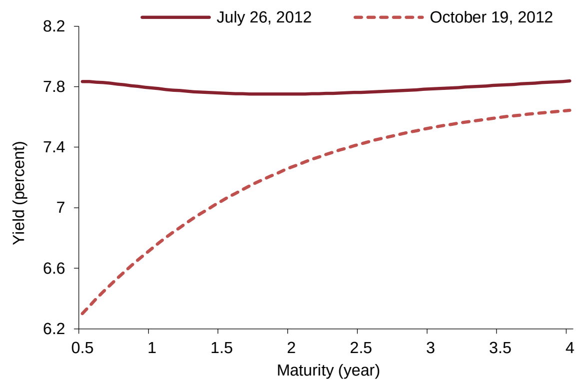
This Chapter summarizes the underlying forecast assumptions and presents the medium-term inflation and output gap forecasts as well as the monetary policy outlook over the upcoming 3-year horizon.

7.1. Current State, Short-Term Outlook and Assumptions

Monetary Conditions

Following the decline in the CBRT's average funding rate after the release of the July Inflation Report as well as the favorable course of global risk perceptions, short-term money market rates trended downwards and the slope of the yield curve turned positive (Chart 7.1.1). Recent hikes in administered prices led interest rates to display a slight increase.

Chart 7.1.1.
Yield Curve*



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

Inflation

On soaring unprocessed food prices above seasonal averages besides higher-than-envisisoned rise in international oil prices, annual CPI inflation went up to 9.2 percent in the third quarter of 2012, remaining above the projections presented in the July Inflation Report (Chart 1.2.1). This is mainly attributed to Decisions on additional fiscal measures taken on September 22, 2012 in consideration of the budget developments also affected the third-quarter, thus fuelling this increase (Box 3.1). In this period, annual inflation in core goods maintained a downward track, while services inflation remained unchanged.

Influenced also by the stagnating economic activity, core inflation indicators exhibited a downward course.

In the third quarter, unprocessed food prices increased faster than historical averages and remained above July Inflation Report forecasts, while processed food inflation slightly slowed down. Hence, food price inflation increased in this quarter on account of the rise in unprocessed food inflation, and hovered slightly above the July Inflation Report forecasts. In the last quarter of the year, the annual inflation in unprocessed food prices is expected to plunge, while upside risks on processed food prices will prevail. Overall, food price inflation assumption for end-2012 is preserved at 7.0 percent with a cautious stance.

Table 7.1.1.
Revisions to 2012 Assumptions

		October 2012	July 2012
Output Gap	2012Q2	-1.65	-1.45
	2012Q3	-2.00	-1.63
Food Price Inflation (Year-end Percent Change)	2012-2013	7.0	7.0
Import Prices (Average Annual Percent Change, USD)	2012	-1.9	-3.9
	2013	0.2	-1.8
Oil Prices (Annual Average, USD)	2012	112	110
	2013	107	100
Export-Weighted Global Production Index (Average Annual Percent Change)	2012	1.2	1.1
	2013	1.7	2.1

Demand Conditions

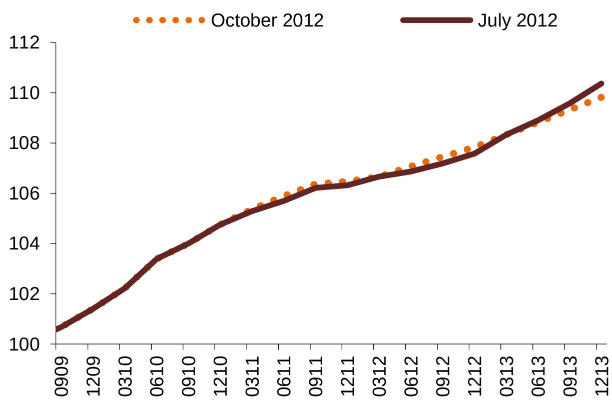
In the second quarter of 2012, economic activity followed a weaker course than envisaged in the July Inflation Report. Domestic demand lost pace due to investment, while net exports remained below projections on account of the developments in global growth outlook in this period.

Third-quarter data suggest that economic activity continues to slow down. Industrial production has recently been volatile, while production recorded a quarter-on-quarter decline. Nevertheless, in the last quarter, economic activity is estimated to improve quarter-on-quarter and the recent monetary policy decisions will bolster the growth outlook.

The sluggish course of global economic activity accompanied by the persisting problems in financial markets remain as a downward risk factor on external demand. Due to the deteriorating global growth outlook since the release of the July Inflation Report, export-weighted global production index was slightly revised downwards (Chart 7.1.2). Hence, no apparent recovery is expected in external economies in the forthcoming period and global uncertainties are estimated to further curtail external demand. Meanwhile, exports are envisioned to maintain their relatively favorable course in the forthcoming period owing to the market and product diversification.

On account of these developments in domestic and external demand indicators, output gap forecasts were revised downwards in the inter-reporting period (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.

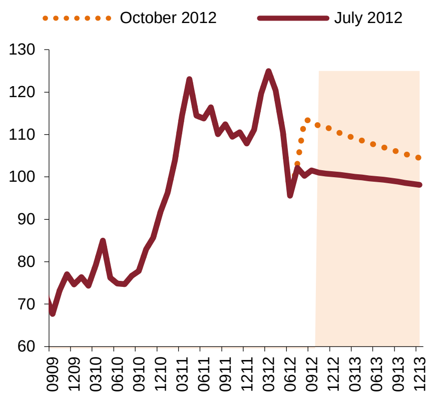
Import Prices

In the third quarter of 2012, oil prices hovered above the assumptions of the July Inflation Report mainly due to supply-side factors. Accordingly, the assumption for average oil price, which was USD 110 in the July Inflation Report, was revised upwards to USD 112 for 2012. Although this seems to be a limited revision for the entire year, average oil prices were remarkably raised for the second half of the year. Similarly, assumptions for 2013 was revised upwards in the inter-reporting period, and average oil price was assumed to be USD 107 in 2013 (Table 7.1.1 and Chart 7.1.3).

A similar negative course prevailed in overall import prices. In current projections based on futures prices, import prices for 2012 were revised upwards in the inter-reporting period (Chart 7.1.3). Along with the exchange rate developments, these revisions in oil and import prices pushed the end-2012 inflation forecast by 0.40 percentage points in total.

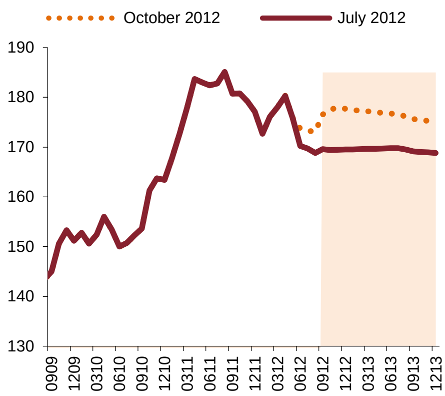
Chart 7.1.3.
Revisions to Oil and Import Price Assumptions

Oil Prices (USD/bbl)



Source: Bloomberg, CBRT.

Import Prices (2003=100)



Source: TurkStat, CBRT.

Fiscal Policy and Tax Adjustments

The most significant development that called for a revision in the short-term inflation projections since the release of the July Inflation Report proved to be the recent tax increases and adjustments to energy prices. These arrangements added 0.9 percentage points to end-2012 inflation forecast.

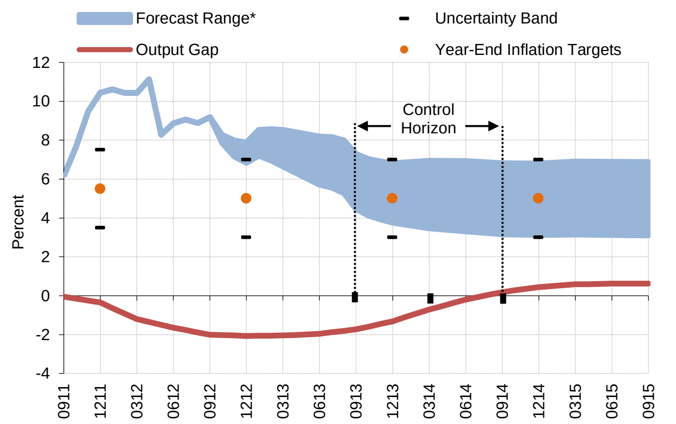
Medium-term projections are based on the assumption that in early 2013, tobacco prices will increase at rates implied by the tax adjustments announced in October 2011. Furthermore, other tax adjustments and administered prices are assumed to be consistent with the inflation targets and the automatic pricing mechanisms.

Regarding the fiscal outlook, medium-term inflation forecasts take the revised projections of the MTP as given. Accordingly, the fiscal discipline is expected to be maintained and the structural budget balance is assumed to remain broadly unchanged in the forthcoming period.

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. Accordingly, inflation is expected to be, with 70 percent probability, between 6.9 and 7.9 percent (with a mid-point of 7.4 percent) at the end of 2012, and between 3.8 and 6.8 percent (with a mid-point of 5.3 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.

In sum, the year-end inflation forecast for 2012 was revised upwards by 1.2 percentage points in the inter-reporting period (Chart 7.2.2). 0.4 percentage points of this increase reflected the upward revision to oil and import prices as well as exchange rate developments, while 0.9 percent was owed to public price hikes that were unforeseen in the previous reporting period. The increase by 0.1 percent due to import prices and public price hikes will be compensated by the downward revision to output gap (Table 7.1.2).

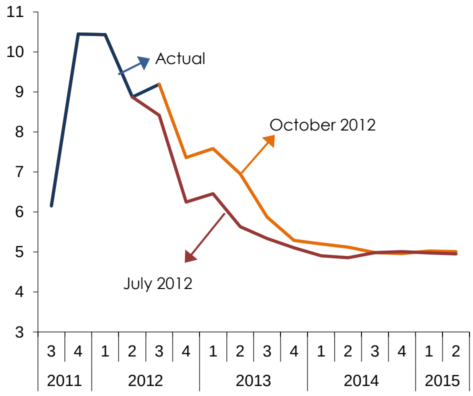
Table 7.2.1
Sources of Revision to 2012 Year-end Inflation Forecast

Oil and Import Prices	**+0.4 percent**
Tax and Administered Price Adjustments	**+0.9 percent**
Output Gap	**-0.1 percent**
Total	**+1.2 percent**

Due to price adjustments in energy and other administered products in September besides the upward revision to import price assumptions, inflation is envisioned to hover above the July Inflation Report forecasts during 2013 (Chart 7.2.2). Starting from October 2013, inflation is expected to plummet as the base effects due to public price adjustments taper off and is envisioned to near the target of 5 percent at end-2013.

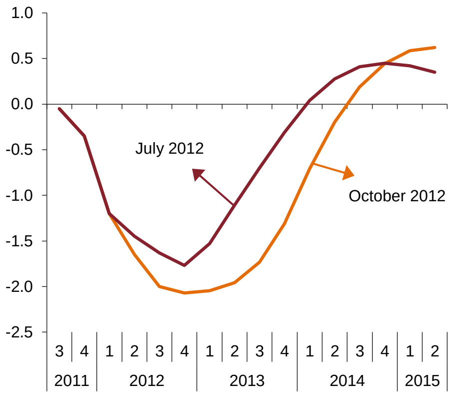
Comparison of July 2012 and October 2012 Inflation Report Forecasts

Chart 7.2.2.
Inflation Forecast



Source: TurkStat, CBRT.

Chart 7.2.3.
Output Gap Forecast

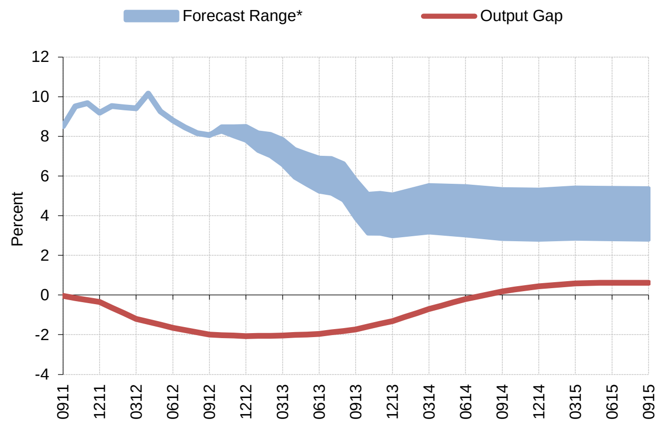


Source: CBRT.

Output gap forecasts are revised downwards starting from the second quarter of 2012 due to weaker course of domestic demand and global economy than envisaged in the July Inflation Report as well as heightened uncertainy regarding global economy (Chart 7.2.3). The higher support provided by aggregate demand conditions to disinflation in the inter-reporting period is estimated to restrain secondary effects stemming from public price adjustments.

Unpredictable price fluctuations in items beyond the domain of the monetary policy, such as unprocessed food and tobacco are among major factors of deviations in inflation forecasts. Hence, inflation forecasts excluding unprocessed food and tobacco are publicly announced. Forecasts are based on the assumption that year-end unprocessed food inflation will be 4.5 percent. 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 maintain its downward path it has assumed since May 2012, but will slightly accelerate in the last quarter due to adjustments to energy and administered prices, stabilizing back again in the last quarter of 2013 slightly below 5 percent.

Chart 7.2.4.
Inflation Forecast Excluding Unprocessed Food, Tobacco and Alcoholic Beverages



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

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, the 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	7.36	7.29	5.0
12-month ahead	5.58	6.70	5.0
24-month ahead	4.98	6.22	5.0

* October 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

The expectation that inflation will overshoot the target for an extended period coupled with the recent hikes in energy prices necessitate a close monitoring of the pricing behavior. The baseline scenario in the Report assumes that second-round effects will be limited. On the other hand, it should be noted that necessary measures will be taken should a different outlook unfold.

Ongoing uncertainty regarding the global economy and the ensuing volatility in capital flows requires preserving the flexibility of monetary policy in either direction. Uncertainties still persist regarding deleveraging of public, household, and banking sector balance sheets. The protracted nature of the global recovery has been prompting the extension of quantitative easing packages across advanced economies. Despite the steps taken for the resolution of problems in the Euro Area, risk appetite remains highly sensitive to any new developments due to ongoing fragilities in the financial system, elevated levels of borrowing costs across peripheral economies and the weakening growth outlook. Therefore, it is highly likely that short-term capital inflows will continue to be volatile in the forthcoming period.

Measures taken by advanced economies during the third quarter have eased the tail risks and alleviated the fluctuations in the global financial system. However, uncertainties regarding the implementation of the policy measures remain critical. The CBRT possesses adequate tools at its disposal to resort to under this uncertain environment.

A prolonged weakness in global economic growth may prompt major central banks to sustain their monetary easing packages. Extension of the duration of new packages would feed into macro financial risks in emerging economies like Turkey. In such a case, a resurge in short-term capital inflows may slow down the rebalancing process through rapid credit growth and appreciation pressures on the domestic currency. Should such a risk materialize, the CBRT may keep short-term rates at low levels, while implementing tightening through macroprudential tools such as reserve requirements. Moreover, the automatic stabilizing nature of the Reserve Option Mechanism will support financial stability.

Quantitative easing policies at a global scale also pose risks to commodity prices. However, upside risks on inflation could be contained in such a case, as periods of quantitative easing typically coincide with a weakening in the global economy. However, the CBRT will take the necessary tightening measures, should the increase in commodity prices prove persistent and consequently lead to a deterioration in the pricing behavior.

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 be 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.

Unprocessed food price developments may lead to a more-than-predicted favorable inflation outlook at the end of 2012. Despite the favorable course of leading indicators, a rather cautious approach was adopted, assuming that the rate of increase in unprocessed food prices will be close to the past years' average. Year-end inflation may be lower than projected in the baseline scenario, should unprocessed food prices display a more favorable course than envisaged.

The CBRT monitors fiscal policy developments closely while formulating its monetary policy strategy. Forecasts presented in the baseline scenario take the framework outlined in the MTP as given. In this respect, it is assumed that fiscal discipline will be sustained and there will be no unanticipated hikes to administered prices. 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.

Prudent fiscal policy 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 savings 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 Medium Term Program remain to be of utmost importance.