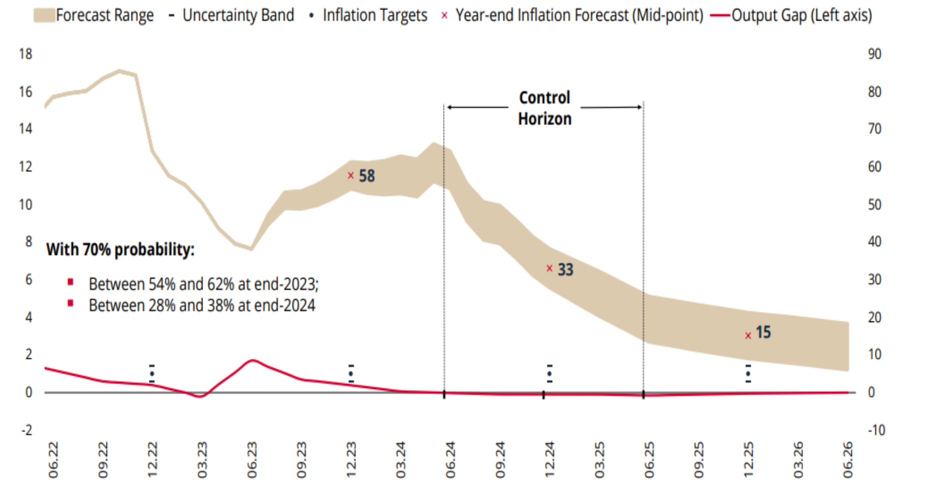
Macro: Sharp revision to inflation forecasts

1. Forecasts

In the first inflation report following the change in the economy management, the CBRT made a significant upward revision in 2023, 2024 and 2025 year-end inflation forecasts, which have been unrealistic recently. 2023 year-end inflation increased by 35.7 points from 22.3% to 58%; 2024 year-end inflation was increased from 8.8% to 33%, and the end-year inflation rate for 2025 was increased from 5% to 15% (Chart 1).

Chart 1.CBRT Inflation Forecast



Sources of forecast revision: All of the assumed variables contributed upwards to the updates in 2023 and 2024 inflation forecasts (Table 1).

Table 1. Revisions to Inflation Forecasts

	2023	2024
IR 2023-II Forecast (%)	22.3	8.8
IR 2023-III Forecast (%)	58.0	33.0
Forecast Revision as Compared to IR 2023-II Period (% Point)	35.7	24.2
Sources of Forecast Revisions (% Point)		
Import Prices in Turkish Lira (Including exchange rate, oil and import prices)	7.5	8.3
Output Gap	1.3	0.4
Food Prices	8.5	6.0
Administered Prices and Unit Labor Cost	7.5	3.6
Forecast Deviation and Change in Forecasting Approach	10.9	5.9

The most important economic reasons for the forecast updates for both years stand out as (i) food inflation, (ii) increase in TL-denominated import prices due to exchange rate, (iii) tax, administered price and wage increases (Table 1).

The "change in forecasting approach" has been added to the sources of forecast revision as a new item that we have never seen in any previous inflation reports. Taken together with the forecast deviation, this item has contributed 10.9 and 5.9 percent to the forecast update for 2023 and 2024, respectively. In the CBRT's own words in the report, the main reason for this change was expressed as "inflation forecasts were highlighted as intermediate targets in the path presented in the previous Inflation Report period, and the CBRT's technical forecasts were taken into account in current forecasts".

We consider the publication of official estimates, which largely reflected the judicial evaluations of the Board in the past, with greater emphasis on the views of economists who carried out modeling and forecasting studies, as an important development in terms of communication and forecast credibility.

2. Assumptions

External demand: While the Export-Weighted Global Growth Index growth assumption for 2023 was marginally revised up to 1.7% from 1.6%, depending on the global activity, which was slightly more positive than the previous projections, for 2024 it was revised from 2.4% to 2.1%.

Food prices: Despite the decline in global prices, due to the persistent supply-side problems as a result of market disruptions in the domestic market, as well as the exchange rate and wage-related effects, the food inflation assumption for 2023 increased by 33.6 points to 61.5%; for 2024, it was updated to 35% from 11.5%.

Oil prices: Due to the normalization in global demand conditions and the improvement in supply conditions, commodity price assumptions are updated slightly. Oil price forecast for 2023 rose from $78.1 to $79.4; and from $73.6 to $76.3 for 2024.

Economic activity: Output gap estimates, which were removed from the recent reports, started to be shared again.

- Although not explicitly included in the main assumptions table, the positive value (1.3 points) given among the sources the revisions for 2023 forecast indicates that a more inflationary growth outlook is assumed compared to the previous report due to stronger-than-expected demand conditions. As a matter of fact, the above-potential production level drawn for the second quarter of the year in the inflation forecast graph (Chart 1) reflects that there is "overheating" in the economy.
- However, the 0.4-point upward revision in inflation forecast for 2024 reflects a policy preference that relinquishes growth to a limited extent, rather than a monetary policy stance that will eliminate the short-term inflationary impact of demand conditions. A soft landing scenario is envisaged in which production gradually converges to its potential level within the control horizon. This picture does not seem to be in line with the message that "closing the output gap will be an important component of the disinflation process".

Table 2. Revisions in Main Assumptions*

		IR 2023-II	IR 2023-III
Global Growth Index* (Average Annual % Change)	2023	1.6	1.7
	2024	2.4	2.1
Oil Prices (USD, Annual Average)	2023	78.1	79.4
	2024	73.6	76.3
Import Prices (USD, Average Annual % Change	2023	-9.8	-9.5
	2024	0.4	2.4
Food Prices (Year-End % Change)	2023	27.9	61.5
	2024	11.5	35.0

* It is constructed by using the growth rates of 110 countries to which Türkiye exports and their share in exports.

- Although there is no communication about potential growth forecasts, we estimate that the growth rates implied by the output gap path will be around 4.5% for 2023 and 4% for 2024.

3. Main Messages

The evaluations and main messages highlighted in the Report and the Briefing are as follows:

Global economy:

- Global growth remains weak. Compared to 2022, external demand is decelerating in annual terms.
- Global economic activity diverges across sectors. Industrial production remains weak, while the services sector remains strong.
- The decline in growth rates and the weakness in industrial production affect inflation favorably through commodity prices.
- Despite a continued decline in both advanced economies and emerging economies global inflation remains elevated, while the persistence in core indicators supports the expectations that this downtrend will lose momentum in the period ahead
- On a global scale, the stickiness of services inflation due to tight labor markets and buoyant domestic demand restrains the decline in core inflation and expectations
- the limited decline in core inflation indicators supports the view that central banks will remain tight for a protracted period
- Emerging economies started rate hikes earlier than advanced economies and have been more successful in reducing core inflation.

Domestic economy:

- Despite earthquake-induced effects, economic activity remained strong in the first quarter of 2023 on the back of domestic demand
- Indicators for the second quarter suggest that domestic demand continued to be stronger than external demand
- The negative effects of the earthquake on Economic activity were largely compensated
- The outlook for domestic demand and production suggests that aggregate demand conditions remain inflationary
- The underlying trend of inflation has started to rise again in recent months due to buoyant domestic demand, wage and exchange rate developments, and persistence in services inflation
- Inflation will rise temporarily in the short run in response to the correction in exchange rates and the measures regarding fiscal discipline.
- Closing the output gap will be an important component of the disinflation process.
- Despite the recent slowdown, loan growth remains high
- Strong domestic demand also affects consumption goods imports
- Despite a strong services balance and the decline in energy imports, the rise in the foreign trade deficit continued to widen the annualized current account deficit.

- Beginning from June, the Central Bank's international reserves have increased, while country risk premium and exchange rate volatility have decreased

Monetary Policy:

- The objective of our monetary policy is to achieve price stability.
- Price stability aims to reduce the volatility of inflation while bringing it down permanently.
- Price stability is a sine qua non for macrofinancial stability
- We embarked on a monetary tightening process to bring inflation down permanently.
- Monetary tightening will be strengthened as much as needed in a timely and gradual manner until a significant improvement in the inflation outlook is achieved.
- We will continue to decisively use all our tools in line with the main objective of price stability.
- In addition to the rate hike, we have taken decisions on selective credit tightening and quantitative tightening to support the monetary tightening process, and will continue to do so.
- In the meantime, we are carefully laying the groundwork for a sustainable start of disinflation in 2024.
- Some of the cumulative positive effects of our rate hike decisions, along with the quantitative and selective tightening decisions will be felt in late 2023 and particularly in the underlying trend of inflation in the second quarter of 2024.
- Once we enter the period of disinflation process, temporary corrections in relative prices will be replaced by exchange rate stability, improved current account balance, fiscal discipline, permanent strengthening in capital flows and increased reserves.
- Post-2025 will be the beginning of a period of stability. During this period, disinflation will accelerate and predictability will increase.

4. Our evaluations

- Updating the main focus of the inflation report and policy communication in a way that puts inflation back in the center is a positive development for the CBRT to embrace its primary duty.
- While the analysis of inflation dynamics has been enriched, short-term forecasts have reached a very realistic point
- The year-end inflation forecast for 2023 seems to be in line with a $28 exchange rate. Therefore, the CBRT predicts a moderate depreciation in the remainder of the year. (i) If this happens, the Turkish lira will start to appreciate again in real terms and the need for readjustment will increase at some point in 2024, (ii) high wage increases will be on the agenda again at the end of the year, as a result of the cumulative inflation of around 30% predicted for the second half, (iii) Under the current policy stance, the year-end forecast for 2024 seems optimistic, as the revaluation rate will reach around 60% as of October, as inflation rigidity will become stronger.
- The pro-growth policy preference indicated by the output gap estimates requires a strong improvement in expectations in order to reach the year-end inflation forecast for 2024. With the current tightening rate, it seems difficult to anchor inflation expectations to the year-end 2024 forecast.

- As a result of the steps taken recently, the question of what the "total policy stance" is gains importance. While the policy rate is increased on the one hand, the regulation changes that lower the deposit rates by the same amount on the other hand complicate the policy signal. In a multi-instrumental framework, such as increasing rediscount credit limits, removing the first stage of the commercial credit multiplier and introducing required reserves to KKM, the need for concrete indicators of monetary stance is increasing.
- Under the current inflation outlook, deposit rates approaching the policy rate poses risks in terms of liraization targets.

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