MACRO BRIEF

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What the IMF Really Predicts and Why Some Wrongly Find Comfort in Those Predictions?

Recently, the IMF published a report on "Global Economic Prospects and Policy Challenges", which also includes macroeconomic forecasts for G-20 countries. Although the report does not have any specific emphasis or a chapter on Turkey, some analysts have chosen to believe otherwise it seems. The Report has been serving as further evidence in support of those who are advocates of an overheating environment in Turkey and thus staunch opponents of the unorthodox policy mix experiment that has been in place for around eight months. The Fund's predictions which captured headlines and led to a second wave of 'verification of the obvious' celebrations are provided in the table below:

INDICATORS	2011	2012
Real GDP Growth	8.7%	2.5%
Inflation (*average*)	5.5%	6.4%
Fiscal Balance (*over GDP*)	-1.9%	-1.6%
Current Account Balance (*over GDP*)	-10.5%	-9.8%

Source: IMF WEO Update, June 2011

The search for comfort in a higher court's approval by market analysts ended up with quite a few houses announcing IMF's Turkey projections as validation of their own forecasts despite the huge disparities we observe between IMF figures and the very same market forecasts. "Broadly in line with ours" was the phrase almost unanimously adopted by these analysts and the implicit 'broadness' of their bands (the explicit absence of which in their previous reports has been a most frequent complaint directed at them by us for so long) is borderline shocking to us.

Before elaborating shortly on methodologies the IMF resorts to (internally coherent large scale models which we will discuss shortly) in order to come up with the above mentioned forecasts and many more in its Report, let us refer to some typical misinterpretations (or interpretations going beyond the Fund's intentions) conducted by market analysts. Partial explanation for such misguided interpretations will be stemming from the very nature of the models the Fund uses, but a more significant portion will be emanating from market participants' urge to match their (common) intuition with any piece of research that is tangentially akin to their predictions (or gut feelings (?), notwithstanding the fact that we fully acknowledge the importance of properly evolved gut feelings).

For instance, in one piece of research from a very prominent investment house, the following comment was quintessential in this respect:

"Although the numbers differ, our macro view and forecasts are broadly in line with the IMF. The Fund implicitly makes the same point as we do that the macro imbalances in Turkey requires some old fashioned fiscal and monetary policy tightening and the macro prudential measures should act as supporting rather than the main policy tool. (…) and inflation moving higher- suggests us that IMF believes that the current policy mix would yield an inferior outcome unless supported by more prudent macro policies, in our view."

The numbers truly differ; this particular house expects a deceleration in growth from 6.7% to 4% while IMF forecasts almost imply a sudden stop as depicted in the table provided before. To claim that a 6.2 percentage point reduction in growth expectation is "broadly in line with" a 2.7 percentage point reduction projection is admittedly unacceptable by any calculus. As for the remainder of the remarks in the same commentary, it is a mystery to us as to why the Fund would think that *"some old fashioned fiscal and monetary tightening"* is required GIVEN the reduction in growth to 2.5% in 2012.

The IMF may indeed be saying something different and yet more alarming: the unorthodox policy mix (coupled with an unpromising global setting?) DOES indeed lead to a significant slowdown but even that will not be enough to bring down current account deficit in a discernible fashion. To say that current policy does not work in slowing down the economy is one thing, but to say that the slowdown does not reduce CAD as it had done in the past is something else. How do old fashioned policies deal with this problem aside from the option to further pull down growth to say zero percent levels?

The 2.5% forecast MUST have come as a shock to advocates of orthodox policies[1] who had opined that only lower growth would handle the CAD problem and thus the need for orthodoxy. But alas, here is a reduction larger than they had sought for yet no contemporaneous CAD reduction is accompanying it. Consequently, the response is to seek refuge in the high CAD figure as circumstantial evidence supporting the failure of the current policy mix while totally ignoring the borderline sudden stop growth reduction contemplated by the Fund.

Here is another excerpt from another research piece which suffers from all methodological deficiencies we insistently emphasized and outlined in our recent research pieces and is as difficult to trace and interpret as the previous commentary above:

"Economy is slowing down, but C/A deficit continues to widen, why? In 1Q11, Turkish economy was very close to overheating, but as the economy slows down, the overheating debate should come to an end. But there is an illusion for those, who believe that there is/was no overheating in Turkey. ***The illusion is that people including the CBT look at macroeconomic figures and say that economic activity started to decelerate compared to 1Q11.*** *That observation is definitely true, but this does not necessarily mean that the widening C/A deficit should reverse. Turkish economy will be slowing down from a base, which was very close to overheating and even that slowdown will mean strong growth"*

The CBRT as well as we at YKB Research are suffering from an illusion which the author of the comment above is not, but the nature of the illusion is a bit mysterious to us. We have put forward credible research[2]concluding that 'no overheating' cannot be rejected but we have seen nothing convincing that serves the rival point of view. Is 'no overheating' an illusion or is it its degree, or is it, as the author says explicitly, the fact that the economy is slowing down as of Q11? But if the observation is true, as he admits himself, then it cannot be an illusion per se. If a non-shrinking CAD in the face of a slowdown is a fact that will be observed going forward, that may very well be the case for myriad reasons. The illusion nature of overheating which can be looked into from already existing data is very different from the illusion nature of a forward looking statement which will stand the test of time in the first place AND does not necessarily contradict the probability distribution in the minds of no overheating advocates anyway. As such, we split hairs to identify the illusion but desperately fail to do so. These stand out as efforts to 'divine the meaning in the thinking' but economics is more closely linked to natural sciences than to theology.

As for the claims by the IMF on Turkey in the aforementioned Report, here is the full list that we came up with:

i) *In emerging and low-income economies, fiscal deficits and debts are being reduced gradually. However, cyclically adjusted balances are still negative in a number of economies (e.g. Brazil, India, and Turkey) even though demand is at or above capacity.*
ii) *Growth in emerging Europe is now projected to be higher than previously expected in 2011, followed by a softening in 2012, driven by a sharp domestic demand cycle in Turkey.*
iii) *In some emerging markets, the task is to avoid overheating and prevent the build-up of financial imbalances. In such economies—which include Brazil, India and Turkey—there is room for further consolidation. This will take pressure off monetary and prudential policies and create fiscal space to respond to future shocks.*

Regarding the first and third claims, there is a bundling problem from our point of view in the sense that putting these countries together and ending up with generic conclusions is risky business as common characteristics could be less than assumed. As for cyclically adjusted deficits and the underlying assumptions/estimations utilized in those adjustments (output gap and myriad elasticities with respect to the output gap most important of all), no one is better authorized than the Fund to come up with "caution required" sign which they explicitly put in their Global Economic Outlook (April 2011 and earlier Outlook reports as well) as follows:

[1] Indeed, the commentary we referred to in the main text makes its introduction by describing IMF forecasts as "..quite out of consensus forecasts for Turkey".

[2] Those research pieces have not been discredited by any market analyst so far, but they may not have been deemed worthy of commenting on for some reason; a probability we would like to treat as 'tail'.

*"…Structural balances are expressed as a percent of potential output. The structural budget balance is the budgetary position that would be observed if the level of actual output coincided with potential output. Changes in the structural budget balance consequently include effects of temporary fiscal measures, the impact of fluctuations in interest rates and debt-service costs, and other noncyclical fluctuations in the budget balance…**Estimates of the output gap and of the structural balance are subject to significant margins of uncertainty."***

The emphasis in the last sentence is ours and it is *"NOT broadly in line with"* but ***very much*** in line with the cautious stance we have been advocating for any statistical research piece.

As for the third claim alone, overheating is a much debated issue in Turkey and so is the output gap itself, and the IMF's cautious stance regarding these issues is made explicit by them in the first place. So one can ask why the Fund is doing the kind of 'bundling' it is doing and thus to some extent ignoring non-similarities between countries in a given bundle? That brings us to the nature of the models the Fund is using in coming up with these 'broad' conclusions.

The IMF currently uses two global macroeconometric models for producing its forecasts and each serves a different purpose. The newest one is called GEM, which is a large-scale version of a micro-founded open economy model. However, the model imposes a very tight theoretical economic structure and therefore makes its use impractical for developing countries that still deal with the problems of defining a plausible Dynamic Stochastic General Equilibrium (DSGE) type macroeconomic model. Moreover, transmission mechanisms are quite difficult to identify and quantify within a single country, let alone internationally. No need to mention the difficulty of calibration of such a model in the case of Turkey.

MULTIMOD is the other macroeconometric model that the Fund uses for projection purposes. Although MULTIMOD is a dynamic multi-country macro model, only the seven largest industrial countries are explicitly modeled. Small industrial countries and developing countries (along with the rest of the world) are aggregated and treated as two different groups and each group is represented by the same set of equations. Even if we assume that global links are perfectly established and modeled for Turkey, which is almost a virtual impossibility and not even a priority given the size and the objective of the model, the model still suffers from the same problems that we have outlined in our previous reports (*unavailable structural indicators, policy changes, structural breaks, high volatilities, large uncertainties, etc.*).

To put it in slightly vulgar and blunt terms which hopefully does semantic justice to our point, it would be more appropriate for market analysts to use the phrase "IMF's Global Forecasts Including Turkey" rather than "IMF's Turkey Forecasts". This distinction may sound secondary or tertiary to the novice analyst, but our more seasoned colleagues would know better that reliable Turkey forecasts would/should be coming from a Turkey model which delicately and properly identifies a 'global setting indicator' variable to be used in that single country model. To seek refuge in single country forecasts obtained in a multi-country model is doing injustice to that model even in the face of all the reservations the model developer so duly emphasized in every relevant instance.

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