TÜRKİYE CUMHURİYET
MERKEZ BANKASI

Speech

Central Bank of the Republic of Türkiye

Prof. Şahap Kavcıoğlu, Governor

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Distinguished Members of the Press, Esteemed Participants,

I would like to extend my warm greetings to our guests in the meeting hall and those following us online. Welcome to our third Inflation Report Briefing in 2022. Now, we will explain our evaluations regarding the economic developments of the last three months and our inflation forecasts.

I will start my speech by giving you a brief account of global economic developments before moving onto our evaluations of the macroeconomic outlook. Then, I will summarize our monetary policy practices since our previous Inflation Report. Then, I will explain our medium-term inflation forecasts and conclude my remarks with an overall assessment.

Macroeconomic Outlook

Energy and supply constraints as well as supply chain disruptions led by the geopolitical risks in the second quarter coupled with the lingering impacts of the pandemic weigh on the global economic activity. The mounting and persisting adverse effect of the Russian-Ukrainian conflict on energy-commodity supply as well as price and trade channels, chiefly in the euro area, poses risks to the global growth outlook. In addition, the significant divergence among countries with respect to monetary policy decisions, which were taken in consideration of a longer-than-expected rise in inflation leads to uncertainty in financial conditions and strengthens the possibility of a significant slowdown in the global economy.

There has been a relative improvement in energy and commodity prices, supply conditions and lead times recently. The energy, industrial metal and agricultural commodity price indices, which reached historic highs amid the Russian-Ukrainian conflict and the pandemic, are now displaying slight decreases, and lead times decline further in advanced and emerging economies. In particular, the lead times in emerging economies have converged to their normal levels in recent months, while the delay times in advanced economies still remain high, despite the improvement. However, the elevation in energy prices and volatility continue to put pressure on prices.

Global inflation continues to rise sharply. Inflation rates in advanced and emerging economies hit their highest levels of the last 25 years. Year-end inflation forecasts in these countries were revised upwards due to supply constraints, uncertainty in energy prices and disruptions in the energy supply process. All these aggravate the concerns about the persistence of high levels in global inflation.

Distinguished Participants,

Despite major supply shocks, the domestic economic activity is functioning without interruption in a sustainable way. The Turkish economy, which quickly normalized after the pandemic and underwent a transformation in its foreign trade structure driven by the manufacturing industry, grew by 7.3% on an annual basis in the first quarter of 2022.

Net exports provided positive contributions to annual growth over the last five quarters. On the production side, the services and industrial sectors continued to support growth.

The Turkish economy is going through a process of structural transformation that focuses on increasing production, exports and employment. As a reflection of this process, the current account balance continues to improve in cyclically adjusted terms. Adjusted for price and business cycle effects, the Turkish economy had a current account surplus for two consecutive quarters for the first time since the start of this analysis in 2004. In other words, when global commodity prices start to normalize, our economy will have attained the capacity to run a current account surplus.

This indicates the start of a new era for the Turkish economy, one of export-led growth, in which short-term financing needs are minimized when energy and commodity prices normalize. Through the policies we are implementing, we will continue to support the sustainability of this transformation, which we consider to be one of the main elements of price stability.

As a result of this transformation process, investment expenditures continue in a healthy and sustainable framework. Investments that support productive capacity, primarily machinery and equipment investments, the drivers of industrial production, indicate a stable and strong growth. As a matter of fact, machinery and equipment investments grew by 10.5% on an annual basis in the first quarter of 2022. In this context, it is important to meet the investment need, which is necessary for continuous supply-side support to sustainable growth and price stability, with accessible, long-term and low-cost Turkish lira financing.

Machinery and equipment investments and net exports are the supporting components of the strong and sustainable growth performance of the Turkish economy as it turns towards increasing production, exports and employment, and their share in national income is on a steadily rising track. As of the first quarter of 2022, the total share of both components in national income hit historical highs with 18%. The steady increase in machinery and equipment investments will expand the supply capacity of our economy and contribute to permanent price stability.

In the second quarter of the year, domestic demand remained almost flat, while industrial production remained strong with the contribution of external demand. Having grown constantly on an annual basis in the third quarter of 2020 and onwards, industrial production recorded a strong annual increase of 9.1% in May 2022. This strong increase in production has spread across the manufacturing industry, while industrial production is even stronger in exporting sectors. Industrial turnover indices also indicate that external demand has a positive impact on industrial production.

Strong economic growth is also reflected on capacity utilization rates. Capacity utilization rates have increased in all sectors and exceeded historical averages in some sub-sectors.

This indicates the need for additional capacity and supports investment demand. Meanwhile, hovering above historical averages, manufacturing industry capacity utilization rates encourage firms to expand their capacities and point to a continued strong trend in investments. Accordingly, capacity increases have been more pronounced recently in sectors with higher investment appetite.

In fact, as of July, survey data suggest that firms' investment expenditures will continue to increase in the coming periods. We observe that this trend has strengthened across all sectors, especially for producers of investment goods and exporters. As suggested by January-May averages, the increases in the volume of imports of investment goods and industrial production, particularly of capital goods, confirm that the demand for fixed capital goods remains strong.

The increase in the share of sustainable components such as investment and exports in production has also had a positive effect on employment. In the labor market, the workforce participation rate continues to increase, while the number of unemployed people continues to decline. Thus, as of May, the total number of employed persons reached a historical high of 30.8 million in seasonally and calendar-adjusted terms. In addition, the unemployment rate of 10.9% indicates that the employment gap is still high.

Recent employment developments in the Turkish economy are promising. The number of employed people increased by around 2.7 million, 1.3 million in the services sector and more than

900 thousand in the industrial sector as of the first quarter of 2022, thanks to the rapidly increasing industrial production since the second quarter of 2020 as well as investment expenditures and exports. This increase in employment is quite high compared to peer countries. Since the beginning of the year, employment has increased by approximately 846 thousand people. The fact that indicators for labor force participation and employment have exceeded pre-pandemic levels are significant developments in terms of showing how healthy post-pandemic labor markets are.

Dear Guests,

I have emphasized that the growth structure of the Turkish economy is undergoing an export-oriented transformation. Our exports, which had a steady growth trend before the pandemic, increased sharply after the pandemic and reached USD 126 billion in the first half of 2022, up nearly 20% year-on-year. This marks a historical high for our exports in the first six months of any year.

Imports rose on the back of energy prices, while imports excluding energy and gold remained stable despite the growth in economic activity.

We identify three main reasons for our record-breaking export performance despite the armed conflict between our major trading partners. First, Türkiye's advantages in the reshaped global market after the pandemic. Second, the capacity of our exporters to adapt to changing conditions thanks to their resilient and flexible structure. We believe that the third reason is the favorable conditions provided by our financial system, especially the Central Bank, to our exporters at this critical juncture for our national economy. As of May, investment and export credits account for 28% of commercial credits, the highest level of the last 17 years.

In this context, the increase in domestic production and exports is important. With the contribution of relevant economic policies, the price-adjusted export quantity index rose sharply and the import quantity index posted a small decline. However, record-high price increases driven by global energy and commodity prices outpaced the decline in the import quantity index, limiting the improvement in the external trade deficit.

The product and market diversity of our exports has been steadily growing, and at a much faster pace recently. In fact, the destination and product diversity of our exports doubled in 2022 compared to 2006. Around 29% of the increase in our exports between 2015 and 2022 was generated by new markets. The flexible and dynamic structure of our exporters protects our economy against external shocks. Our companies' flexibility in introducing new products and finding new markets allows them to compensate for possible losses in adverse conditions, including the current armed conflict.

The performance of the tourism sector, which is not only an important factor for the external balance, but also an important source of employment and revenues, was quite pleasing in the first five months of the year. The monthly number of visitors increased compared to 2021 and converged to numbers recorded in 2019. Meanwhile, travel revenues exceeded 2019 figures. Tourism income per visitor has been increasing and tourism revenues have been hovering well above the expectations recorded at the beginning of the conflict in our region.

Distinguished Guests,

We closely monitor the compatibility of the development of commercial loans with economic activity with respect to financial stability. This is because it is of great importance for our current policies that loans are used in investments in targeted areas that will boost capacity and exports.

Targeted use of loans, which will increase investments and production capacity, will contribute positively to achieving sustainable growth and current account balance. The growth in commercial loans in the first six months of the year increased by 3.9 times the growth in the previous six months, and 2.5 times the increase in 2021. Following this acceleration in loans in the first quarter of the year, we took macroprudential measures in coordination with our stakeholders and in line with our targeted loan policy, excluding some selected loan types such as SME, export, investment and agriculture loans. As a result of these measures, recently, a slowdown has been observed in growth rates of commercial and individual loans. Accordingly, on the back of the steps taken as of the second half of 2021, the share of consumer loans in the total decreased significantly.

Distinguished Members of the Press, Esteemed Participants,

In the second quarter of the year, the strong increases in global commodity prices – particularly in energy and food prices – supply constraints stemming from ongoing disruptions in the global supply chain and exchange rate developments continued to exert pressure on consumer prices and became the main drivers of the rise in inflation. In June, annual consumer inflation was recorded at 78.6%, exceeding the path that we had envisioned in the April Inflation Report.

In June, 81.5% of the annual consumer inflation was driven by food, energy and core goods groups that were most severely affected by external shocks. Meanwhile, core inflation indicators display a more positive outlook. After reaching the highest levels in December 2021, the monthly rate of change of B and C indices decreased and remained relatively flat. The improvement in this trend continued in June as well.

Distinguished Participants,

Our analysis of inflation dynamics suggests that key determinants of inflation in non-food and non-energy items were external supply shocks and exchange rate developments, while the impact of demand conditions remained limited.

In the second quarter of the year, the import unit value index rose particularly due to the increase in energy prices and became one of the main factors driving inflation up. In this period, despite a slight decline in agricultural and industrial metal prices, international commodity prices remained relatively high. Supply and demand imbalances in global energy markets, which became more evident due to the conflict between Russia and Ukraine, continued in the second quarter of the year leading to sharp increases in energy prices. In the second quarter, international energy prices increased by 11.4%, exerting a significant amount of pressure on consumer prices.

Over the last three months, due to disruptions in the global supply chains and lingering geopolitical problems, transportation costs hovered above historical averages and the negative outlook for domestic delivery times persisted, albeit with some improvement.

The elevated levels of international and domestic energy prices, disruptions in supply chains and exchange rate developments affected producer prices adversely.

Survey data regarding manufacturing industry companies' orders and high-frequency indicators such as credit card spending suggest that domestic demand has decelerated, being more prominent towards the end of the second quarter. Interviews with real sector companies confirm this trend as well. As a matter of fact, output gap indicators display a slowdown compared to the previous quarter. Once global growth expectations are revised downwards, in the second quarter of the year, the output gap is expected to decrease gradually and demand conditions' contribution to inflation is expected to decrease further.

On the other hand, output gap indicators displayed a varying outlook. While production-based output gap indicators slowed down in the second quarter, the indicator including the credit effect, which was strong in the first quarter, remained strong again. As I will discuss shortly, strong policy responses have been given to these developments.

Monetary Policy

Distinguished Participants,

Before moving on to our medium-term forecasts, I would like to give information on our monetary policy implementations in the period following the April Inflation Report.

With the decisions we take, we aim to ensure a permanent decline in inflation as soon as possible. Accordingly, together with the interest rate policy, we have been effectively making use of the policy mix composing of liquidity, collateral, reserve requirements and management of international reserves. In the context of our integrated policy framework, in the last quarter we have effectively used our instruments with a liraization perspective, and will continue to do so.

In an outlook in which persistent and strong negative supply shocks are the most significant determinants of inflation, with a holistic and prudent approach that takes into account all the risks to our economy, we decided to keep the policy rate unchanged in the May-July period to create the financial conditions that will support the continuity of supply and the capacity for a current-account surplus.

Meanwhile, as I stated in the previous Inflation Report briefing, we decisively took measures to align the growth rate and composition of loans with real economic activity. In the face of the surge in commercial loans that threatens monetary stability, we have recently strengthened our macroprudential policies. First, we announced the new reserve requirement practice that involves the asset side of the balance sheets of banks and non-bank financial intermediaries. In this context, we introduced different reserve requirement ratios according to loan types and loan growth rates of banks.

With another arrangement we made regarding the reserve requirement ratios, we differentiated the reserve requirement ratio for FX deposits according to the ratio of conversion to FX-protected deposit accounts for real persons. Moreover, we made a decision that allowed banks to maintain additional Turkish lira long-term fixed-rate securities for FX deposits and participation funds, thus, we took a significant step in terms of the effectiveness of monetary transmission.

Esteemed Participants,

Another important step that we have recently taken in line with the liraization strategy is the changes we made in collateral management. The main aim of these changes is to increase the share of Turkish lira-denominated assets in the guarantees pledged in return for the funding we provide to the market. We are re-shaping our financial architecture on the axis of liraization and on sound foundations.

As part of collateral regulations, we changed the composition of the GDDS basket to be used in the collateral blockage for currency swaps and Interbank Money Market operations in May. We set the GDDS collateral blockage for all swap transactions with the CBRT and the minimum GDDS collateral requirement for Interbank Money Market Operations at 30%, and we gradually raised it to 50%.

Additionally, regarding the banking sector, we also gradually raised the collateral discount rate for indexed securities as well as FX and gold-denominated assets subject to collateral, which had been 5% in May, to 50%.

Following our inter-complementary collateral and reserve requirement arrangements, we observe that long-term Turkish lira interest rates have converged to the policy rate, and the yield curve has trended down for all maturities, increasing the effectiveness of the monetary policy.

We will continue to take the necessary steps to ensure that all Turkish lira interest rates, including money market, public borrowing and loan rates, converge to our policy rate and that the monetary transmission is maintained, while paying heed to a monetary growth consistent with the economic potential.

Medium-Term Projections

The starting point for our medium-term projections is based on the economic outlook I have summarized so far. We have reviewed and revised our assumptions for external factors such as import prices, food prices, global growth and fiscal policy.

Commodity prices that hit historic highs as the tension between Russia and Ukraine turned into an armed conflict have posted declines in the recent period. Besides, relaxation of pandemic measures in China and the increase of freight capacities have also supported the decline in commodity prices. Thus, the upside forecast bias that occurred in the early reporting period was somewhat compensated for on the back of recent positive developments. In addition to concerns regarding global demand, the outlook for oil prices suggests persistence, albeit with some easing, in the supply-side factors such as the continuation of sanction commitments against Russia, and the maintenance and repair of some energy facilities. Against this backdrop, while keeping our yearly average assumptions for crude oil prices and the general level of commodity prices for 2022 largely intact, we have revised them downwards for 2023.

We have revised our assumptions for food prices for 2022 and 2023 upwards, taking into account geopolitical risks, high agricultural commodity and energy prices, trade restrictions and supply constraints.

We have revised our assumptions for external demand downwards compared to the previous reporting period, due to the heightened uncertainties over global economic activity, geopolitical risks, rising energy costs and possible supply shortages. In addition, we have assumed that due to the increase in global inflation, financial conditions in the upcoming period will be tighter than anticipated in the previous reporting period.

Our projections are based on an outlook in which macroeconomic policies are determined with a medium-term perspective and a focus on bringing inflation down, and in a coordinated manner within the scope of liraization steps.

Distinguished Guests,

Now, I would like to present our inflation forecasts based on the framework I have described so far. Based on our main assumptions and short-term projections, under an outlook in which the monetary policy stance will be set in line with the sustainable price stability objective, we anticipate that inflation will gradually decrease and converge to the targets once the global peace environment is restored and commodity prices, including energy, normalize after the negative supply shocks end.

Another important factor that I would like to point out regarding our forecasts is related to our forecast ranges. As inflation rises, the inflation expectations range widens, and so does the range in which inflation can be predicted. This is reflected in our forecasting path.

Accordingly, the mid-points of our inflation forecast range are projected to be 60.4% at the end of 2022, 19.2% at the end of 2023, and 8.8% at the end of 2024.

Thus, we have revised our year-end inflation forecast for 2022 up by 17.6 points, from 42.8% to 60.4%, and for 2023 up by 6.3 points, from 12.9% to 19.2%. For these two years, the effect of the revision in initial conditions increased the forecasts by 4.1 and 4.4 points, respectively. The revisions in assumptions for import prices in Turkish lira and food prices drove up the inflation forecast for 2022 by 7.4 and 3.0 points, respectively while they increased the inflation forecast for 2023 by 0.1 points and 1 point. Meanwhile, adjustments in administered prices and the rise in real unit wages pushed the year-end inflation forecast for 2022 up by 2.8 points in total. The revision in these items had a smaller effect of 0.9 points on the year-end inflation forecast for 2023. On the other hand, we gauge that the revision in the output gaps for 2022 and 2023 will have a very limited effect on the forecasts.

Esteemed Guests,

Adverse geopolitical risks and increased volatilities in global financial conditions have led to historically high levels of inflation driven by successive supply shocks, and a slowdown in economies at the same time. Including advanced economies, we are going through a period of disrupted accessibility to certain products. While inflation is also having a marked impact on our economy, our country is among the best economies in terms of the continuity of supply. Our labor market, including labor force participation and employment, functions soundly, and our manufacturing- and export-oriented production structure follows a strong course.

Powerful and continuous supply shocks, exchange rate developments, and the related deterioration in pricing behavior are the main drivers of the high inflation that we experience. In our monetary policy decisions, we attach importance to the creation of financial conditions that will ensure sustainability of production and investments and support the sustainable current account balance objective. We also support this stance with targeted export and investment loan programs that will lead the sector as well as with our macroprudential policies. In fact, our exports remain strong on the back of our companies' performance as well as the financing conditions provided.

Increasing the current account surplus capacity of the economy through arrangements that support the positive contribution of targeted export and investment loans to the current account balance is crucial for permanent price stability. We have raised the limits in both programs. As a result of the arrangements we put in place to increase the potential of our exports through a sustainable approach, the access of SMEs to resources has reached a historically high level in line with their share in exports.

In the second quarter of the year, especially after the escalation of the regional conflict, we saw a significant rise in the loan growth rate. We have spotted that a portion of the financing resources offered had been used in a way that threatens exchange rate stability due to the increased global uncertainty perception, although some of it was due to the rising need for working capital and investment in the face of geopolitical risks. Therefore, we have decisively put into effect our measures addressing the growth rate of loans and the use of loans in consistence with economic activity. As a result of the policies we implemented alongside complementary measures taken with a high degree of coordination with our stakeholders, we see that loans have started to normalize. The effects of the decisions taken will be closely monitored, and additional measures will be taken against extraordinary developments in commercial and retail loans when necessary. The course of the Turkish lira in line with economic activity is of critical importance in terms of more efficient use of resources by directing them to the right areas as well as in terms of avoiding artificial pressures on the exchange rate.

In order to increase and maintain the effectiveness of monetary transmission, we act with an approach that will enable the convergence of bond, loan and deposit rates to our policy rate and the liraization-based provision of liquidity. The Central Bank, as the fundamental provider of the Turkish lira, will increase the demand for the lira structurally and permanently with all the tools at its disposal, and will gradually exit all the mechanisms that conflict with this objective. We implement our strong collateral and liquidity measures in line with this principle. We will continue to take our steps with a gradual approach and measuring their effects until we see that the value of the Turkish lira is stable in the financial system and liquidity is distributed efficiently.

Before concluding my remarks, I would like to emphasize that the holistic policies, which safeguard the supply security and the diversity and saving of resources in agriculture, trade and energy as well as balanced taxation leading to both fiscal discipline and disinflation, have also supported and complemented our fight against inflation. We are going through a difficult period in which foreign policy can directly affect inflation. In this framework, we observe the positive contributions of effective policies implemented in response to global geopolitical risks on both supply security and our current account balance, as measurable by economic parameters. Similarly, we are receiving and will continue to receive the support of this holistic perspective also in liraization.

With the measures taken and the normalization of the conditions, our economy will achieve a sustainable level of current account balance in addition to fiscal balance. Accordingly, a strong financial architecture will be established in line with liraization, and inflation will fall to levels consistent with our forecasts.

As I conclude my speech, I would like to thank all my colleagues who contributed to the Report, primarily the members of the Monetary Policy Committee and the staff of the Research and Monetary Policy Department as well the staff of other departments who contributed to the related preparatory work. Now, we can move on to the question and answer session.