TÜRKİYE CUMHURİYET MERKEZ BANKASI

# Speech

Central Bank of the Republic of Turkey

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Inflation Report Briefing 2022-II

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Distinguished Members of the Press, Esteemed Participants,

Welcome to our second Inflation Report Briefing in 2022.

I would like to welcome our guests at the meeting hall and salute those following us online.

I will start my speech by giving a brief account of our evaluations about macroeconomic outlook that form the rationale for our policies. Then, I will move onto our medium-term inflation forecasts and give an overall assessment of our monetary policy. Lastly, I will answer your questions and finish our meeting.

**Macroeconomic Outlook**

Geopolitical risks, which turned into a conflict in February, led to a rise in disruptions in supply chains and worse supply chains again after the pandemic. The expansion of quarantine measures taken because of the rise in the number cases in China further aggravates the deterioration in supply continuity. The impact of the conflict between Russia and Ukraine on the global economy, particularly in the euro area, via commodity prices, supply and trade channels increases the risks to the global growth outlook. Accordingly, growth expectations in our trade partners have also been revised downwards compared to the previous Report period.

Inflation, which increased due to supply problems during the pandemic, has been currently increasing due to rising commodity prices because of the heightened geopolitical risks. Strong negative supply shocks triggered by regional conflicts led to sharp increases in global raw material prices. Both headline and core inflation rates have reached high levels around the world. Meanwhile, supply chain problems, which had been expected to disappear once the effects of the pandemic abated, have not yet shown any improvement. Moreover, geopolitical risks continued to affect inflation via these channels adversely.

Distinguished participants,

I would like to continue my speech with the domestic macroeconomic outlook. In the final quarter of 2021, amid post-pandemic normalization process and with the support of foreign demand, economic activity remained strong and the growth was recorded at 11% in 2021.

In the final quarter of 2021, on the manufacturing side, the highest contribution to annual growth came from the services and industry sectors. As for the expenditure side, both domestic and foreign demand contributed to annual growth in the fourth quarter. In this quarter, net exports contributed to annual growth by 4.2 points. Thus, in the fourth quarter of 2021, Türkiye was one of the OECD countries that enjoyed the highest contribution from net exports to annual growth.

Data for the first quarter indicate that the improvement in the composition of economic activity continues. In this period, although domestic demand lost some momentum, production remained strong thanks to foreign demand. Compared to the previous quarter, January-February average of industrial production adjusted for seasonal and calendar effects, increased by 2%. Meanwhile, in the first quarter, calendar-adjusted industrial production displayed a strong increase at 13.3% on an annual basis. While the increase in production was observed in the manufacturing industry in general, industrial production is stronger in exporting sectors. Industry turnover indices also show that foreign demand has had a positive effect on industrial production. Despite the long-standing supply constraints, industrial production supports growth and the labor market thanks to its flexible and strong structure.

Investment expenditures have been on a strong uptrend. Machinery-equipment investments, one of the drivers of potential growth, have been increasing on an annual basis for nine consecutive quarters since the last quarter of 2019. In the said period, the average annual growth rate of machinery-equipment investments was around 20%. Meanwhile, the contribution of components that support the current account balance, such as net exports, has remained high after the pandemic. This indicates that sustainable components of growth are getting stronger. In 2021, the share of machinery-equipment investments and net exports in gross domestic product reached 17.4%, the highest level recorded over the last decade.

Survey data indicate that as of April, companies are planning to increase their investment expenditures in the next quarter. This trend has been getting stronger and spreading across all sectors, particularly in sectors producing investment goods and exporting sectors. An analysis of January and February averages reveals that the rise in imports of investment goods and industrial production, particularly of capital goods, continue and confirm that the demand for fixed capital goods is strong.

Capacity utilization ratio in some sectors have exceeded historical averages. We consider that the need for additional capacity might be a factor that can support investment demand in the upcoming period. In this respect, it is important to meet the increasing investment need with long-term Turkish lira investment loans.

The composition of growth has become stronger and it has had a favorable impact on the labor market. While domestic production has been strong with the contribution of exports, our economy’s capability to create employment opportunities has been constantly increasing. In February, seasonally adjusted employment increased by 2.4 million people in the last year. In this period, while the labor force participation rate increased, the unemployment rate decreased from 13.2% to 10.7%. Among OECD countries, Türkiye has been the country that has increased its employment the most in the post-pandemic period. High-frequency data indicate that the improvement in the employment outlook and the favorable course in the labor market have been in line with the outlook of the economic activity.

While the industrial sector made a strong contribution to employment increases after the pandemic, surveys show that employment expectations in the manufacturing industry are high. In this context, we foresee that the increase in employment will continue in the upcoming period.

Export-led growth is important for achieving sustainable price stability. A comparison of the Turkish economy with neighboring, close region or peer countries reveals that the share of the manufacturing industry in exports and the number of exported products of Türkiye are higher and its export markets and exports are more diversified. The share of manufacturing industry products in Türkiye’s exports is approximately78% and this share is higher than most of Türkiye’s peers and neighboring countries. Türkiye has been exporting around 4300 products to more than two hundred countries, and thus Türkiye has a higher diversity with respect to export markets and products. The share of the top three export products in Türkiye’s total exports is relatively low, around 29%, indicating that exports are not concentrated in certain products. During the pandemic, Türkiye's position in global trade became more important and Türkiye enjoyed an opportunity window to make use of its relative advantages. The Turkish economy has been rapidly transforming into a regional production center.

Türkiye's growth structure has been going through an important export-oriented transformation. While our exports reached USD 225 billion in 2021, compared to the pre-pandemic period, Türkiye's growth in exports showed one of the best performances among OECD countries.

The uptrend in exports during the pandemic continued in the first quarter of 2022 despite rising regional risks. While our exports to Russia and Ukraine inevitably decreased due to the regional conflict, our exports to the EU significantly increased in the same period, and possible losses in exports were compensated in a very short time. Nevertheless, imports increased in the first quarter as the surge in energy prices continued due to geopolitical developments. Excluding gold and energy, imports of intermediate goods continued to rise in tandem with the rise in commodity prices excluding energy, while the increase in imports of consumption and investment goods remained relatively limited.

We believe that sustainable current account balance is crucial for lasting price stability. When we analyze our foreign trade adjusted for price effects and on the basis of quantity, we observe that there has been a significant improvement in the amount of exports compared to imports. In 2021, the amount of exports excluding gold increased by 21.3%, while the annual increase in imports excluding gold was 4.4%. Meanwhile, the key current account balance indicator adjusted for business and price cycles, turned positive for the first time at the end of 2021. In the second half of 2021, the uptrend in the number of foreign visitors, which reaccelerated by the spread of vaccination and the relaxation of travel restrictions, remained strong. Thus, the positive contribution of the services balance to the current account balance has been increasing. Meanwhile, risks arising from energy prices continue to pose risk to the current account balance. The 12-month cumulative current account deficit, which shows the long-term trend, has increased in recent months due to rising energy prices. Excluding gold and energy, the improvement in the annual current account balance continues.

One of the pillars of our liraization strategy is to make sure that loans act in harmony with economic activity. In order to establish a sustainable current account balance, it is crucial to direct long-term Turkish lira resources to investments, exports, capacity increases and particularly SMEs. In the framework of the liraization strategy, the growth rate and composition of loans will be aligned with price stability and financial stability. The increase in loans extended to companies in the first quarter of the year was the most important driver of loan growth. In April, the growth rates of commercial loans and consumer loans adjusted for exchange rate effects, were 47.9% and 17.7%, respectively.

The rise in global commodity prices as a result of geopolitical risks increased the demand for working capital and played an important role in the increase in commercial loans. However, commercial loan growth was slower than inflation. Meanwhile, we expressed in the MPC decisions that we were unhappy with the part of the acceleration in commercial loans that was not compatible with economic activity and we stated in our final decision that we would strengthen our macroprudential tools to this end. In this context, we have been resolutely implementing our macroprudential measures for the use of loans in production, investment and exports.

Distinguished Members of the Press, Distinguished Participants,

I will now briefly evaluate the inflation outlook.

In the first quarter of the year, consumer inflation was 61.14% and inflation increased across all sub-groups. Seasonally adjusted data suggest that monthly increases are still high but they tend to slow down. In the first quarter of the year, the hikes in global commodity prices, particularly in energy and food, were the main drivers of the rise in inflation. In March, international commodity prices displayed one of the highest rates recorded in history. In addition to the increase in import prices, supply-side factors such as high transportation costs and disruptions in the supply process have been affecting the inflation outlook adversely. The rise in inflation was led by energy and food groups due to the sharp increases in commodity prices.

Distinguished participants,

Before moving on to our medium-term forecasts, I think it would be useful to talk about our assessments of the main macro determinants inflation. The analyses we carried out suggest that the main determinants of the rise in inflation were global commodity prices, exchange rates and supply-side disruptions.

In the first quarter of the year, the import unit value index increased significantly following the rise in commodity prices, and became one of the main factors driving inflation up. Ongoing price increases in commodity markets due to imbalances between supply and demand were aggravated by the conflict between Russia and Ukraine. While the energy index stood out with a quarterly increase of 44%, increases in commodity prices spread across sub-indices.

With the geopolitical developments that turned into an armed conflict at the end of February, risks regarding food prices became evident, and large increases were observed in international agricultural commodity prices, particularly wheat and sunflower seed oil. In this period, international food prices reached their historically highest level.

We see that the disruptions in global supply chains continued in the first quarter of the year. In addition to geopolitical problems, China's tightening of pandemic measures due to increased cases limits the improvement in supply processes and causes international transportation costs to remain elevated. Besides global problems, developments in domestic energy prices also exert pressure on producer prices.

Output gap indicators monitored by the Central Bank pointed to an economic activity above the potential in the last quarter of 2021. Domestic demand, which was brisk last year, decelerated in the first quarter of 2022. In this period, external demand remained strong despite geopolitical developments, and the recovery in exports of services accompanied the strong course of exports of goods.

After the slowdown in credit utilization reversed in the last quarter of 2021, it assumed an upward trend in the first months of 2022 and became one of the factors supporting economic activity. When analyzed in a breakdown of sectors, it is observed that the credit developments were driven by Turkish lira corporate loans. With retail loans following a course close to their historical average, consumer credits-driven effects on inflation remained moderate.

Although output gap indicators decelerated in the first quarter of the year compared to the previous quarter, they remained in the positive territory, and the impact of demand conditions on the rise in inflation was low compared to other main determinants such as the exchange rate, global commodity prices and supply-side disruptions.

**Medium-Term Projections**

Esteemed guests, after a brief account of the monetary policy developments within the framework I have summarized so far, I would like to move on to our medium-term projections.

As we mentioned in our December statement, we completed the use of the room implied by transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases. In the January-April period, we decided to keep the one-week repo auction rate constant at 14%.

The CBRT provided funding within a simple operational framework through Open Market Operations and swap transactions, and the overnight interest rates materialized around the CBRT policy rate. Owing to the CBRT's predictable liquidity management framework, Borsa Istanbul overnight repo rates continued to hover around the CBRT's policy rate.

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

Due to the tension between Ukraine and Russia, which has turned into an armed conflict, international commodity prices increased significantly compared to the previous reporting period. Large increases were seen in electricity and natural gas prices in the first quarter of the year. Forward price curves that we use in our forecasts indicate that crude oil prices will remain significantly above the January Inflation Report assumptions in the upcoming period. Accordingly, we have revised our assumptions for crude oil prices to an average of USD 102.2 in 2022 and to an average of USD 93.9 in 2023. Non-energy commodity prices continue to rise due to the supply-demand mismatch, increases in transportation costs, geopolitical developments, and agricultural drought. Our assumptions regarding the general level of import prices have also been revised upwards.

We have revised our assumptions for food prices upwards for 2022 and 2023, taking into account geopolitical risks, the cumulative effects of the ongoing increases in international food prices, and the developments in agricultural drought.

We have revised our assumptions for external demand downwards compared to the previous reporting period, due to the increased uncertainties over global economic activity arising from geopolitical risks, increased energy costs, and possible supply constraints. In addition, we have assumed that financial conditions in 2022 would be tighter than anticipated in the previous reporting period, due to the rise in global inflation.

Our projections rely on an outlook in which macroeconomic policies are set in a coordinated manner under the liraization strategy, with a medium-term perspective focusing on bringing inflation down.

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 the base effects disappear.

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 42.8% at the end of 2022, 12.9% at the end of 2023, and 8.3% at the end of 2024.

Thus, we have revised our year-end inflation forecast for 2022 up by 19.6 points, from 23.2% to 42.8%. Compared to the previous reporting period, the revision due to import prices in Turkish lira increased the inflation forecast by 5.5 points, while a 2.8 points of contribution came from the increase in food prices assumption. Meanwhile, administered prices pushed the year-end inflation forecast up by 2.1 points, largely due to the increase in alcohol-tobacco prices and electricity and natural gas prices. The effect of the revision in initial conditions on the underlying trend of inflation increased the forecasts by 9.3 points. In addition, the revision in the output gap had a downward effect of 0.1 points to our forecasts.

We have also raised our end-2023 inflation forecast from 8.2% to 12.9%. The effects of the revision in initial conditions on the underlying trend of inflation increased the year-end inflation forecast for 2023 by 1.9 points. On the other hand, the revision in the food inflation assumption increased the forecast by 0.7 points. While import prices in Turkish lira increased the forecast by 2.2 points, the revisions in the output gap had a downward effect of 0.1 points.

Distinguished guests,

Driven by the supply constraints due to geopolitical risks and the increased uncertainty, global inflation is exceeding the highest levels in recent history and global growth expectations are rapidly deteriorating. However, our economy is strengthening its position in global trade in the post-pandemic period, and there is a structural development in our growth, which is manifested by the increase in the contribution of investments and net exports. In this framework, labor market indicators are constantly improving in the aftermath of the pandemic and the increase in the employment creation capacity of the economy is boosted by the sectors that strengthen the current account balance. Export quantity is registering a strong increase compared to import quantity, and our current account balance, adjusted for cyclical effects, indicates a surplus.

Energy and raw material prices, which have recently posed a risk to our current account balance and peaked with the conflicts in our region, have a negative impact on inflation. As long as there is a normalization in energy price levels, which we do not find sustainable in terms of the global economy, we will reach our targets of decrease in inflation and sustainable current account balance. We are determined to carry out this process with strong steps to be taken within the framework of the liraization strategy.

In the final part of my speech, I would like to give some information about the liraization strategy that constitutes the essential element of the Central Bank's policy review process. We had shared the baseline features of our liraization strategy in the January Inflation Report. The ultimate goal of our liraization strategy is to permanently increase the weight of our national currency in the balance sheets of households, companies and banks, and to make the Turkish lira the only payment instrument in our country.

As you may know, we have recently introduced a series of implementations for which the review process has been completed within the scope of the liraization strategy. In line with the principle of maintaining required reserves for Turkish lira liabilities only in Turkish lira, we terminated the facility allowing for the maintenance of required reserves in foreign currency. By allowing net exporters to use our rediscount credits only in specific Turkish lira-denominated spending areas, we ensured that there is no foreign currency demand originating from the funding of the Central Bank, and that rediscount credits are used  for their relevant purpose.

In December 2021, by encouraging the conversion of foreign currency and gold deposits into TL, we took an important step towards strengthening the preference for TL deposits. This implementation increased the TL share in banks' balance sheets and extended the funding maturity. We clearly see the contribution of this implementation to financial stability by strengthening banks’ balance sheets.

An important component of our liraization strategy is that affordable and long-term loans support sustainable price stability through increases in production, investment and exports. We continue to use our macroprudential tools vigorously to ensure that long-term and affordable Turkish lira loans are used in economic activity with the right composition and in a broad-base manner.

Our technical teams have completed the steps regarding the collateral structure of liquidity management, the review process of which continues within the scope of the liraization strategy. In the very near future, in line with our roadmap shared via the Monetary and Exchange Rate Policy document, we will take additional steps to increase the use of and demand for Turkish lira-denominated assets as collateral in the funding structure.

On the other hand, as the Central Bank, we deem it important that our companies make their payments in Turkish lira within the scope of liraization. Being aware of the harms of currency substitution and indexation to foreign currency, which make monetary transmission inefficient and increase inflation, we find the recent steps taken in this regard valuable.

Establishing the infrastructure for solid, strong and stable Turkish lira is the primary threshold on the way to our objective of permanent price stability. Together with all parties, we carry out comprehensive studies that will increase the effectiveness of our monetary policy instruments as a whole. Our ultimate goal is to complete a financial architecture in which all our economic agents can make savings in Turkish lira without the need for any currency other than lira in all their decisions, and make all their financial decisions in Turkish lira.

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, and to all our employees who have worked hard to develop our policies.

Taking this opportunity, I congratulate the Ramadan Feast in advance, and I hope that it brings health, peace and welfare to our country and the whole world.

Now, I’ll try to answer your questions, time permitting.