TÜRKİYE CUMHURİYET
MERKEZ BANKASI

Speech

Central Bank of the Republic of Turkey

Prof. Şahap Kavcıoğlu, CBRT Governor

Briefing on Inflation Report 2021-II

29 April 2021, Ankara

Distinguished Members of the Press, Esteemed Participants,

Welcome to the briefing on the second Inflation Report of the year.

Today, I will share with you our evaluations of global and domestic economic developments, and the inflation outlook, as well as our medium-term inflation forecasts and monetary policy strategy. Then I will answer your questions.

Macroeconomic Outlook

Distinguished Participants;

After experiencing a sharp contraction in 2020 due to the pandemic, the global economy continues to recover on the back of supportive policies and positive developments regarding the vaccination process. This recovery is mainly determined by the acceleration in the manufacturing industry activity and in the global trade. While a deceleration is expected in European countries in the short run due to the recently tightened restrictions, the outlook for the US economy has improved noticeably over the previous reporting period thanks to the pace of vaccination and the fiscal stimulus. A scrutiny of 2021 growth forecasts pertaining to our main trading partners for an evaluation of our foreign trade outlook indicates that while some European countries have revised their growth forecasts slightly downwards depending on the course of the pandemic and the pace of vaccination, our major export markets, the US and the UK in particular, have showed significant improvements. Against this background, the positive outlook presented in the January Inflation Report regarding the exports-weighted global growth that shapes Turkey's foreign demand has been maintained.

High levels of commodity prices and the improvement of growth expectations in advanced economies are having an effect on the global inflation outlook. Rising global inflation expectations cause uncertainties for advanced economy monetary policies, an increase in long-term bond yields, and fluctuations in global financial markets. This exerts a pressure on emerging market currencies, and such shocks have a more adverse impact on those countries with more fragile macro balances. Despite strong forward guidance on the maintenance of the low interest rate environment, we are closely monitoring the fluctuations in global financial markets caused by cost and demand-side global inflationary pressures. Against this backdrop, we consider that we have entered a period marked by increased data-sensitivity and related volatilities in global financial markets, and therefore where a prudent stance in the monetary policy is more of an issue.

As a matter of fact, the rise in the long-term bond yields of advanced economies since the previous reporting period hampered portfolio inflows towards emerging economies. Except for China, which continued to receive inflows to equity markets, portfolio movements in emerging economies have turned to outflows since February.

Distinguished Participants,

I would like to continue with the macroeconomic outlook.

Economic activity, largely consistent with earlier predictions, maintained a strong course in the last quarter of 2020 and continued to hover above its long-term trend.

Domestic demand excluding construction investments accelerated with considerable strength. While private consumption demand remained brisk, the public sector also supported domestic demand. In this period, machinery-equipment investments surged.

Despite the constraining effects of the pandemic, industrial production and turnover indices continued to increase in the first quarter of the year. The strong acceleration in the manufacturing industry activity became widespread across sectors, more visibly in intermediate goods and durable consumption goods. Excluding some tourism-related sectors, the manufacturing industry remains positive overall. However, the weak course in the most severely affected areas of activity continues to limit the improvement in the services sector.

High-frequency data indicate that economic activity remains strong amid credit developments and controlled normalization. However, risks for economic activity exist in both directions depending on the progress of the pandemic and the rollout of vaccinations in the period ahead. Due to the recently announced restrictions in addition to the tightening financial conditions, economic activity is predicted to slow down in the second quarter of the year.

Despite the strong course in economic activity, employment growth has lagged behind economic growth and unemployment rates have remained high. This development is mainly attributed to the fact that labor-intensive services sectors such as accommodation, catering and recreation-culture have been adversely affected by the pandemic, as well as to the rise in labor force participation rates. Thanks to the attenuation of pandemic-associated problems amid continued vaccination at home and abroad in the second half of the year, resulting in an improvement in the outlook for the services sectors and acceleration of tourism, employment opportunities are expected to expand.

In spite of the employment-restricting effect the pandemic has had for certain services sectors, the investment appetite of industrial firms gives positive signs. The investment demand that started to recover in the second half of last year strengthened in the first quarter of this year. In this period, we see an increased use of loans for investment purposes and an improved investment tendency particularly among large firms.

Exports continued to grow across regions and sectors in the first quarter. While exports to Europe and non-Europe regions performed favorably, the ongoing strong course in the manufacturing industry at a global level underpins the outlook for foreign demand and exports.

Nevertheless, the strong domestic demand and increased international commodity prices adversely affect the import bill. Gold imports started to slow down gradually as of the second half of January in particular. High-frequency data show that gold imports, a major component of the deterioration of the external balance last year, fell below their historical averages in March. This trend eases the negative effect of the terms of trade on the current account balance.

Current trends suggest that the annualized current account balance that flattened out in the first quarter will start to improve from the second quarter of the year. We envisage that vaccination-led reduced case numbers both at home and abroad in the second half of the year will support tourism activities and the external balance. The pandemic-led international restrictions and supply constraints have significantly expanded export opportunities in some sectors, and exports in certain sectors, led by ready-to-wear and textiles, gained additional momentum as a result of the shifting of supplies to our country. Meanwhile, supply problems are having an effect on production and exports in parallel to global trends by causing a shortage of raw material and equipment in some sectors, primarily in the automotive sector. We predict that supply constraints will be removed over time as the pandemic-related conditions improve in the second half. All in all, we welcome the developments on the exports side where we have performed above expectations. The export/import coverage ratio rose significantly above its historical average and stabilized in the 80-90% band, which, along with its sustainability, is critical in terms of a sound external balance and macrofinancial stability. Amid tightening global financial conditions, aggregate demand follows a moderate and balanced course in terms of speed and composition, which will support financial stability and price stability via the external balance.

In this scope, the growth rate and composition of loans are critically important. Depending on the monetary tightening steps taken as of the third quarter of 2020 and other coordinated policies, loan growth decelerated significantly, but started to trend up by the end of January. While commercial loans have recently been moderate, retail loan growth continues to accelerate despite tightening financial conditions. In this period, general-purpose loans have also grown at a relatively high rate, whereas housing loans, after having decelerated in the last quarter of the previous year, have remained weak. Meanwhile, in terms of productivity and sustainable growth, it is pleasing to see the increase in commercial loans, which is attributable to the fact that they have been used for working capital purposes due to strong activity and that they have been increasingly used for investment purposes.

Distinguished Participants,

Within the framework that I have summarized so far, the demand and cost-side factors that affected the inflation outlook in the period following the January Inflation Report necessitated additional tightening in monetary policy. Considering the upside risks to its medium-term inflation outlook, the CBRT implemented a strong front-loaded monetary tightening in March, and maintained its tight policy stance in April. In the past quarter, the CBRT provided funding within a simplified operational framework through open market operations and swap transactions, and the overnight interest rates materialized around the CBRT policy rate.

Taking into account the reverberations of the fluctuating global risk appetite on the Turkish economy, a disinflation-focused monetary policy stance is essential to a lasting improvement in the country risk premium and external financing opportunities. As fluctuations in global financial conditions pose more risks to emerging economies, decisively maintaining a tight monetary policy stance that prioritizes disinflation will act as an important buffer against such volatilities.

Distinguished Members of the Press, Esteemed Participants,

Now I would like to share the indicators and our evaluations related to the inflation outlook shaping in this macroeconomic background.

The rise in international commodity prices, the strong domestic demand, supply constraints associated with global and domestic supply problems, high inflation expectations, and cumulative exchange rate effects continue to affect the inflation outlook adversely. In the first quarter, consumer inflation rose to 16.2%, from 14.6% at end-2020. The pandemic caused significant changes in household consumption patterns, leading to a revision in the consumer inflation basket weights. This development pushed up the inflation forecast path that we shared in the January Inflation Report in the short run. As we stated in our previous communications, the impact of the revision of the consumer inflation basket weights was projected to gradually decrease after reaching 0.5 points in April, and disappear by the end of the year. Adjusted for the impact of this revision, the actual consumer inflation of the first quarter was fully consistent with our earlier projections. While this consistency was mainly driven by the positive course of highly volatile items such as fresh fruits and vegetables, inflation of the core index B remained above our expectations.

The core goods and energy groups were the prominent factors that led to an increase in inflation in the first quarter. On the other hand, the net effect of administered price and tax adjustments, coupled with the support of the sliding scale system, contained inflation in this period.

Annual inflation rates of core indicators increased compared to end-2020. While their trends improved somewhat, they remained high. The trend of inflation receded slightly due to the weakened cumulative exchange rate effects on core goods, but rose in the processed food group and services. We project that although the inflation trend will continue to improve in April, it will remain high. The seasonally-adjusted monthly inflation figures are yet to signal a slowdown to the extent that we desire.

Distinguished Participants,

Before moving on to our medium-term forecasts, I think it would be useful to share with you our evaluations of the main macro determinants of inflation.

Data for the first quarter indicate that aggregate demand conditions were at a more inflationary level than previously envisaged in our assessments about the cyclical state of the economy. We assess that economic activity was stronger in this period than projected in the January Inflation Report, driven by domestic and external demand. Output gap indicators monitored by the Central Bank reveal that the demand-side inflationary effects persisted in the first quarter of the year.

Our analyses suggest that domestic demand was shaped by the cumulative effects of the previous year's monetary expansion as well as by the upward trend in loan growth since late January and the controlled normalization steps in early March. Meanwhile, external demand and exports remained very brisk on the back of the positive outlook in global manufacturing industry activity, despite the pandemic restrictions. Accordingly, a stronger outlook emerged compared to previous projections that demand-side inflationary pressures would start to ease in the first quarter of the year. We envisage that the restricting impact of the additional monetary tightening delivered in March against this backdrop on credit and domestic demand will become pronounced in the upcoming period, and the demand-side inflationary pressures will start to ease on the back of the deceleration in net credit utilization and economic activity.

While cumulative exchange rate effects on annual inflation partially eased with the appreciation of the Turkish lira in the first quarter of the year, significant increases in import prices played an important role in the elevated course of inflation. International agricultural commodity and metals prices, which posted sharp increases compared to last year due to global recovery, affected the inflation in food and core goods groups negatively. In addition, in the context of the reference price practices, inflation was influenced by the lagged effects of the currency depreciation on certain items that are subject to time-dependent pricing.

Leading indicators suggest that following the partial improvement in the first quarter of the year, price increases somewhat accelerated in groups that are highly sensitive to exchange rates. Moreover, despite the curbing effect of the sliding scale system, cost factors remain significant due to the rise in international commodity prices.

Price increases due to global and domestic supply problems stand as another factor affecting the inflation outlook. Information derived from survey indicators and meetings with firms points to lengthened supplier delivery times. In a breakdown by sectors, delivery delays are more significant in minerals, metals, machinery, electronic products and associated sectors. While there are uncertainties as to how long these supply problems will continue, we expect them to ease gradually in the second half of the year.

Lastly, following the improvement in the first two months of the year, survey-based and market-based inflation expectations have increased recently due to the rise in financial volatilities. The current levels of inflation expectations continue to pose a risk to pricing behavior and the inflation outlook.

Medium-Term Forecasts

Dear Participants,

Before moving on to our forecasts for the medium-term inflation outlook, I would like to talk about our main assumptions on which these forecasts are based. We based our medium-term forecasts on the economic outlook that I have summarized so far. We reviewed and revised our assumptions for exogenous factors such as import prices, food prices, global growth, and fiscal policy.

Projections for crude oil prices have been revised upwards amid surging oil prices and strengthened expectations of global recovery in the recent period. The futures curve suggests that oil prices will increase somewhat further before decelerating in the second half of the year, hence standing at an average of USD 64.4 and USD 61.9 per barrel in 2021 and 2022, respectively. Besides oil prices, we see that prices of commodities such as industrial metals and agricultural products are also displaying a course higher than previously projected. Accordingly, we have revised up our assumption for import prices for 2021. On the other hand, the futures curve in the international markets envisages a limited decline in import prices in 2022.

Taking into account the exchange rate developments and the outlook of international prices, we have revised up our food inflation assumptions for 2021 and 2022. We assess that the course of international prices is the major upside risk to our food price assumption.

As I have said in the first part of my speech, we have not made a significant change in our assumptions for the external demand outlook.

Our projections are based on a medium-term outlook in which fiscal and financial policies will be determined in tandem with the monetary policy and in line with the projected disinflation path.

Esteemed Participants,

Now I would like to present our inflation and output gap forecasts based on the framework I have described so far. Based on our main assumptions and short-term projections, and under the scenario in which the policy rate would continue to be determined at a level above actual and expected inflation to maintain a strong disinflationary effect, we expect inflation to converge gradually to the targets. Accordingly, inflation is projected to be 12.2% at the end of 2021, and fall to 7.5% at the end of 2022 before stabilizing around 5% in 2023, which is the medium-term target.

Thus, we have revised the year-end inflation forecast for 2021 up by 2.8 points to 12.2% from 9.4%. Compared to the previous reporting period, the revision due to Turkish lira-denominated import prices has increased the inflation forecast by 1.8 points, while the projected high course of food prices has pushed the forecast up by 0.4 points. On the other hand, administered prices have driven the forecast up by 0.1 points, largely due to the impact of the increase in the special communication tax in communication services and the tax adjustment made in tobacco products in January. In addition, the upward revision in the output gap path due to the stronger-than-projected course of aggregate demand conditions has raised the year-end inflation forecast by 0.4 points. Lastly, the increase in the underlying trend of inflation over the previous reporting period has added 0.1 points to the year-end inflation forecast for 2021.

We have also revised the year-end inflation forecast for 2022 to 7.5% from 7%. The revision in the year-end inflation forecast for 2021 drives the year-end inflation forecast for 2022 up by 0.3 points due to its impacts on the backward-indexation behavior and the underlying trend of inflation. Additionally, Turkish lira-denominated import prices have pushed the forecast up by 0.3 points while the revision in the food inflation assumption has increased it by 0.1 points. Meanwhile, the revision in the output gap has pushed the forecast down by 0.2 points.

Dear Guests,

In my first Briefing on the Inflation Report, let me briefly share with you some points that I find important regarding the monetary policy.

Under the global and domestic macroeconomic outlook that I have summarized in my speech, demand- and cost-side effects remain significant for inflation. Moreover, the current levels of inflation expectations keep the risks to pricing behavior and the inflation outlook alive. The current outlook requires the tight monetary stance to be maintained decisively and patiently until the indicators point to a permanent fall in inflation expectations and the inflation trend.

We are aware that macroeconomic stability is a prerequisite for achieving sustainable growth and an increase in employment. With this in mind, we will continue to use all available instruments decisively in pursuit of the price stability objective in the upcoming period as well. We will also continue to make our monetary policy decisions in a transparent, predictable and data-driven framework.

The monetary policy stance will be set taking into account the upside risks to the inflation outlook, and with a focus on bringing inflation down permanently in a cautious manner and achieving the price stability objective. Accordingly, the policy stance will continue to be determined by taking into account inflation developments and inflation expectations, and at a degree of tightness that will restore the disinflation process as soon as possible and ensure its sustainability until the medium-term targets are achieved.

The tight monetary stance will serve as a significant buffer against external and temporary volatilities in the context of inflation expectations, pricing behavior and financial market developments.

The policy rate will continue to be determined at a level above actual and expected inflation to maintain a strong disinflationary effect until strong indicators point to a permanent fall in inflation and the medium-term target is reached.

The stability in the general price level will foster macroeconomic stability and financial stability through the fall in country risk premium, reversal in currency substitution, accumulation of foreign exchange reserves and perpetual decline in financing costs. This would create a viable foundation for investment, production and employment to continue growing in a healthy and sustainable way.

Distinguished Participants;

Before concluding my remarks, I would also like to share with you my assessments of some issues I consider to be important.

I would like to underline that we are committed to bringing inflation down to 5% in 2023, consistent with the medium-term framework we have set out in our Inflation Report, and keeping it at this level permanently. I am aware that the low-inflation environment that we target is a prerequisite for achieving sustainable growth and an increase in employment. We will remain determined and resolute to reach this target with our institutional capacity, strong analytical capability and sense of responsibility.

The Central Bank of the Republic of Turkey, the 90th anniversary of which we are proudly celebrating in 2021, is a Republic institution that has been working for the welfare of our country since its establishment. In this context, it is responsible for establishing and maintaining a low-inflation environment, which is essential for the increase of social welfare. Today, with its qualified human resources and strong technical infrastructure, the Central Bank is a dynamic, visionary and pioneering institution that closely follows the developments in the world and Turkey and constantly renews itself. It has a strong corporate culture and tradition.

At the Central Bank, we carry out all our activities in order to contribute to economic development by considering the good of each citizen of our country. Together with our qualified employees producing work at international standards in the academic field and policy making, we labor resolutely in line with our goal of establishing a low-inflation environment by making the most of our institutional capacity. While carrying out our activities, we wholeheartedly believe that constructive criticism, feedback and common sense provide an opportunity to improve ourselves.

I attach importance to the endorsement of inflation targets by all our stakeholders and the common public understanding of the importance of a low-inflation environment. In this context, we will use all the tools of the communication age to create intellectual wealth with and for all our stakeholders.

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.

I would also like to thank you for your participation.