TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Türkiye

Prof. Şahap Kavcıoğlu, Central Bank Governor

Briefing on Inflation Report 2022-IV

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Ankara

Distinguished Members of the Press, Esteemed Participants,

Welcome to our last Inflation Report Briefing in 2022.

Before I start my speech, I commemorate Professor Doctor Yusuf Tuna, our Monetary Policy Committee member, who passed away in the last weeks, with mercy in your presence. Before taking office in our Bank, Professor Tuna was one of the most competent academicians in our country, who served on the boards of directors of important institutions. During the time we worked together on the Monetary Policy Committee, he made a great contribution to our Board with his vast knowledge and experience. Once again, I wish God's mercy on him and offer patience and condolences to all his relatives.

In my briefing, I will share with you our evaluations regarding global and domestic economic developments in light of the data announced over the past three months and our monetary policy implementations during this period. After explaining our medium-term inflation forecasts, I will end my speech with an overall assessment.

Leading indicators show that the slowdown in global economic activity that started in the second quarter has continued. Escalating geopolitical risks arising from the Russia-Ukraine War negatively affect the global supply chains, which deteriorated during the pandemic, and these lead to supply constraints and high price volatility in energy, various intermediate goods and commodities.

This causes inflation to rise and demand to weaken on a global scale, while also fueling expectations for a longer-than-anticipated rise in inflation rates. As a result of the high inflation across the world, financial conditions are tightening further, which is another important factor limiting economic activity.

The aforementioned risks on global economic activity are expected to continue in the upcoming period and will have more pronounced effects on the world economy, particularly in the coming year.

In this context, compared to the previous reporting period, growth forecasts for 2023 have been revised significantly downwards on a global scale. The downward revisions are more pronounced for European countries whose production capacity is at risk due to energy-related cutbacks.

However, commodity prices started to decline in the second quarter due to the slowdown in global economic activity. The recent downward trend in commodity prices is expected to affect inflation dynamics positively. On the other hand, commodity prices still remain above historical averages, and energy prices have been following a volatile course due to the ongoing effects of the war.

On the other hand, as has been the case in the resolution of the grain supply problem, the constructive role played by our country will also contribute to the elimination of supply problems in the energy market, and may positively affect the course of price developments.

Despite the weaker global growth outlook as well as the milder course in transportation costs and commodity prices, global inflation rates continue to increase.

Inflation expectations for 2022 have been revised upwards for many advanced economies compared to the previous reporting period. The elevated course of global inflation rates is expected to continue for a while.

Macroeconomic Outlook

Distinguished Participants,

Domestic economic activity has continued without interruption and in a sustainable manner despite major supply shocks. The growth rates in the Turkish economy during the last eight quarters have trended above other growth periods.

The Turkish economy, which normalized rapidly after the pandemic and underwent a transformation in its external trade structure led by the manufacturing industry, registered a strong performance also in the second quarter of the year and grew by 7.6% on an annual basis. Meanwhile, international organizations have revised their 2022 growth forecasts for Türkiye significantly upwards.

Exports and machinery-equipment investments, which are among the most important cornerstones of Türkiye's structural transformation, continue to contribute to annual growth at an accelerating pace. This is also in line with the objectives of the Türkiye Economy Model.

Of the annual growth of 7.6% registered in the second quarter, 2.7 points came from net exports and 2.2 points from machinery-equipment investments. On the production side, the services and industrial sectors have also continued to contribute to growth in the second quarter.

Indicators for the second half of the year indicate that exports remained high and the investment tendency continued to be strong.

Thanks to the effective policies implemented, Türkiye achieved strong and inclusive growth, and noticeably diverged positively from the G20 countries.

The analysis of the Gross Domestic Product per capita based on purchasing power parity, which better reflects welfare gains and productivity, reveals that Türkiye grew faster than high-income countries and also diverged positively from upper middle-income countries after the pandemic.

Actual and expected growth rates indicate that this will continue in 2022 as well.

Machinery-equipment investments, one of the focus areas of our targeted loan policies, have been on a strong upward trend recently. Being one of the drivers of potential growth, machinery-equipment investments have been increasing without interruption since the last quarter of 2019.

In this period, the average annual growth rate of machinery-equipment investments was 20%. In the second quarter of this year, machinery-equipment investments grew by 17.8% despite the high base effect from last year.

Net exports, which is another indicator of sustainability of growth, and machinery-equipment investments have increased their total share in national income to 19.1%, the highest value since 2009.

Esteemed Guests,

Leading indicators since the beginning of July point to a limited slowdown in growth in the third quarter of the year due to weakening foreign demand.

While our industrial production still maintains high after the pandemic, we have started to feel, albeit to a limited extent, the effects of the risks that especially the European economy, our most important export market, faces in the upcoming period.

As we have also stated in detail in our previous speeches, reports and publications, we attach great importance to increasing the resilience of the industrial sector, which is the main driver of our structural gains, against external shocks, and to keep its positive trend.

Manufacturing industry capacity utilization rate hovers around its historical average. Additional capacity continues to be a factor supporting investment demand. Across the manufacturing industry, we see that capacity utilization in sectors declaring high investment demand is well above the overall manufacturing industry.

The investment and export-oriented strengthening in the production structure continues to have positive effects on employment. While the labor force participation rate continues to rise, the downward trend in the number of unemployed has become more pronounced, and the seasonally adjusted unemployment rate has dropped to 9.6% as of August, the lowest level recorded since March 2014.

In this period, the number of people employed reached the historically highest level of 31.3 million people. The fact that labor force participation and employment indicators exceed pre-pandemic levels is important in terms of demonstrating the healthy functioning of labor markets.

Compared to OECD countries, the increase observed in the unemployment rate during the pandemic period was more limited, whereas the recovery after the pandemic was faster and stronger in our country.

On the back of the rapid increase in industrial production that started in the second quarter of 2020 as well as investment expenditures and exports, the number of people employed increased by 4.1 million people since the first quarter of 2020. The increase in employment is considerably higher than that of peer countries. In the same period, the increase in industrial employment is even more remarkable in terms of showing Türkiye's relative performance. We care about preserving the structural gains in employment, which are strengthened by the direct and indirect effects of the development in industrial production.

As we also stated in our previous Report, we continue to monitor the reflections of the structural transformation that we are going through on the cyclically adjusted current account balance.

Adjusted for price and cyclical effects, the improvement in our current account balance continued in the second quarter as well. As a result, the Turkish economy posted a structural current account surplus for three consecutive quarters.

The improvement in our current surplus capacity was supported by the strong export-oriented improvement in manufacturing industry, which increased its share in value added from 15 percent in 2010 to 22 percent in 2021.

At the end of this period that is marked by energy costs reaching an extraordinarily high level on a global scale, we will see that our country, with the normalization of energy prices, will achieve an external balance with a current account surplus while also growing.

As a result of the export-weighted transformation in the growth structure of the Turkish economy, record-high increases were observed consecutively in exports in 2022. Exports, which were 225 billion USD in 2021, exceeded 250 billion USD on an annual basis in September 2022.

On the other hand, due to the recent partial slowdown in external demand conditions, seasonally adjusted exports decreased in the third quarter. In the same period, imports recorded an increase due to energy prices.

Although the downside risks on exports for the upcoming period have increased compared to the previous reporting period, I would like to especially emphasize that the strong increase in our exports was dominated by structural and permanent factors in the post-pandemic period.

The strengthening in our export capacity is clearly observed when developments in our export quantity are compared to those of other countries. The divergence between Türkiye's exports quantity index with other countries, which started in 2018, had been more remarkable after the pandemic.

While Türkiye's export quantity has increased approximately by 35.4% since June 2018, the rate of increase in export quantity in emerging and advanced economies remained limited at 15.8% and 3.7%, respectively.

The positive divergence of our export performance was driven by our increased competitiveness on the back of product-market diversification in the post-pandemic period.

The effective steps that we have taken to increase the supporting role of the financial system for exporters have also played an important role in this positive divergence.

As of August, the share of investment and export loans in total commercial loans exceeded 28%, reaching the highest level of the last 20 years.

The tourism sector's performance, which is an important element of external balance as well as a big source of employment and revenues, was quite satisfactory in the first eight months. Travel revenues increased significantly on a monthly basis compared to 2021 and exceeded 2019 figures. Leading indicators for September indicate that the strong trend in tourism revenues continues.

Distinguished Members of the Press, Esteemed Guests,

In September, consumer prices increased by 83.5% year-on-year and were close to the mid-point of the path we forecasted in the July Inflation Report.

Core inflation indicators in annual terms, on the other hand, displayed a relatively more positive outlook. There has been a slight slowdown in the monthly rate of change of B and C indices over the recent months.

Alternative core inflation indicators, which we calculate for the distribution of inflation, also confirm this moderate slowdown in monthly increases of B and C indices. The CPI diffusion index also posted a slight decrease in the third quarter.

Esteemed Guests,

The slowdown in global economic activity and the relative decrease in supply-side constraints eased the pressure in commodity markets. Despite the downtrend in global commodity prices, natural gas prices increased significantly in the third quarter due to geopolitical problems. As a result of these developments, in the third quarter, the import unit value index posted a limited decrease of 1.9% compared to the previous quarter.

International transportation costs are declining amid the global economic outlook. On the other hand, geopolitical developments may occasionally create irregularities in delivery times and conditions. The unfavorable outlook in the domestic delivery times continued, but faded slightly compared to the previous reporting period.

While producer price increases are above historical averages, it is observed that the upward trend weakened during the previous three months.

Leading indicators for the third quarter suggest a milder course for demand conditions compared to the previous quarter. An analysis of registered domestic and external orders and future order expectations of manufacturing industry firms reveals a slowdown in aggregate demand, particularly for external demand, while investment tendency remains strong. Field interviews also produce similar signals regarding economic activity.

Output gap indicators declined in line with our projections in the previous reporting period, also with the support of our macroprudential measures.

Monetary Policy

We deem it necessary to evaluate our implementations regarding policy rate, targeted loans, macroprudential measures, improvement of the collateral structure, and management of reserve resources as integral parts of a single policy framework.

We are going through a period of heightened pessimism regarding global growth and constantly escalating geopolitical risks. In such an environment, we believe that financial conditions should be supportive, especially through the financing cost channel. This is important to sustain the momentum we achieved in industrial production, which is the most important element of our structurally strengthened current account surplus capacity, and the increase in employment.

Therefore, we cut the policy rate by a total of 350 basis points in the August-October period. We anticipate that the decisions we have taken will contribute significantly to continuity of supply, investments and exports by increasing the resilience of our economy in 2023.

Esteemed Guests,

With our targeted credit approach, we consider it important that credits show a balanced development in terms of growth pace and use in line with economic activity. As we shared with you in the previous reporting period, we identified the problems related to both the cost and utilization of loans, and we strengthened and activated our macroprudential policy tools.

As stated in our Monetary Policy Committee decisions, in order to improve the targeted loan mechanism and support the effectiveness of the monetary transmission mechanism, we have recently taken important steps regarding the usage area and methods of the credits and their financing costs.

Thanks to the effectiveness of our macroprudential measures, we have observed changes in the loan composition in line with our targeted loan policies. While credit growth has been more balanced, we observe that monetary transmission has been supported by the macroprudential measures introduced for loan rates, and TL commercial loan rates have declined by around 10 points.

In addition, the composition of loans continues to improve due to our targeted loan policies. While the share of consumer loans in commercial loans decreased, the share of investment and export loans in commercial loans increased significantly.

One of the most important results of targeted loan utilization is the development in loans extended to SMEs. In the January-September period, net loans to SMEs amounted to 558 billion TL. This amount is more than ten times the 54 billion TL of loans extended to SMEs in the same period of 2021.

In addition, the net credit utilization of SMEs in September 2022 was 1.5 times higher than the January-September period of the previous year. Hence, in this period, the amount of SME loans and their share in banking sector loans reached a historically high level.

Esteemed Participants,

We also took important steps in terms of collateral arrangements. We gradually increased the minimum GDDS holding ratio required for collateral blockage applied for CBRT-sided currency swap transactions and for transactions to be carried out by banks in the Interbank Money Market. In addition, we gradually increased the collateral discount rate for banks' indexed securities and assets subject to collateral in FX and gold.

Following these decisions, we observe that interest rates on long-term fixed-income and TL-denominated securities converged to the policy rate, and the yield curve shifted down across all maturities, reflecting continued monetary transmission. GDBS yields have decreased by approximately 1600 basis points since the implementation on maintenance of securities and by up to 800 basis points since the previous reporting period.

In line with our macroprudential measures and our liraization strategy, we consider it necessary that the share of the Turkish lira increases in the liability composition of the banking sector as well. In this context, we initiated the liraization process in deposits, which is the most important component of the sector's funding structure, with the FX-protected deposit product.

The practice continues to support both the TL deposits of the banking sector and our international reserves. Moreover, we implement a diversified and proactive reserve resource management, such as the sale of a portion of export revenues to the Central Bank, which strengthens the continuity of demand for the Turkish lira and supports the robustness of our reserve structure. In addition, we continue to develop our macroprudential practices that encourage liraization in deposits for the banking sector. As a result of all these, we see that the share of TL deposits has been steadily increasing since the end of 2021.

Medium-Term Projections

Estemeed Guests,

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

Leading indicators are giving strong signals regarding a higher recession risk in global economy. We revised our forecasts for external demand in 2023 downwards due to heightened risks related to the energy crisis and financial conditions.

Despite the declining commodity prices amid the expectations for global demand, we revised our forecasts for energy and import prices slightly upwards for 2022 and 2023 due to the recent volatile course of energy prices amid geopolitical risks.

We revised our assumption regarding import prices slightly upwards for 2022 due to the realizations, and downwards for 2023 in line with the global demand outlook.

We assumed that food prices will decline towards the year-end and complete 2022 at 75%, and 2023 at 22%.

Our forecasts are based on an outlook in which macroeconomic policies are determined in a coordinated manner with a medium-term perspective, focusing on disinflation and in line with the liraization steps.

Esteemed Guests,

Now, I will share with you our inflation forecasts based on this framework. The mid-points of our inflation forecast range correspond to 65.2% at end-2022, 22.3% at end-2023 and 8.8% at end-2024.

The forecasts indicate that the underlying inflation will gradually decline in 2023 and onwards in a framework where monetary policy is determined in line with the objective of achieving price stability on a sustainable basis.

Our forecasts are based on outlook where the normalization in import prices will continue through slowdown in global demand amid tighter financial conditions.

Under these external conditions, we anticipate that, together with the stabilizing effects of our macroprudential measures on monetary developments, the supply-demand balance, the current account balance, and the stable course in the foreign exchange market will have a positive impact on inflation expectations and pricing behavior.

Thus, we have revised our inflation forecast by 4.8 points from 60,4% to 65.2% for end-2022, and by 3.1 points from 19.2% to 22.3 % for end-2023. The revision in initial conditions affected the forecasts for both years by 0.9 and 2.9 points, respectively.

The revisions in the assumptions for TL-denominated import prices and food prices pushed the 2022 inflation forecasts up by 2.2 and 0.9 points, respectively. As for 2023, the revision in import prices raised the 2023 inflation forecast by 1.1 points, and the revision in food prices pushed the inflation forecast downward by 0.9 points.

Adjustments in administered prices due to natural gas and electricity prices increased the year-end inflation forecast for 2022 by 0.6 points.

On the other hand, we estimate that the effect of the revision in the output gap to be 0.2 points for 2022, and to be quite limited 2023.

Distinguished Participants,

We have reviewed all our policy tools in 2022, and we have gradually established our monetary policy framework, which would best suit the needs and conditions of our country. We have taken strong and decisive steps to ensure the success in our liraization strategy, which is aimed at permanent price stability.

I would like to conclude my speech by giving a brief account of how to achieve a decline in inflation in line with the projections I have shared. As elsewhere in the world, supply shocks constitute a key source of inflation in our country. Although commodity and energy prices have decreased slightly in the recent period, they have posted increases above their historical averages.

These developments are the result of major supply constraints that emerged as a result of both the pandemic and geopolitical risks. We, as the Central Bank, assess that policy rate hikes are ineffective in easing these supply-driven cost pressures, which are beyond the control of economic policies.

By implementing only contractionary demand-side policies to reduce inflation, we cannot go beyond harming the investment and export capacities of producers, who have already been struggling with supply-side pressures. On the contrary, we can reduce inflation by supporting production and expanding our production potential.

We aim to expand our supply and current account surplus capacity by creating favorable financing conditions with our policy rate and targeted loan decisions. Towards this aim, we have contributed to the continued growth in investment, employment, production and exports by supporting producers' access to credit.

In addition, the share of Turkish lira deposits has been on a rapid rise. We continue to set clear goals in this regard. In the coming period, we evaluate that the share of the Turkish lira will rise even further. Therefore, by contributing to the stability in exchange rates through this channel, we also control an important factor that feeds inflation.

In the upcoming period, expectations and exchange rate stability must be compatible with the disinflation process in order for inflation to decline faster. The partial improvement we have observed in the underlying trend of inflation, core indicators and expectations will continue to strengthen in the upcoming period as well. In addition, with the implementation of our effective policies, we will not allow deterioration in the pricing behavior of our companies and unhealthy price formations. As a result, we will ensure that expectations and exchange rate stability support the disinflation.

While we have the power to support production by bringing loan rates closer to policy rates through interest rate cuts, we are also able to ensure that loans are distributed in a way that contributes to stability with our macroprudential tools. Just as we care about the cost-effectiveness of loans, we also care about the use of loans in efficient areas. This is one of the key points of our policy.

Inflation will decrease rapidly on the back of continued supply, the maintenance of stability in exchange rates and the normalization of pricing behavior. We consider that there are two prerequisites for this decline to ensure permanent price stability.

First of all, when we reach the capacity to have a permanent current account surplus, our FX supply will also strengthen, and we will naturally ensure healthy price formation and stability in the foreign exchange markets. Although energy prices cast a shadow on this, we are closer to this goal than anticipated, as we have been stating in detail for some time.

The second prerequisite that will ensure permanent price stability is the dominance of the Turkish lira in balance sheets of households, firms and banks. Towards this goal, we are striving to unveil all the structural elements that distort liraization and correct them. Some of the issues within our liraization strategy that will find more areas of application in the period ahead include making contracts in Turkish lira, proper management of capital flows in accordance with international standards, strengthening Turkish lira assets that offer attractive returns by deepening capital markets, ensuring transparency in foreign exchange markets, and supporting a balanced structure in foreign exchange markets with trade in local currencies. We will take important steps regarding those in our areas of responsibility and work closely with relevant institutions on other matters.

We are implementing a disinflation program that is suited to current conditions and aiming at a permanent solution. In the previous reporting period, we said that we would increase the effectiveness of the monetary transmission and strengthen the prudent stance in loans. With the implementations we made in this context, interest rates on bonds and commercial loans decreased significantly and credit developments were in line with our targeted credit policies.

Despite the global challenges that we are currently facing, as an institution working in harmony and coordination with all of our stakeholders, we are implementing a program that will reduce inflation, not for a while, but permanently and completely, with patience and determination.

As I conclude my speech, I would like to thank all my colleagues who took part in the preparations of the entire Report and the press conference, primarily the members of the Monetary Policy Committee and the staff of the Research and Monetary Policy Department.

We will celebrate the 99th anniversary of our Republic on Saturday. I would like to take this opportunity to congratulate the Republic Day of our guests, colleagues and our beloved nation, and I commemorate with respect and mercy all our heroes, especially Veteran Mustafa Kemal Atatürk, the founder of our Republic, who did not avoid any sacrifice on the path of national independence.

We can move on to the question and answer session of the briefing.