TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Türkiye

Prof. Şahap Kavcıoğlu, Governor

Briefing on 2023-I Inflation Report

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Ankara

Distinguished Members of the Press, Esteemed Participants,

Welcome to our first Inflation Report Briefing Meeting of 2023, the year in which we will proudly celebrate the centennial of our Republic. I would like to extend my warmest greetings to all participants following this meeting both here and online. On behalf of the Central Bank, I hope that the year 2023 and our meeting will be auspicious for all of us.

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

In 2022, energy and commodity prices reached extraordinarily high levels due to the Russian-Ukrainian War. As a result, the ratio of energy expenditures to GDP in OECD member countries rose from a historical average of 11.5% to 18%, the highest level recorded since the OPEC crisis. This unfavorable development in energy prices was also reflected in the record deficit in the energy and external trade balance of the European Union, our largest trading partner.

This large shock to energy prices had an impact on all economic indicators in 2022, with inflation in the lead.

However, energy prices have recently started to normalize with the significant decline, especially in European natural gas prices.

In 2022, global inflation was pushed up by the upsurge in energy costs. However, the recent decline in energy and commodity prices, the improvement in lead times due to the change in China's pandemic policies and the subsidies on energy prices had a favorable effect on consumer price inflation. As the factors causing an uptick in inflation have eased, inflation expectations for 2023 are being revised downwards in many countries, including Türkiye.

The slowdown in the global economic outlook, which started in the second quarter, became more pronounced in the last quarter of the year. On the other hand, growth rates have started to recover as suggested by leading indicators. The data released regarding economic activity in 2022 are more favorable than projected. Due to global financial conditions and geopolitical risks, the growth forecasts for 2023 have been revised somewhat downwards globally compared to the previous reporting period, but have been revised upwards in many countries since November. Against this background, the possibility of a deep recession has largely weakened.

Estemeed Guests,

Following our assessment of the global outlook, I will talk about developments in the Turkish economy.

Despite global supply shocks and the Russian-Ukrainian War, the Turkish economy continued to grow at a sustainable and uninterrupted pace. With its growth performance since the last quarter of 2019, the Turkish economy ranked first among G20 countries and second among OECD countries.

Türkiye's share in the global economy has doubled over the years to 2% on the basis of national income calculated according to the purchasing power parity. In addition, this increase has enabled Türkiye to move up from eighteenth in the world ranking in 2000 to eleventh by 2022. In the same period, Türkiye's export share has more than doubled by increasing from 0.43% to 1.02% which indicates that growth has been realized on solid foundations.

The Turkish economy, which normalized fast after the pandemic, displayed a strong performance in the first and second quarters of 2022, growing by 7.5% and 7.7%, respectively. In the third quarter of the year, the Turkish economy grew by 6.2% year-on-year, albeit at a slightly slower pace due to the weaker external demand.

Throughout 2022, growth displayed a healthy structure in terms of sustainability. Our economy's production capacity increased on the back of exports, while investments continued uninterruptedly despite adverse global conditions. Accordingly, net exports have contributed to annual growth for the last seven quarters in a row, while machinery-equipment investments rose by 14.3% year-on-year in the third quarter, extending its contribution to annual growth to the twelfth quarter. Contributions of net exports and the increase in machinery-equipment investments accounted for two-thirds of the average annual growth rate in the first three quarters of the year.

In an environment of higher borrowing costs, tighter financial conditions and lower risk appetite on a global scale, domestic financial conditions played a critical role regarding these investments. As I will mention in the following parts of my speech, the utilization of commercial loans for production and investment purposes was encouraged.

Esteemed Guests,

After the surge in the first half of the year, effects of the slowdown in external demand appeared in industrial production in the third quarter, albeit to a limited extent. On the other hand, industrial production recovered in the fourth quarter and hit record levels, especially in export-intensive sectors.

In 2022, there was an important development in the structure of industrial production also in terms of technological production capacity. As of November, high technology-intensive industrial production increased by 49.7% year-on-year.

We project this trend in technology-intensive sectors to continue with our targeted loan and industrial policies. These developments, which will accelerate productivity gains, will strengthen our current account surplus capacity through two channels. First, the acceleration in technology sectors will directly enhance the current account surplus capacity by increasing the unit value of exports. Second, it will ensure that our exports are less affected by global demand cycles and thus secure the sustainability of foreign sales performance.

The effects of the slowdown in global demand were also visible in the manufacturing industry capacity utilization rates. For some firms, high levels of capacity utilization also help investment appetite to remain high.

Despite the external demand-driven deceleration in economic activity, the labor market maintains a sound improvement thanks to the measures we have taken with foresight. In November, the seasonally adjusted labor force reached 35.2 million people, while the unemployment rate stood at 10.2%.

As of November, employment increased by around 500 thousand people compared to the previous reporting period and by 1.6 million people in the first 11 months of 2022 to 31.6 million people. In the same period, the labor force participation rate also increased and reached 54.1%, exceeding the historically high levels seen in the pre-pandemic period. Across sectors, in the third quarter of 2022, the number of people employed rose by 3.1 million in the services sector growing by 21.4% and by 1.3 million in the industrial sector growing by 25%, totaling 4.9 million people compared to the pandemic period. Among OECD countries, Türkiye has been one of the countries with the highest increase in total employment in terms of both the number of people and the growth rate since the pre-pandemic period.

The tourism sector, which strongly supported the services sector's growth and employment in 2022, also contributed positively to the current account balance. Following an upward trend throughout the year, travel revenues accelerated especially towards the summer months, and reached 39.9 billion dollars as of November with a 22% increase compared to the pre-pandemic period. The increase in expenditures per visitor and the spread of tourism activity over the year indicate that an important threshold for the development of tourism value added is being crossed.

Our exports, which constituted one of the main drivers of growth in 2022, maintained their strong course supported by sound economic fundamentals, despite the war in the first half as well as the slowdown in global economic activity and the unfavorable impact of the euro-dollar parity in the second half of the year. Having amounted to 225 billion dollars in 2021, Türkiye's exports exceeded 231 billion dollars in the first eleven months of 2022, and reached 254.2 billion dollars overall in the year according to provisional data. Thus, following the successful performance of the previous year, our exports reached the highest-ever level this year gaining an even greater momentum.

In 2022, with the extraordinary rise in global energy and commodity prices, the share of our energy imports in national income increased from 3.8% to 11%, which is a historical record. In the second half of the year, gold imports also increased significantly and foreign trade of gold made a negative contribution of 16.8 billion dollars to the current account balance of 2022 as of November. Accordingly, our current account deficit increased in 2022. On the other hand, recent developments in energy prices and parity are expected to have a positive impact on the current account deficit.

While energy import prices increased by more than 100% compared to 2021, the quantity of imports decreased due to natural gas. Therefore, the nearly 50-billion-dollar increase in our energy imports is due to international prices, and this effect points to a higher figure than our current account deficit. In other words, excluding energy price developments, our economy had a current account surplus in 2022.

Against this background, throughout the year, there was an increase in the structural current account surplus calculated by excluding the cyclical effects on international prices. This indicates that exports have been making a persistent contribution to the current account surplus capacity. As we have frequently emphasized, sustainability of structural gains in current account balance is of critical importance for permanent price stability.

Distinguished Guests,

Having shared our assessments of economic activity, I would like to continue with the inflation outlook now.

Consumer price inflation, which had increased in the first half of 2022 due to geopolitical developments, decelerated in the following months on the back of considerably waning effects of global supply shocks, and lost momentum significantly in the November-December period. Annual inflation declined by 19.2 points in the last quarter of the year to 64.3% as of December, remaining on the path we projected in the October Inflation Report and approximately one point below the mid-point of our forecast.

The slowdown in inflation is also supported by core inflation indicators. Inflation rates of B and C indices have also decreased significantly in recent months in line with the headline inflation.

Our indicators for the underlying inflation trend confirm the marked slowdown in inflation. The diffusion index, which provides insight as to the ratio of items with increasing prices to items with decreasing prices, also verifies the loss of momentum in inflation particularly as of the third quarter. Consistent with our projections, monthly inflation rates are gradually converging to their historical averages.

The deceleration in inflation has also been reflected in expectations. The 12-month-ahead and 24-month-ahead inflation expectations have declined by 11.6 and 7.2 points, respectively since September.

The Turkish lira-denominated import unit value index, which had increased since the last quarter of 2021 and gained momentum with geopolitical developments, dropped in the last quarter of 2022. The ongoing normalization tendency in international prices and the stabilization of exchange rates with the effectiveness of our policies played an important role in this development.

The domestic lead time, which was on a recovery trend throughout the year, improved significantly as of September. Particularly starting from October, it reached a reasonably good historical level.

Producer price hikes decreased gradually throughout 2022. This favorable outlook was also reflected in the annual rates of increase in producer prices, which decelerated sharply as of October. In December, the producer price index decreased for the first time in 37 months. In addition, 12-month-ahead PPI expectations decreased by 14.2 points in January.

There is no ground for the persistence of high price increases in an environment in which external shocks have lost their impact, cost shocks have been entirely reflected, predictability has increased at a time when exchange rate volatility is heightened all over the world, and our companies are also supported in terms of financing costs. In the upcoming period, we will see that pricing behavior will become more compatible with the economic fundamentals in line with the fall in inflation. In 2023, we will implement all our policies decisively to ensure that inflation is aligned with the forecasts.

Monetary Policy

Esteemed Guests,

Now, I would like to move on to our monetary policy implementations and their implications.

In the recent months, we have evaluated that financial conditions should remain supportive for the sustainability of the momentum in industrial production and the growth in employment in a period of increasing uncertainties regarding global growth as well as further escalation of geopolitical risks. In our policy framework, commercial loan rates have an important role in enhancing supply and the current account surplus capacity, particularly through the financing cost channel. Therefore, we reduced the policy rate by a total of 500 basis points in the August-November period, bringing it down to 9%.

The policies we have been implementing with a holistic approach to strengthen monetary transmission continue to be effective. TL commercial loan interest rates have dropped by around 18.5 points since July, consistent with our policy rate. Interest rates for Turkish lira-denominated securities have also decreased by approximately 16 points across all maturities since June, converging to the policy rate.

In 2022, TL commercial loans increased significantly and were approximately 5.5 times the amount of 2021. Moreover, unlike previous years, the share of SMEs in commercial loans increased in 2022 and the amount of loans extended to SMEs was approximately 7 times the amount extended in 2021.

In order to achieve permanent current account surplus, we need to see continued normalization in international prices and we should improve our exports capacity despite declining external demand. Once Türkiye achieves external balance via permanent surplus, the supply-demand balance in foreign exchange markets will stabilize permanently. We see this as a prerequisite for maintaining price stability.

In this critical transformational process, we continue to support the investment environment via the financing cost channel, the Bank's targeted loan policies and all elements of the financial sector. Meanwhile, our practices aim at preventing resources from turning into excessive imports and direct demand for foreign exchange.

To achieve permanent price stability, loans should contribute to the balance between supply and demand. If financial conditions are not supportive, we will not be able to bring our production capacity to a permanent current account surplus under current global conditions. On the other hand, the efficient distribution of resources is important in terms of supporting the disinflation process and predictability. Therefore, it is essential for the sustainability of our policies that we rigorously follow a targeted and selective credit approach.

The liraization in the funding structure of the banking sector that started in 2022 continues to grow stronger thanks to the measures taken. The Turkish lira deposit ratio increased from 35.6% in January to 55.1% at the end of 2022. As we have mentioned in the Monetary Policy and Liraization Strategy for 2023, our liraization target in deposits for the first half of 2023 is 60%.

In 2022, significant achievements have been made on the back of our effective policies towards diversification and strengthening of reserve resources, and compared to the end of 2021, our international reserves increased by 17.7 billion dollars and reached 128.8 billion dollars by the end of 2022. Meanwhile, in 2022, international reserves of central banks decreased by 6% globally, and many countries, including advanced economies, experienced reserve losses of more than 10%. In the same period, our international reserves increased by 16%.

Medium-Term Projections

Distinguished Guests,

After our evaluation of the implications of our monetary policy, now I would like to share with you our medium-term forecasts.

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

Although the data on the global economy has improved recently, global growth forecasts have been revised downwards compared to the previous reporting period.

Despite declining commodity prices due to expectations regarding global demand, we have revised our forecasts for oil prices slightly upwards for end-2023 due to geopolitical risks. However, we continue to predict a decrease in our average oil price assumptions for 2023 compared to the previous year.

We still expect import prices to decline in 2023 in line with the global demand outlook, while we project a slight increase in 2024 in line with the global economic activity.

We have assumed that food prices will increase by 22% in 2023, and by 11.5% in 2024, in line with our previous forecast.

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 would like to share with you our inflation forecasts that we have produced in line with this framework. The mid-points of our inflation forecast range correspond to 22.3% at the end of 2023 and 8.8% at the end of 2024, in line with our projections in the previous Report.

Our assumptions for both inflation and our forecasts have remained in line with our forecasts presented in the previous Inflation Report. While inflation was about one point below the mid-point of the previous forecast, there was no significant variation in our forecasts for exogenous variables. Therefore, we have not introduced any changes to our forecasts and kept them unchanged both for end-2023 and end-2024 at 22.3%, and 8.8%, respectively.

As we stated in the 2023 Monetary Policy and Liraization Strategy, we consider our inflation forecasts as an interim target. We will continue to use all the tools of our Liraization Strategy to support an inflation path consistent with our forecasts. We anticipate that the improvement seen in pricing behavior and inflation expectations will continue in the upcoming period in line with our previous inflation forecasts, thanks to the evident contribution of the decisions we have taken within the scope of our policies.

The underlying trend of inflation and the improvement in expectations, which is expected to continue, had a downward impact of 1.4 points on the forecasts for 2023.

The revisions in the assumptions for TL-denominated import prices and unit labor costs pushed the 2022 inflation forecasts up by 0.1 and 1.5 points, respectively.

Adjustments in administered prices due to natural gas and electricity pulled the inflation forecast for end-2023 down by around 0.2 points.

Distinguished Guests,

Before concluding my speech, I would like to present our overview of 2023 in the framework of our monetary policy implementation.

Our country implements the Turkish Economy Model, which envisages investment, employment, production and export-oriented development for the continuation of sustainable growth. We reviewed all our policy tools in 2022, and we gradually built a monetary policy framework, which would best suit the needs and conditions of our country. Within the scope of the Liraization Strategy we developed to this end, we used our policy rate as well as our instruments for the management of liquidity, collateral, reserve requirements and international reserves in the most effective way with a holistic approach.

To reduce inflation and achieve price stability on a permanent basis, we implement policies to support production and investments, and to expand our current account surplus capacity. Additionally, by designing our monetary policy practices with a focus on liraization, we also fight against structural factors that disrupt price stability and expose the economy to external shocks.

We take strong and decisive steps to ensure success in our Liraization Strategy, which aims permanent price stability.

The targeted loan approach, which is the key pillar of our monetary policy, is based on the permanent reduction of financing costs and the use of credits in a way that will increase the production potential of the economy in the most efficient way. Accordingly, in TL loans, we achieved a gradually increasing credit volume in favor of firms, particularly SMEs.

Within the framework of our Liraization Strategy, we support a gradual increase in the share of Turkish lira items in the assets and liabilities of households, firms and the banking sector, and a Turkish lira-weighted structure in the financial system. Thanks to the effectiveness of the policies we implemented, we crossed an important threshold in a short period of time and increased the demand for TL assets and the Turkish lira.

We closely follow the climate change issues, which occupy an important place in the global agenda due to their implications for the economy and the financial system. As the Central Bank, we actively participate in national and international studies on climate change in order to contribute to our country's "2053 Net Zero Emissions" target and "Green Development" vision within the scope of our own duties and responsibilities.

In the upcoming period, we will continue to monitor the effects of climate change on the economy and the financial system and cooperate with national and international stakeholders on this issue.

We also made important technological investments for the central banking and payment systems of the future. Accordingly, taking innovative steps, we established the Digital Turkish Lira Collaboration Platform through an inter-institutional agreement, pioneered by the Central Bank. We successfully executed our first payments on the Digital Turkish Lira Network, which we established within the scope of the first phase pilot studies.

Moreover, we launched the open banking services in the payments area, which is an essential component of the digital economy roadmap of our Liraization Strategy, and allowed our banks to provide services through the GEÇİT infrastructure.

We developed and introduced the SIPER, which is a vital overlay service for our Instant and Continuous Transfer of Funds (FAST) system, and facilitates the detection of illegal uses by enabling very fast information and document transfer.

We will carry our innovative initiatives in payment systems and financial technologies forward, and by expanding the Digital Turkish Lira Collaboration Platform, we will move on to the advanced phases where we will carry out pilot tests with broad participation.

Esteemed Guests,

We left behind 2022, the year in which we built our Liraization Strategy and started to yield the positive results of our monetary policy actions. In 2023, in which we will proudly celebrate the centenary of our Republic, we will continue to use all available tools in the most effective way to achieve and maintain our primary objective of price stability. We will continue to oversee financial stability as a supportive factor for permanent price stability. We will further strengthen the Liraization Strategy, the backbone of our integrated policy framework, and implement it decisively.

In the period ahead, we will continue to improve our targeted loan practices to support investment, employment, production and exports, which are the sustainable components of growth. Accordingly, we will assure that credit developments are balanced and stable in a way that safeguards financial stability, while ensuring that the growth rate and composition of loans are supportive of price stability and in line with the projected inflation path. We will make use of our liquidity and collateral policies decisively in line with these objectives.

We will continue to strengthen the policies we will implement as part of our Liraization Strategy to permanently increase the weight of the Turkish lira in the banking system. With a focus on liraization, we will improve the composition of funding in a way to reduce the weight of currency swaps.

We will sustain the steady increase in our international reserves by further diversifying the sources for our reserves and support the stability of the Turkish lira.

For permanent price stability, we need to restore an equilibrium that incorporates current account surplus and liraization. We can achieve this only through investment, employment, production and exports. We consider it important that financial conditions are adequately supportive of these goals. Our targeted loan and liquidity steps, along with our liraization steps and diversified reserve sources management practices ensure sustainability on the way to this goal, which I have mentioned.

I would like to emphasize again that in an environment where global energy prices decline, cost shocks are fully reflected, the predictability of exchange rates increases, and our companies have improved profitability performance and are supported financially, there is no ground for the continuation of high price increases. With the coordination of all economic policies and stakeholders, we will ensure that disinflation continues in line with our projections.

We are determined to implement our Liraization Strategy, which we have continuously developed into a strong policy framework. By bringing inflation down to 20% by the end of 2023 and below 10% by the end of 2024 in line with our projections, we will achieve our price stability objective on a permanent basis.

As I conclude my remarks, I wish that we attain all our goals in the 100th year. 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.

I would like to take this opportunity to celebrate the holy Raghaip night of our esteemed guests, audience and the entire Islamic world.

We can now move on to the question and answer session.