TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Turkey

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Inflation Report Briefing 2021-IV

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Distinguished Members of the Press, Esteemed Participants,

Welcome to the October Inflation Report Briefing, which is the last one in 2021.

Today, I will share with you our evaluations of global and domestic economic developments, and the inflation outlook since our last meeting in July. I will also touch on our medium-term inflation forecasts and monetary policy strategy. Then I will answer your questions. I hope we will have a fruitful meeting.

Macroeconomic Outlook

Despite the recovery in global economic activity in the first half of the year, the recently announced confidence indices started to decline due to the pandemic. In spite of the increase in the vaccination rate, new variants keep the downside risks to global economic activity alive. While growth forecasts for some of Turkey's main export markets led by German and the US have been revised downwards; significant upward revisions have been seen for major trading partners such as Italy and Russia. While global PMI indices receded from their peak, they remained above the 50 threshold for both the manufacturing and services sectors. These developments indicate that Turkey's external demand outlook remains favorable. When we look at the labor market, the level of employment in many advanced countries is still below pre-pandemic levels.

Although commodity prices posted an increase on average compared to the previous reporting period, the differentiation between energy and non-energy prices persists. Energy prices have recently gained pace due to the increase in crude oil and natural gas prices. On the other hand, non-energy commodity prices remained almost flat driven by differing prices among products.

The recovery in global demand, high course of commodity prices, supply constraints in some sectors and rise in transportation costs have led to producer and consumer price increases internationally. We are seeing the unfavorable effects of weather conditions in major agricultural commodity exporting countries on global food prices. Central banks are closely monitoring the effects of the rise in global inflation on inflation expectations and international financial markets.

Central banks in advanced economies assess that the rise in inflation would be mostly temporary with normalization in demand composition, easing of supply constraints and waning base effects, but that there is still uncertainty about the timing of the fall in inflation. Accordingly, advanced economy central banks continue their supportive monetary stances and asset purchase programs. In most of the emerging economies, both actual inflation and inflation expectations remain above the targets. However, expectations suggest that inflation will converge to targets by end-2022.

As a reflection of these developments in global markets, we see that portfolio flows towards emerging economies follow a fluctuating course. Except for China, emerging economies have recently posted portfolio outflows. The course of the pandemic and the projections on when and at what speed the monetary policies will normalize in emerging economies will continue to have an effect on portfolio movements and financial markets in these economies in the upcoming period.

In the current reporting period, the global risk appetite followed a fluctuating course amid global inflation developments and higher energy prices. Risk premiums and the implied exchange rate volatility were higher for emerging economies, including Turkey, while exchange rates depreciated due to the strengthening dollar index.

Distinguished Participants,

I would like to continue with the domestic macroeconomic outlook.

In the second quarter of 2021, GDP increased by 0.9% on a quarterly basis and by 21.7% on an annual basis. Although economic activity lost some pace amid pandemic restrictions and tightening financial conditions, it remained above its long-term trend in this period. The quarterly growth was boosted by both domestic demand and net exports in the second quarter. While the contribution of domestic demand was led by private consumption, public expenditures and investments remained moderate. The boost to growth given by net exports was driven by imports that receded against strong exports and slowing gold imports.

Leading indicators reveal that economic activity remained strong in the third quarter on the back of external demand. Industrial production increased further in July-August. Turnover indices suggest that external demand continued to support industrial production particularly in intermediate goods and capital goods in the third quarter.

The speeding up of the vaccination rollout has been supporting the global economic recovery. The phasing-out of the pandemic measures thanks to higher vaccination rates in Turkey and all over the world acts as a factor that enhances the contribution of external demand to economic activity. Meanwhile, the increase in the number of cases driven by new virus variants causes the uncertainties regarding the course of the pandemic to persist.

The acceleration of domestic vaccination rollout facilitates the recovery in services sector, especially tourism, which has been adversely affected by the pandemic, and leads to a more balanced composition in economic activity. Retail sales volume index gained considerable pace due to the reopening. The easing of restrictions coupled with the strong momentum in vaccination since June fostered the recovery in tourism and related services. Demand for durable goods lost pace, while that for non-durable goods improved. This balancing in demand is important due to its positive effects on the current account balance, inflation and employment.

Survey data indicate that firms are planning to increase their investment expenditures for the future. In the third quarter, the investment tendencies of manufacturing industry firms has recorded the highest figure since the third quarter of 2011. The increase in investment tendency continued in October, which we observe across companies of a variety of scales. From a sectoral perspective, an investment tendency spreading across the main sectors has been recorded, with a stronger focus on intermediate goods and investments.

As for the relationship between investments and loans, we observed that our firms' demand for loans for fixed investment increased in the third quarter. In our MPC decisions, we stated that the tightness in the monetary stance started to have a more-than-expected contractionary effect on commercial loans. Due also to the impact of falling commercial loan rates, loans will further support fixed capital investments in the upcoming period.

High-frequency data on employment also indicate some recovery in the labor market due to the re-opening. Services sector employment recorded a slower recovery due to pandemic-led restrictions, but we have recently witnessed that the losses of the pandemic period have been fully compensated with a strong employment increase. In addition, with the contribution of strong exports, it is noteworthy that the employment of the industrial sector is more favorable compared to other sub-items.

All in all, we see that non-farm employment started to recover owing chiefly to the contribution of the industrial sector, and reached the pre-pandemic levels in the first quarter of 2021, despite the limited contribution from the services sector. Finally, we can say that the labor market has largely survived the effects of the pandemic period, thanks to the contribution of the services sector and tourism.

Exports remained strong in the third quarter due to the fast recovery in global demand and the rise in export prices. The mitigating effects of monetary tightening on loans and domestic demand limited the increase in imports. Thus, despite the hike in international commodity prices and the strong course of economic activity, imports followed a more moderate upward trend in the third quarter compared to the previous quarter.

Thanks to its strong performance in exports, Turkey has started to give a surplus in its foreign trade with Europe, our biggest trade partner. We continue to have a deficit in trade with the Asian region.

In the third quarter, the upward trend in import prices continued due to soaring international commodity prices, while the increase in export prices remained relatively weak. This limits the impact of the quantity-based balancing in foreign trade on the current account balance. On the other hand, the recovery in services revenues gained strength owing to the acceleration of vaccination and the removal of restrictions. In the upcoming period, we expect the annualized current account balance to improve further in the rest of the year with the support of the strong uptrend in exports on the back of favorable external demand conditions. Maintenance of this trend in the current account balance with a stronger pace will have a positive effect on the country's risk premium by reducing the need for external financing in the upcoming period.

We see the positive reflections of the developments in the balance of payments on the international reserves of the CBRT. Reserves have recently settled into a trend of steady increase. In this period, especially rediscount credit returns, required reserve measures and gold ore purchases stand out as the factors boosting the CBRT's reserves. In addition, developments such as swap transactions with other central banks and SDR allocations also have an upside effect on increases. As of October 15, 2021, reserves climbed to approximately USD 126 billion. In the upcoming period, the CBRT aims to continue with the accumulation of reserves to strengthen the monetary transmission mechanism. Accordingly, rediscount credits come to the fore as the main reserve accumulation tool. Moreover, we have recently taken steps to enhance the effectiveness of the rediscount credit mechanism.

Moving on to financial conditions, the slowing effects of strong monetary tightening on loans and domestic demand persist. Annual loan growth declined to 8.7%, indicating a notable decline in real terms. However, a closer look at loan growth composition reveals a higher-than-expected decline in commercial loans as of the third quarter led by the tight monetary stance. With a 6.7% exchange-rate- adjusted growth, commercial loans are far below the average of previous years. In addition, the macroprudential policy framework that was strengthened to bring general-purpose loans and credit card transactions back on a moderate course has begun to show positive effects. High-frequency loan data indicate that the growth rate of general-purpose loans slowed due to these measures, while their maturities somewhat shortened. We follow the developments in commercial loans to be able to support the financing of companies with a high investment appetite. I would like to emphasize once again that a more moderate and balanced growth in personal loans is important to limit the risks to the inflation outlook and external balance.

Dear Guests,

Dear Members of the Press and Guests,

Now, I will give a brief account of the inflation outlook amidst this macroeconomic background.

In the third quarter, consumer inflation increased due to supply-side factors such as rising food and import prices, especially for energy, and supply chain disruptions as well as higher administered prices, and developments driven by the reopening. At 19.58%, consumer inflation was above the forecast range presented in the July Inflation Report, while core B inflation remained within the forecast range at 18.63%. This discrepancy was mostly due to rising unprocessed food prices. In the core C index, inflation was 16.98%.

In the third quarter, annual inflation recorded a quarter-on-quarter increase in the B index, but was slightly down in the C index. Inflation fluctuated over this period, reflecting economic shutdown and reopening. The inflation trend decreased across core goods, but increased in processed food and services, the latter due to the reopening.

Food prices continue to shape inflation dynamics across the world. Adverse weather conditions, drought, special restrictions on food exports in some countries and increased stocks drive food prices higher globally. Thus, central banks and policy makers of other countries, like ours, carefully monitor the developments in food prices and core inflation and the impact of rising inflation on inflation expectations.

Food prices follow a similar trend in Turkey. In July and August, food price inflation remained significantly higher than both historical averages and non-food inflation. In September, unprocessed food inflation saw some correction after rising sharply in the last two months, while processed food inflation was around historical averages. Annual food inflation remained high despite a small decline in September due to fresh fruit and vegetable prices. Due to their relatively larger weight in the consumption basket and the currently high food inflation, food prices contribute more significantly to consumer inflation in Turkey than in other countries.

Dear Guests,

Before moving on to our medium-term forecasts, I think it would be useful to present our assessments of the main macro determinants of inflation.

Output gap indicators monitored by the Central Bank indicate that total demand strengthened in the third quarter following normalization. After the second quarter's pandemic measures, restrictions were lifted amid accelerated vaccination, and domestic demand picked up as spending resumed. The positive trend in exports continued in this period. Thanks to a faster vaccination rollout, some countries loosened their travel restrictions for Turkey. Thus, aggregate demand conditions were supported through both channels, while loan growth continued to slow due to the tight monetary policy stance. Given the reopening-led recovery in the third quarter, we expect demand conditions to follow a more moderate course in the last quarter.

International commodity prices continue to weigh on producer and consumer prices. The first striking development in commodities was that prices of agricultural products ceased to rise in the third quarter. Nevertheless, prices of some basic agricultural products continued to increase in this period, and price hikes became more widespread in October. Prices of industrial metals continue to rise, while the subcategory of energy has diverged negatively recently due to the supply-demand mismatch caused by the recovering global demand. After having fallen to a historical low at the beginning of the pandemic, oil prices have risen sharply in 2021. We see that, the recent rise in oil prices was mostly driven by supply constraints.

In addition to the increase in commodity prices, disruptions in the supply chain also cause a rise in producer prices. In this period, transportation costs have posted high increases and suppliers' delivery times have been extended. This, in turn, has exerted an upward pressure on prices due to supply constraints. An analysis of suppliers' delivery times published in the scope of Turkey PMI data reveals that there has been some improvement although they are still below the threshold value of 50. This indicates that supply-related problems continue despite some decline.

Looking at the course of inflation expectations, both the Survey of Market Participants and market-based indicators point to a slight increase in inflation expectations recently.

Considering the inflation outlook, the course of the pandemic and impacts of pandemic-specific conditions on supply chains, the developments regarding the economic activity and demand composition, and financial conditions, it was evaluated that there was a need for an update in the monetary policy. Within this framework, the policy rate was lowered by a total of 300 basis points in September and October. While determining our monetary policy stance, we evaluated the analyses to decompose the impact of demand factors that monetary policy can have an effect, core inflation developments and supply shocks. In the last three months, the Central Bank provided funding in a simplified operational framework, via open market operations and swap transactions. The overnight interest rates on the money market continued to materialize around the CBRT policy rate.

Medium-Term Forecasts

Distinguished participants,

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

Crude oil prices have been broadly consistent with our July Inflation Report forecasts. Nevertheless, price increments stemming from the supply-demand mismatch, which were observed in September and continued in October, signal that that crude oil prices will remain above our July forecasts in the upcoming period. For this reason, we have revised our crude oil price assumptions upwards. As you all know, our assumptions for crude oil prices are based on the average of futures curves in international markets. Accordingly, we have revised our assumption for average crude oil prices upwards as USD 70.8 for 2021 and USD77.5 for 2022. In addition to the climb in oil prices, recently, natural gas prices have also increased rapidly and international commodity prices rose with the impact of energy prices. Accordingly, the assumptions regarding the general level of import prices exceeded our July Inflation Report assumptions due to energy prices. The futures price curve in international markets indicates that import prices will continue to increase for a while and then take a downtrend.

Taking into account the rise in international prices and developments regarding agricultural drought, we have revised our food inflation assumptions upwards for 2021 and 2022.

Despite increasing uncertainties over the global economic activity stemming from the delta variant, we have not updated our assumptions regarding the external demand outlook.

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

Distinguished Participants,

Now, I would like to present our inflation and output gap forecasts based on the framework I have described so far. In line with our main assumptions and short-term projections, and under the scenario in which the monetary policy stance would continue to be determined tight enough to ensure return of inflation to a downtrend once temporary effects disappear, we expect inflation to converge to the targets gradually. Accordingly, inflation is projected to be 18.4% at the end of 2021, fall to 11.8% at the end of 2022, further decrease to 7.0% at the end of 2023 and stabilize around 5% in the medium term.

Thus, we have revised our year-end inflation forecast for 2021 up by 4.3 points, from 14.1% to 18.4%. Compared to the previous reporting period, the revisions in assumptions for food prices and Turkish lira-denominated import prices have increased the inflation forecast by 2.1 points and 1.5 points, respectively. Meanwhile, administered prices have driven the forecast up by 0.3 points, largely due to the impact of the rise in alcohol-tobacco prices. Moreover, the revision in the output gap raised this forecast by 0.4 points.

We have also revised our year-end inflation forecast for 2022 upwards from 7.8% to 11.8%. Effects of the revision in initial conditions on the underlying trend of inflation have pushed the year-end inflation forecast for 2022 up by 2.2 points. Meanwhile, revision in the food inflation assumption have added 1.0 points to the forecast while that in the output gap have increased the forecast by 0.8 points.

Distinguished Guests,

Before concluding my remarks, let me briefly share with you some points that I find important regarding the monetary policy.

The recent increase in inflation has been driven by supply side factors such as rise in food and import prices, and supply constraints, increase in administered prices, and developments due to the reopening. Particularly in summer months, we observed demand-side effects in some sectors such as restaurants-hotels due to the reopening. Also, our exports registered a strong upward trend on the back of additional demand for some sectors in Turkey during the pandemic period. Currently, data for supply processes suggest that supply-side factors remain influential on a global scale. Supply conditions struggled to respond to the sudden increase in global demand particularly at the early period of the pandemic. Against this background, international commodity prices and freight costs have posted substantial increases. Pandemic conditions have further aggravated the situation. We expect such constraints to ease gradually in the upcoming period.

After evaluating the analyses to decompose the impact of demand factors that monetary policy can influence, core inflation developments and supply shocks, we revised our monetary policy stance. However, we assess that, till the end of the year, supply-side transitory factors leave limited room for the downward adjustment to the policy rate.

Lastly, I would like to touch briefly on our stance on the impact of climate change on central banking. The global warming problem triggered by the advance of technology and rapid industrialization also brings about climate change. Global climate change affects economic activity, and may lead to fluctuations in the general price level, particularly in food prices, and consequently in inflation. Moreover, global climate change may also affect the financial system adversely through the different financial risks it creates. As a matter of fact, global climate change is closely monitored by many central banks and international financial institutions due to the risks it poses to price stability and financial stability.

In this context, we observe that sustainability-themed syndicated loan and eurobond security issuances have been carried out recently by domestic banks and the real sector in Turkey. We consider it important to increase the share of sustainable-themed resources within the funding structure of domestic banks and the real sector, and to realize environmentally friendly and social-themed investments in this way. In this direction, the CBRT continues to work on various steps such as encouraging reserve requirement practices regarding these funding sources, and accepting sustainable-themed securities as collateral within the framework of the CBRT liquidity management.

In this respect, the Central Bank of the Republic of Turkey attaches importance to supporting sustainable finance initiatives as a long-term policy to reduce financial risks driven by global climate change, without prejudice to the main objectives of monetary policy.

As I conclude my speech, I would like to extend my heartfelt thanks to 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. Also tomorrow is the 98th anniversary of the Republic of Turkey. Taking this opportunity, I congratulate the October 29th, Republic Day of our esteemed guests, colleagues and beloved nation and I commemorate all our martyrs and veterans, especially the founder of our Republic, Veteran Mustafa Kemal Atatürk, with respect and mercy.