TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Turkey

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Briefing on Inflation Report 2021-III

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Distinguished Members of the Press, Esteemed Participants,

Welcome to the briefing on the third Inflation Report of the year. This meeting is of particular importance to me as it is the first face-to-face meeting we have held since I took office.

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

The global economy continues to recover on the back of the vaccination rollout as well as monetary and fiscal policies. In countries with high vaccination rates, social mobility restrictions have largely been lifted compared to the first quarter of the year. The economies that registered progress in vaccination achieve stronger performance in economic activity by easing restrictions. Leading indicators suggest that the services sector that was affected more by pandemic restrictions started to accompany the ongoing recovery in the manufacturing sector. Significant increases in services PMI indices, particularly in the euro zone, which was more adversely affected by the pandemic, indicate a more broad-based recovery in the global economy. These developments reveal an improved outlook for Turkey's external demand outlook compared to the April Inflation Report period.

Although commodity prices posted an increase on average compared to the previous reporting period, the recent decrease in agricultural commodity prices in particular caused a differentiation between energy and non-energy prices. Energy prices remained flat in March and April and resumed their increase in May. Increases seen in commodity prices during the recovery period have stemmed generally from production falling short of meeting the soaring demand and logistical constraints.

Inflation in advanced and emerging economies has been rising due to both cost and demand in response to the increases in international commodity prices, deferred demand becoming active with normalization, and supply constraints. We see that the difference between producer and consumer inflation has recently increased well above the long-term averages in many advanced and emerging economies. Secondary effects of supply-side factors on inflation expectations and their interaction with financial indicators are monitored closely by central banks.

As uncertainties regarding persistency of the increase in global inflation rates have caused volatility in international financial markets, the long-term interest rates of advanced economies have shown fluctuations in this period. On the other hand, rising inflation gives way to the expectation of an earlier-than-anticipated normalization in extremely accommodative policies of central banks.

Another reflection of these developments in global markets is seen in portfolio flows towards emerging economies. Apart from China, emerging economies posted portfolio outflows in the first half of the year. Projections regarding when and to what extent the advanced economy monetary policies will be normalized will continue to have an effect on portfolio flows and financial markets of emerging economies in the upcoming period.

Distinguished Participants,

I would like to continue with the domestic macroeconomic outlook.

In the first quarter of 2021, GDP increased by 1.7% on a quarterly basis and by 7% on an annual basis. Economic activity remained strong, in line with our earlier projections, and continued to hover above its potential. In the first quarter, while domestic demand was the driver of annual growth, net exports made a positive contribution to growth for the first time since the third quarter of 2019. On the other hand, final domestic demand dampened quarterly growth due to consumption amid tightening financial conditions and pandemic restrictions, while net exports contributed positively. From the production side, the largest contribution to annual growth in the first quarter came from the industry and services sectors, while the main determinant of quarterly growth was the industrial and construction sector value added. The services sector value added had a more limited contribution to growth due to pandemic restrictions.

Leading indicators show that economic activity also maintained its strength in the second quarter. Having shown a widespread decline in April, industrial production trended upwards in May. Although the pace of industrial production growth slowed slightly in the April-May period compared to the first quarter, turnover indices suggest that this slowdown was driven by domestic demand in response to the pandemic measures and tightening financial conditions, whereas external demand supported industrial production. In addition, we see that supply constraints in some sectors, the automotive sector in particular, limited production in this period.

Phasing-out of pandemic measures on the back of a more widespread vaccination rollout and the decrease in cases have underpinned economic activity. The acceleration of the domestic vaccination rollout facilitates the recovery in tourism and other services sectors, which have been adversely affected by the pandemic, and leads to a more balanced composition in economic activity.

While confidence indices registered widespread increases both in June and July due to the reopening, the services sector became the main driver of this recovery. High-frequency data suggest that mobility and services expenditures increased with the gradual easing of restrictions following the full lockdown period. Although the recovery is stronger in services sector items most affected by the pandemic, as of June, activities in these sectors still remain below their pre-pandemic levels. High-frequency data that we monitor indicate that a considerably high rate of growth will be recorded in the second quarter due to the base effect. We envisage that economic activity will also continue to increase with a more balanced composition in the second half of the year. This rebalancing in demand is important in terms of its positive effects on the current account balance, inflation, and employment.

The impact of pandemic measures was also visible in the labor market in the second quarter. While unemployment rates rose in April and May compared to the first quarter of the year, employment also posted a recovery on the back of the revival of economic activity and the gradual normalization steps. When we look at the sectoral composition of employment in the second quarter, we see that the increase in services employment was milder compared to industrial and construction sectors. We expect the rise in employment to continue, most significantly in the services sector. This expectation is mainly shaped by the easing of pandemic restrictions, the successful vaccination rollout, and the revival of tourism.

Exports soared in June compared to the previous month, and maintained their momentum in the second quarter of the year. The recovery in global industrial production, particularly in Europe, and the rise in export prices were influential on this development. The strong exports performance despite the weak course of exports in the automotive sector, which was affected by supply problems, contributes to the improvement in the current account balance.

Meanwhile, despite the rise in commodity prices, imports followed a milder course in the second quarter due to the tightening in financial conditions.

Adjusted for price movements, we see a rebalancing in foreign trade in real terms. From a broader perspective, the export/import coverage ratio has increased consistently since 2011, reaching the 85%-90% levels. I would like to say that we are pleased with the structural improvement trend that this development has triggered in the current account balance, given its contribution to financial stability.

Consistent with our previous projections and public communication, the current account balance started to improve in the second quarter. The tight monetary policy we are implementing and the strong external demand conditions are affecting the current account balance positively. The current account is expected to post a surplus in the rest of the year due to the strong upward trend in exports, and the boost to tourism given by strong progress in vaccination. In addition, gold imports falling significantly below the historical averages in the second quarter of the year was among the drivers of the improvement in the current account balance. This outlook in the current account balance will affect the country risk premium favorably by reducing the external financing need in the upcoming period.

Taking this opportunity, I would like to mention a joint study of the Central Bank and the Turkish Statistical Institute on short-term external debt statistics that we have also shared in the Inflation Report. In the scope of compliance with updates in international standards and access to new data, we are planning to make a revision in some of our main statistics. With this revision, we aim to correct the possible biases in short-term external debt statistics in particular as well as in the Gross External Debt Stock of Turkey, International Investment Position, Foreign Exchange Assets and Liabilities of Non-Financial Companies, and Balance of Payments statistics. The most important improvement under this revision will be the compilation of trade credits due to exports and imports data from companies via direct reporting. Findings obtained from this study will contribute to making more realistic evaluations of the real sector's external financing need in particular. We are planning to announce the results of this study, carried out with technical support from international organizations, together with the Short-Term External Debt Statistics we will publish on 19 August.

After having summarized our evaluations regarding the current account and external financing, now I would like to continue with credit developments. Having decelerated due to the monetary tightening, loans followed a moderate course in the second quarter. Loans, which had decelerated due to the full lockdown measures between 29 April and 17 May, started to pick up largely on the back of consumer loans due to the reopening and deferred demand in the following period. In terms of loan composition, while corporate and housing loans maintained their mild course, consumer loans excluding housing loans posted a relatively stronger increase in the recent period. We envisage that the decisions by the Banking Regulation and Supervision Agency aimed at ensuring a balanced growth of consumer loans will limit this increase in the upcoming period. I would like to emphasize once again that a milder and more balanced growth in personal loans is critical to curb risks to the inflation outlook and external balance.

Distinguished Participants,

Within the framework that I have summarized so far, I would also like to evaluate monetary policy developments briefly. Taking into account demand and cost side factors as well as elevated levels of inflation and inflation expectations, since April we have kept the policy rate constant and maintained our tight monetary policy stance. 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 in the money market continued to materialize around the CBRT policy rate.

In a period of increased data-sensitivity in global financial markets, Turkey's risk premium and exchange rate volatility are down from the previous reporting period, albeit still at elevated levels. Fluctuations in global financial conditions pose more risks to emerging economies. Thus, 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 our evaluations related to the inflation outlook that is taking shape against this macroeconomic background.

In the second quarter, while aggregate demand conditions displayed a milder outlook, the rise in international food and commodity prices, exchange rate developments, and the course of inflation expectations affected the inflation outlook negatively. Consumer inflation remained consistent with April Inflation Report forecasts in April and May, but it hovered close to the upper bound of the forecast band in June, reaching 17.53% in this quarter, due also to the controlled normalization. Core goods, energy and food were the main drivers of the increase in inflation during April-June, whereas services provided a small contribution due to coronavirus restrictions. On the other hand, the net effect of adjustments to administered prices and taxes, coupled with the support of the sliding scale system, contained inflation in this period.

In the second quarter, core inflation was up year-on-year on the back of core goods and processed food. Prices of core goods were driven up by exchange rate developments and higher international industrial metal prices. It would be safe to say that the underlying trends of core indicators and subcategories remain high, despite having somewhat decreased recently.

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 second quarter indicate that aggregate demand is above trend, as envisaged in our assessments of the cyclical state of the economy. Nevertheless, we believe that aggregate demand is converging to levels that are more moderate. We saw that domestic demand weakened in this period amid tight financial conditions but external demand was stronger than projected in the April Inflation Report thanks to global recovery. Output gap indicators monitored by the Central Bank reveal a more moderate demand outlook for the second quarter than in the first quarter.

The rise in exchange rates due to volatile international financial markets, surging commodity prices and disruptions in supply chains were the main drivers of the increase in producer and consumer prices. Although agricultural commodity prices and industrial metal prices fell in June and July, the general level of commodity prices increased due to energy prices.

Meanwhile, ongoing global supply constraints, output bottlenecks and rising transport costs cause supply problems and push producer prices up in advanced and emerging economies. As suggested by the details of Turkey's PMI data, suppliers' delivery times continue to lengthen and supply constraints have been a drag for the last year and a half.

Lastly, when we look at the course of inflation expectations in the second quarter, we see an increase in the inflation expectations from the Market Participants Survey. Despite having edged down recently, market-based inflation expectations hover above historical averages.

Monetary policy is the primary tool to reach inflation forecasts, manage expectations and achieve price stability. However, our experience so far in fighting inflation has also shown that monetary policy alone is not enough to bring inflation down. Therefore, we believe that reducing inflation and achieving a permanently lower inflation rate require a broad consensus and joint efforts. Thus, in addition to having a well-suited monetary and fiscal stance in place, it is necessary to reduce structural rigidities that delay or hamper disinflation, and adopt measures that promote competition to prevent any deterioration in the pricing behavior.

Pandemic-led conditions and uncertainties driven by episodes of shutdowns and reopenings, coupled with reviving pent-up demand following faster vaccinations, led to unusual dynamics in the pricing behavior across the globe. These dynamics are evident in almost all sectors in Turkey, and they cause unhealthy pricing and further deterioration in inflation expectations. A micro-level analysis of the pricing behavior plays a key role in better understanding how these exceptional conditions affect inflation dynamics. In this regard, we should focus on the micro dimension of the fight against inflation while taking necessary steps in coordination with macroeconomic policies to that end. We believe that a micro-level study is necessary to ensure the effective functioning of the market mechanism, to understand the factors that may deteriorate the pricing behavior, and to prevent imperfect competition from inducing inflation rigidity. Findings have also clearly shown that inter-institutional coordination plays a major role in the normalization of unconventional pricing.

Medium Term Forecasts

Dear Participants,

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.

Due to uncertainties regarding the oil supply coupled with the demand-driven rise in oil prices triggered by the rebound in global economy, 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 from USD 64.4 in to USD 69.6 for 2021, and from USD 61.9 to USD 69.4 for 2022. Although some commodity prices have declined, more sharply in the case of agricultural commodities, the general level of import prices stood above our April projections. Accordingly, we have revised our assumptions for import prices upwards for 2021. Meanwhile, the futures curve in international markets indicates that current levels in import prices will be maintained in 2022.

Taking into account the exchange rate developments and the outlook of international prices, we have revised our food inflation assumptions upwards for 2021 and 2022.

As I have said in the first part of my speech, in view of the favorable growth prospects abroad, we have revised our assumptions for the external demand outlook upwards.

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.

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 inflation to maintain a strong disinflationary effect, we expect inflation to converge gradually to the targets. Accordingly, inflation is projected to be 14.1% at the end of 2021, and fall to 7.8% 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 1.9 points to 14.1% from 12.2%. Compared to the previous reporting period, the revision due to assumptions for Turkish lira-denominated import prices and food prices has increased the inflation forecast by 0.8 points and 0.5 points, respectively. On the other hand, administered prices have driven the forecast up by 0.3 points, largely due to the impact of the increase in electricity and natural gas prices. In addition, the increase in the underlying trend of inflation pushed the year-end inflation forecast up by 0.2 points, while the revision in the output gap raised this forecast by 0.1 points.

We have also revised the year-end inflation forecast for 2022 to 7.8% from 7.5%. Effects of the revision in initial conditions on the underlying trend of inflation have pushed the year-end inflation forecast for 2022 up by 0.1 points. Meanwhile, revisions in the food inflation assumption as well as the output gap have increased the forecast by 0.1 points, each.

Dear Guests,

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

In this summer season, effects of various supply and demand side factors, with import prices and administered prices in the lead, may cause inflation to follow a volatile course. Our current monetary policy stance is tight enough to prevent repercussions on the underlying trend. Our projections indicate that fluctuations in inflation to emerge in the short term will be temporary and inflation will decrease notably in the last quarter of the year. In view of the current outlook, we estimate that the impact of temporary factors that affect inflation in the short term will fade starting from the third quarter and inflation will assume a slowing trend in the last quarter. The currently high levels of inflation as well as inflation expectations requires the tight monetary stance to be maintained decisively until strong indicators point to a permanent fall in inflation.

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 target. Accordingly, the policy rate will continue to be determined at a level above inflation to maintain a strong disinflationary effect until strong indicators point to a permanent fall in inflation and the medium-term target of 5% is 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.

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.