TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Türkiye

Prof. Şahap Kavcıoğlu, Governor

Inflation Report Briefing 2022-I

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Distinguished Members of the Press, Esteemed Participants,

Welcome to our first Inflation Report Briefing in 2022. Due to inclement weather, we have fewer participants here than in previous meetings. I would like to salute those following us online, and hope the meeting will benefit all participants.

I will start my speech by giving you a brief account of global and domestic economic developments since our last meeting in October 2021 before moving onto our evaluations of the inflation outlook.

After my remarks on our medium-term inflation forecasts, I will give an overall assessment of our monetary policy. Lastly, I will answer your questions. I hope we will have a fruitful meeting.

Macroeconomic Outlook

After hitting the peak, the global PMI indices decreased, yet remained above the threshold level of 50 for both the manufacturing and services sectors. Despite the recovery in global economic activity and the increase in vaccination rates, new virus variants and geopolitical risks keep downside risks to global economic activity alive and further weigh on uncertainties. As there remain risks from variants, the growth outlook for 2022 worsened for some countries and their growth forecasts are revised downwards. Growth forecasts for Türkiye's main trade partners were revised more upwards for 2021 than what was projected in the October reporting period, and slightly downwards for 2022. However, we consider the risks to global economic activity to be limited thanks to a rapid vaccination rollout and the experience of maintaining operations under pandemic conditions. In light of these developments, Türkiye's external demand outlook remains positive.

Commodity prices remain high on the whole. Although crude oil prices declined in December amid mounting uncertainty over global commodity demand following the emergence of the omicron variant, they rose again in January. Energy prices are down from the previous reporting period due to lower natural gas prices. However, natural gas prices are much higher than in 2020. On the other hand, non-energy commodity prices remained on the rise since the October reporting period.

Factors such as the recovery in global demand, high commodity prices, extended supply delivery times, historically high global freight costs and supply-demand mismatches cause global inflation to rise sharply. Both headline and core inflation accelerated around the world. In particular, inflation hit a historic high in advanced economies by surpassing the level of 2008.

Central banks closely monitor the effects of the rise in global inflation on inflation expectations and international financial markets. Accordingly, in their communications, central banks state that the inflation trend appears to be more lasting than projected. Supply and provision problems were expected to disappear amid the fading effects of the pandemic. However, it is considered that they have not started to improve and still push inflation upwards, and this is chiefly due to advanced economies. We are witnessing a growing divergence in the rhetoric of major central banks. Banks continue to engage in asset purchases, albeit more modestly, and keep an accommodative policy stance. In many emerging economies, both actual inflation and expected inflation are above the target.

We observe that there have been portfolio inflows to emerging economies recently. Despite the inflow trend that started in November, portfolio flows to emerging economies have yet to regain pre-pandemic levels. Unlike the previous periods, there were also inflows to stock markets outside of China. Turkish stock markets continued to attract portfolio inflows in November, but both GDDS and stock markets suffered capital outflows in December. We think that prospects for the course of the pandemic and the monetary policies of major central banks will continue to affect the global risk appetite and portfolio movements in the coming period.

Distinguished Guests,

I would like to continue with the domestic macroeconomic outlook.

Gross domestic product grew by 7.4% year-on-year and 2.7% quarter-on-quarter in the third quarter of 2021. Economic activity remained robust thanks to the easing of restrictions prompted by faster vaccination and the significant rebound in tourism. With buoyant tourism activity and strong exports, net exports contributed by a sizable 6.8 percentage points to annual growth. Thus, Türkiye was one of the OECD countries where net exports contributed the most to annual growth in the third quarter.

Capacity utilization levels and other leading indicators show that economic activity remained strong in the last quarter of the year on the back of both external and domestic demand. Industrial production remained on an upward trend in the fourth quarter. In particular, we think that higher external turnover indices indicate that external demand continued to support industrial production in the fourth quarter.

Faster vaccination supports the recovery in the global economy. Pandemic measures have been gradually lifted with the increase in vaccination rates in Türkiye and all over the world, which helped increase the contribution from external demand to economic activity. On the other hand, although there is an increase in the number of cases due to the emergence of new variants of the virus, isolation measures are loosened on a global scale with the help of vaccination.

The spread of vaccination throughout the society helps revive pandemic-stricken services, tourism and related sectors, and leads to a more balanced composition in economic activity. Indices of retail sales volume and services turnover continue to rise with the support of tourism-related items. The easing of restrictions amid rapid vaccination played an important role in the recovery of tourism activity and related services items. In fact, according to data on credit card spending, the rate of increase is higher for services sectors that are severely hit by the pandemic. On the other hand, credit card spending lost some momentum in December but remains high.

Survey data indicate that companies were planning to ramp up their future investment expenditures in the last quarter of 2021 as well. Excluding the vehicles sector, where supply problems drag on production, external trade and production indices confirm as of November that the demand for fixed capital goods remained strong in the fourth quarter.

We see that the capacity utilization rate for the manufacturing industry surpassed its pre-pandemic level in this period. We believe the need for additional capacity can bolster investment demand in the upcoming period as well. Therefore, we think that long-term Turkish lira financing is particularly important in meeting the investment demand.

High-frequency data indicate that the improved employment outlook and the upbeat labor market are in line with the economic activity outlook. Employment remains on an upward trend on the back of the services sector and the tourism rebound, while labor force participation has recorded a small increase.

In the fourth quarter, industrial employment increased with the support of strong exports, while services employment increased thanks to the recovering tourism. Surveys show that employment expectations are high for the manufacturing industry. Therefore, we expect employment to grow further in the upcoming period.

Having been on an uptrend since the second half of 2020, exports continued to grow in the last quarter of 2021. Meanwhile, despite the decline in real exchange rates, imports went up due to higher energy prices in this period.

Adjusted for price effects, export quantity remained on an upward trend due to the recovering global demand and the level of real exchange rates. Import quantity, on the other hand, remained flat and the rebalancing continued in real terms.

Services revenues regained pre-pandemic levels following the fourth-quarter increase in the number of tourists prompted by the removal or relaxation of most travel restrictions due to widespread vaccination. An indicator of the long-term trend, the 12-month cumulative current account balance continued to improve in November, albeit at a slower pace. Except for gold and energy, the annual current account balance continues to improve.

The ongoing strengthening of the current account balance will help improve Türkiye’s risk premium by reducing the need for external financing in the upcoming period. In this context, we expect the current account balance to return to a surplus in 2022.

With regard to financial conditions, annual loan growth fell to 13.8% and followed a moderate course. In the fourth quarter, loan growth converged to historical averages amid falling interest rates. The increase in corporate loans was the most important driver of loan growth. At the end of 2021, the exchange rate-adjusted growth rates of commercial loans and consumer loans were 10.9% and 20.2%, respectively. While corporate and home loans gained momentum, the growth of general-purpose loans remained horizontal.

We believe developments in commercial loans are very important for investments that boost capacity and eliminate supply constraints. I would like to emphasize that the relatively moderate growth of retail loans is crucial to limiting the risks to the inflation outlook and external balance.

Dear Members of the Press and Guests,

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

Consumer inflation ended 2021 at 36.08%, and annual inflation increased in all subcategories. Exchange rate developments were one of the main drivers of the rise in inflation over the final quarter of the year. The strong economic activity in the fourth quarter, higher import prices and international food prices as well as supply-side factors such as agricultural drought, supply chain disruptions and transportation costs that remained high despite a partial recovery, continued to affect the inflation outlook adversely. Accordingly, the key drivers of the rise in inflation were core goods, food, and energy.

Distinguished Participants,

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 continue to point to an economic activity above the potential in the last quarter of the year. Thanks to the reduced risks related to the pandemic, postponed expenditures became active in a short time in the third quarter, and domestic demand accelerated. In the following quarter, domestic demand maintained its positive course, albeit with a slight decline. In this period, foreign demand remained favorable thanks to both goods and services sectors. We consider that the economy has been growing in a more balanced composition.

Pricing behavior indexed to exchange rates due to unhealthy price formations in the foreign exchange market in the last quarter was the key driver of the rise in inflation. In this context, the core goods and energy groups came to the forefront, while items with high exchange rate sensitivity diverged negatively within the food and services groups.

The high course of international commodity prices continues to have an impact on producer and consumer prices, as is the case all over the world. After following a moderate course in the third quarter, agricultural product prices rose again. Although international energy and industrial metal prices decreased slightly after October, they ended the last quarter of the year with an increase.

In addition to the exchange rate developments and rising import prices, the disruptions in supply chains cause producer prices to rise. When we look at the supplier delivery times released as part of Türkiye PMI data, we see that the ongoing improvement trend reversed in the last months of the year and delivery times lengthened again. Although freight prices have slightly receded, they maintain their high levels, confirming that supply-side problems persist.

Medium-Term Projections

Esteemed Guests, after a brief account of the monetary policy developments within the framework I have summarized so far, I would like to move on to our medium-term projections.

We evaluated the analyses to decompose the impact of demand factors that monetary policy can have an effect, core inflation developments and supply shocks, and we reduced the policy rate by a total of 500 basis points in the September-December period. As we mentioned in our December statement, we completed the use of the limited room implied by transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases. In January, we decided to keep the one-week repo auction rate constant at 14%. We are monitoring the cumulative impact of the recent policy decisions, and to create a foundation for sustainable price stability, we are conducting a comprehensive review of the policy framework with the aim of prioritizing Turkish lira in all policy tools of the CBRT.

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

Although international commodity prices remained high compared to the previous reporting period, they followed a volatile course due to the uncertainties stemming from the omicron variant. Crude oil prices fell in December on concerns over the pandemic, but rose again in January on the expectation that the effects of the omicron variant on global energy demand would be limited. After having increased in the previous reporting period, natural gas prices declined but still remain high. Forward price curves indicate that crude oil prices will remain slightly above the October Inflation Report assumptions in the upcoming period. Accordingly, our assumptions regarding crude oil prices have been revised to an average of USD 80.4 in 2022 and to an average of USD 74.3 in 2023. Non-energy commodity prices continued to rise due to the imbalances between supply and demand, increases in transportation costs and agricultural drought. Our assumptions regarding the general level of import prices have also been revised upwards.

We have revised food prices upwards for 2022 and 2023, taking into account the cumulative effects of the ongoing increases in international food prices, especially the exchange rate developments, and the developments in agricultural drought.

We revised our assumptions regarding external demand slightly downwards compared to the previous reporting period, due to the increased uncertainties over global economic activity arising from the omicron variant. In addition, we assumed that financial conditions in 2022 would be tighter than anticipated in the previous reporting period, due to the rise in global inflation.

Our medium-term projections rely on an outlook in which macroeconomic policies are set in a coordinated manner with a medium-term perspective focusing on bringing inflation down.

Distinguished Participants,

Now, I would like to present our inflation forecasts based on the framework I have described so far. Based on our main assumptions and short-term projections, under an outlook in which the monetary policy stance will be set in line with the sustainable price stability objective, we anticipate that inflation will gradually converge to the targets once the base effects disappear.

Another important factor I would like to point out regarding our estimates is related to our forecast ranges. As inflation rises, the inflation expectations range widens, and so does the range in which inflation can be predicted widens. This is reflected in our forecasting path.

Accordingly, the midpoints of our inflation forecast range is projected to be 23.2% at the end of 2022, 8.2% at the end of 2023, and 5.0% at the end of 2024.

Thus, we have revised our year-end inflation forecast for end-2022 up by 11.4 points, from 11.8% to 23.2%. Compared to the previous reporting period, the revision due to import prices in Turkish lira increased the inflation forecast by 4.2 points; 2.5 points contribution came from the increase in food prices assumption. Meanwhile, administered prices pushed the year-end inflation forecast up by 3 points, mainly due to the increase in alcohol-tobacco prices and electricity and natural gas prices. In addition, unit labor costs increased inflation by 2.0 points due to the minimum wage rise determined for 2022, while the revision in the output gap pulled the forecasts down by 0.3 points.

We also raised our end-2023 inflation forecast from 7% to 8.2 %. The effects of the revision in initial conditions on the underlying trend of inflation increased the year-end inflation forecast for 2023 by 0.8 points. On the other hand, the revision in the food inflation assumption increased the forecast by 0.1 points. While import prices in Turkish lira increased the forecast by 0.5 points, the revisions in the output gap lowered it by 0.2 points.

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

The recent rise in inflation has been driven by supply-side factors such as increases in global commodity prices and disruptions in supply processes, and demand developments for a while.

Additionally, pricing behavior indexed to exchange rates due to unhealthy price formations in the foreign exchange market have played an important role in recent months. The steps taken to restore price stability and financial stability, the roots of unhealthy price formations have been removed.

Thanks to a gradual decrease in supply-demand mismatches and disruptions in supply chains, in addition to the results of the steps taken for price stability and financial stability, we predict that the disinflation process will begin in the upcoming months.

Capacity utilization levels and other leading indicators point to strong domestic economic activity thanks to the positive impact of foreign demand. We attach importance to eliminating supply-demand mismatches and capacity constraints that increase inflation and strengthening the trend in the current account balance. In this context, we closely monitor commercial and personal loans. We consider it necessary for sustainable price stability that the resources provided to the economy are effectively directed to intended activities.

We are closely monitoring the cumulative effects of the decisions taken in the first quarter of the new year. In this period, we are conducting a comprehensive policy framework review that prioritizes the Turkish lira in all policy tools of the Central Bank to create a foundation for sustainable price stability.

In this context, the "liraization strategy" constitutes one of the essential elements of the Central Bank's policy review process. As the relevant box in our report elaborates, the liraization strategy is created with a holistic approach that focuses on the use of the Turkish lira in the system through new financial products, collateral diversification and regulations regarding liquidity management practices

The Central Bank has recently implemented a series of practices in the context of this strategy. As you know, in December 2021, a step was taken to strengthen the preference for TL deposits by supporting the conversion of foreign currency and gold deposits into TL. Along with the complementary product of the Ministry of Treasury and Finance, unhealthy price formations in exchange rates have been prevented.

Elements of liquidity management such as funding amount, instruments used, distribution, maturity and collateral structure are important for the efficiency of the monetary policy transmission mechanism. In this regard, the size of the OMO and swap transactions, which are the main components of the current Turkish lira liquidity management, their share in the volume of total CBRT funding, their distribution according to the facility used and the collateral structure are reviewed within the scope of the liraization strategy.

The use of the loans provided to the real sector by the financial system in accordance with their determined purposes is essential for financial stability and hence for the strength of the Turkish lira.

In this context, the Central Bank supports exports and investments through rediscounts and Advance Loans Against Investment Commitment (YTAK). We will contribute to the achievement of a sustainable price stability by not only supporting exports, the current account balance, investments and employment through targeted loans, but also taking steps to stabilize credit growth with a balanced composition.

In line with the pro-lira strategy within the Central Bank's policy review process, the focus of all actions to be taken in the short, medium and long term will be to promote the conversion into liras in the financial system in order to achieve a more sustainable price stability.

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.

Once again, I would like to thank you all for your participation, both online and in-person. Now, I'll try to answer your questions, time permitting.