# Speech

Central Bank of the Republic of Turkey

Prof. Şahap Kavcıoğlu, Central Bank Governor

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Dear Guests,

First, I would like to thank the German-Turkish Chamber of Commerce and Industry for their kind invitation. In my speech, I will share our views on the recent economic developments in Turkey.

The European Union is Turkey's top trading and investment partner. EU countries account for 55% of our exports and 50% of our imports. Most of our exports are destined for Germany. Despite the pandemic-driven drop in numbers, the majority of foreign visitors Turkey receives are from the EU. European countries account for about 60% of foreign direct investments. Therefore, I would like to express that I find your participation and the mutual exchange of ideas that will come out of this meeting very important.

The sped-up vaccine rollout worldwide bolsters global economic recovery. Looking at the world economy, the services sector appears to have been more hampered by COVID-19 restrictions than the manufacturing industry. Recent PMI data indicate that the services sector is matching the ongoing recovery in the manufacturing sector. This supports a more balanced global economic outlook in terms of demand composition. Strong increases in services PMI hint at a worldwide economic rebound, particularly for the pandemic-damaged euro zone.

Growth prospects for our main trading partners suggest that the growth outlook might be more upbeat in August than in April. These developments reveal that our trading partners have seen their revenues increase, translating into an improved external demand outlook for Turkey. This is conducive to the increase in our exports.

During the pandemic, countries have propped up their economies with direct public expenditures, other financial aid, and incentives. Some countries have used direct public expenditures more extensively depending on the fiscal room available, while others have introduced capital, credit and other liquidity incentives. Advanced economies announced public assistance programs amounting to more than 20% of their national income. For example, in the United States, the economy has been buoyed by government spending, at a rate of 25% of GDP, and forgone revenue. In some countries such as Italy and Germany, financial assistance has comprised capital, credit and other liquidity incentives as well as fiscal policy. Developing countries have supported their economies through various measures, albeit less vigorously than developed countries.

In addition to following supportive monetary, fiscal and financial policies, Turkey is among the economies that have made great progress in vaccination and proved more successful in containing the pandemic, which had positive implications for Turkey's production, investment and employment.

Here, I think we can have a better understanding of each country's economic and public health policies if we review some basic macroeconomic variables.

Compared with other developing economies, Turkey's economy has room for improvement in terms of inflation, reserves and risk premium. On the other hand, having tightened its monetary policy sooner and more strongly than its peers, Turkey has become one of the few economies that have offered a substantial real interest rate since the beginning of 2021. Along with a better current account balance, risk premiums affecting borrowing costs will also continue to improve as we make progress in our efforts on inflation and reserve accumulation. In addition, as of May 2021, short-term external debt is down USD 25.7 billion from USD 144.9 billion to USD 119.2 billion thanks to our recent work on compiling debt statistics. This will have positive implications for our external debt indicators.

Some developed countries have large external debts and many have high budget deficits, but their risk premiums and policy rates remain low. Due to fiscal, monetary and financial policy responses to the pandemic and its negative effects on households and the corporate sector, indebtedness rates have surged in many countries.

Amounting to USD 289 trillion globally, debt exceeded 360% of the world's income (GDP). In the coming months, both public and private sector indebtedness will become a growing issue worldwide. In this context, among sectors of the economy, the public sector and households have a very high debt burden across advanced economies. In terms of indebtedness, Turkey diverges quite positively from advanced economies in all categories.

Compared to other developing countries, I can say that Turkey is in a relatively good position in terms of public and household indebtedness.

However, we do see relatively higher rates in the corporate sector. Examination of the financial positions of companies in Turkey is important to better understand this issue. I should also note that an indebted corporate sector is not a purely negative thing. Besides, the debt rollover ratio of the corporate sector is quite high.

In countries like Turkey which have a young population and high growth potential but lack sufficient savings, borrowing to finance production, exports and investments is a normal situation. We attach importance to the channeling of such borrowings into productive companies and areas that support the increase in exports, reduce imports and underpin employment.

In sum, we see that the current structures and vulnerabilities of countries as well as the policies they adopted during the pandemic are an important determinant of their economic performance. That said, new virus variants leading to resurgence of cases keep the uncertainty about the course of the pandemic in place. As shown in the relevant slide, a new wave of pandemic has been seen in many countries. However, along with Germany, Turkey is among those countries with a relatively smaller number of cases due to its better performance than countries such as the UK and US. Like all the other central banks, we are closely monitoring developments regarding the course of the pandemic and their impact on the global economy.

Turkey is very successful in vaccination, and has diverged positively from other countries in terms of the vaccination level. The number of vaccine doses administered has exceeded 99 million, with 50 million people getting at least one dose. Despite the recent increase in social mobility following the reopening, the number of cases remains relatively low thanks to the performance of the vaccination rollout. The widespread vaccination of the population has a positive impact on the economic activity, employment and the current account balance.

As for Turkey's macroeconomic outlook, consistent with our projections, national income has grown by 21.7% annually in the second quarter on the back of the base effects. Looking at quarterly growth figures excluding the base effects, we see a 0.9% increase in national income compared to the first quarter, with contributions from both domestic and external demand.

In the second quarter of the year, many European countries recorded high rates of growth due also to the base effects. In this period, Turkey's growth outperformed many European countries, and the Turkish economy recorded the second-highest rate of growth after the UK.

Consumption and machinery-equipment investments were the main drivers of annual growth. The positive outlook in vaccination in Europe is affecting our economy via tourism and external demand channels. In this context, net exports also continue to contribute positively to growth.

Leading indicators show that domestic economic activity remains strong in the third quarter, with the help of robust external demand. Survey-based indicators point to a strong upward movement in both domestic and export orders.

High-frequency data show a rapid recovery in the pandemic-stricken subsectors of services amid increased mobility. Thus, the recovery in the services and tourism sectors ensures a rebalancing in the composition of demand in the third quarter in terms of goods and services. In fact, sectoral confidence indices also suggest a significant improvement in recent months particularly in the services and retail sectors.

When talking about the recent developments, I would like to place a special emphasis on investments. Data for the second quarter indicate that investments, particularly in machinery-equipment, contributed significantly to growth. The CBRT's research shows that our firms have a high investment appetite.

In the recent surveys, firms operating in all sectors excluding construction have reported that the weight of financial constraints among factors limiting activity/production has declined. We see that the weight of this factor is even below the historical averages currently.

Moreover, investment and employment tendencies of firms have reached very high levels compared to previous years. We are pleased to see that the improvement in the employment expectation of firms also continues in the third quarter while the investment tendency remains strong across main sectors.

We envisage that as the improvement in macro indicators continues in the upcoming period, as the risk premium declines and volatility decreases on the back of improving current account and inflation outlook, the credit channel will function effectively and stabilize the positive outlook regarding the investment appetite. Although there seems no obvious problem in accessing credit, high loan rates limit the access to credit. We are closely monitoring the progressive increase in the demand for loans for investment, operating capital and stock enhancement, and the gradual decrease in demand for debt rollover.

High-frequency data also signal a recovery in the labor market on the back of the reopening. Although employment in the services sector has been recovering more slowly amid pandemic-related restrictions and is still slightly below its pre-pandemic level, employment growth in the industry and construction sectors as well as the non-farm employment has exceeded pre-pandemic levels.

We consider that the services employment will also exceed its pre-pandemic levels in the upcoming period.

In the last couple of years, our economy suffered a variety of shocks, with the pandemic in the lead. The Central Bank has adopted a policy that curbs the lasting effects of these shocks, safeguards domestic and external balances and prioritizes price stability as the ultimate goal.

We are closely monitoring the current account and external financing data. Currently, the upward trend in exports, the recovery in tourism and the significant decline in gold imports support the ongoing improvement in the external balance. According to the provisional foreign trade data for August, our exports particularly to Europe are quite strong.

The strong momentum in vaccination since June played an important role in the improvement of the risk perception towards Turkey and the easing of restrictions. In this context, we are getting positive signals on the recovery in tourism activity. Survey indicators point to a continued strong course in external demand in the manufacturing industry.

The ratio of exports to imports reached a high plateau of some 85%. In the first half of the year, the real balancing in foreign trade is quite evident. Against this background, we expect that the current account will post a surplus in the rest of the year due to the strong upward trend in exports, and stimulus to tourism from the progress in the vaccination program.

Turkey has gradually reduced its foreign trade deficit with Europe, but continues to run a deficit in trade with Asia. At this point, I would like to reiterate that the swap agreements we have made as the Central Bank essentially aim to facilitate trade in local currency.

Distinguished Guests,

Now, I would like to touch on the inflation outlook. Last Friday, August inflation data were released. Annual inflation increased by 0.30 points to 19.25%. In this period, the annual inflation rate of the B index, which is a core inflation indicator and obtained by excluding unprocessed food, energy, alcoholic beverages and tobacco from the CPI, decreased by 0.05 points to 18.46%, and that of the C index, which excludes processed food from the B index, declined by 0.46 points to 16.76%. In August, while annual inflation increased significantly in the food group, it posted a limited rise in services and receded across other main groups. Meanwhile, producer inflation continued to increase due to commodity prices, disruptions in supply chains and demand conditions.

We forecast that the temporary factors that are affecting the inflation outlook in the short term will lose their effect and inflation will assume a downward trend in the last quarter. We also expect that inflation excluding food prices will continue to be lower than headline inflation in the rest of the year.

When talking about the recent inflation dynamics, food prices require special attention. In food prices, we see a global increase reflecting unfavorable weather conditions, drought, particular restrictions on food exports in some countries, and an increase in stockpiling. In this respect, central banks and policy makers monitor the developments in food prices, core inflation and the effect of increasing inflation on inflation expectations. Indeed, in the recent update of the World Economic Outlook, the IMF noted that central banks should analyze price dynamics and take into account whether movements in inflation are transitory or not. In Turkey as well, food prices are on the rise, and food inflation hovered significantly above historical averages and non-food inflation in July and August.

Another important issue regarding inflation dynamics is the difference between PPI and CPI inflation. Producer prices are high in advanced and emerging economies, as is the case in Turkey. This is driven by the increase in commodity prices as well as supply constraints arising from production failing to match the rapidly increasing demand. Another factor driving producer prices up are rising international freight costs and extended delivery times. The increase in consumer prices, however, remained more limited compared to producer prices inflation.

Thus, the gap between producer and consumer inflation has recently risen well above the long-term average in many advanced and emerging economies. For instance, the PPI in the euro area has risen to almost five times the area's CPI.

As Fed Chair Powell mentioned in his Jackson Hole Symposium welcoming remarks, during the pandemic, we saw that a narrow group's contribution to inflation dominated price developments. For example, prices of consumer durables, which had been declining on average over the 25 years preceding the pandemic, became one of the groups that contributed the most to the recent rise in inflation with the effect of supply constraints.

During the process of re-opening and economic normalization, energy and services prices significantly increased globally. Global central banks consider that high price increases in some sectors stemming from energy and the pandemic will be temporary as demand composition normalizes, supply constraints ease and base effects are eliminated. In the upcoming period, these factors will have a disinflationary effect in our country as well.

In global central banking practice, while determining the monetary policy stance, central banks take into account core inflation indicators adjusted for short-term incidental factors that are outside the control of monetary policy. For the reasons I have just mentioned, extraordinary conditions brought about by the pandemic increase the importance of core inflation indicators, which are used to measure the underlying trend of inflation adjusted for short-term volatility.

I would like to note that like other central banks, we also have considerations regarding the temporary nature of price movements resulting from supply shocks. While maintaining the tight monetary policy focusing on demand factors and their consistency with our medium-term inflation target, we will be giving more weight to decomposing the effects of supply shocks in the upcoming period.

Before I finish my evaluations on inflation, I would like to make a few notes on the pricing behavior. Recently, price increases in certain products have exceeded their historical averages. When we look into the products that made the highest contribution to inflation, we observe that in August, annual price increases in those products exceeded the average price increases of the last 10 years by more than three to four times. Although one reason for this situation, as I mentioned before, is developments such as the pandemic-led increases in commodity prices and supply constraints, these factors alone may not fully explain the price increases in some products. However, we consider that such pricing behavior will converge to its pre-pandemic level as the economic and social normalization gains pace in the upcoming period.

Lastly, when we look into exchange rate developments, we see that the improvement in our reserves is consistent with our forecasts. Reserves increased by USD 30 billion from USD 85-90 billion to USD 115-120 billion. Swap agreements, rediscount credits, gold ore purchases and reserve requirement steps have been the primary factors contributing to reserves.

Distinguished guests,

Stability to be established in the general price level in Turkey will foster macroeconomic stability and financial stability through the fall in country risk premium, acceleration in reverse currency substitution, accelerated accumulation of foreign exchange reserves and perpetual decline in financing costs. This will create a viable setting for investment, production and employment to continue growing in a healthy and sustainable way.

I would like to thank you all for your participation.