INFLATION REPORT

2024-II

9 May 2024

TÜRKİYE CUMHURİYET MERKEZ BANKASI

1. Overview

Consumer inflation was 69.8% in April 2024, hovering above the forecast range presented in the first Inflation Report of the year. The underlying inflation, which had been declining since September, posted an increase in January due to wage revisions as well as backward-indexation behavior in time-dependent price setting and in administered price adjustments. While the underlying inflation weakened in the subsequent months and reverted to the level it reached in December, it remained above the path envisaged in the first Inflation Report of 2024. Following geopolitical tensions and production cuts, global commodity prices rose in the first quarter, led by the energy group. These geopolitical developments led to the preference for alternate trade routes, prolonged delivery times, and raised freight charges. Food prices saw strong increases in the last reporting period, with red meat prices rising notably. The tight monetary policy stance pushed 12- and 24-month-ahead inflation expectations down, yet year-end expectations remained above the Inflation Report forecasts. The diffusion index, which provides information on how widely the price increase trend has spread, showed no significant change in March and April following increases in the first two months of the year. Aggregate demand conditions followed a strong course, and credit usage increased in the first quarter. The rise in real wages has been a supporting factor for domestic demand conditions. The backward-indexation behavior led to the maintenance of inertia in services inflation, with the rent subgroup particularly standing out. More frequent wage revisions compared to the past were another development that contributed to the persistence of services inflation.

Indicators for the underlying monthly inflation increased in January in line with projections and slowed down in the subsequent period, yet followed a higher-than-expected course. After having declined more than projected in the last quarter of 2023, seasonally-adjusted monthly increases in core indicators strengthened in January, led by services inflation. The underlying inflation declined in the following period, yet remained higher than projected. Alternative underlying inflation indicators such as median inflation, SATRIM, and Dynamic Factor also confirmed this outlook by displaying a similar pattern. It is projected that the slowdown in the underlying inflation will continue as the effects of monetary tightening become more evident.

Inflation is projected to be 38% by the end of 2024 and to fall to 14% by the end of 2025. While the end-2024 inflation forecasts were revised upwards, end-2025 inflation forecasts were kept unchanged. Data released for the first quarter of the year suggests that the rebalancing process for demand will be more delayed compared to the projections in the previous Inflation Report. Resilient domestic demand, the slower-than-anticipated decline in the underlying trend of inflation, and the upward revision in assumptions for commodity and import prices were the main factors that pushed the inflation forecasts upwards. On the other hand, strong monetary policy tightening and measures taken to support the monetary transmission mechanism are expected to limit the deterioration in the inflation outlook. It is expected that inflation expectations will converge to inflation forecasts and support the disinflationary process, and that tightening financial conditions will weaken the resilient course of domestic demand, thereby exerting a downward influence on inflation.

The disinflation process starting in June is projected to continue with a stronger pace in the second half of the year. Owing to the notable policy rate hike of March coupled with the additional macroprudential measures, financial conditions are considered to be significantly tightened. Given the lagged effects of policy measures, the moderation in domestic demand is projected to become more evident from the second quarter of the year onward. Medium-term projections are based on an outlook in which the tight monetary policy stance will be maintained until the inflation outlook displays a significant improvement and the coordination among economic policies will be preserved. Forecasts rely on a monetary policy that will remain tight until a significant and sustained decline in the underlying trend of monthly inflation is observed, and inflation expectations converge to the projected forecast range. With the contribution of the monetary policy forward guidance emphasizing the decisive tight stance, the convergence of inflation expectations to the Inflation Report forecasts in the short term and to the inflation target in the medium term is critical for ensuring an enduring price stability. Moreover, it is assumed that the fiscal discipline will be preserved in the forecasting period and fiscal policies will support the disinflation process in coordination with the monetary policy. The decisive monetary policy stance is expected to ensure moderation in domestic demand, real appreciation in the Turkish lira and improvement in inflation expectations. All these factors are expected to lower the underlying trend of monthly inflation and establish disinflation in the second half of 2024.

In the last quarter of 2023, economic activity remained strong, and indicated that the rebalancing in domestic demand lost momentum. In the last quarter, Gross domestic Product (GDP) grew by 4% on an annual basis, and by 1% on a quarterly basis. Thus, the growth rate reached 4.5% across 2023. On the expenditures side, private consumption, which had contracted in the third quarter, improved markedly in the last quarter and confirmed the resilience of household demand. Net exports made a positive contribution to growth, albeit less than in the previous quarter. On the production side, quarterly growth was mainly driven by services value-added, while the industrial sector had a limiting impact on growth.

Indicators for the first quarter of 2024 point to a strong course in domestic demand, while leading indicators for April suggest that domestic demand is not as strong as in the first quarter. The retail sales volume index accelerated in the first quarter as of February, on both a quarterly and annual basis. In contrast, the growth rate of the trade sales volume index slowed down in the same period due to the relatively weaker outlook in the wholesale trade volume index, one of the subcategories of the index. Card spending suggests that the higher consumption demand in the first quarter of the year continued on a quarterly basis. In this period, sales of white goods gained a significant momentum on a quarterly basis, while car sales maintained their rising momentum on the back of special offers and SCT-exempt sales. After declining in the previous quarter, manufacturing firms' registered orders from the domestic market increased again in the first quarter of the year, amid wage adjustments. On the other hand, firms' expectations for domestic market orders over the next three months posted a decline in this period. Interviews with firms indicated that domestic sales increased on a quarterly basis in the first quarter, due to wage increases, additional promotions introduced by firms, and the demand brought forward. On the production side, industrial production, adjusted for seasonal and calendar effects, rose by 3.4% in the first quarter as of February compared to the previous quarter. Likewise, seasonally adjusted employment increased by 1.4% (449,000 people) on a quarterly basis in the same period. On the other hand, in addition to the rise in the labor underutilization rate in the first quarter, survey data imply that signs of weakening have emerged in the labor market. High frequency data for April and field observations involve some signals of a moderation in domestic demand. Card spending, in real terms, posted a monthly decline in April, which includes the religious holiday. Similarly, interviews with firms for April imply a deceleration in consumption spending due to the demand brought forward in the previous quarter as well as the extended holiday. PMI data also indicate that, as of April, both new orders and production remained under the threshold value and registered a moderate weakening in the second quarter. On the other hand, imports of consumption goods increased in April, diverging from this outlook.

The improvement in the current account balance gained momentum in the first quarter due to the narrowing of the foreign trade deficit and the strong outlook for the services balance. The foreign trade deficit continued to narrow on the back of the increase in exports excluding gold and the decrease in imports. In the first quarter, foreign demand remained subdued despite a partial recovery, whereas exports excluding gold increased further in seasonally and calendar-adjusted terms. Gold exports, on the other hand, declined significantly due to higher gold demand in the domestic market. On the import side, the seasonally and calendar-adjusted imports excluding gold and energy remained almost unchanged in the first quarter due to resilient domestic demand. In the first quarter of 2024, energy imports were close to their previous quarter levels, while gold imports fell on a quarterly basis, leading to a continued decline in imports. Additionally, as of February, the flat course of terms of trade and the real balancing in foreign trade supported the improvement in the foreign trade deficit. In the first quarter of the year, import volumes fell not only in capital goods and intermediate goods, but also in consumption goods. The favorable trend in the services balance continued to strengthen on the back of travel revenues. Against this background, amid the ongoing increase in the goods trade balance and the growing positive contribution of the services balance to the current account balance, the seasonally and calendar-adjusted current account deficit narrowed significantly compared to the previous quarter. On the financing front, the weight of long-term items increased in the first quarter, while net errors and omissions recorded outflows, and reserves declined.

Although the disinflation process continues across the globe, inflation is still above the targets and upside risks to the inflation outlook remain in many countries. While tight labor markets and related wage pressures lead to stickiness particularly in services inflation across the globe, geopolitical developments also adversely affect the disinflation process through energy prices and global supply conditions. The US economy started to diverge from other major economies in terms of growth and inflation outlook, which has also led to a partial divergence in expectations regarding the monetary policy of the US Federal Reserve

(Fed). Compared to the previous reporting period, markets have priced in later and slower policy rate cuts across all advanced economies, with this change being more evident for the Fed. In many emerging economies, inflation has receded to levels within the tolerance band, while rate cuts also continue. In the coming period, rate cuts are likely to spread across advanced and emerging economies depending on the fall in inflation. However, considering the level and persistence of inflation, increased uncertainties and risks, rate cuts are expected to be carried out in a way that will maintain sufficient monetary tightness and ensure a continued decline in inflation.

The global risk appetite weakened in the current reporting period, and the monetary tightening process supported the positive divergence of Türkiye's risk premium from peer countries. While global financial conditions tightened due to geopolitical risks and postponed expectations for monetary policy easing in advanced economies, risk perceptions towards emerging economies deteriorated. Against this backdrop, risk premium indicators rose in emerging economies whereas Türkiye's CDS premium diverged positively, falling below 300 basis points again. On the other hand, the exchange rate volatility of the Turkish lira surged in shorter maturities but the increase remained limited in longer maturities. The CBRT's gross international reserves decreased to USD 124.1 billion as of 26 April, driven by the decline in CBRT's swap funding in this period. In the current reporting period, government domestic debt securities (GDDS) yields rose in shorter and medium maturities in line with the higher policy rate but the increase remained subdued in longer maturities.

Financial conditions continued to tighten as a result of the monetary policy decisions and other measures supporting the monetary tightening process. In addition to the policy rate hike, regulations towards increasing the share of Turkish lira deposits, quantitative tightening decisions, and steps taken to simplify the macroprudential framework have continued to strengthen the transmission mechanism and improve the funding composition of the banking system since the previous reporting period. In the current reporting period, deposit rates rose by an average of 14.0 percentage points across all maturities, and the share of Turkish lira deposits in total deposits increased while the decrease in FX-protected accounts continued. Meanwhile, general-purpose and Turkish lira commercial loan rates increased substantially. In commercial loans, Turkish lira loan growth decreased, while FX loans accelerated. The exchange rate-adjusted 13-week annualized growth rate of total commercial loans rose by 19.5 percentage points to 34.7% in the current reporting period. On the other hand, the 13-week annualized growth rate of retail loans decreased slightly to 51.7% due to the fall in the growth rates of personal credit card stock balance.

1.1 Monetary Policy Decisions

Taking into account the lagged effects of monetary tightness established through a strong rate-hike cycle of eight months, as well as other policy measures supporting monetary transmission, the CBRT kept the policy rate constant in February. Due to month-specific and time-dependent price and wage adjustments, the underlying trend of monthly inflation rose in January in line with the inflation projections, and headline inflation edged up. In addition, stickiness in services inflation, geopolitical risks, and food prices kept inflation pressures alive. The CBRT communicated that it would closely monitor the alignment of inflation expectations and pricing behavior with projections, and the impact of wage increases on inflation. It also provided forward guidance that the monetary policy stance would be tightened in case of a significant and persistent deterioration in the inflation outlook was anticipated.

Underlining the deterioration in the inflation outlook, the CBRT decided to raise the policy rate in March. In February, the underlying trend of monthly inflation turned out higher than projections, led by services inflation. Recent indicators suggest that the resilient course of domestic demand continued to strengthen due also to the changes made in the methodology. Medium-term inflation expectations continued to decline, while year-end inflation expectations for 2024 and 2025 rose. Accordingly, in response to the deterioration in the inflation outlook, the CBRT raised the policy rate to 50% at its March MPC meeting. Additionally, the Central Bank also made a technical adjustment and decided to set the overnight borrowing and lending rates 300 basis points below and above the one-week repo auction rate, respectively. The CBRT emphasized that the tight monetary stance would be maintained until a significant and sustained decline in the underlying trend of monthly inflation was observed, and inflation expectations converged to the projected forecast range. The CBRT maintained the forward guidance that the monetary policy stance would be tightened in case a significant and persistent deterioration in the inflation outlook is foreseen.

In April, the CBRT kept the policy rate unchanged, but reiterated its cautious stance against upside risks to inflation. In March, the underlying trend of monthly inflation turned out higher than expected despite the ongoing weakening. While consumption goods and gold imports contributed to the improvement in the current account balance, other indicators pertaining to the recent period implied a persistent resilience in domestic demand. The high level of and the stickiness in services inflation, inflation expectations, geopolitical risks, and food prices keep inflationary pressures alive. The actions taken in March led to a significant tightening in financial conditions. Noting that the effects of monetary tightening on credit conditions and domestic demand were closely monitored, and considering the lagged effects of the monetary tightening, the CBRT kept the policy rate unchanged and emphasized its cautious stance against upside risks to inflation. The Bank reiterated its forward guidance that the monetary policy stance would be tightened if a significant and persistent deterioration in the inflation outlook is foreseen.

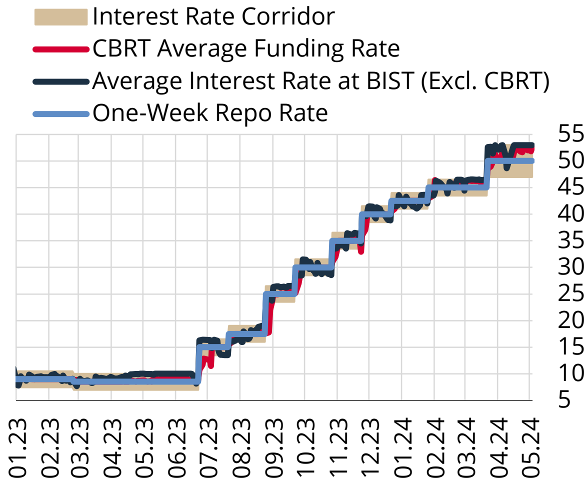
The CBRT continued to take macroprudential measures to support the monetary transmission mechanism. In this context, the monthly growth limit for Turkish lira commercial loans and general-purpose loans was reduced to 2% from 2.5% and 3%, respectively and the 2% growth limit for vehicle loans was maintained. To increase the effectiveness of this regulation, the Bank replaced the securities maintenance with maintenance of Turkish lira reserve requirements in blocked accounts for a period of one year for the portion of these loans exceeding the monthly growth rate. Thresholds for the credit growth rates have been designed to not serve as an alternative to the main policy instrument, but as a counterbalancing factor in the face of an additional credit demand that may arise from fluctuations in expectations. Additionally, the Bank raised the maximum monthly interest rate on credit card cash advances and overdraft accounts to 5% from 4.42%, and the maximum monthly contractual interest rate for credit card transactions to 4.25% from 3.66%, in order to balance excess consumption demand.

The CBRT continues to take policy steps supporting Turkish lira deposits in order to strengthen monetary transmission. Accordingly, an improvement target of 0.5 percentage points was introduced for Turkish lira legal entity deposit share of those banks with a share below 50%. Meanwhile, the growth target for the Turkish lira share of real persons was revised and the commission rate to be applied in case of not achieving these targets was increased from 2% to 3%. The remuneration of reserve requirements for banks meeting the target for transition to Turkish lira was extended to include demand deposits and deposits with maturities up to one month. The upper limit of the remuneration rate applied to required reserves maintained for Turkish lira deposits, which is based on the Turkish lira conversion rate, was set at 80% of the policy rate, thus the upper limit was increased from 36% to 40%. The upper limit of the remuneration rate applied to required reserves maintained for KKM accounts, which is based on the renewal and Turkish lira conversion rate, was set at 60% of the policy rate, thus the upper limit increased from 25% to 30%. Moreover, in order to decrease volatility in market liquidity and support monetary transmission, the CBRT decided that a portion (15% or 25% based on the asset size of the bank) of the required reserve amount for Turkish lira liabilities which used to be maintained on 14-day average basis in free accounts, would be kept in blocked accounts.

The CBRT continues to simplify macroprudential policies to improve the functionality of market mechanisms and strengthen macro financial stability. With the change on 6 April 2024, the securities maintenance ratio applied to liabilities subject to securities maintenance was reduced from 4% to 1% and the implementation regarding securities maintenance based on loan growth was terminated. With the amendment dated 9 May 2024, the securities maintenance regulation was completely abolished.

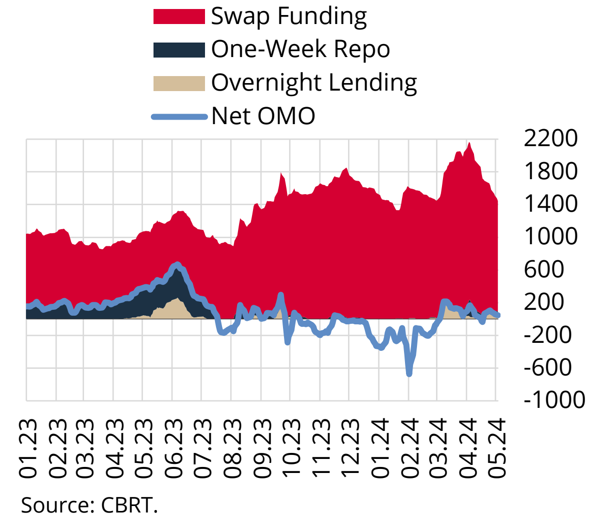
While the amount of the CBRT's swap transactions has gradually decreased since the end of March, the funding provided through Open Market Operations (OMO) has fluctuated. In the current reporting period, overnight rates moved within the CBRT interest rate corridor depending on liquidity conditions in the market (Chart 1.1.1). The amount of currency swap transactions, which was TRY 1.45 trillion as of 8 February 2024 due to exchange rate difference payments to FX-protected deposits, the CBRT's FX transactions and government expenditures, decreased to TRY 1.31 trillion on 29 February 2024. Then, it climbed throughout March and reached TRY 1.82 trillion as of 1 April 2024 before displaying a significant downtrend and dropped to TL 1.18 trillion as of 3 May 2024. The OMO funding, which was volatile in the current report period due to the CBRT's FX transactions, exchange rate difference payments for FX-protected deposits (KKM) and government expenditures, increased from TRY -110.4 billion on 8 February 2024 to TRY 53.2 billion on 3 May 2024 (Chart 1.1.2).

Chart 1.1.1: CBRT Interest Rates and Short-term Interest Rates (%)



Source: BIST, CBRT.

Chart 1.1.2: CBRT OMO and Swap Transactions (One-Week Moving Average, TRY Billion)



Source: CBRT.

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