Fatih Karahan: Recent economic and financial developments in Turkey

Speech by Ms Fatih Karahan, Governor of the Central Bank of the Republic of Turkey, at the 92nd Ordinary Meeting of the General Assembly, Ankara, 30 April 2024.

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Esteemed Shareholders, Distinguished Guests,

In 2023, we proudly celebrated the 100th anniversary of our Republic. 2023 was also a year in which the Central Bank of the Republic of Türkiye (CBRT) carried out its activities with the awareness that the main contribution it can make to social welfare is to achieve price stability and took decisive steps accordingly.

Before moving on to the agenda items to be discussed at the General Assembly, I would like to share with you our assessments of macroeconomic developments since 2023 and provide some information on the monetary policy we have been implementing. In the last part of my speech, I will briefly talk about the activities that we carried out in 2023.

Distinguished Participants,

In 2023, global economic activity remained weak. The gradual decline in growth rates, particularly in our export partners, continued in 2023. Meanwhile, global inflation declined significantly from the high levels of the previous year yet remained above central banks' targets. In this period, monetary tightening continued in countries with inflation rates above targets.

In Türkiye, economic activity, which remained strong in the first half of 2023 on the back of domestic demand, lost momentum in the second half of the year but remained robust. On the production side, the services sector stood out as the main driver of growth. The industrial sector made a negative contribution to growth in the first half of the year due to earthquake-related effects and weak external demand but made a positive contribution in the second half of the year. On the expenditures side, although the contribution of final domestic demand remained high, it declined in the second half of the year due to the slowdown in private consumption growth. Net exports made a negative contribution to annual growth throughout the year due to the weak course of global economic activity. However, in the second half of the year, imports decreased due to the tight monetary policy while exports remained relatively strong.

The current account balance posted a deficit of USD 45.4 billion in 2023. The largest negative contribution to the current account deficit came from the energy balance. The foreign trade balance excluding gold and energy made a negative contribution to the current account balance due to strong domestic demand, while the positive contribution of services items to the current account balance continued to increase.

In 2023, annual consumer inflation stood at 64.8 percent. In the first half of the year, inflation receded due to the base effects as well as the flat course of exchange rates, the decrease in foreign currency-denominated import prices, and energy subsidies. Thus, annual inflation stood at 38.2 percent in June. In the first half of the year, demand-side effects on inflation became more pronounced due to the strong increase in credit growth driven by monetary conditions, wage increases and transfers to households.

The inflationary pressures increased due to supply-demand imbalances driven by the earthquakes in February, and the short and medium-term repercussions of reconstruction efforts on public finances. These developments facilitated a resurgence in inflation in the second half of the year, which had declined in the first half of the year, by adversely affecting pricing behavior.

In the third quarter of 2023, inflation dynamics were shaped by the cumulative effects of the ongoing strong course of domestic demand, tax adjustments, exchange rate developments, wage increases, the stickiness of services inflation, and the sharp rise in crude oil prices. Moreover, the concurrence of several historically large shocks accelerated the passthrough of these shocks to prices, leading to a significant increase in inflation in the third quarter. Against this background, inflation rose by 23.3 percentage points between June and September, reaching 61.5 percent. In the final quarter of the year, annual consumer inflation ended the year at 64.8 percent on the back of the improvement in the underlying trend.

Distinguished Guests,

I have summarized the negative impact of the strong course of domestic demand on the current account balance and financing conditions in the first half of the year. This process was also accompanied by the decline in international reserves, which led to a marked deterioration in pricing behavior by increasing volatilities in financial markets. In the face of these developments, we initiated a strong monetary tightening process in June 2023 to establish disinflation as soon as possible, to anchor inflation expectations, and to control the deterioration in pricing behavior. Accordingly, we raised the policy rate from 8.5 percent to 15 percent in June, to 17.5 percent in July, and to 25 percent in August. We communicated that the monetary tightening process would continue until a significant improvement in the inflation outlook was achieved.

As inflation exceeded our projections in the third quarter of the year, and the stickiness of services prices and the deterioration in inflation expectations continued to exert upward pressures on inflation, we continued the monetary tightening process in the September-December period, raising the policy rate from 25 percent to 42.5 percent. Simultaneously, we simplified the macroprudential framework to enhance the functioning of market mechanisms and strengthen macro financial stability. We also supported this process through selective credit tightening and quantitative tightening measures. In sum, from June through December, we raised the policy rate by a total of 34 percentage points from 8.5 percent to 42.5 percent.

In January 2024, we raised the policy rate to 45 percent, based on our assessment that inflation expectations and pricing behavior had continued to moderate. Taking into account the lagged effects of monetary tightening and other policy actions supporting monetary transmission, we kept the policy rate constant in February.

However, driven by services inflation, the underlying trend of monthly inflation in February was higher than expected. Taking into account the risks to inflation and the deterioration in the inflation outlook, we raised the policy rate by 5 percentage points to 50 percent in March. Moreover, we adjusted the monetary policy operational framework by setting the Central Bank overnight borrowing and lending rates 300 basis points below and above the one-week repo auction rate, respectively. I would like to reiterate that this change is a technical correction considering the high level of interest rates. In other words, the one-week repo rate will remain as our main policy rate.

Distinguished Guests,

In March, despite an ongoing decline, the underlying trend of monthly inflation was higher than our projections. While imports of consumption goods and gold contributed to the improvement in the current account balance, other recent indicators implied that domestic demand remained resilient. On the other hand, our policy decisions in March led to a significant tightening in financial conditions. We closely monitor the effects of monetary tightening on credit conditions and domestic demand. Accordingly, although we kept the policy rate unchanged at our April meeting, considering the lagged effects of the monetary tightening, I would like to underline that we remain highly attentive to inflation risks.

The effects of the monetary tightening that we have been implementing since June is observed on financial conditions, and spilled over into demand conditions to some extent. In the second half of 2023, external financing conditions improved significantly, reserves increased, the current account balance improved, the share of Turkish lira deposits increased and the demand for Turkish lira assets grew stronger. All these developments contributed to the stabilization of the Turkish lira and the effectiveness of monetary policy.

Backed by the monetary tightening, 12 and 24-month ahead inflation expectations have been improving since September. Meanwhile, year-end inflation expectations still hover above the projections we shared in the inflation reports.

We observe the effects of the decisive steps we have taken within the scope of simplification as enhanced functionality of the market mechanism and a strengthened monetary transmission mechanism. As part of this process, the share of the Turkish lira deposits in the financial system has increased, while that of the FX-denominated and FX-protected deposits has decreased, which has strengthened monetary transmission as well as financial stability. The ability of the banking system to fulfill its intermediation function with maximum efficiency is a prerequisite for a successful disinflation process. In this context, while implementing simplification, we also take steps to support the monetary transmission mechanism in case of unanticipated developments in credit growth and deposit rates. Total credit growth has lost considerable pace since March due to our monetary and quantitative tightening measures, and we expect it to weaken the resilience of domestic demand. We thereby expect an upcoming period of a healthy disinflation process to be accompanied by moderation in domestic demand.

We closely monitor monthly price developments. We will maintain our tight monetary stance until the underlying trend of monthly inflation displays a significant and sustained decline and inflation expectations converge to the projected forecast range.

The monetary policy stance will be tightened in case a significant and persistent deterioration in inflation is foreseen. We anticipate that our decisive monetary policy stance will bring down the underlying trend of monthly inflation through moderation in domestic demand, real appreciation of the Turkish lira and an improvement in inflation expectations. Consequently, disinflation will be established in the second half of 2024.

Esteemed Shareholders, Distinguished Guests,

Before concluding my speech, I would also like to mention the major activities we carried out throughout the year.

As I have elaborated in the previous part of my speech, we have implemented a strong monetary tightening as of the second half of 2023 to establish disinflation as soon as possible, anchor inflation expectations and contain the deterioration in pricing behavior.

However, effective communication and coordination of these policies with other stakeholders are as important as the implementation of our monetary policy. Accordingly, we adopted a simple, transparent and two-way communication policy to explain our policy decisions to all stakeholders in line with our main objective of achieving price stability and to ensure effective expectations management.

In 2023, we took steps towards a more intensive and effective use of technological and financial infrastructure. I would like to now mention some of these.

We enhanced the information technology infrastructure in cash transactions and increased our daily banknote processing capacity through technological investments.

In the field of information technologies, we made further efforts to create the systems needed in line with our vision of superior technological infrastructure and to ensure the security and continuity of these systems in 2023.

In view of the considerable interest in the FAST system and the dynamic requirements of the payments ecosystem, we increased the FAST transaction limits for money transfers.

We shared the findings of the first phase of the Digital Turkish Lira Project through a comprehensive evaluation report.

Esteemed Guests,

I would like to underline once again that the CBRT's main objective and priority is to achieve price stability. In line with this objective, we will continue to make our monetary policy decisions in a way that will create monetary and financial conditions that will bring inflation down to single digits first and to the 5 percent target in the medium term.

Concluding my remarks, I would like to thank my valuable colleagues who support the Bank's activities with great dedication, and I would like to extend my respects to all of you for your attendance.