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 briefing on the Inflation Report 2024-II, Ankara, 9 May 2024.

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Distinguished Members of the Press, Esteemed Participants,

Welcome to the briefing to convey the main messages from the second Inflation Report for 2024. I would like to extend my respect and greetings to all of you.

As we have always underlined, the CBRT's primary objective is to achieve and maintain price stability. To this end, we have been implementing strong monetary tightening since June 2023.

We closely monitor price setting behavior and inflation expectations.

We are determined to maintain our tight monetary policy stance until inflation falls to levels consistent with our target.

I would like to emphasize again at the beginning of my speech that we will definitely not allow a permanent deterioration in the inflation outlook.

I will start the meeting with a presentation on our assessment of the global and domestic macroeconomic outlook and our monetary policy stance, as well as our inflation forecasts. Later on, I will address your questions.

Before I begin my assessments, I would like to draw your attention to the box studies we have included in our Inflation Report regarding the prominent issues on the agenda.

The boxes in the Report cover different topics such as services inflation, expectations and TL deposits. I would like to make a special note here for those who are interested.

Distinguished Guests,

I will first touch upon recent key developments in the global economy.

Global financial conditions continue to weigh on growth. Geopolitical developments and the ongoing tight monetary policies stand out as risk factors for the course of global economic activity.

Meanwhile, both the export-weighted global growth outlook and leading indicators point to a limited improvement in global economic activity, compared to the previous reporting period, mostly driven by the services sector.

The recent growth outlook for the US economy has diverged favorably from that of the euro area and other advanced economies, and economic activity in the US has been relatively robust.

Commodity prices continue to be driven by the outlook and composition of global growth, geopolitical risks, financial conditions, and supply-side factors.

Commodity prices have posted broad-based increases since the previous reporting period.

In addition to supply-side factors, some industrial commodities have recorded notable price increases, particularly in line with China's growth.

With the heightened geopolitical tensions, precious metal and oil prices also soared significantly, compared to the previous reporting period.

While global disinflation remained on track, inflation was above the targets in many economies.

The stickiness of services inflation and geopolitical developments are impeding the disinflation process.

While headline inflation receded to near-target levels in some emerging economies, it remained significantly above the targets in others.

Meanwhile, in advanced economies, the decline in headline inflation was replaced by a flatter course, and core inflation continued to fall.

Against this backdrop, expectations have strengthened that the central banks of advanced economies will cut interest rates later and at a slower pace compared to the previous reporting period.

As seen on the graph, the flattening of the market-implied policy rate path was more pronounced for the Fed.

This divergence increases global uncertainty and puts pressure on the currencies of emerging economies.

Accordingly, we consider that the central banks of emerging economies will be more prudent in cutting interest rates.

These developments led to a decline in the global risk appetite as well as portfolio outflows from emerging economies in the recent period.

Macroeconomic Outlook

Distinguished Guests,

Now I would like to share with you our observations on macroeconomic developments in Türkiye.

Data for the last quarter of 2023 indicate that the annual contribution of domestic demand to economic activity declined. Meanwhile, the negative contribution of net exports decreased in this period.

In the first quarter of 2024, domestic demand is still resilient. Retail sales and trade sales volume indices, and card spending pointed to an acceleration in consumption in the first quarter.

On the other hand, despite some uncertainty due to the religious holiday, leading indicators for the second quarter suggest a milder outlook for domestic demand compared to the first quarter.

While card spending weakened in real terms in April, manufacturing firms' expectations for future domestic orders continued to decline on a quarterly basis.

Similarly, interviews with firms in April confirmed this outlook.

On the other hand, imports of consumption goods diverged from this trend by recording an increase in April.

In this respect, we closely monitor the impact of monetary tightening on domestic demand using a variety of indicators.

Compared to the outlook I summarized for domestic demand, domestic production has been on a milder course.

As of February, industrial production increased on a quarterly basis, but this increase seems to be more limited when highly volatile sectors are excluded.

The Services Production Index, which started to be released as of March, remained relatively flat in the first quarter. I would like to note that our report includes a box that examines the relationship of this index with services consumption and value added.

Having increased in the first quarter, the PMI data implied a mild weakening in production in the second quarter.

After a slight decline in the first quarter, the capacity utilization rate remained somewhat above its historical averages in April.

The outlook for domestic demand and production signals that aggregate demand conditions remain inflationary.

Our previous report included a box explaining eight different output gap indicators monitored by the CBRT. Our output gap forecast based on the average of these indicators suggests that the output gap resumed its uptrend in the first quarter of 2024 after a weakening in the second half of 2023.

Here I would like to underline that our tight monetary policy will moderate demand and encourage savings. As a result, the output gap will fall to negative territory, and will be an important component of the disinflation process.

In the second half of 2023, exports grew in real terms, while imports declined, and the foreign trade balance improved.

We estimate that this rebalancing continued in the first quarter of 2024 and that the ratio of the current account deficit to GDP declined below 3 percent.

Distinguished Participants,

The shaded areas on the chart in the right panel show the recent monetary tightening cycles.

During these periods, the current account balance improved on the back of weakening demand and improving expectations.

We project that the lagged effects of the monetary transmission will lead to a weakening in domestic demand in the second half of 2024, and as a result, the improvement of the current account balance you see on the chart will continue.

Esteemed Participants,

Now, I would like to share our assessments of the recent inflation developments and the factors that will be influential on inflation.

In the last quarter of 2023 and January 2024, consumer inflation remained close to the mid-point of the forecast range.

Annual inflation has recently moved up. We already stated in all our policy texts, presentations and Inflation Reports that we anticipate inflation to rise until the first half of 2024.

However, we see that inflation has been even higher than our projections for the last three months. In fact, consumer inflation ended April at 69.8 percent, which was 0.9 points above the previous Inflation Report forecast range.

In our previous communication, I emphasized that in terms of inflation developments, we closely monitor the underlying trend of monthly inflation as well as the annual indicators.

Now I would like to share the recent course of various underlying trend indicators.

Having declined since September, the underlying trend of inflation reversed and went up in January due to the backward-indexation tendency as well as wage adjustments.

The underlying trend moderated in the following months to return to its December level, but remained above the path we had projected in the first Inflation Report of the year.

The B and C indices have come out higher than our forecasts. I would now like to summarize the economic outlook that caused this.

As I mentioned earlier in my presentation, global commodity prices rose in the reporting period, led by the energy group.

Over the last three-month period, food prices posted significant increases, with red meat prices in the lead.

12-month and 24-month ahead inflation expectations declined, while year-end expectations were above our Inflation Report forecasts.

Contrary to our projections, aggregate demand conditions followed a strong course and credit utilization increased in the first quarter of the year. The rise in real wages was a factor that supported domestic demand conditions.

Backward-indexation behavior led to inertia in services inflation, which was more pronounced in the rents subgroup.

I would like to remind you that considering the deterioration in the inflation outlook, we delivered a strong increase in the policy rate and an additional tightening in monetary conditions.

Analyzed by main groups, we see that the services group has posted stronger price increases than other groups in the recent period.

As of April, annual inflation was around 57 percent in the core goods group while it was 97 percent in the services group. The diffusion index for the services sector remains above its historical average, suggesting that the price increases continue to spread across the sector.

While this can be attributed partly to the labor-intensive nature of the sector, the impact of the backward-indexation behavior was visible particularly in administered items, rents, health and education services.

These services items cause the impact of shocks on inflation to extend over a long period of time.

Moreover, ongoing substantial increases in food prices, red meat in particular, also adversely affect prices of restaurants-hotels.

In this context, services inflation remains elevated despite a slowdown on a monthly basis.

When services inflation is decomposed into two components as items displaying high inertia and items displaying relatively low inertia, we see that "items displaying high inertia" are the main drivers of this elevated course. On the other hand, we consider the recent slowdown in inflation in these items as a favorable development.

When we look at global developments, we also see a similar trend in terms of composition. The stickiness of services inflation has been a significant factor slowing the convergence of headline inflation to targets in advanced economies.

In both the USA and the euro area, services inflation is significantly above the headline inflation and the targets.

Rents are one of the important drivers of the high course of services inflation in Türkiye. Therefore, we closely monitor housing market developments as a leading indicator.

The growing demand driven by the impulse to hedge against inflation, and the supply-demand imbalances caused by the earthquake led to substantial increases in housing prices. The impact of these developments is strongly observed on rents with a lag.

On the other hand, following the monetary tightening, the rate of increase in housing prices has significantly decelerated. The upward course in housing prices remains below the consumer inflation trend.

Studies at the CBRT suggest that, in addition to other factors, the change in housing prices affects rent inflation in the same direction.

Therefore, we think that the deceleration in housing prices may restrain the increase in rents with a lag in the period ahead.

On the other hand, the impact of monetary tightening is more evident on goods inflation in the short term. Besides, the passthrough of exchange rates to prices of durable consumption goods is high.

The stable course of the Turkish lira, the tightening in financial conditions, and weaker domestic demand will lead to a slowdown in price increases in the goods group in the coming period, particularly in durable consumption goods.

Convergence of inflation expectations to the forecast range is of critical importance for disinflation.

Due also to the upside surprises in inflation, the expectation curve shifted upwards in February and March. This upward movement ended following the monetary tightening in March. Survey participants faced an upside inflation surprise of 3.8 percentage points in the first quarter; yet, their revision of year-end inflation expectation was rather limited at 2.1 percentage points.

In the current situation, expectations suggest that the year-end inflation forecast in our previous Inflation Report will be reached with a three-month lag.

Additionally, micro data from the consumer tendency survey show that consumers' inflation expectations have also declined somewhat in the recent period, albeit still remaining high. For further information about this issue, you can refer to the relevant box in our Report.

We envisage that our decisions will facilitate an improvement in inflation expectations, and the gap between market expectations and our interim targets will be closed.

Monetary Policy

Distinguished Participants,

In this part of my speech, I would like to talk about our monetary policy strategy.

As you know, we initiated a strong monetary tightening process in June 2023 to establish the disinflation course as soon as possible, to anchor inflation expectations, and to control the deterioration in pricing behavior.

Accordingly, we have raised the policy rate from 8.5 percent to 50 percent.

As a technical adjustment, we widened the interest rate corridor in March.

In addition, against the divergence in expectations of economic units and possible volatilities, we continue to implement macroprudential policies to enhance the effectiveness of monetary transmission.

Accordingly, in order to support the rebalancing process in domestic demand, we lowered Turkish lira commercial loan and general-purpose loan growth limits to 2 percent, we introduced reserve requirements and terminated securities maintenance practice. Moreover, we raised the maximum interest rate on credit cards.

In order to reinforce the monetary transmission mechanism and increase the share of Turkish lira deposits, we started remunerating Turkish lira required reserves according to targets and revised targets for growth of Turkish lira deposit share.

As of today, we completely terminated the securities maintenance practice in order to enhance the functionality of market mechanisms and strengthen macro-financial stability.

Thus, we were able to enhance the functionality of the bond market, normalize the yield curve and strengthen the monetary transmission mechanism.

We have sterilized the excess liquidity stemming from the exchange rate difference payments of FX-protected accounts and the increase in the CBRT's swap transactions with domestic banks in the final quarter of 2023.

More than 1 trillion Turkish liras were sterilized from the market via the increases in required reserves.

In December, we started holding Turkish lira deposit buying auctions to sterilize access liquidity.

We are sterilizing the temporary excess liquidity via deposit buying auctions.

We will monitor liquidity conditions closely and we will effectively use necessary sterilization tools when necessary.

Our monetary tightening steps have immediate and strong effects on financial markets. In this part of my speech, I will talk about the impacts of our policies on financial conditions.

As a result of our policy rate hike as well as macroprudential arrangements in March, commercial loan rates increased by 14 points, consumer loan rates rose by 18 points and deposit rates increased by 15 points. The current level of loan rates will contribute to the slowdown in loan growth and the rebalancing in domestic demand.

Meanwhile, the level of Turkish lira deposit rates supports the rise in the share of Turkish lira deposits in the system. Actually, latest data points that transition from FX deposits to Turkish lira deposits has accelerated.

Our monetary policy stance and the macroprudential framework will ensure that deposit rates remain at levels that will support the transition to the Turkish lira and boost savings.

It is crucial for consumer loans to grow at a pace that will restore rebalancing in domestic demand.

In the first quarter of 2024, the acceleration in loan demand amid heightened uncertainty perceptions led to a rise in consumer loan growth driven by credit cards and general-purpose loans.

With the tightening measures we took, consumer loan growth weakened in April and fell below the average of the last quarter of 2023.

Commercial loans had been stable until February.

Nevertheless, commercial loan growth strengthened in a short time due to loan demand exceeding forecasts in March.

In order to balance this demand driven also by expectations, in addition to the interest rate hike, we lowered the loan growth limit, as in general purpose loans, and introduced the reserve requirement practice.

Following these steps, Turkish lira commercial loan growth declined, while FX loans have recently increased.

The strong demand for foreign currency deposits in February and March quickly disappeared with the decisions taken in March.

In April, Turkish lira deposits increased by 539 billion Turkish liras, while parity-adjusted FX deposits and FX-protected deposits decreased by 6.2 billion dollars and 19 billion Turkish liras, respectively.

Thus, in the last 8 months, the share of Turkish lira deposits increased from approximately 32 percent to 44 percent, while the share of Exchange Rate Protected Deposits decreased from 26 percent to 14 percent.

Our monetary policy stance and the macroprudential framework we are implementing will continue to contribute to the tendency to switch to TL deposits.

The negative slope of the yield curve, consistent with monetary tightening, has become evident since the last Report period.

The termination of the securities maintenance practice will support healthy price formation.

The current policy mix has helped improve the risk sentiment towards Türkiye and lower the risk premium.

The improvement in Türkiye's risk premium has slowed since the beginning of the year. Increased exchange rate volatility and the deterioration in the reserve outlook weakened risk sentiment in March.

We reinforced our tight monetary policy stance with the decisions we made in March that resulted in increased confidence in our policies and improved reserve outlook. Against this background, the risk premium fell below 300 basis points again.

This outlook bolstered portfolio inflows to Türkiye.

In April, marked by escalated geopolitical risks and reduced global risk appetite, emerging market economies saw portfolio outflows, while Türkiye recorded portfolio inflows.

Portfolio inflows have concentrated in the GDDS market, while inflows through the offshore swap channel is also growing.

Between the last Inflation Report period and the March MPC Meeting, reserves registered a decline. The additional monetary tightening we delivered in the March meeting fostered the confidence of resident and non-residents to the Turkish lira and bolstered reserves.

In fact, from 22 March to 26 April, foreign currency-denominated deposits dropped by 7 billion dollars, while under the scope of reserve management, the CBRT swap balance was reduced significantly. In this period, gross reserves remained unchanged, while net reserves excluding swap improved by 16.4 billion dollars.

When we look at net reserves excluding swaps as of today, we see an additional improvement of 18 billion dollars in the last two weeks. Thus, net reserves excluding swaps increased by a total of 34 billion dollars in this period.

MEDIUM-TERM PROJECTIONS

Distinguished Guests,

Against the backdrop of the economic outlook I have summarized so far, I will share with you our medium-term forecasts.

We updated our assumptions regarding external demand slightly upwards for 2024 and kept them unchanged for 2025.

In line with the outlook in oil and commodity prices I have mentioned at the beginning, we revised our assumptions for crude oil and import prices for 2024 and 2025 upwards.

Considering the recent outlook for food prices, we raised our assumption for food prices by around 1 point for 2024.

Medium-term forecasts are based on an outlook in which both the tight monetary policy stance and the coordination of economic policies will be maintained until a significant improvement is achieved in the inflation outlook.

Accordingly, we revised the year-end inflation forecast for 2024 upwards by 2 points to 38 percent.

We kept forecasts for 2025 and 2026 unchanged at 14 percent and 9 percent, respectively. We target inflation to stabilize at the 5 percent in the medium term.

The lower and upper ends of the forecast ranges correspond to 34 percent and 42 percent for 2024, and 7 percent and 21 percent for 2025.

The termination of the regulation for free use of the first 25 cubic meters of natural gas will add 0.7 points to monthly inflation in May. What is more, due to the negative base effect, inflation will hit the peak in May. Thus, we will have come to the end of the transition period we frequently underline in our policy communication.

Our decisive stance in the monetary policy will bring down the underlying trend of monthly inflation through moderation in domestic demand, real appreciation in Turkish lira and improvement in inflation expectations. Thus, we will witness a disinflation period in the remainder of the year, marked by a steady fall in inflation.

This period will be shaped both by the favorable base effects and, more importantly, the sustained decline in the underlying trend of inflation.

We expect a decline in seasonally adjusted monthly inflation to around 2.5 percent on average in the third quarter, and slightly below 1.5 percent in the last quarter of the year.

As the tight monetary stance is maintained and the rigidity in services inflation weakens, the decline in the underlying trend of inflation will continue in 2025.

Revisions in our forecasts for 2024 mostly stem from macroeconomic developments in the first quarter of the year.

Compared to the previous Report, we expect the output gap to be higher in the first half of the year, due to resilient demand conditions.

The moderation in domestic demand will continue with the contribution of tight monetary policy and fiscal policy coordination.

Against this background, our revision to the output gap forecast increased our inflation forecast for 2024 by 0.4 points.

We calculate the total impact from our Turkish lira-denominated import prices, food inflation and administered price assumptions as -0.2 points.

The underlying trend has been higher than our projections recently.

Tight monetary policy stance and policy coordination will partially compensate for this deterioration in initial conditions. Thus, we expect that the impact of the underlying trend of inflation on year-end inflation will be limited to 1.8 points.

We will decisively maintain our tight monetary policy stance until price stability is achieved.

We will focus on two pillars during this period:

First, a significant and sustained decline in the underlying trend of monthly inflation. As part of this, we are closely monitoring indicators of the underlying trend, domestic demand, imports, and financial conditions.

Second, the convergence of inflation expectations to the projected forecast range. Accordingly, we are keeping track of a wide range of inflation expectation indicators.

As a result of the steps we took in March, financial conditions have tightened significantly. We observe their impact on loans.

We project this to weaken demand, have a positive impact on pricing behavior, and strengthen the disinflation process in the period ahead. The contribution of fiscal policies and the coordinated setting of administered prices will support the disinflation process.

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.

We will tighten our monetary policy stance if a significant and persistent deterioration in inflation is foreseen.

Esteemed Participants,

Before concluding my remarks, I would like to emphasize that price stability is a prerequisite for sustainable growth and improvement in the social welfare.

The most important contribution of central banks to these factors is the achievement of price stability. With this in mind, as the CBRT, have taken important steps. We will decisively pursue our tight monetary policy stance until we achieve sustained price stability.

As we begin the process of disinflation in June, we will continue to do whatever is necessary to bring inflation down in line with our intermediate targets.

As I conclude my remarks, I would like to thank all of my colleagues who have contributed to the writing of the Report and the organization of the press conference, primarily the members of the Monetary Policy Committee and the staff of the Research and Monetary Policy Department.

We can now move onto the Question and Answer session and our Deputy Governors will also be happy to answer your questions.