Fatih Karahan: Recent economic and financial developments in Turkey

Speech by Dr Fatih Karahan, Governor of the Central Bank of the Republic of Türkiye, at the briefing on the Inflation Report 2024-III, Ankara, 8 August 2024.

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Distinguished Members of the Press, Esteemed Participants,

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

As you know, the disinflation process has started as we had envisaged. Macroeconomic indicators are in line with this process.

As a result of our tight monetary policy stance, the slowdown in credit growth has recently become more evident.

Domestic demand has been declining since the second quarter. We envisage that the rebalancing in demand will continue and further strengthen. Thanks to this rebalancing, current account deficit continues to decline.

The only factor that has not changed since the previous Report is our decisive monetary policy stance. In the upcoming period, we will maintain this stance and act in a way to make sure that disinflation continues.

In the following parts of my speech, I will give you detailed information about these topics.

I will start my presentation by sharing our assessment regarding the macroeconomic outlook and our monetary policy stance. Later on, I will present you our medium-term projections. After my presentation, our Deputy Governors and I will be answering your questions.

Our Inflation Reports include boxes on the prominent issues on the agenda as well as thematic analyses.

In this Report, we discussed topics such as sterilization tools, determinants of inflation expectations as well as relation of credits with exports and inflation expectations. I would like to draw your attention to these boxes.

Esteemed Guests,

I would like to start my speech with the recent key global economic developments.

The limited recovery in global growth continues, led by the services sector.

Growth forecasts have been revised slightly upwards in the Euro area and downwards in the Middle East and Africa. Thus, Türkiye's foreign demand outlook remained flat compared to the previous reporting period. A more pronounced recovery is expected in 2025.

The global growth outlook, geopolitical risks and supply-side factors continue to affect commodity prices.

While non-energy commodity prices have been moderate recently, oil prices remained volatile.

The decline in global headline and core inflation continues.

The normalization trend in the labor market continues, while persistence in services inflation is weakening.

In line with inflation outlook, some advanced economies have started to cut policy rates. Faster cutting cycles are being priced across advanced economies, particularly in the USA. In emerging economies, however, rate cuts have continued at a slower pace.

The moderate growth and inflation outlook suggest that central banks may ease monetary tightness in the period ahead as well.

However, central banks continue to communicate that they will maintain the necessary monetary tightness until permanent disinflation is established and that they will continue to cut rates cautiously.

Macroeconomic Outlook

Esteemed Guests,

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

Data for the first quarter of 2024 indicate that the annual contribution of domestic demand to economic activity declined, albeit still remaining high.

In this period, net exports made a positive contribution to growth on an annual basis, for the first time since the third quarter of 2022.

Thus, the composition of growth became more balanced.

Data for the second quarter suggests a slowdown in domestic demand. Retail and trade sales volume indices imply a quarterly decline.

The decline in retail sales volume is more significant in expenditure items such as electrical appliances and furniture, which are sensitive to funding conditions.

The fact that there were two religious holidays and bridge days in the second quarter makes it difficult to get a clear idea regarding the extent of the slowdown in demand. Nevertheless, leading indicators for the third quarter suggest that normalization in domestic demand continues.

Manufacturing firms' expectations for domestic orders continued to decline on a quarterly basis as of July.

Similarly, findings from our interviews with firms also confirm that normalization in domestic demand continues.

The level of card spending is high, yet it has remained relatively flat in the recent period.

We looked into this normalization in more detail by dividing expenditure items into discretionary and non-discretionary spending.

We observe that non-discretionary spending such as food, clothing and meals remained flat. On the other hand, recently, discretionary spending such as jewelry, electronics and car rental has decreased.

Monetary tightening has been effective particularly on discretionary spending.

In fact, the decline in white goods and automobile sales supports our assessment.

Turning to supply conditions, industrial production decreased in the second quarter, based on the May data.

On the other hand, the decline in production was less pronounced when bridge days and highly-volatile sectors were excluded.

Survey-based indicators, such as the capacity utilization rate and the PMI, confirm the loss of momentum in the industrial sector.

The services production index also saw a limited decline on a quarterly basis as of May.

A broad look at the indicators reveals that the decline in production is not as deep as implied by the industrial production index.

Nevertheless, the decline is in line with the deceleration in demand.

Accordingly, we assess domestic demand to have slowed down in the second quarter, albeit still remaining at an inflationary level.

Indicators based on alternative methods reveal that the output gap narrowed in the second quarter. We expect the narrowing to continue in the third quarter as well.

Here, I would like to emphasize that the rebalancing of domestic demand will continue as a result of our tight monetary policy. The output gap, which will fall to negative levels over the remainder of the year, will be an important component of the disinflation process.

We see that the foreign trade balance continues to improve in line with the rebalancing in domestic demand.

As a result, we estimate that the ratio of the current account deficit to GDP fell below 2.5 percent in the second quarter. As of July, we expect the annualized current account deficit to continue its downtrend and fall to around USD 20 billion.

As we previously communicated, the current account balance improves during monetary tightening periods.

In the upcoming period, we expect the improvement in the current account balance to continue, in line with our tight monetary stance.

Distinguished Participants,

In this section of the presentation, I would like to share our assessments of inflation.

The annual inflation, which peaked in May, has dropped in the subsequent two months.

Thus, consumer inflation stood at 61.8 percent in July, falling within the forecast range projected in the previous Inflation Report.

In addition to annual inflation, we also closely monitor monthly inflation developments.

The recent trends in various indicators suggest that the underlying inflation continues to weaken. The underlying inflation, which was 2.9 percent on average in the last six months, declined to 2.6 percent in the past three months and to 2.4 percent in the past two months.

The slowdown in the underlying trend of inflation is in line with our projections.

In the second quarter, price increases slowed down in all subgroups of the B index, with the weakening in core goods in the lead.

In July, the underlying inflation edged up compared to June. However, we need to emphasize that, the slowdown in the underlying trend continues, compared to April and May.

Now, I would like to briefly focus on July.

Consumer inflation increased temporarily in July due to factors such as administered prices and tax adjustments, which are relatively beyond the control of monetary policy. We estimate the impact of these factors on monthly consumer inflation to be 1.4 points.

On the other hand, the rise in core indicators, mainly core goods, was less pronounced in this period.

Despite the recent weakening in services inflation, we see that the price increases in this group are stronger than those in core goods.

The widespread time-dependent and backward-looking price setting behavior across the services sector leads services sector inflation to weaken with a delay.

On the right panel, we see that inertia is higher in services than in goods. Among the services subgroups, rent inflation stands out with its high inertia.

In fact, annual rent inflation still stands out among the main consumer price groups with its course at high levels. On the other hand, as seen in the chart on the right, leading indicators have been on a downtrend for a while.

Both online listings and our indicators based on valuation reports for housing loans, as shown by the red and dark blue lines in the chart on the right, have been on a downtrend for a long time.

The rent increase rates of the new and renewed contracts obtained from the Retail Payment System data are below the current rent inflation in the CPI. This implies a decline in annual rent inflation in the coming period.

As you know, core goods inflation slows down in a faster and more visible way during disinflation periods.

The main drivers of this phenomenon are the stabilization of exchange rates and the moderation in demand during monetary tightening periods.

Due to these factors, the core goods group, particularly durable goods, posted limited price increases in this period as well. We have even started seeing declining prices in some durable goods items.

As shown in the charts, the annualized underlying inflation in the last three-month period is at 20 percent in core goods, while the weakening is more pronounced at below 10 percent in durable goods.

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

Due also to the recent inflation outlook, the expectation curve has shifted downwards in the reporting period.

Currently, the year-end inflation expectation of market participants is slightly above the upper end of the forecast range shared in the previous report.

On the other hand, the improvement in the 12-month-ahead inflation expectations continues as the distribution has shifted leftward.

In June, we also started publishing firms' and households' inflation expectations that we compile from various surveys.

Expectations of market participants are important in terms of pricing in financial markets. Likewise, firms form their price-setting, wage-setting, inventory management, and investment strategies in line with their inflation expectations. On the other hand, consumer expectations play an important role in their consumption, saving, and portfolio decisions.

An analysis of inflation expectations reveals that the expectations of firms and especially consumers are higher than those of market participants. This is the case even in periods of low inflation.

As for the dynamics shaping inflation expectations, while headline inflation is an influential factor for all three groups, firms stand out as the most sensitive group. Expectations of consumers are highly sensitive to frequently consumed food and fuel products. For further information on this topic, you can refer to the relevant box in our Report.

We envisage that the expectations of all sectors will decline in tandem with the fall in headline inflation.

With our tight monetary policy stance, we are committed to ensure that expectations are formed so as to contribute to the disinflation process.

Monetary Policy

Distinguished Participants,

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

As you know, we started the tightening cycle in June 2023, and raised the policy rate from 8.5 percent to 50 percent as of March 2024.

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.

I would like to mention some of the important macroprudential measures we have taken since the previous Inflation Report:

In May, we sterilized excess liquidity by increasing the Turkish lira reserve requirement ratios.

We introduced monthly growth limit for FX loans, and increased the tightness in financial conditions.

We changed the KKM renewal and conversion targets and lowered the minimum interest rate, thereby accelerating the decline in KKM balances.

To support sound pricing in credit market, we revised the maximum early payment fees for commercial loans.

We are sterilizing temporal excess liquidity via reserve requirements and our existing toolset.

We continue to sterilize excess liquidity particularly through Turkish lira deposit buying auctions. We also draw excess liquidity via overnight transactions at the Borsa Istanbul Repo Markets and the Interbank Money Market.

In addition, we started holding FX and gold swap auctions against the Turkish lira as well as deposit buying auctions with different maturities twice within the same day. In the upcoming period, we will start to conduct transactions at other money markets as well, and continue to sterilize excess liquidity. For detailed information, you can see the relevant box in our Report.

We closely monitor and assess liquidity conditions by considering prospective developments. We will continue to effectively implement sterilization by expanding our toolset whenever needed.

As for financial conditions, compound interest rates for commercial loans and deposits are priced at around 60 percent, while consumer loans are priced at around 70 percent.

Deposit rates are determined by the policy rate, market liquidity, and macroprudential policies as well as inflation and exchange rate expectations.

As a result of our policies, inflation and exchange rate expectations have improved significantly in recent months. We believe that this improvement has played a decisive role in recent deposit rate movements.

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

It is critical that consumer loans grow at a pace that will support the rebalancing in domestic demand.

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

Macroprudential measures taken in this regard and our tight monetary policy stance have weakened consumer loan growth since the second quarter.

The more stringent monthly growth limits we introduced in March had a significant impact on Turkish lira commercial loan growth.

In July, Turkish lira commercial loan growth was even below the monthly limits.

This slowdown is in line with the improvement in inflation expectations.

Our analysis, which you can find in detail in the related box in our Report, indicates that the fall in firms' inflation expectations reduces the demand for Turkish lira loans.

Improving inflation expectations lead to an increase in real credit costs and a decline in firms' loan appetite. Consequently, firms borrow in smaller amounts of loans at lower cost.

The box also reveals that firms' demand for FX loans increased in line with improving inflation expectations.

In July, we further reduced the monthly growth limit for FX loans that we introduced in May to contain the expansionary effect of increased demand for these loans and the exchange rate risk of the real sector.

These measures resulted in a slowdown in FX loan growth and a decline in total commercial loan growth.

Recent developments in loan growth confirm that financial conditions are tight enough to support the disinflation process.

The tight monetary stance that we have decisively pursued has increased interest in Turkish lira assets.

While the share of Turkish lira deposits has increased since March, exceeding our year-end target of 50 percent, the share of FX-protected deposits declined to 11 percent.

When money market funds are treated as deposits, we calculate an even higher share for the Turkish lira.

We expect that the share of Turkish lira deposits will continue to grow on the back of the steps taken regarding the targets and minimum interest rate for FX-protected accounts.

Our current policy stance also contributed to the improvement in risk perception towards Türkiye and the fall in the risk premium.

The decisions taken in March reinforced our tight monetary policy stance, boosted confidence in our policies, and improved the reserve outlook.

Moreover, rating upgrades by credit rating agencies supported the external financing outlook. Despite being volatile due to geopolitical developments, the risk premium maintained its moderate course.

Although the risk premium outlook seemed supportive for portfolio flows to Türkiye, portfolio outflows were observed in June.

Capital flows stabilized in July and have recently been on a mild track.

Since the previous reporting period, portfolio inflows have mainly concentrated in the GDDS market, while there have also been inflows through the offshore swaps.

Capital inflows might be volatile in the upcoming period due to geopolitical developments.

The additional monetary tightening we delivered in March boosted residents' and non-residents' confidence in Turkish lira and had a favorable impact on reserves.

As of July 31, we reduced the CBRT's outstanding swap balance with local banks to zero. Subsequently, we initiated sell-side swap transactions for sterilization purposes.

While gross reserves increased by USD 26.5 billion between 22 March and 2 August 2024, our net FX position improved by USD 93.1 billion.

As of 2 August, gross reserves exceeded USD 150 billion. Our net reserves excluding swaps rose to USD 28.6 billion, including sell-side FX swaps.

Medium-Term Projections

Distinguished Participants,

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

We updated our assumptions regarding external demand slightly for 2024 and 2025.

Due to the realizations, we revised our assumptions for crude oil prices downwards for 2024, and broadly preserved them for 2025.

We kept our assumption for food prices intact.

Our medium-term forecasts are based on an outlook in which the tight monetary policy stance will be maintained until a significant and sustained improvement is achieved in the inflation outlook. In addition, our forecasts are based on the assumption that there will be a continuation of economic policy co-ordination.

Accordingly, we kept the year-end inflation forecasts for 2024, 2025 and 2026 unchanged. We project that inflation will fall to 38 percent at the end of 2024.

We kept our 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.

As we approach the year end, the forecast range corresponding to 2024 should have narrowed down mechanically. However, given the mounting uncertainties amid recent geopolitical developments and global financial volatility, we kept the forecast range between 34 percent and 42 percent.

When we look at the sources of inflation for the 2024 year-end, we see that the downward and upward effects offset each other.

The rebalancing in demand conditions and the slower than anticipated decline in inflation expectations had an upward impact on our forecast by 0.2 points, each.

Meanwhile, we calculate the total impact from our Turkish lira-denominated import prices and administered price assumptions as -0.4 points.

As annual inflation had peaked in May, we entered the disinflation period we frequently underlined in our policy communication.

Inflation will decline significantly in the third quarter owing also to the favorable base effect from the last year.

Our decisive monetary policy stance will support the downtrend in the monthly underlying inflation amid the rebalancing in domestic demand, the real appreciation in the Turkish lira and the improvement in inflation expectations.

By maintaining the cautious stance in monetary policy, we envisage that the inflation will decline steadily in the rest of the year. Also, we expect that the tightening in financial conditions will lead the rebalancing in demand conditions to be more apparent in the upcoming period.

We project that seasonally adjusted average monthly inflation will fall to approximately 2.5 percent in the third quarter, and slightly below 1.5 percent in the last quarter.

As the tight monetary policy is maintained and the stickiness in services inflation weakens, the underlying trend of inflation will decline further in 2025. Moreover, the coordination of monetary and fiscal policies will contribute to this disinflation process.

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

As we have previously stated, 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.

We consider that there is still some progress to be made in both criteria. Therefore, we will maintain the tight monetary policy stance.

Esteemed Participants,

I would like to once more emphasize that price stability is a prerequisite for sustainable growth and improvement in the social welfare.

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, the Chief Advisors 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.