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-IV, Ankara, 8 November 2024.

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Distinguished Members of the Press, Esteemed Participants

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

Our disinflation process continues. Macroeconomic indicators are also in line with this process.

We assess that domestic demand continued to decline and reached levels that support disinflation. In accordance with this slowdown, the current account deficit continues to decline.

The underlying inflation has been improving, albeit at a slower pace than we had projected.

We will maintain our decisive monetary stance to ensure 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 assessments regarding the global economy, macroeconomic outlook and our monetary policy stance. Later on, I will present our medium-term projections. After my presentation, our Deputy Governors and I will be answering your questions.

Our Inflation Report once again includes boxes on thematic analyses of prominent issues on the agenda.

The boxes in this report include topics on the effects of Fed rate cuts, fiscal policy within the context of Medium-Term Program, underlying inflation, consumers' inflation expectations, findings from interviews with firms, and loans. 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.

In line with the previous reporting period, we maintained our projections for a gradual recovery in the global growth outlook. However, we evaluate that downside risks have become more pronounced.

The divergence between manufacturing and services sectors observed in the previous reporting period also persists.

Leading indicators suggest that downside risks have increased slightly, particularly in the manufacturing industry.

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

While there have been widespread increases in non-energy commodity prices recently, geopolitical developments have particularly increased volatility in energy prices.

Depending on the inflation outlook, central banks of advanced economies have begun to cut rates. The Fed made its first rate cut in September.

In emerging economies, new central banks have joined the rate cutting process.

Moderate global growth and inflation outlook suggest that central banks may continue to ease monetary tightness in the upcoming period.

Meanwhile, inflationary inertia persists, yet it has weakened. Therefore, central banks continue to communicate that they will maintain necessary monetary tightness and adopt a cautious approach in rate cuts.

Moreover, central banks of some countries such as Brazil and Russia have increased policy rates in response to their country-specific inflation outlook.

Macroeconomic Outlook

Esteemed guests,

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

In the second quarter of the year, the contribution of domestic demand to annual growth decreased significantly, while net exports continued to make a positive contribution to growth.

In this period, domestic demand contributed 1.2 points to growth, while net exports' contribution was 1.3 points.

Thus, demand composition in growth displayed a more balanced outlook.

Current data for the third quarter reveal that the mild course of domestic demand continues.

In this period, retail sales and trade sales volume indices increased slightly compared to the previous quarter.

However, looking at the retail sales volume index in more detail, the increase is milder when gold is excluded.

In addition to these indicators, field observations from interviews with firms also confirm the slowdown in domestic demand.

Current supply indicators for the third quarter were consistent with the slowdown in domestic demand.

Although industrial production decreased in this period, the fall in production was more limited when highly volatile sectors are excluded.

The services production index displayed a stronger outlook than industrial production, yet posted a limited quarterly decline according to July-August data.

In the third quarter, the moderate loss of momentum in production indicators is in general consistent with the demand developments I have summarized.

Against this background, domestic demand conditions have approached levels that support the decline in inflation.

Indicators constructed with alternative methods reveal that the output gap declined in the third quarter. We assess that this decline continues in the last quarter of the year as well.

At this point, I would like to emphasize that the rebalancing in domestic demand will continue as a result of our tight monetary policy. The output gap, which will fall to negative levels in the upcoming period, will be an important component of the disinflation process.

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

Accordingly, the ratio of the current account deficit to GDP dropped to 1.7 percent in the second quarter. We estimate that the cumulative current account deficit will continue to decline in the third quarter.

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 part of my presentation, I would like to share our assessments of inflation.

Consumer inflation decreased to 48.6 percent in October, significantly down from the peak level in May.

Except for October, global commodity prices remained on a downward trajectory and supported the disinflation process. The nominal exchange rate followed a mild course after the rise in August.

As I have said before, demand also continued to lose pace, and came close to levels supportive of disinflation.

Moreover, inflation expectations continued to improve gradually.

As we always emphasize, we closely monitor the underlying inflation.

We evaluated our underlying inflation indicators in terms of unbiasedness, volatility and forecast performance. You can review the related box in our Report.

Our analyses reveal that the performance of indicators varies according to different criteria. This fact underlines the importance of using different indicators to monitor the underlying inflation.

When we examine the indicators that we monitor within the CBRT as a whole, we see that the underlying inflation continued to decelerate in October.

Core goods inflation remains low, driving the deceleration in the underlying inflation.

The slowdown in services inflation, on the other hand, lags behind our projections. We see a gradual improvement here, which is more pronounced in items excluding rent. Meanwhile, we witnessed a moderate course in certain services items sensitive to demand in October, which we believe to continue.

On the other hand, in groups other than the core ones, the rise in energy prices strengthened in the third quarter. This was led mainly by the price developments in administered energy items coupled with the lump sum tax revisions.

On the food front, the improving outlook in the third quarter was interrupted in October due to unprocessed food prices. In this period, we witnessed an upsurge in prices of fresh fruits and vegetables, which are relatively beyond the domain of monetary policy. On the other hand, food inflation excluding fresh fruits and vegetables remained lower.

Focusing on services inflation, the high course, led by rents and education groups with strong time-dependent price setting and backward-indexation behavior, persisted in the third quarter.

In the third quarter, services inflation was mostly shaped by opening of schools. Education services increased at a high rate due to university tuition fees. School bus fares and student residence fees raised prices of transport services and accommodation services, respectively. As the back-to-school period ended, the relative price adjustment in these groups was mostly completed.

We evaluate that it is more reliable to assess the dynamics of services prices in rent and non-rent terms.

Having also a structural dimension, rents need to be handled separately due to factors such as earthquakes, urban renewal (demolishing-rebuilding) and limitations on rent increases.

In fact, the high price increase in rents continued in the previous quarter as the contract renewal rate increased. As you can follow from the right panel, the rent increase rates obtained from both the Retail Payment System data and housing valuation reports remain below the CPI annual rent inflation and are receding.

The decline in the reference rates in contract renewals suggests that monthly rent inflation will lose pace in the last quarter. We recommend you to read the box on this subject.

The inertia in rent inflation is higher than we projected, yet we see that the deceleration in services excluding rent is more pronounced.

In the industrial sector, pricing behavior of firms exhibit a clear improvement.

The analysis of domestic sales price expectations in the manufacturing industry reveals that among firms expecting an increase in either domestic demand or unit costs, the ratio of those planning to increase prices has been declining steadily.

The ratio of those planning to increase prices among firms not-expecting an increase in unit costs is also decreasing.

In fact, the average monthly producer inflation hovers around 1.4 percent in the last three-month period. Therefore, producer-driven pressures on consumer inflation are weakening.

This course in producer inflation affects goods prices in CPI favorably. You can see on the left panel that price increases lost pace considerably. Despite a relative increase due to the depreciation in the Turkish lira in August, core goods inflation remains low overall.

The annualized underlying inflation in the last three-month period hovers around 20 percent in core goods.

The moderate outlook is maintained particularly in prices of durable goods.

The diffusion of price increases is as crucial as their size for the course of price-setting behavior.

Demand conditions affect not only the size but also the diffusion of price increases. In fact, there is a significant positive relationship between the output gap and the diffusion index.

Consumer price increases are less broad-based during downturns when the output gap takes negative values.

The diffusion index has declined in the current period with the normalization in demand conditions.

Analyses suggest that as the output gap continues to narrow, the diffusion of price increases may even weaken further in the period ahead.

The course of inflation expectations is important for the pace of disinflation.

A leftward shift in the distribution of market participants' 12-month-ahead inflation expectations indicates an improvement in expectations. Moreover, the distribution is unimodal, suggesting an increased level of consensus among expectations. However, the pace of improvement in expectations is not yet at the desired level. The convergence of inflation expectations to our forecast range is critical for the cost of disinflation.

The right panel shows that real sector and household inflation expectations continue to improve. We recommend you to read the box on consumer inflation expectations.

All sectors gradually lower their expectations in tandem with the fall in headline inflation. With our tight monetary policy stance, we are committed to ensuring 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 have kept the policy rate, which we raised to 50 percent in March, unchanged for seven months.

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.

The macroprudential measures that support our tight monetary stance can be summarized under three main categories:

First, we have regulations on deposits. In this regard, we have taken measures to increase the share of Turkish lira deposits and to gradually reduce KKM. We revised these regulations in August and September, taking into account conjunctural developments.

Second, we have regulations on loans. We have prevented fluctuations in loan demand by introducing monthly growth limits for Turkish lira and FX loans. We have also revised the maximum early payment fees for commercial loans in order to support sound pricing in the credit market.

Third, we have taken steps on liquidity management.

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

In addition to Turkish Lira Deposit Buying Auctions, we sterilize excess liquidity through gold and FX swap auctions against the Turkish lira.

We closely monitor liquidity conditions, by considering prospective developments. We will continue to utilize our toolset effectively.

As for financial conditions, compound interest rates for commercial loans are priced at around 56 percent, consumer loans at around 66 percent, and deposits at around 59 percent.

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

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

The continued improvement in expectations aligns credit pricing with our disinflation path.

As inflation expectations improve, we observed a decline in long-term Turkish lira financing costs.

We expect this trend to continue in the period ahead as expectations further improve.

It is crucial that consumer loans follow a pace that will restore the rebalancing in domestic demand.

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

With the macroprudential measures we have taken and our tight monetary policy stance, consumer loan growth has weakened and is on a more moderate path.

As for the commercial loans, Turkish lira loan growth is in line with monthly growth limits and loan demand.

On the other hand, the monthly growth limit for foreign currency loans introduced in May, was reduced in July.

As a result of these limits, the growth path of foreign currency loans aligns with targets.

We see that the interest and confidence in Turkish lira assets have increased due to our decisively implemented tight monetary policy stance and the measures to reduce the KKM balance.

The share of Turkish lira deposits has reached 56 percent. The share of KKM fell below 8 percent.

In August 2023, the total value of KKM accounts surpassed USD 140 billion. The current balance decreased to USD 37 billion.

While the transition rate from maturing KKM accounts to Turkish lira was around 10 percent at the start of the year, it is recently over 25 percent.

The decline in the KKM balance strengthens the monetary transmission mechanism and reduces the risks on the central bank's balance sheet by increasing the share of Turkish lira deposits.

We expect that a gradual and steady increase in the share of Turkish lira deposits will continue to be a key component of our disinflation path.

On the other hand, although capital inflows have slowed recently due to the decline in risk appetite in global markets, we see that capital flows to Türkiye have followed a moderate course.

In the coming period, capital inflows may be volatile due to geopolitical developments.

The increasing confidence in the Turkish lira among both domestic and foreign residents in the recent period continues to positively impact on our reserves.

In August, we initiated reverse swap transactions for sterilization. While gross reserves increased by USD 36 billion between March 22 and November 1, 2024, our net FX position excluding swaps improved by USD 110 billion.

As of November 1, gross reserves exceeded USD 159 billion. Our net reserves excluding swaps rose to USD 46 billion, when we add sell-side FX swaps conducted in domestic markets.

Our tight monetary policy stance has contributed to the improvement in risk sentiment towards Türkiye and the decline in the risk premium.

As a result of the confidence in our policies, the level and composition of reserves improved significantly.

Although the risk premium followed a volatile course due to geopolitical developments, it maintained its moderate course.

Moreover, rating upgrades by credit rating agencies supported the external financing outlook.

Medium-Term Projections

Distinguished Participants,

Against the backdrop of the economic outlook I have presented so far, I will now proceed to share our medium-term projections.

We preserved our assumptions on external demand.

We revised down our crude oil assumption for 2024 and 2025 due to realizations.

Meanwhile, we revised our food price assumption upwards owing to the unprocessed food inflation.

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. Our forecasts are also based on the assumption that economic policy co-ordination will continue progressively.

In this context, we revised our year-end inflation forecasts for 2024 and 2025 upwards to 44 percent and 21 percent, respectively.

We predict that inflation will decline to 12 percent at end-2026. We target inflation to stabilize at 5 percent in the medium term.

The lower and upper ends of the forecast range correspond to 42 and 46 percent for 2024, 16 and 26 percent for 2025, and finally 6 and 18 percent for 2026.

The recent high food prices had a 1.6 points-effect on the revision of our end-2024 forecast.

The total effect of Turkish lira-denominated import prices and demand conditions on our forecast revision is half a point.

The slower-than-anticipated decline in expectations, initial conditions and underlying inflation pushed our end-2024 forecast by 3.9 points.

In the revision of end-2025 forecast, we calculate the total effect of our assumptions on food prices, Turkish lira-denominated import prices and administered prices as 3.3 points.

In addition, due to the revision of our 2024 forecast through inflation inertia and underlying inflation, our end-2025 forecast went up by 3.5 points.

Finally, the revision of the output gap path had a 0.2 points-effect on the end-2025 forecast.

Our decisive monetary policy stance will support the downtrend in the monthly underlying inflation through moderation 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 period ahead. Also, demand conditions, along with tight financial conditions, will continue to support the decline in inflation.

As the stickiness in services inflation weakens, the underlying trend of inflation will decline further in 2025. Moreover, the increased 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 underlined, 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.

Distinguished Participants,

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

In the disinflation process, we will continue to do whatever it takes 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. Our Deputy Governors will also be happy to answer your questions.