TÜRKİYE CUMHURİYET MERKEZ BANKASI

Speech

Central Bank of the Republic of Türkiye

Hafize Gaye Erkan, Ph.D., Central Bank Governor

Briefing on Inflation Report 2023-IV

2 November 2023

Ankara

Distinguished Members of the Press, Esteemed Participants,

Welcome to the last Inflation Report Briefing of 2023. I would like to extend my respect and greetings to our esteemed guests, who joined our meeting today and the audience, who follows us on screen.

I would like to take this opportunity to share with you our joy and pride in celebrating the centennial of our Republic. As we enter the second century of our Republic – the symbol of our national struggle and the spirit of independence, every one of us has important duties to carry our country further. Our duty at the Central Bank of the Republic of Türkiye is to establish the disinflation course as soon as possible and bring inflation down to single digits again, in line with our price stability objective. We carry on working with perseverance and determination. I would like to commemorate Ghazi Mustafa Kemal Atatürk, the founder of our Republic, and all our heroes who devotedly fought for our country.

We, at the Central Bank, are aware that we will make the greatest contribution to social welfare by achieving price stability.

Therefore, we are decisively fighting with inflation via the strong monetary tightening that we initiated in June.

Being aware of the fact that it will be a long and challenging process to rein in the persistently high and volatile inflation, we will decisively use all the tools at our disposal until a significant improvement in the inflation outlook is achieved.

Our policy affects financial conditions such as interest rates, loans, deposits, foreign exchange markets, domestic and external financing, and reserves very strongly and in the targeted direction. The widescale effects of monetary tightening on the economy extend over time. However, we are already receiving some preliminary signals regarding the rebalancing process in domestic demand. The cumulative effects of monetary policy will kick in during the transition period we are in, and we aim to enter the disinflation process in the second half of 2024.

In this context, we deem the Inflation Report and this meeting a very important opportunity and platform to share with you our monetary policy as well as our insights regarding inflation.

In my speech, I will first share with you the developments regarding the global economy and inflation, our monetary policy strategy, and the effects of our decisions on financial markets. Afterwards, I will present our medium-term inflation forecasts and our evaluations concerning the upcoming period.

Looking at global growth, economic activity remains weak in the last quarter of 2023. Growth rates in our export partners, which had gradually declined last year, continued to decrease in 2023.

The global manufacturing industry PMI has remained below the threshold level of 50 since the previous reporting period. In the services sector, which became the driving force of global growth with an acceleration in the first half of 2023, the PMI declined from its peak of 56 and approached the threshold level.

This general outlook prevails in both advanced and emerging economies.

The manufacturing PMI in the euro zone, our major trading partner, remained significantly below the threshold value in October, standing at 43. This indicates a decline in the zone's economic activity.

In addition, due to its significant weight in the world trade, China's weakening growth dampens global demand through both direct and indirect production linkages. The PMI data for China in September and October also indicates a weakening.

In line with the global growth outlook, the non-energy commodity index has weakened, while energy prices have diverged also due to geopolitical developments.

Oil prices stand as the most important driver of the rise in energy prices. Having exceeded 95 dollars with an increase of more than 30 percent over the last three months, oil prices remain highly volatile around 90 dollars.

As we have also detailed in our Inflation Report, oil price forecasts of international institutions and organizations also indicate a significant uncertainty.

Global inflation has significantly declined from its high levels in the first half of 2022. However, the decline in core inflation has been more resistant than headline inflation in advanced economies.

On the other hand, the picture in emerging economies is more diverse. Countries that started the monetary tightening process earlier and have been relatively less affected by global commodity shocks have made progress in the fight against inflation, while inflation in other countries has remained significantly above the targets.

Monetary tightening continues in advanced economies with above-target inflation.

Central banks of advanced economies have underlined in their communication that they will have “a tighter stance for a longer period” due to the persistence of the labor market and core inflation. Accordingly, global financial conditions have tightened.

Monetary tightness is also maintained in emerging economies. Monetary policy decisions of central banks vary depending on expectations regarding inflation, exchange rates and global financial flows.

Against this backdrop, there have been portfolio outflows from emerging economies in recent months due to the rise in US government bond yields and the negative impact of geopolitical developments on risk sentiment.

To sum up, the weakening global economic activity, the increased volatility in oil prices, the expectation that monetary policies will remain restrictive for a longer period, and the capital outflows pose risks to the inflation outlook in Türkiye as well. I will elaborate on the forecast uncertainty caused by these risks in more detail later in my speech.

However, despite all these negative shocks, I would like to note the balanced course of financing conditions in Türkiye as a favorable development.

Esteemed Guests,

After our evaluations regarding the global economy, now I would like to share with you our assessments of the inflation developments in Türkiye.

We had shared in our policy texts and the July Inflation Report that we projected a significant increase in headline inflation and the underlying trend of inflation in the short term.

In fact, consumer inflation rose to 61.5 percent as of September, increasing by 23.3 points compared to June.

An analysis of the contributions of sub-items indicates that the services, core goods and food groups were the leading drivers of this increase with 7.9, 5.3 and 4.8 points of contribution, respectively.

The main reason for the increase in inflation between June and September was simultaneous large shocks.

Looking at the determinants of inflation from this perspective, fuel prices, which increased by 90 percent between May and September, stand out with a contribution of 4.8 points.

During the same period, the approximately 40 percent increase in the currency basket has added 4.3 points to inflation through the cost channel.

In addition, supportive measures were taken as of July in order to counterbalance the earthquake-driven financial needs and increased public expenditures. Various adjustments in administered prices and taxes, VAT and lump-sum SCT in particular, took place in a short period of time. These tax adjustments have had an impact of 2.5 points.

The combination of these historically larger shocks also led to further deterioration in expectations and pricing behavior. The 10.1 points of strong impact through this channel played a significant role in inflation in this period.

The September inflation, the high-frequency data in October, and all the leading indicators suggest that the pass-through of these shocks to inflation has been completed to a large extent.

Now, I would like to present you our evaluations regarding domestic demand, services prices, and inflation expectations that play an important role in inflation.

The structure and balancing of demand is the main factor that drives the rise in inflation and plays a critical role in establishing disinflation through monetary tightening.

Accordingly, demand remains robust, but some indicators point that the excess demand is gradually fading out. For instance, domestic sales reveal that automobile and white goods sales remained above their historical averages in the third quarter, but decelerated on a quarterly basis.

Similarly, according to the Business Tendency Survey data for October, despite the course above historical averages, firms' registered domestic orders decelerated recently. This outlook is even more evident in the durable goods group.

The joint analysis of the domestic demand and production outlook suggests that aggregate demand conditions are still inflationary despite the loss of momentum.

In fact, as of August, the industrial production index increased by around 3 percent on an annual basis, while the rise in the retail sales volume hovered above 17 percent year-on-year, despite a monthly decline.

Based on the indicators we monitor, our forecasts suggest that the output gap, which peaked in the second quarter, still resides in the positive territory in the third quarter, albeit narrowing amid monetary tightening.

The balancing of consumption demand is supported by the increased demand for Turkish lira savings instruments with the monetary tightening process. The selective credit tightening that we implemented in this process also takes into account the alignment of supply and demand balances. We envisage that this gradual balancing will continue as the cumulative effects of monetary tightening kick in.

On the other hand, in the first half of the year, being fed by the insufficient return of Turkish lira-denominated fixed-income instruments in a high inflation environment, strong consumption demand had an impact both on the current account balance and also on inflation dynamics through the current account balance.

As of August, the current account deficit increased by 23.5 billion dollars in 12-month cumulative terms compared to 2022 and reached 57 billion dollars in 2023.

This increase was led by the nearly 28 billion dollars of rise in the foreign trade deficit. Exports remained relatively flat in this period, while imports increased by 31.1 billion dollars.

As of August, the 1.6 times increase in annualized imports of consumer goods and 3.3 times increase in gold imports compared to 2022 stand out. This was driven by the motivation to hedge inflation.

On the other hand, the near-term trend based on seasonally adjusted data indicates that the foreign trade deficit decreased by 2.7 billion dollars to 5.8 billion dollars in September due to the decrease in imports. Gold and consumer goods imports, which decreased by a total of 1.5 billion dollars, became the main driver of the decline in imports.

Elimination of excessive demand and an increased demand for Turkish lira savings instruments will have a dampening effect on inflation both directly and indirectly through the current account balance.

The rigidity in services inflation, which grew stronger through sub-items such as education, rent, health, restaurants and hotels, as a result of years of high inflation, remains as a significant component of inflation.

In fact, with a high potential to post hikes due to various factors such as exchange rates and commodity prices, core goods inflation falls immediately after the removal of these factors. However, services inflation, which increases gradually, takes time to slow down.

Rents are notable in terms of the recently increased rigidity in services inflation. Impacted by multiple sources such as high inflation, demand for housing for saving purposes and supply problems, the upsurge in rents continues.

However, there are signs of a slowdown in price increases in rental ads, mainly in metropolitan areas.

On the other hand, it will take some time for the projected slowdown in new house prices and rent increases to spill over into inflation.

This is due to the high inertia in services inflation. The prevalence of time-dependent price updating behavior in services causes price increases to spread over a longer period of time.

Breaking of the inflation inertia, chiefly in services, depends on the re-anchoring of expectations.

However, the recent higher-than-expected increases in monthly inflation have had a negative impact on expectations. In fact, as shown in the left panel, 12-month-ahead inflation expectations in the Survey of Market Participants rose by 12 points from July to October. However, the deterioration in inflation expectations lost pace on a monthly basis.

The convergence of inflation expectations also got somewhat stronger after July. Meanwhile, near-end inflation expectations for 2024 are around 40 percent.

On the other hand, as you know, we made a comprehensive revision in our participant list in October to enhance the representativeness of the survey.

Analyzing a fixed panel of October data adjusted for the effect of this revision, we see a decline in 12-month, 24-month and five-year ahead expectations.

Expectations are shaped not only by past inflation developments but also by forward-looking factors based on the Central Bank's forecasts.

Therefore, the decisiveness and consistency in monetary policy and the communication policy we have developed accordingly aims to increase the weight of the Central Bank's forecasts in the formation of expectations, and to re-anchor expectations in turn.

Following our assessments regarding the determinants of inflation, I will now talk about our views on the underlying inflation.

To understand the underlying trend of inflation, we closely monitor monthly inflation as well as various indicators that better reflect the monetary policy domain and enable the decomposition of situation- and product-specific shocks.

To this end, we jointly utilize the B and C indices, which are core indicators based on exclusion methods, and also statistical methods like SATRIM and median inflation.

Monthly inflation in the seasonally adjusted B index fell below 5 percent in September from 9.7 percent in August.

Likewise, monthly inflation in the C index dropped to 5.5 percent in September from 9.1 percent in August.

Accordingly, we consider that cost-side shocks that I have previously mentioned have spilled over into inflation to a large extent with a higher-than-normal pass-through.

Leading indicators for October also suggest that the decline in monthly inflation will continue.

We are determined to establish disinflation in 2024 by weakening the underlying trend of inflation further through the cumulative effects of our monetary tightening steps.

Monetary Policy

Distinguished Participants,

Now, I would like to elaborate on the monetary policy strategy we are implementing in line with this objective.

As we also stated in the previous Report, we designed the monetary tightening process in a holistic manner.

We have increased our policy rate from 8.5 percent to 35 percent. With the decisions taken at the Monetary Policy Committee meetings between June and October, we implemented a strong policy hike by 26.5 points in total.

In this process, we also introduced quantitative tightening and selective credit policies to complement the rate hikes.

Regarding the details of quantitative tightening in this context, we introduced reserve requirement ratios on FX-protected deposit accounts, and set these ratios at 15 percent initially.

Subsequently, we raised the required reserve ratios to 25 percent for FX-protected deposits, and lowered these ratios to 5 percent for accounts with longer maturities.

Thus, a total of 700 billion TL worth of quantitative tightening has been made through sterilization.

With our decision, which came into effect as of today, we increased the required reserve ratios by 5 points each, to 30 percent and 10 percent for the relevant maturities, respectively. In addition, we decided to impose an additional 4 percent required reserve for foreign currency deposits in Turkish lira. Thus, an additional 350 billion Turkish lira of liquidity will be withdrawn from the system, and the total sterilization will exceed 1 trillion Turkish lira.

In the context of selective credit tightening, we attach importance to maintaining the economy's production capacity on one hand, while contributing to rebalance demand on the other.

Accordingly, we lowered auto and commercial loan growth caps to curb excessive domestic demand.

At the same time, we raised credit card maximum interest rates in line with the policy rate hike.

On the other hand, there is no loan growth cap for commercial loans for export, investment and agriculture, and the interest rate cap has been kept lower.

Together with these steps, during the simplification of the macroprudential framework, while we lowered the interest rate threshold value for general-purpose loans to a single tier, we abolished thresholds for commercial loans.

Additionally, in line with the healthy credit growth and distribution in the recent period, we abolished the practices of securities maintenance and lending against expenditure for flow credits.

On the deposits-related regulations side, we took simplification steps to encourage the transition to Turkish lira deposits to increase the share of TL in total deposits.

In this process, exempting the switch from FX-protected deposits to TL deposits from the securities regulation, we subjected these deposits to commission regulation.

We consider that the steps we have taken in relation to TL deposits are critical for a stronger monetary transmission mechanism.

Distinguished Guests,

Although targeted effects of our monetary policy steps will become fully visible over a period of time, I will now present to you some of the promising preliminary results we have achieved so far.

The deposit rates increased in line with the policy rate, and the transmission of the policy rate to deposit rates has strengthened.

Simultaneously, the negative spread between commercial loan rates and deposit rates has ended, leading to a healthier balance in the banking sector.

In line with our selective credit policy, consumer loan rates remain well above commercial loan rates.

As a positive reflection of our monetary policy strategy, retail loans have significantly slowed compared to the previous reporting period.

As you may recall, in the first half of 2023, retail loans grew significantly above historical averages driven by credit cards and auto loans.

In response to our selective credit measures, retail loans grow in line with the new limits set in July.

As illustrated in the slide, the 4-week growth rates for retail loans declined to 2.1 percent in October from its peak of 7.4 percent in early April. The growth rate for auto loans decreased to 0.8 percent, while general-purpose loans remained relatively flat at around 1.4 percent.

Spending on personal credit cards, which are used both as consumption and borrowing instruments, is relatively high at 4.2 percent, but progressing towards a milder path.

The commercial loan flow shows continuity and contributes to production capacity.

Having accelerated in the first half of 2023, commercial loan growth came to a standstill at the end of May.

With the gradual and steady increase in the policy rate and the simplification of the macroprudential framework, we restored the market mechanism.

Thus, with the recovery of the Turkish lira-denominated credit flow to the real sector, commercial loans assumed a balanced and sustained growth path.

The improvement in the functionality of the credit market mechanism also became visible in the distinction between private and public banks. Private banks have started to play an active role in commercial loan growth.

Also noteworthy is the improvement in the composition of commercial loans thanks to our effective steps towards selective credit tightening.

In fact, investment and export loans recovered to increase by more than six-fold in the July-September period, after a standstill in the May-June period.

The CBRT-mediated rediscount and advance loans against investment commitment also increased in this period.

Thus, rediscount loans and advance loans against investment commitment, have contributed significantly to the commercial loan composition as targeted over the last three months.

Developments regarding deposits reveal the favorable effects of our decisions in late August that encouraged transition from FX-protected deposits to TL time deposits.

As a result of our decisions, the demand for Turkish lira savings instruments, particularly time deposits, increased. As of 20 October, TL deposits rose by 970 billion Turkish liras in only eight weeks, while FX-protected deposits declined by 300 billion Turkish liras and FX deposits by 3.9 billion dollars.

Consequently, the share of TL deposits in total deposits increased by around 5 percent. We expect the effects of the regulations that we have strengthened on deposit composition to become more apparent over time.

In the meantime, I would like to emphasize that our reserves continue to increase.

The CBRT's international reserves have been on a strong rise since June.

As of 20 October, gross international reserves were up by more than 28 billion dollars compared to the end of May, to over 126 billion dollars.

The increase of reserves against the decline in the FX-protected deposit balance indicates that our strategy of switching to deposits is on the right track.

policies that we have introduced recently also had a positive impact on financial markets.

The policy normalization incorporating tight monetary stance and macroprudential simplification had a significant impact on the CDS premium.

Having hovered around 700 basis points in May and declining to around 370 basis points, the 5-year CDS premium is currently below 400 basis points despite geopolitical uncertainties.

Another positive outcome of our policy stance is the decline in exchange rate volatility.

The exchange rate volatility implied by one-month US dollar/Turkish lira options fell sharply from around 60 points in May to almost 10 points.

Despite various unfavorable global developments I have mentioned at the beginning of my speech, financing conditions remain balanced. We aim to decisively implement our policies that we have developed with a holistic and sustainable approach and boost the positive effects on financing conditions.

Medium-Term Projections

Esteemed Participants,

After the economic outlook that I have summarized so far, I will now share with you our medium-term projections.

First of all, I would like to mention that in order to improve our forecast performance, we have updated our modeling framework to include the nonlinear effects of large shocks.

Accordingly, we revised the year-end forecast mid-points as 65 percent for 2023, 36 percent for 2024 and 14 percent for 2025.

We revised the lower and upper bounds of the forecast range as 62 percent and 68 percent for 2023, and 30 percent and 42 percent for 2024.

Here, I would like to emphasize two points. Firstly, we have widened the uncertainty band around our forecasts due to the increased geopolitical risks and uncertainties regarding administered prices.

Secondly, although we have revised our forecasts upwards, we estimate that the timing, pace and the course of disinflation will remain unchanged.

As for the details of our forecast path, after high increases in July and August, the monthly increases in consumer prices weakened in September. Leading indicators suggest that the slowdown in monthly inflation continued in October.

As we have stated in our monetary policy decision documents, we also expect a decline in the underlying trend of monthly inflation. Nevertheless, we expect that there will be temporary rises in the monthly inflation path in November, January and May owing to several factors that fall outside the scope of the monetary policy.

For example, we expect that households will exceed the free natural gas utilization limit once natural gas consumption increases in November. This will have an upward mechanical effect on inflation, causing a temporary rise in monthly inflation in November. As for January 2024, we expect the impact of minimum wage adjustments, the developments regarding services items with time-dependent price setting and automatic tax adjustments to kick in.

The peak of annual inflation will be recorded in May 2024 due to base effects stemming from natural gas prices. In the second half of 2024, we expect a strong and uninterrupted disinflationary process to begin as the cumulative effects of the monetary tightening will begin to take hold.

Now, I would like to mention the sources of revisions in our forecasts. 2.9 points of the 7-point upward revision in the inflation forecast for end-2023 is the reflection of the inflation that posted a higher-than-projected increase in the July Inflation Report. Meanwhile, 1.3 points resulted from the developments in food prices. The impact of developments in energy import prices, particularly oil, on the forecast revision is 2 points.

We have revised our forecasts for end-2024 by 3 points, 1.4 points of which stem from the higher-than-estimated inflation stated in the previous Report and 1.5 points from administered prices. Meanwhile, the output gap has had a downward impact on forecasts.

Distinguished Guests,

As we have stated in our previous policy documents, we are still going through the transition period before the disinflation and stabilization processes we have envisaged.

During this transition period, we are witnessing a temporary rise in inflation as we had transparently shared in the July Inflation Report.

In this process, we are carefully laying the groundwork for a sustainable disinflation process.

The impact of monetary policy on inflation is determined by various channels such as demand, expectations, asset prices, financial conditions and loans. Therefore, monetary transmission is achieved through effects that are spread over several quarters.

We will continue monetary tightening until significant improvement in inflation outlook is observed.

We will see the effects of our monetary tightening process in 2024, when disinflation will be established.

During the disinflation period, exchange rate stability, improvement in the current account balance, lasting increase in capital inflows and an increase in reserves will continue.

Disinflation period will be followed by the stability period in which predictability will increase, inflation will come down to single digits, and high-quality growth and disinflation will be achieved permanently.

I would like take this opportunity to re-iterate that we will decisively use all the tools at our disposal until inflation falls to single-digit levels and to our medium-term target.

Distinguished Guests,

As I conclude my remarks, I would like to thank you for your participation in our conference and your interest in our Report. I also would like to thank all my colleagues who took part in the preparation of the entire Report and the press conference, primarily the members of the Monetary Policy Committee and the staff of the Research and Monetary Policy Department.

Now, we can move on to Q&A session.