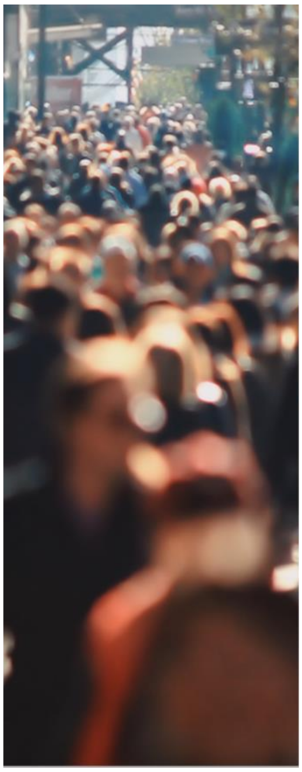


# INFLATION REPORT

## 2022-III

28 July 2022

TÜRKİYE CUMHURİYET MERKEZ BANKASI

# 1.Overview

***Economic activity remained strong in the first quarter of 2022.*** In the first quarter, Gross Domestic Product (GDP) increased by 7.3% year-on-year and 1.2% quarter-on-quarter. In terms of production, services and the industrial sector were the main drivers of annual growth in the first quarter. The construction sector continued to restrain growth. On the expenditures side, the main driver of annual growth was final domestic demand, led by private consumption. Meanwhile, final domestic demand made a negative contribution to quarterly growth. On the production side, all components except for agriculture and net tax revenues made a positive contribution to quarterly growth.

***The higher share of sustainable components in the composition of growth supports the rise in employment.*** The annual increase in machinery-equipment investments, one of the drivers of potential growth, has continued for ten quarters since the last quarter of 2019. Moreover, the contribution of other components that support the current account balance positively, such as net exports also increased. In the first quarter of 2022, machinery-equipment investments and net exports contributed to annual growth by 1.4 and 3.5 percentage points, respectively. Thus, the share of these components in GDP reached its highest level of the last decade. A stable growth with production, investment and export-oriented sustainable components also has positive implications for employment. The April-May average of the seasonally-adjusted total unemployment rate declined by 0.3 points quarter-on-quarter to 11.1%. While employment grew by 2.3% (approximately 696,000 people) quarter-on-quarter in the said period, the increase in the participation rate limited the decrease in the unemployment rate. Additionally, employment gains became widespread across sectors.

***The levels of capacity utilization, investment trends and other leading indicators indicate that the strong growth in the first quarter of 2022 continued in the second quarter with the support of external demand.*** The industrial production of sectors with higher export shares posted a strong growth. Adjusted for seasonal and calendar effects, the April-May average of the Industrial Production Index (IPI) was up by 0.5 points compared to the previous quarter. Industrial turnover indices also show that external demand continued to support industrial production. Increasing by 18.5% year-on-year, the retail sales volume index increased significantly compared to the previous quarter.

***Despite the sustained strong course in exports and the recovery in services revenues, the current account deficit increased amid rising energy and commodity prices.*** The escalating geopolitical risks were adversely realized in the first half of the year and caused a weakening in the global economic activity. Leading indicators signal a higher risk of recession for the global economy. The exports of Türkiye, on the other hand, remained resilient to the weakening global economic activity, and maintained its strong course in the second quarter of 2022 thanks to the increases in both price and quantity. Dynamic capacities and market diversification flexibility of exporting companies played a significant role in compensating for regional losses in exports stemming from the Russia-Ukraine conflict. Hence, regional exports exceeded their pre-conflict level. Meanwhile, as economic activity remained buoyant and international energy prices increased particularly in natural gas, imports also maintained its uptrend in the second quarter of 2022. The 12-month cumulative current account balance excluding gold and energy has continued to run a surplus, which is particularly important for the manifestation of the soaring energy prices on the current account balance. On the other hand, the positive contribution of the services balance to the current account balance continued to rise. Backed by travel and transportation revenues, services revenues have gained further momentum in the second quarter of the year.

***The rise in global inflation and increased concerns of a recession in advanced economies caused the global risk appetite to decline in the current reporting period.*** Lingering geopolitical risks and fluctuating commodity prices have weakened the expectations of a recovery in the global risk appetite. The volatility in long-term bond rates in advanced economies and the course of global financial conditions keep the risks to portfolio flows to emerging market economies (EMEs) alive, and cause outflows from bond markets in particular.

***Targeted use of credits to enhance investments and production capacity will contribute both to sustainable growth and the current account balance positively.*** Despite losing momentum, credit growth, and allocation of funds for real economic activity purposes are closely monitored. In the second quarter of the year, credit demand for TL-denominated loans in particular, surged due to soaring input costs and the firms' perceptions of uncertainty led by geopolitical conditions. During this period, reinforced macroprudential measures led normalization to start in credit growth as of the end of the quarter.

***Consumer inflation was 78.62% annually in the second quarter of 2022, and annual inflation increased across all sub-categories, with energy and food groups in the lead.*** Despite some weakening, adverse supply shocks led by the prospects for global energy, food and agricultural commodity prices amid geopolitical developments, pushed inflation further upwards in this period. The Russian-Ukrainian conflict imposed additional pressure on food prices chiefly through the cereal production-supply channel. The effect of aggregate demand conditions on inflation remained limited compared to other main determinants such as the exchange rate, global energy and commodity prices. Regarding core inflation indicators, monthly rates of increases lost pace, whereas annual increases continued.

***In the May- July period, the CBRT reinforced the macroprudential policy set by putting into practice the credit, collateral and liquidity policy actions, the review process of which was finalized.*** In the Monetary Policy Committee (MPC) meetings held between May and July, the CBRT stated that the rise in inflation was driven by: the rise in energy costs caused by geopolitical developments, price formations detached from economic fundamentals, supply-side factors such as increments in global energy, food and agricultural commodity prices. To support sustainable price and financial stability, the CBRT continues to take monetary policy measures decisively in line with the liraization strategy. In this framework, the policy rate was kept unchanged at 14% in the May-July period, the macro-prudential policy set was strengthened, and credit, collateral and liquidity policy steps, whose evaluation processes were completed, were put into practice (Box 1.1).

## 1.1 Monetary Policy Decisions

***In May meeting, the CBRT drew attention to the temporary effects of price formations that are not supported by economic fundamentals and decided to keep the policy rate unchanged.*** In the summary of the MPC meeting in May, it was stated that the increase in inflation was driven by rising energy costs resulting from geopolitical developments, temporary effects of price formations that are not supported by economic fundamentals and strong negative supply shocks caused by the rise in global energy, food and agricultural commodity prices. The Committee stated that disinflation process was expected to start once the ongoing regional conflict was resolved and base effects on inflation were eased. Moreover, it was announced that collateral and liquidity policy steps would be taken to encourage permanent liraization.

***In May, in the scope of the liraization strategy, the CBRT introduced an arrangement to increase the weight of TRY-denominated assets in the collateral system.*** In this context, the CBRT decided that at least 30% of the collateral blockage applied in currency swap transactions would consist of GDDS assets, moreover, the scope of the GDDS basket to be accepted as collateral was limited. In addition, the discount rates for indexed securities, FX-denominated and gold-backed assets were increased from 5% to 15% (Table 1.1).

***In its June meeting, the CBRT decided to keep the policy rate unchanged, preserving its prediction that the disinflationary process would start once the ongoing regional conflict was resolved and base effects on inflation were eased.*** The CBRT also stated that the collateral and liquidity policy actions, the review processes of which have been finalized, will continue to be implemented to strengthen the effectiveness of the monetary policy transmission mechanism. It was stated in the MPC decision that the CBRT closely monitored credit growth and allocation of funds for real economic activity purposes. CBRT will continue to implement the strengthened macroprudential policy set decisively and take additional measures when needed. (Table 1.1).

***In June, in the scope of the liraization strategy, the share of TRY-denominated securities in the collateral pool was increased, and it was stipulated that banks would maintain securities for FX liabilities and required reserves for TRY commercial loans.*** The minimum GDDS collateral blockage applied to all currency swap transactions with the CBRT and transactions at the Interbank Money Market was increased to 45%, while the discount rate applied to CPI-indexed securities accepted as collateral was increased to 30%. Moreover, to increase the effectiveness of the monetary policy, it was stipulated that banks will maintain additional Turkish lira long-term fixed-rate securities for FX deposits/participation funds. Meanwhile, the reserve requirement ratio for Turkish lira-denominated commercial cash loans except for some selected areas, which was announced as 10%, was increased to 20% (Table 1).

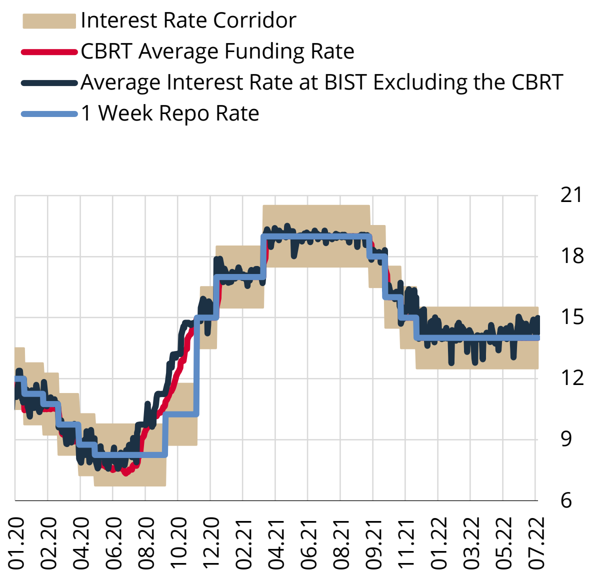
***The CBRT rearranged the rediscount credit conditions and increased the commission rates applied to FX reserve requirements and FX accounts with notice.*** The CBRT also rearranged maturities of rediscount credits. Accordingly, 40% of export proceeds, which were sold by exporters to the CBRT pursuant to the relevant legislation, started to be counted as Turkish lira rediscount credit commitment; moreover, it was stipulated that companies seeking to use TRY rediscount credits would be extended credits upon submission of a commitment to sell 30% of their export proceeds to commercial banks. Moreover, the commission rates applied to FX reserve requirements and FX notice deposit accounts were increased, and since the sector's weighted average legal person conversion rate significantly exceeded the target value of 20% set for 2 September 2022, the deadline for the target value of 20% for legal person conversion rate was scheduled earlier for 8 July 2022 instead of 2 September 2022 (Table 1.1).

***In July, the CBRT drew attention to the weakening global economic activity and likely recession risks.*** In the MPC decision for July, it was pointed to the divergence in monetary policy communication and decisions of central banks in advanced economies and increasing uncertainty in global financial markets. Moreover, it was stated in the MPC decision that the slowing credit growth and allocation of funds for real economic activity purposes were closely monitored; the credit, collateral and liquidity policy actions, of which the review processes were finalized, would continue to be implemented to strengthen the effectiveness of the monetary policy transmission mechanism, and the policy rate was kept unchanged.

***In July, additional steps were taken regarding the collateral system, and the scope of the KKM was extended.*** The GDDS collateral requirement in swap transactions with the CBRT and Interbank Money Market operations was raised, while the discount rates for CPI-indexed securities were increased to 50% from 30%. Additionally, resident legal entity was also allowed to convert their FX deposit accounts held at banks between 31 December 2021 and 30 June 2022 into the KKM.

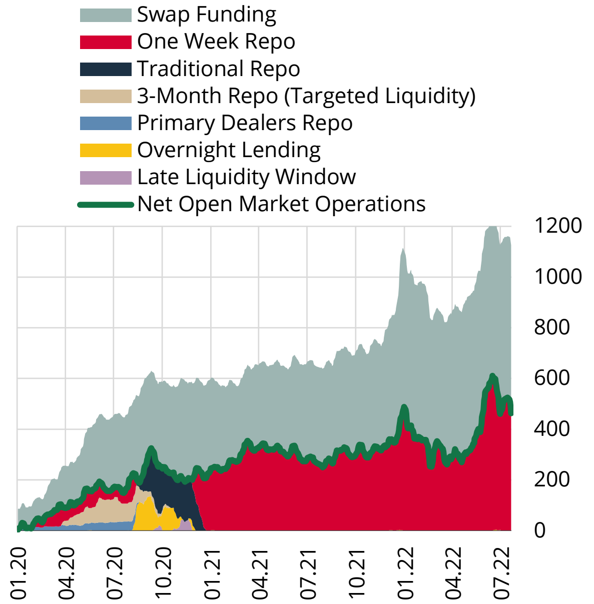
***In the current reporting period, the CBRT continued to provide funding within a simple operational framework through Open Market Operations (OMO) and swap transactions, and the overnight interest rates hovered around the CBRT policy rate.*** Owing to the CBRT's predictable liquidity management framework, Borsa Istanbul (BIST) overnight repo rates continued to hover around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TRY 607 billion as of 29 April 2022, increased to TRY 661 billion as of 22 July 2022. In the same period, the net OMO funding also rose to TRY 455 billion (Chart 1.1.2).

**Chart 1.1.1: CBRT Rates and Short-Term Interest Rates** (%)




Sources: BIST, CBRT.

**Chart 1.1.2: CBRT OMO and Swap Transactions** (One-Week Moving Average, TRY Billion)




Source: CBRT.

**Table 1.1: Monetary Policy Implementations**

| Date | Policy Decision |
|---|---|
| **11 May 2022** | ▪ The reserve requirement ratio for Turkish lira liabilities of financing companies was set at 0% until the calculation date of 13.05.2022 (included), while the reserve requirement ratio for their FX liabilities was set at 0% until the calculation date of 13.05.2022 (included) and at 3% until the calculation date of 23.12.2022 (included). |
| **16 May 2022** | ▪ As part of the steps to increase the weight of Turkish lira assets in the collateral system in the scope of the Monetary and Exchange Rate Policy for 2022 document and the Liraization Strategy, it was stipulated that effective from 27 May 2022,<br>• a minimum of 30% of the collateral blockage for all swap transactions with the CBRT should be composed of the GDDS basket,<br>• the GDDS basket should be composed of only TRY-denominated, zero-coupon, fixed-coupon, floating-rate and TLREF-indexed GDDS or lease certificates issued domestically by the Ministry of Treasury and Finance Asset Leasing Company.<br>▪ With an amendment to the Implementation Instructions for Turkish Lira Operations and the Implementation Instructions for FX Markets, the collateral discount rates were increased from 5% to 15% for indexed securities as well as FX-denominated and gold-backed assets subject to collateral. |
| **6 June 2022** | ▪ To increase the weight of Turkish lira assets in the collateral system in the scope of the Monetary and Exchange Rate Policy for 2022 document and the Liraization Strategy, effective from 24 June 2022,<br>• the minimum GDDS collateral blockage for all swap transactions with the CBRT and the GDDS collateral requirement for Interbank Money Market Operations were increased from 30% to 45%.<br>• With an amendment to the Implementation Instructions for Turkish Lira Operations and the Implementation Instructions for FX Markets, the collateral discount rates were increased from 15% to 30% for indexed securities as well as FX-denominated and gold-backed assets subject to collateral. |
| **10 June 2022** | ▪ It was decided that banks should maintain additional Turkish lira long-term fixed-rate securities for foreign currency deposits/participation funds.<br>▪ The reserve requirement ratio for Turkish lira-denominated commercial cash loans was increased from 10% to 20%.<br>▪ Of the domestic loans of financing companies that were subjected to reserve requirement for the first time, those available as of 23 April 2022 were excluded from reserve requirement liabilities until their maturities. |

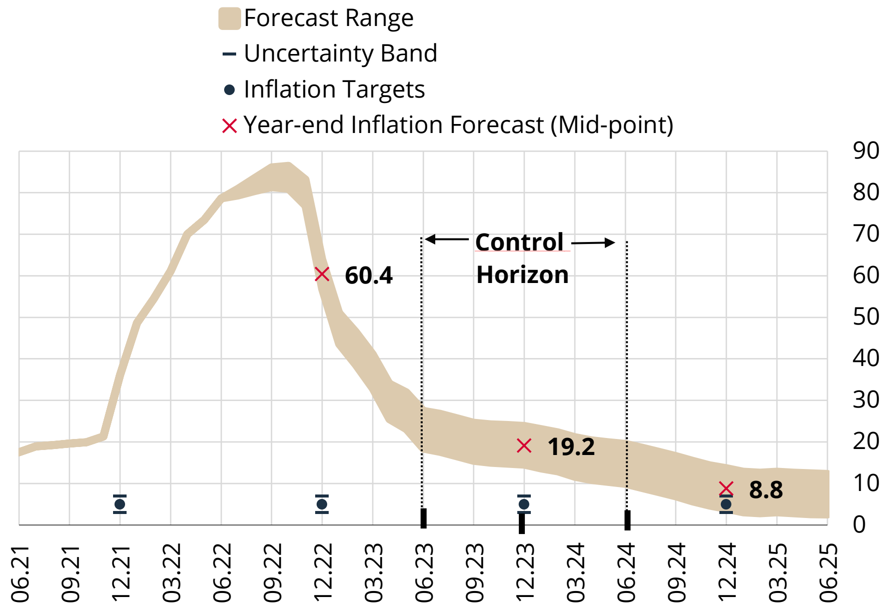
| | |
|---|---|
| **13 June 2022** | ▪ The Implementation Instructions for Rediscount Credits for Export and Foreign Exchange Earning Services were revised.<br>▪ Accordingly:<br>• The maximum maturity was set at 360 days for Turkish lira rediscount credits and 720 days for the defense industry,<br>• Interest rates for Turkish lira rediscount credits were set to be 300 basis points, 200 basis points, and 100 basis points below the policy rate for maturities of 0-90 days, 91-180 days, and 181-720 days, respectively,<br>• In addition to the existing condition for access to TRY rediscount credits (stipulating that 40% of export proceeds should be sold to the CBRT), firms should also make a commitment to sell at least 30% of their export proceeds to a bank,<br>• Firms using TRY rediscount credits should pledge not to buy the sold amount of foreign currency again for a month from the date of the first sale of export proceeds. |
| **30 June 2022** | ▪ The commission rate applied to reserve requirements that banks maintain at required reserve and FX notice deposit accounts for their FX deposit/participation fund liabilities was increased from 1.5% to 5%.<br>▪ The conditions for commission exemption were changed, whereby the deadline for the target value of 20% for the conversion by legal persons was revised from 2 September 2022 to 8 July 2022. Moreover, the practice of charging double the commission rate to the banks that could not achieve a 10% conversion rate for real and legal persons (separately for each) was abolished. |
| **4 July 2022** | ▪ Steps were taken to increase the weight of Turkish lira assets in the collateral system in the scope of the Monetary and Exchange Rate Policy for 2022 document and the Liraization Strategy.<br>▪ Accordingly, effective from 22 July 2022,<br>• the minimum GDDS collateral blockage for all swap transactions with the CBRT and the GDDS collateral requirement for Interbank Money Market Operations were increased from 45% to 50%.<br>• With an amendment to the Implementation Instructions for Turkish Lira Operations and the Implementation Instructions for FX Markets, the collateral discount rates were increased from 30% to 50% for indexed securities as well as FX-denominated and gold-backed assets subject to collateral. |
| **6 July 2022** | ▪ With an amendment to the CBRT's communiqué on supporting the conversion to TRY deposits, resident legal persons were allowed to convert their FX deposit accounts, which were held at banks at any date between 31 December 2021 and 30 June 2022, into TRY deposits. |

## 1.2 Medium-Term Projections

***In the second quarter of 2022, consumer inflation and the B index reached 78.62% and 64.42%, respectively, exceeding the forecast range of the April Inflation Report.*** The deviation in the B index inflation remained more limited. The deviation in forecasts was driven by strong negative supply shocks such as hikes in commodity prices led by geopolitical developments, persisting supply chain disruptions driven by the effects of pricing behaviors detached from economic fundamentals, and soaring domestic energy costs.

***The monetary policy stance will be determined with the focus on evaluating the sources of the risks to inflation, their permanence and to what extent they can be controlled by monetary policy, targeting sustainable price stability with a prudent approach.*** The disinflationary process is expected to start with the steps taken and resolutely implemented to achieve sustainable price stability and stronger financial stability as well as the re-establishment of the global peace environment. Accordingly, inflation is projected to be 60.4% at the end of 2022; fall to 19.2% at the end of 2023; and sustain the downward trend by receding to 8.8% by the end of 2024. With a 70% probability, inflation is expected to be between 56.9% and 63.9% (with a mid-point of 60.4%) at end-2022, and between 14.5% and 23.9% (with a mid-point of 19.2%) at end-2023, and between 3.9% and 13.7% (with a mid-point of 8.8%) at end-2024 (Chart 1.2.1).

**Chart 1.2.1: Inflation Forecasts* (%)**




Sources: CBRT, TURKSTAT.
* Shaded area denotes the 70% confidence interval for the forecast.

***Forecasts are based on an outlook entailing a weaker global economic activity, a sustained rise in global inflation, and tighter global financial conditions compared to the previous reporting period.*** Mounting uncertainties regarding global food security amid trade bans, the elevated course of commodity prices accompanied by persisting supply constraints in specific sectors, with staple food and energy in the lead, push producer and consumer prices upwards on an international scale. Inflation may remain on an upward track longer than expected due to higher energy prices and the supply-demand mismatch. The persisting acceleration in global inflation coupled with the escalated concerns over recession caused global risk appetite to decline in the current reporting period.

***Forecasts focus on an outlook where credits move in tandem with economic activity on the back of the reinforced macroprudential policy set, whose evaluation processes have been completed and have recently proved quite effective, and liquidity and collateral policy actions are based on liraization.*** The measures taken against accelerating commercial and consumer loans in the second quarter of the year were gradually increased, and a normalization trend appeared in loans. As loans remain aligned with economic activity and the output gap gradually closes as its narrowing trend continues, growth will be in line with the potential throughout the year. Moreover, the efficient use of loans in real economic activity is expected to prevent loans from putting pressure on asset prices and exchange rates.

## 1.3 Key Risks to Forecasts

***The outlook underlying the medium-term projections presented in the Inflation Report is based on the Monetary Policy Committee's judgments and assumptions.*** The major downside and upside macroeconomic risks that may lead to a change in baseline projections and the associated monetary policy stance are as follows.[1]

***In this current reporting period, the key risk factors on economic activity and inflation have been the supply shocks that started with the pandemic and grew amid the Russian-Ukrainian conflict.*** Causing a pickup in commodity prices as well as transportation costs, a slowdown in global trade, and a tightening in global financial conditions, supply shocks keep risks brisk, which are both upside and downside to inflation and downside to economic activity.

***Downside risks to foreign demand have increased compared to the previous reporting period, and they point out that regional divergences may become more evident.*** Uncertainties regarding global financial conditions weigh on the risk of stagflation. The Russian-Ukrainian conflict poses risks to travel and transportation revenues. Geopolitical risks, developments regarding the new variants, and new waves related to the pandemic, and the consequences of these developments on domestic and foreign demand are monitored closely.

***Upside risks to the current account balance are in place due to soaring energy prices amid the Russian-Ukrainian conflict.*** Despite the ongoing robust performance of exports and the recovery in services revenues, risks persist to soaring energy prices. Accordingly, pricing differentiations are observed according to the types of energy.

***Global inflation continues to rise sharply, while monetary policy steps and communications of major central banks exhibit a wider divergence due to the varying economic prospects among countries.*** Major central banks underline that inflation may remain on the rise for a longer-than-expected period due to higher energy prices and supply-demand mismatch. Central banks increased their efforts to develop new supportive measures and tools to cope with the increasing uncertainties in financial markets. The divergence and mounting uncertainties in financial markets lead to volatilities in exchange rates. The increased possibility of divergence in economic conditions and problems among advanced economies in the upcoming period pose additional risks to the global economic activity and uncertainties regarding financial conditions. This outlook results in downside risks to international prices and foreign demand.

***Credit growth and the allocation of financial funds for real economic activity purposes are essential for CBRT.*** The effects of the credit, collateral, and liquidity policy actions on the liraization of financial sector balance sheets and the reinforcement of the monetary transmission mechanism are monitored closely. The strengthened macroprudential policy toolkit is further expanded through additional measures when needed.

***Pressures on producer prices keep mounting.*** The supply shock posed by the Russian-Ukrainian conflict weighs on existing supply constraints and causes international commodity prices to follow a high course that varies among different products.

***Deterioration in pricing behaviors persists.*** Depending on the frequency of incoming shocks, the frequency of price updates is getting higher, and the average period for prices to remain unchanged is getting shorter. This outlook will be shaped depending on the effectiveness of the holistic policy mix to fight inflation, the frequency and the magnitude of the supply shocks, and their degree of diffusion to the economy. Despite the disinflationary content of implemented policies coupled with the increased coordination, ongoing effects of supply shocks on the economy increase upside risks.

## Key Risks to Inflation Forecasts and Possible Impact Channels

Macroeconomic risks may change the outlook on which the inflation forecasts are based, and the monetary stance is shared in detail in Section 1.3. Evaluations of the channels through which these risks may influence inflation forecasts presented in Section 1.2 and the direction in which they may change the forecasts are summarized in Table 1.3.1.

**Table 1.3.1: Key Risks**

**Cost Pressures**

- The supply shock caused by the Russia-Ukraine conflict aggravated the current supply constraints, causing international commodity prices to remain high. Historically high international food prices, soaring energy prices, and supply chain disruptions add to the pressures on producer prices. On the other hand, risks looming over global growth led to a decline in commodity prices, particularly for metals. The key role Türkiye plays in resuming grain shipments from war-hit Black Sea ports to global markets may affect the course of food prices. There remain both upside and downside risks to inflation and downside risks to economic activity due to supply shocks that cause commodity prices to surge, transportation costs to rise, global trade to slow and global financial conditions to tighten.

  **Tracked Indictors:** Geopolitical developments and the course of the Russia-Ukraine war, the course of global growth expectations, crude oil prices and supply-demand balance, OPEC+ decisions, industrial metal prices, agricultural commodity prices, supply-demand balance in agricultural products, indicators pertaining to the divergence between producer and consumer prices, global supply indicators, transport, and freight costs, climate change, drought indicators, indicators for international food prices, indicators for the domestic energy market, administered prices.

**Uncertainties Regarding Financial Markets and the Global Macroeconomic Outlook**

- Global inflation continues to rise sharply, while monetary policy actions and communications of major central banks diverge more markedly due to varying economic outlooks across countries. In this environment, uncertainties regarding global financial conditions raise the risk of stagflation. This poses an upside risk through financial conditions and a downside risk through international prices.
- Domestically, the growth rate of loans and the targeted use of accessed funds for real economic activity are important regarding the current account balance, asset prices, domestic/external demand balance, and healthier pricing in foreign exchange markets.

  **Tracked Indictors:** The course of demand and growth components, developments in loan and deposit rates, credit conditions (Bank Loans Tendency Surveys), financing of the balance of payments, portfolio flows to stock and bond markets, bond yields and monetary policy stances of advanced economies, risk premium indicators, foreign exchange markets, dollarization indicators, global inflation indicators and expectations, the course of global monetary policies, demand and supply indicators for FX-protected deposits.

**Geopolitical Risks, the Pandemic and Economic Activity**

- Geopolitical tensions and rising commodity prices, especially for energy, add to the downside risks to global and regional economic activity expectations for 2022. There are more downside risks to external demand than in the previous reporting period, indicating regional divergences may become more evident. Moreover, the Russia-Ukraine war poses risks to travel and transportation revenues. Meanwhile, geopolitical risks, new COVID variants and waves, and their effects on domestic and international demand conditions are closely monitored.
- There remain upside risks to the current account balance due to soaring energy prices amid the Russia-Ukraine conflict. Despite the ongoing robust performance of exports and the recovery in services revenues, risks persist to soaring energy prices. Accordingly, pricing differentiations are observed according to the types of energy.

  **Tracked Indictors:** Geopolitical developments, the course of the pandemic and vaccination in Türkiye and abroad, exports, imports and the current account balance, developments in tourism and transport, demand and inflation indicators by sectors and subsectors, wage and labor cost indices.

**Pricing Behavior and High Inflation Expectations**

- The deterioration in pricing continues. The frequency of price updates is getting higher, and the average period for prices to remain unchanged is getting shorter. This outlook will be shaped depending on the effectiveness of the holistic policy mix to fight inflation as well as the frequency and magnitude of the supply shocks and their visibility on the economy. The disinflationary content of implemented policies coupled with the increased coordination increase the downside risks on inflation while ongoing effects of supply shocks on the economy increase upside risks.

  **Tracked Indictors:** Survey and market-based expectations for inflation and exchange rates, indicators for backward indexation, indicators for inflation uncertainty, financial volatility indicators

**Monetary, Fiscal and Financial Coordination**

- The disinflation process may be delayed or accelerated depending on whether administered price and tax adjustments exceed or fall below the path envisaged in this Report.

  **Tracked Indictors:** Adjustments to administered prices and taxes, developments in tax revenues and public spending, government wage policies, indicators for government budget and public debt stock, fiscal stance (structural budget balance)

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