Turalay Kenç: The Turkish economic outlook and monetary policy – challenges and policy response

Remarks by Mr Turalay Kenç, Deputy Governor of the Central Bank of the Republic of Turkey, at the EU Ambassadors Meeting, Ankara, 28 January 2016.

* * *

I would like to start by thanking His Excellency Ambassador Cornelis van Rij for the opportunity to share with such distinguished audience some views about the Turkish economy, the challenges stemming from a very volatile external environment, and the policy approach that has been implemented to cope with these challenges. The Turkish economy has shown a relatively robust performance in the face of major external and internal shocks. GDP growth is estimated at around 4 percent in 2015 with an expected gradual strengthening of economic activity in 2016 and in 2017. The rise in GDP growth rate observed in 2015 is mostly attributed to strong private consumption. Private investment recorded a moderate recovery. The challenging external conditions especially geopolitical events in the region have adversely affected exports. However, the economic recovery in most EU member states enabled Turkey to largely compensate its loss in other exports markets as Turkey increased exports to the EU countries by more than 10 percent in euro terms in 2015. This outcome also highlights Turkish exporters' resiliency in adopting to adverse economic conditions.

Of course, probably the most significant development of the last year or so has been the sharp decline in oil prices. Turkey, being an energy importing country benefited from lower oil prices in many dimensions. The current account deficit fell from $52 billion in June 2014 to below $35 billion in November 2015 in 12 month rolling terms. This sharp improvement in the current account balances is also greatly helped by prudent macro-economic polices including monetary, macro-prudential and fiscal policies. Tight monetary policy, well-targeted macro-prudential measures and strong fiscal balances have all contributed to lower levels of domestic demand by stabilizing loan growth and reducing risk taking behavior.

Going forward, the current levels in oil prices and depressed producer prices in most part of the world due to weak economic activity are expected to lead to further improvements in external balances. Therefore, it is highly likely that Turkey will record a current account deficit of below 4 percent of its Gross Domestic Product in 2016, representing a major achievement in satisfying the norm of the European Union's Macroeconomic Imbalances Procedure.

Unlike these positive developments in the economy, inflation increased and its outlook worsened in 2015 reflecting the pass-through from the TL depreciation, elevated food inflation, and markedly increased minimum wages. These factors together with some deterioration in inflation expectations led the MPC to revise its inflation forecasts for 2016 and 2017 up to 7.5 percent and 6 percent respectively and postpone the projected realization year of the 5% target to 2018.

Going ahead, we see there are three potential developments which would improve the inflation outlook a great deal. First, the latest improvement in the external balances together with the already strong fiscal balances is likely to boost the effectiveness of the monetary policy. The ongoing tight monetary policy stance is then likely lead to lower inflation than otherwise. Second, in coming years the implementation of the structural reforms identified in the 10th Development Plan aims to address the structural causes of inflation and hence is expected to support disinflation process. Finally, the Food Committee (the Food and Agricultural Products Markets Monitoring and Evaluation Committee) was founded in December 2014 with an objective of identifying policies to alleviate the contribution of structural and cyclical factors to elevated food inflation.

Of course, the credibility of monetary policy is key to achieving price stability. Therefore, let me devote the final part of my talk to explaining our policy strategy to cope with current challenges.

Like most emerging market economies (EMEs) Turkey has also faced tightening external financial conditions since May 2013. The normalization of US monetary policy, diverging monetary policies of advanced economies, uncertainty in commodity prices and the risk of China's economic hard-landing all have created volatile global financial markets and widened spreads for EMEs. The Central Bank of Turkey has introduced several mutually complementary policies and announced a "road map" document back in August 2015 outlining monetary policy, foreign currency liquidity and financial stability related measures.

The aim of the CBRT's road map is to improve the resiliency of the economy to external shocks through (i) maturity lengthening – encouraging banks to shift their non-core liabilities from short-term to long-term; (ii) providing incentives to banks for borrowing and lending directly from and to the Central Bank on times when foreign players are reluctant to engage with banks in Turkey due to heightened volatility in global markets; (iii) bolstering safety-nets – making sure that the banking sector has access to adequate foreign exchange liquidity in times of market stress; (iv) supporting financial stability – providing incentives to banks to improve loan to deposit ratios; and (v) simplifying the monetary policy framework to improve the communication of the monetary policy stance. All but the interest rate corridor simplification step on the roadmap have already been taken and the focus is now firmly on fine-tuning their parameters.

Overall, these measures ease the policy tradeoffs posed by the excessive volatility in cross border flows, enabling the interest rate policy to concentrate on the primary objective of price stability. So far the financial market performance of Turkey suggests that the measures undertaken since August 2015 have helped Turkey outperform many peer EM countries. Of course, on the way, Turkey also enjoyed the benefits of lower oil prices relatively more than many EMEs and reduced political uncertainty after the general election result in November 2015.

The banking sector maintains its strong and sound position as banks in Turkey are well-capitalized with high quality and highly liquid assets and continue to offer solid rates of return on capital. As a result the banking sector still provides a reasonable loan growth for the economy despite heightened uncertainty in global markets.

To conclude given the ongoing challenging external conditions it will be essential to continue to implement a tight and flexible monetary policy in order to lower inflation in a volatile environment. Meanwhile, taking liquidity stabilizing measures for the foreign currency market and ensuring the stability of the financial system are key to alleviate policy tradeoffs. Last, but not the least, maintaining the fiscal discipline; and adhering strictly to the announced structural reform agenda in order to lift potential growth in accordance with the country's needs remains the key to stability.