ahap Kavcolu: Views on the role of central banks amid a pandemic

Speech by Mr ahap Kavcolu, Governor of the Central Bank of the Republic of Türkiye, at the Future of Finance Summit, Istanbul, 28 September 2021.

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Mr. Minister, Distinguished representatives of the finance sector, Distinguished members of the press, Dear Guests,

First, I would like to thank A Para Team for their kind invitation. Today, I will share our views on the Role of Central Banks amid a Pandemic.

I think it would be useful to break the issues that economic policy has focused on since the beginning of the pandemic into two periods. The first was a period in which economies came to a standstill with historically unprecedented shutdowns across the globe. In this period, central banks and other policy makers took many measures to prevent job losses and bankruptcies and to make sure financial markets continued to function. The second period is still ongoing with accelerated recovery amid faster vaccination in the face of global output failing to keep pace with increased demand and surging global inflation due to rising commodity prices.

In the first period when coronavirus spread around the world, the global economy suffered a much deeper downturn than the financial crisis of 2008. As the pandemic also caused a large-scale supply shock, the negative impact on economies was much bigger and more permanent than in 2008. The economic effects of the pandemic were felt worldwide and more deeply than the global financial crisis while policy responses were diverse and unprecedentedly strong.

Dear Guests,

In my speech, after a brief review of the global policy response to the pandemic, I will give information about the measures taken in Turkey and the pandemic-era outlook for the country. The period of normalization, which I will talk about later, is marked by the inflation outlook. In this period, central banks have undertaken the difficult task of controlling inflation without harming economic recovery after having suffered severe costs in terms of growth and employment. In the last part of my speech, I will touch on the risks that remain due to the latest state and course of the pandemic.

The rapid spread of the coronavirus around the world caused a significant slowdown in global trade and economic activity. Due to lockdown measures, unlike the 2008 crisis, we saw a more devastating supply shock, and thus, it is safe to say that COVID-19 has been economically more costly.

The rapid global spread of COVID-19 affected economies through various channels, causing a sharp contraction in global economic activity. The pandemic first hit the global supply chain and production. Then, mounting uncertainties, tighter financial conditions, household income losses and worsened cash flows of businesses caused demand to weaken substantially.

Lockdown measures around the world caused services activity to decline rapidly in March 2020. In the following period, the slowdown also spread to the manufacturing industry as global trade contracted. Both advanced and emerging economies saw a negative decoupling of the services sector due to pandemic measures. This trend appears to be in stark contrast to the 2008 crisis. As the services sector is a labor-intensive sector, the cost that the pandemic imposed on employment has been much higher than that of the financial crisis of 2008.

In this process, central banks all over the world took extraordinary expansionary policy measures such as interest rate cuts, asset purchases, liquidity steps and credit support programs. The experience of policy makers in unconventional monetary policy after the 2008 crisis and the expansion of the toolkit has made a positive contribution to the policy response to the pandemic.

Central banks of advanced and emerging economies used the existing policy space without hesitation and promptly, and cut policy rates as a first response to the crisis.

Central banks also reintroduced bond purchases that they had included in the post-crisis toolkit. It is noteworthy that emerging market central banks also resorted to bond purchases, unlike in the 2008 crisis.

Central banks have provided more funding through repo transactions and extended the maturity of funding to prevent liquidity squeeze in the money market and to facilitate access to liquidity. In this period, when economies came to a standstill, this intervention by central banks was appropriate and vital for the functioning of the financial system.

Globally, policy rates have been rapidly lowered and the average interest rate in both advanced and emerging economies has fallen below the levels in the 2008 crisis. The Central Bank of the Republic of Turkey was one of the central banks that cut their policy rate in the said period.

The rapid policy rate cuts on a global scale were accompanied by massive asset purchasing programs led by advanced economies and rapid balance sheet expansion. Meanwhile, the speed of asset purchases has outpaced the previous crisis.

The objective of the financial policies introduced to provide liquidity to the banking sector was to protect the fiscal structure of the financial sector and to ensure credit flow to the private sector. Many central banks provided additional liquidity to the banking system by lowering reserve requirements and easing capital and liquidity buffers. With the regulations introduced, existing loan payments of the real sector experiencing a halt in cash flows were postponed or restructured.

We can analyze the fiscal policy measures under some main headings such as new credit channels and government guarantees for loans, tax exemptions and reductions, and direct expenditures. Incentives of this kind are widely used in all major economies.

During the pandemic, countries supported their economies with direct public spending, other financial supports and incentives. In some countries, direct public expenditures were more widely used depending on the fiscal space, while in others, capital, credit and other liquidity supports were used. In advanced economies, public incentives exceeded 20% of their national income. For example, in the USA, the economic support provided via public spending and forgone revenues reached 25% of the national income. In countries such as Italy and Germany, supports in the form of capital, credit and other liquidity were employed in addition to the fiscal policy. Meanwhile, in emerging markets, economies were supported by various measures, although these measures were more limited compared to advanced economies.

With the rate cut decision we took at the Monetary Policy Committee Meeting on 17 March 2020, we announced our first set of measures geared towards countering the economic effects of the pandemic.

These measures aimed to;

1. enhance predictability by providing banks with flexibility in Turkish lira and foreign exchange liquidity management,
2. offer targeted additional liquidity facilities to banks to secure uninterrupted credit flow to the corporate sector,
3. boost cash flow of exporting firms through arrangements on rediscount credits, and
4. boost the liquidity of the Government Domestic Debt Securities (GDDS) market.

The uninterrupted and smooth functioning of financial markets, the credit channel and firms' cash flows was essential to contain the adverse effects of the coronavirus. The measures taken boosted the financial sector's liquidity and credit conditions, and the monetary transmission mechanism continued to function effectively.

In sum, we aimed to support financial stability and the post-pandemic recovery process by providing much-needed liquidity to the financial system and the real sector under appropriate conditions during the pandemic. Thus, we sought to minimize the long-term damage to production and employment that may be caused by temporary effects arising from the pandemic.

I think that a comparative analysis of some key macroeconomic variables may help us better evaluate Turkey's current performance.

Considered alongside OECD countries and China, Turkey has become one of the two economies that recorded positive growth in 2020. Data on the first half of 2021 showed that growth remained positive. The positive performance of vaccination in Europe has been reflecting on our economy through the tourism and external demand channels. In this context, net exports also continue to contribute positively to growth.

High-frequency data also signal a recovery in the labor market on the back of the reopening. While employment in the services sector was on a slower recovery track amid pandemic restrictions, the losses of the pandemic period have been fully compensated for with the recent surge in services employment. Besides, on the back of strong exports, industrial employment has been following a more positive course compared to other subcategories in the recent period.

All in all, we see that non-farm employment started to recover first with the help of the industrial sector, and reached pre-pandemic levels in early 2021 despite the limited contribution from the services sector. Finally, we can say that the labor market has largely overcome the effects of the pandemic on the back of the services sector and tourism.

Distinguished guests,

During the post-pandemic recovery, economic activity started to normalize at a global level. However, we see that a series of problems that may be largely attributed to the pandemic period have caused a rise particularly in producer prices in developed and developing countries, as is the case in Turkey. Therefore, central banks are closely monitoring the implications of high inflation for expectations and international markets in the current normalization period.

One of the key drivers of the increase in inflation was rising commodity prices. We witnessed sharp increases in both energy and non-energy commodity prices due to the recovering global demand.

Parallel to the rise in commodity prices, supply constraints caused by the failure of production to match the rapidly increasing demand also play a role in the rise in prices. Increasing international transportation costs and lengthened delivery times also drive producer prices up. We see that post-pandemic problems such as container shortages create a supply-demand mismatch, exerting upward pressure on prices. The fact that exchange rates and commodity prices, which used to explain producer inflation developments in Turkey to a large extent, have fallen short of explaining producer inflation in the recent period points to additional supply-side factors.

Recent surveys of the European region reveal that supply constraints are among the leading factors that restrain manufacturing, and their impact has increased significantly. These developments show us that pandemic-related conditions or their impacts have not disappeared yet. Central banks continue to emphasize these factors in their recent evaluations of inflation.

Thus, the gap between producer and consumer inflation has recently increased well above the long-term average in many advanced and emerging economies. For instance, PPI is four times the rate of CPI in the euro area.

In the price developments during the pandemic, we have seen that a limited group may have a significant contribution to inflation. For example, the durable goods group, which had decelerated on average in the US for the last 25 years, has been one of the items that had the largest contribution to the recent rise in inflation, due also to supply constraints.

In the reopening and economic normalization period, energy and services prices registered significant increases across the world. Global central banks think that energy and pandemic-driven high rates of price increases in some sectors will prove to be temporary with the normalization in demand composition, easing of supply constraints, and waning base effects. These factors will also have a downward effect on Turkey's inflation in the upcoming period.

Having touched on the current state of global inflation and how it has been affected by pandemic-driven conditions, I would now like to share with you our evaluations of inflation developments in Turkey. In August, annual inflation rose by 0.30 points to 19.25%. In this period, annual inflation of the B index, which is a core inflation indicator and obtained by excluding unprocessed food, energy, alcoholic beverages and tobacco from the CPI, decreased by 0.05 points to 18.46%, and that of the C index, which excludes processed food from the B index, declined by 0.46 points to 16.76%. In August, while annual inflation increased significantly in the food group, it posted a limited rise in services and receded across other main groups. Meanwhile, producer inflation continued to increase due to commodity prices, disruptions in supply chains, and demand conditions.

At this point, I would like to note a couple of points regarding pricing behavior. Recently, price increases in certain products have far exceeded their historical averages. Considering the products with the largest contributions to inflation, we see that the annual price increases in August may have been more than three to four times the average price increases in the last 10 years. While factors such as the pandemic-driven rise in commodity prices and supply constraints are some of the reasons for this development, as I mentioned earlier, these factors per se may fall short of explaining the price increases in some products. In particular, we see higher rates of price increases in sectors that were adversely affected by the pandemic and registered brisk demand after the pandemic. However, we assess that such pricing behavior will converge back to its pre-pandemic state in the upcoming period as the economic and social normalization gains pace.

We have witnessed a global trend of increasing food prices, which is yet to be normalized. Many food products surged in price during the exit from the pandemic. The persisting drought also has an adverse impact on production conditions and prices in this area.

On the other hand, weight of food items in the global consumption basket and domestic food inflation may differ between countries. Hence, this increase in food prices can affect inflation at different rates in different countries. A cross-country comparison reveals that Turkey is among the countries in which the prices are the most adversely affected. In the table, we see that food inflation in August was considerably higher than the average of the last three years.

Finally, I would like to talk about our foreign exchange reserves while evaluating our economy. The improvement in reserves is in line with our projections. Our reserves, which were USD 85-90 billion, increased by approximately USD 30 billion and exceeded USD 120 billion. Swap agreements, rediscount credits, gold ore purchases and arrangements in required reserves were the main factors contributing to this increase.

Before concluding my speech, I would like to talk about the Central Bank's views on the future of the normalization process.

Although significant progress has been made in the struggle with the pandemic, virus variants have caused case numbers to rise again, which adds to uncertainty over the course of the pandemic. As you can see on the slide, many countries are now facing a new wave of infection. It is clear that mortality rates do not increase in parallel to the surging number of cases in countries with relatively high vaccination rates. Accelerating the global vaccination program is also critical to economic normalization.

A second important factor for the future is that the post-pandemic economic recovery reveals a considerable variation among countries for reasons such as vaccination and policies implemented. This was also emphasized in the publications of many international institutions and central banks, and it contributes to the supply-demand mismatches and the rise in inflation I highlighted earlier. The relatively slow recovery in the services sector also delays the recovery in employment, which also increases the cost of the pandemic incurred by households. We can minimize all these negative consequences by remaining resolute in the struggle with the pandemic, abiding by the measures and continuing the vaccinations. Employing all policy tools through this process, central banks will continue to achieve price stability and support the post-pandemic normalization.

Like all central banks, we are closely monitoring the developments regarding the course of the pandemic and its impacts on the global economy.

As a result, it is apparent that central banks play an important role both in the past lockdown and the current normalization processes. The recent past revealed that central bank policies were quite effective in ensuring the uninterrupted functioning of the financial system, minimizing the pandemic-led damage suffered by both the banking and the corporate sectors, and capping the economic and social costs of the lockdowns.

To ensure that the normalization process continues properly, the Central Bank of the Republic of Turkey will take the necessary policy steps, as it has done so far.

Concluding my speech, I would like to thank you all for your participation.