

## **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 2025-I, Ankara, 7 February 2025.

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Distinguished Members of the Press, Esteemed Guests,

First, I would like to welcome you all. We mark the second anniversary of the earthquakes of February 6. We still feel the pain of our losses in our hearts. Before I begin my speech, I commemorate with mercy, our citizens who lost their lives in the earthquake disaster and the recent fire in Bolu Kartalkaya. With my heartfelt condolences, I wish strength to mourning families.

Today, we are here to share the main messages of the Inflation Report.

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

We think that domestic demand has reached levels supportive of disinflation and the underlying inflation is on a downward path.

We will maintain our tight monetary policy stance in a way to make sure 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 macroeconomic outlook and our monetary policy stance. Later on, I will present you our medium-term projections. Finally, our Deputy Governors and I will be answering your questions.

As usual, our Inflation Report includes boxes on prominent issues on the agenda as well as thematic analyses.

In this Report, we discuss topics such as price setting behavior, the relationship between producer and consumer prices in services, valuation effect on household assets and the foreign trade effects of changes in euro-dollar exchange rate.

Distinguished Guests,

I would like to start my speech with the recent key global economic developments.

We maintain our projection for a gradual recovery in global growth in line with the previous reporting period.

The divergence between the manufacturing industry and the services sector, observed in the previous reporting period, continues.

Leading indicators point to increased downside risks for the manufacturing industry.

The uncertainty regarding global trade policies has significantly increased in the recent period.

Increased protectionism in trade, uncertainties regarding global economic policies, and geopolitical risks amplify downside risks to global growth and upside risks to inflation.

The global demand outlook, geopolitical risks and supply-side factors remain determinant on commodity prices.

Global developments have recently increased the volatility in Brent oil prices.

Non-energy commodity prices, on the other hand, posted limited increases.

Central banks of advanced economies continue to cut interest rates in line with the inflation outlook.

Inflation remains persistent all over the globe, albeit at a subdued level.

Due to increased uncertainties regarding the inflation outlook as well as fiscal and trade policies, central banks are placing more emphasis on upside risks to inflation.

Against this background, market pricing also indicates slower rate cuts in 2025 in both advanced and emerging economies.

## **Macroeconomic Outlook**

Esteemed Guests,

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

Data for the third quarter of 2024 indicate that the contribution of domestic demand to annual growth was slightly negative at -0.1 points, while the positive contribution of net exports to growth increased to 2.2 points.

Thus, the composition of growth remained balanced.

Production indicators for the fourth quarter suggest a modest recovery in economic activity.

Having declined in the second and third quarters of 2024, industrial production started to rise again in the last quarter according to November data.

The services production index, on the other hand, registered a lower quarterly increase compared to industrial production.

As you know, this index is also directly related to demand in the services sector. The index signaled a flat course in demand for services throughout 2024.

Indicators for demand for goods also show that domestic demand remains moderate.

In this period, the retail volume index increased in quarterly terms.

However, the increase excluding gold was more limited.

Recent data point to a loss of pace in real spending by card.

Additionally, field observations from our interviews with firms also confirm the moderation in domestic demand.

Accordingly, data on demand for goods and services as a whole suggest that demand conditions are at disinflationary levels.

Indicators based on alternative methods and shown in light colors in the chart reveal that the output gap has remained in negative territory since the third quarter of 2024.

Here, I would like to emphasize that domestic demand will remain balanced in response to our tight monetary policy.

The output gap will hover at negative levels over the remainder of the year, and thus will remain an important component of the disinflation process.

The current account recorded a significant improvement in line with the rebalancing in domestic demand.

The ratio of the current account deficit to GDP dropped to 0.7 percent in the third quarter of 2024. We estimate the cumulative current account deficit to have remained at a similar level in the fourth quarter.

As noted in previous presentations, the current account balance improves during monetary tightening periods.

In the upcoming period, we expect the current account deficit to widen. However, it will be limited on the back of our tight monetary stance. We project that the current account deficit relative to GDP will remain below its historical average in 2025.

Distinguished Participants,

Now, I would like to share our assessments on the inflation outlook, shaped in the context of these macroeconomic developments.

The disinflation process that started in June is right on track.

Consumer inflation decreased to 42.1 percent in January, a significant decline from its peak level in May.

Since the previous reporting period, inflation developments have been in line with our projections.

The decline in the underlying inflation continued in the last quarter.

Underlying inflation indicators may differ occasionally from each other. This underscores the importance of monitoring underlying inflation using a variety of indicators.

All the indicators we monitor point to a gradual slowdown in the underlying inflation.

In this period, distribution-based indicators recorded lower values than exclusion-based indicators such as B and C.

In January, the underlying inflation rose in line with our projections.

This was mainly driven by services items with time-dependent price setting and backward indexation. In January, wages, energy prices, administered prices, and tax adjustments affected consumer inflation.

In January, the annualized underlying inflation rose to 34 percent from around 30 percent in December, and remained below annual inflation.

We project that the underlying inflation will decelerate again in the second quarter, following the first quarter's increase.

To better understand the January dynamics, we have categorized the CPI items into two groups: those with state- and time-dependent price setting.

"The time-dependent group" for which the price is set at specific periods of the year, such as in education services; differs from "the state-dependent group" for which the timing of the price setting is based on economic conditions.

In January, the time-dependent price setting group recorded higher price increases.

Furthermore, a closer look at this group reveals that the highest price increases are recorded in January due also to administered items. Price increases are weaker in the following periods.

For items with state-dependent price setting, the price increase rate is lower compared to the previous year. I suggest you to take a look at our Box on this subject.

In the last quarter of 2024, services inflation eased, and core goods inflation remained weak.

In January, core goods prices edged up by 0.7 percent. Annual core goods inflation has fallen to around 24 percent on the back of stable exchange rates, as well as commodity prices and demand conditions. Notably, durable goods prices maintain a positive outlook.

In January, services prices rose sharply by 10.3 percent, led by public and private healthcare services.

The official medical examination co-payment amount increased for the first time since 2017. The impact of this sharp increase on consumer inflation in January was 0.6 points. Moreover, this amendment will have carry-over effects on February inflation.

Despite the monthly surge, the services inflation maintains its downtrend on an annual basis. Meanwhile, items with a high backward-indexation tendency, such as education and rents, push services inflation up.

Given this, it is important to take a moment to discuss rent inflation.

After all, rent inflation differs from other services items in terms of both level and inertia due to factors including earthquakes, urban transformation, demographics, and limits on rent increases.

Despite its high level, we see that rent inflation is on a downward trend.

The Retail Payment System microdata also confirms this observation. Accordingly, the growth rates in new and renewed contracts are declining. Moreover, we see that these growth rates remain below the current annual rent inflation in CPI.

The periodical increase in monthly rent inflation in January, is due to the rise in the contract renewal rates. However, as can be seen in the chart on the right, the rate of increase in these contracts decreased also in January.

Producer prices-led pressure on consumer inflation, particularly on core goods, was moderate.

In this context, monthly producer inflation stood at 1.4 percent on average over the last three months, supporting disinflation in core goods.

As we have already underlined, the course of inflation expectations and price setting behavior is crucial for the pace of disinflation.

Inflation expectations continue to recede, albeit remaining above our disinflation path. Expectations across all sectors are steadily declining amid the fall in headline inflation.

We have recently observed a significant decline in the inflation expectations of consumers and firms. In fact, since March, inflation expectations of households and firms have dropped by more than 20 points and 10 points, respectively. Our decisive monetary policy stance will further improve expectations.

## **Monetary Policy**

Distinguished Participants,

In this part of my speech, I would like to talk about our monetary policy stance.

As you know, we kept the policy rate unchanged at 50 percent in the April-November period.

In December, we observed that the underlying trend of inflation declined further, and expectations and pricing behavior kept improving. Moreover, we concluded that domestic demand remained supportive of disinflation. In line with these assessments, we gradually lowered the policy rate from 50 percent to 45 percent while maintaining the necessary tightness.

We also narrowed the corridor between overnight borrowing and lending rates.

In addition, we support the effectiveness of monetary transmission via macroprudential measures and liquidity management, against the divergence in expectations of economic units and possible volatilities.

We can summarize the tools we use to support our tight monetary stance under three main categories:

With the regulations on deposits, we aim to increase the share of Turkish lira deposits and to gradually reduce FX-protected deposits (KKM).

With the regulations on loan growth, we prevent fluctuations in loan demand.

Third, we manage excess Turkish lira liquidity in the system by taking steps on liquidity.

We sterilize excess liquidity in the market through reserve requirements and our existing toolset.

In this regard, we also utilize Turkish Lira Deposit Buying Auctions and sell-side FX and gold swap auctions against the Turkish lira.

In addition, we started to open deposit buying auctions with 4-week maturity since January 24, aiming to extend the maturity of sterilization operations.

We closely monitor the liquidity conditions. We will continue to utilize our toolset effectively.

As for financial conditions, compound interest rates for deposits and commercial loans are priced at around 54 percent, and consumer loans at around 64 percent.

The five-point cut in the policy rate was reflected in deposit and loan pricing in line with our expectations.

Our monetary policy stance and macroprudential framework ensure that deposit rates remain at a level that supports the transition to the Turkish lira and boosts savings.

As for credit developments, following the mild course in October and November, consumer loan growth accelerated somewhat in December due to seasonal factors. This upturn was driven by credit cards and unsecured consumer loans.

The retail loan growth returned to its mild course in January.

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

For this reason, we will ensure that consumer loan growth remains on a moderate path.

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

On the other hand, we lowered the monthly growth limit on foreign currency loans to 1 percent in January, due to ongoing strong demand for these loans.

We expect that the growth path of foreign currency loans will align with targets.

Our tight monetary stance and the measures to reduce the FX-protected deposits balance have preserved interest and confidence in Turkish lira assets.

The share of Turkish lira deposits neared 60 percent, converging to its historical average, while that of FX-protected deposits receded to 5 percent.

In August 2023, the total value of FX-protected deposits accounts surpassed USD 140 billion. The current balance decreased to USD 29 billion.

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

Despite this significant decline, the transition rate from maturing FX-protected deposits to FX in the last 12 months stood at 12 percent.

Given the current level of FX-protected deposits, we plan to end this practice this year, giving priority to legal persons.

Recently, capital inflows have slowed down due to the decreasing risk appetite in global markets, yet, capital flows to Türkiye have been favorable.

In the upcoming period, capital inflows may display volatility depending on global developments.

Residents' and non-residents' increased confidence in the Turkish lira continues to be reflected positively on our reserves.

In August, we started to conduct sell-side swap transactions for sterilization purposes. Between March 22, 2024 and January 31, 2025 gross reserves increased by USD 42 billion, while our net FX position excluding swaps improved by USD 130 billion.

As of January 31, our gross reserves rose to USD 166 billion, while our net reserves excluding swaps rose to USD 65 billion, including our domestic Turkish lira currency swaps.

Our tight monetary policy stance continued to affect the risk perception towards Türkiye positively.

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

## **Medium Term Projections**

Distinguished Participants,

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

You can find the revisions to our main assumptions in the Report.

Our medium-term forecasts are based on an outlook in which the tight monetary policy stance will be maintained, until the decline in inflation is sustained and the price stability is achieved. We have also reflected in our forecasts that the coordination among economic policies will continue to increase.

Accordingly, we forecast inflation for end-2025 at 24 percent. We maintained our inflation forecast for end-2026 at 12 percent.

We target inflation to decrease to 8 percent in 2027 and stabilize at 5 percent in the medium term.

The lower and upper ends of the forecast range correspond to 19 percent and 29 percent for 2025, and 6 percent and 18 percent for 2026.

The forecast revision for 2025 was driven by factors that are relatively beyond the control of monetary policy.

As for the details of the revision, one of the leading factors was the increase in the weight of the services group in the CPI basket. This update pushed mechanically our previous forecast up by 0.8 points.

The 0.5 points of the 2.2-point forecast revision stem from the update in food inflation due to the unprocessed food.

A significant portion of the 1.7-point revision resulting from administered prices was driven by the increase in co-payment by patients' shares in medical examinations.

This revision is due to the factors that are relatively beyond the control of monetary policy. Thus, it does not signal any easing of the monetary policy stance.

Hence, we kept our 2026 forecast unchanged within a context where the probable secondary effects of the revision in our 2025 forecast through expectations will be offset by the tight monetary stance.



Our decisive monetary policy stance will continue to strengthen the disinflation process through moderation in domestic demand, the real appreciation of the Turkish lira and the improvement in inflation expectations.

By maintaining our cautious stance, we expect inflation to decline steadily in the upcoming period. In this process, tightness in financial conditions coupled with demand conditions will continue to support disinflation.

The decline in the underlying inflation will continue in 2025 as the stickiness in services inflation weakens and the improvement in inflation expectations become more pronounced. The coordination between monetary and fiscal policies will contribute to the disinflation process as well.

We will decisively maintain our tight monetary policy stance until decline in inflation is sustained and price stability is achieved.

We set the policy rate in a way to ensure the tightness required by the projected disinflation path. In this process, we take into account inflation realizations, underlying inflation and inflation expectations.

We make our policy decisions prudently on a meeting-by-meeting basis with a focus on the inflation outlook. Monetary policy tools will be used effectively in case a significant and persistent deterioration in inflation is foreseen.

Distinguished participants,

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

In the disinflation process, we will continue to do whatever it takes to bring inflation down in line with our intermediate targets.

Distinguished Participants,

As I conclude my remarks, I would like to thank all of my colleagues who have contributed to the writing of the Report, primarily the members of the Monetary Policy Committee, the Chief Advisors and the staff of the Research and Monetary Policy Department and everyone that have contributed to the press conference.

We can now move onto the Question and Answer session. Our Deputy Governors will also be happy to answer your questions.