Box 3.2

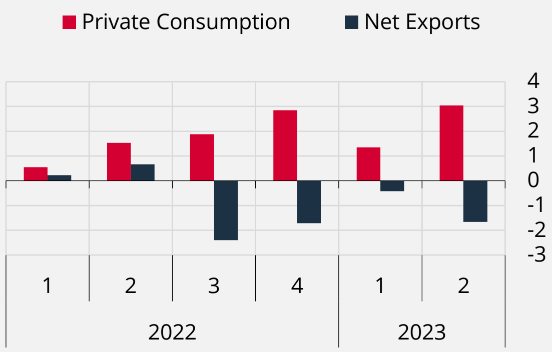
Balancing in Domestic Demand and Monetary Transmission Mechanism

The CBRT implements monetary tightening to achieve price stability through balancing in domestic demand, improving inflation expectations and increasing demand for TL-denominated assets. While monetary tightening encompasses policy rate hikes as well as quantitative and selective credit tightening policies, it is also supported by the simplification of the macroprudential framework and aims to reduce inflation permanently. A particular monetary transmission mechanism is envisaged for the tightening process to ensure disinflation, and policy steps are intended to strengthen this mechanism.

The monetary transmission mechanism includes the channels through which and to what extent the monetary stance determined by central banks affects inflation to achieve the price stability target. Monetary policy is conducted with the use of monetary policy instruments, chiefly the policy rate, and these instruments work through various channels such as domestic demand, exchange rates, financial markets, credits, company balance sheets, financial and real assets and expectations in the economy. The effects of these channels on inflation occur in different lags, and the period in which the effect is most pronounced may vary depending on the existing economic conditions. Therefore, examining monetary transmission channels is important to understand and monitor how the disinflation process, which is included in our medium-term forecasts, will occur. This Box will focus on the main transmission channels that will ensure the upcoming disinflation process, rather than providing a detailed explanation for the entire monetary transmission mechanism (See CBRT, 2013 for a detailed explanation of whole monetary transmission mechanism).

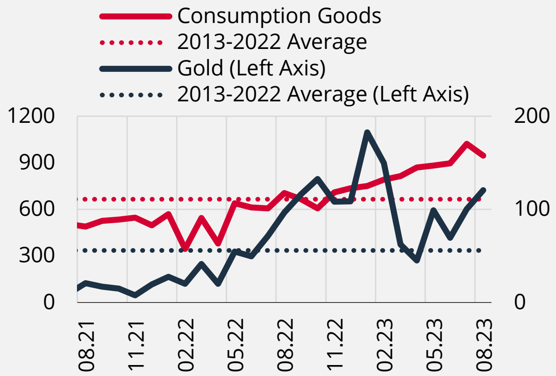
In addition to its direct effect on prices, excessive and high domestic demand created additional inflation by facilitating the pass-through from production costs to prices, and had negative effects on the current account deficit, central bank reserves and exchange rate expectations since some of the excessive demand shifted to foreign goods causing a surge in imports. In addition, expectations that prices will increase and the Turkish lira will depreciate have strengthened the increase in private consumption by causing savings to decrease, demand to be pulled forward and stockpiling behavior to increase. As a matter of fact, as seen in Chart 1, as of the second half of 2022, the contribution of private consumption expenditures to economic activity has risen well above its historical average, and the contribution of net exports has fallen below its historical average. This outlook in the composition of growth is also reflected in the current account deficit, with consumer goods imports significantly exceeding its historical average (Chart 2). On the other hand, the contribution of this excessive domestic demand to the economic growth is significantly offset by the rising imports, a natural reflection of excess consumption.

Chart 1: Contribution of Private Consumption and Net Exports to Quarterly Growth*



Source: CBRT, TURKSTAT.
* Seasonally and working day adjusted. Denotes % points difference from 2005-2021 average.

Chart 2: Consumer Goods Imports, Gold Imports and Historical Averages*

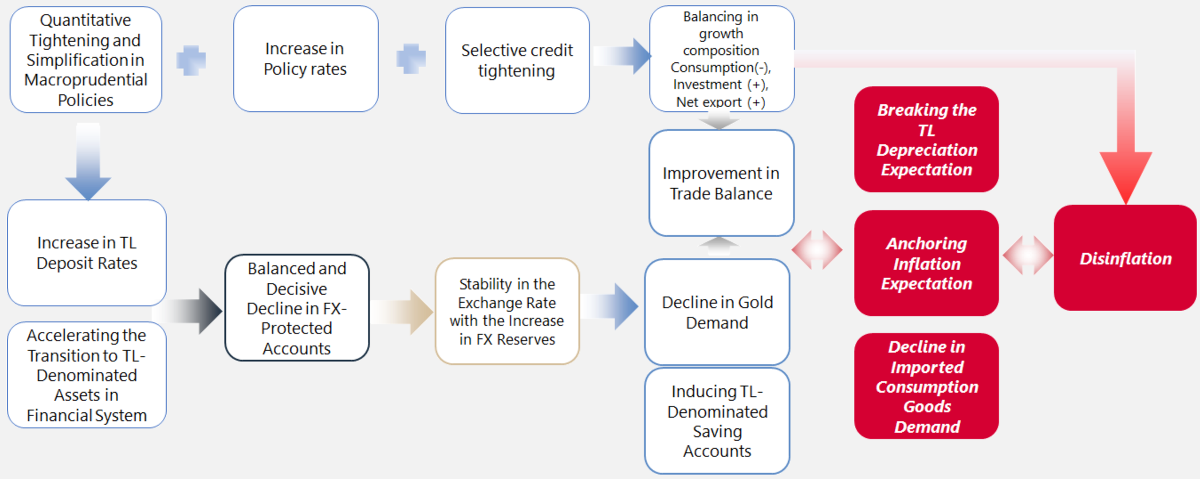


Source: CBRT, TURKSTAT.
* Population growth is controlled by dividing the quantity index by million people.

It is expected that domestic demand will be balanced by the activation of demand channel of monetary transmission through monetary tightening that began in June. Increases in interest rates are expected to stimulate savings and reduce the behavior of pulling demand forward. Monetary tightening accompanied by selective credit tightening aims to balance the consumption side rather than investments. Thus, in the upcoming period, it is planned that investment and exports will be the main drivers of economic growth, while consumption and imports decrease. In addition to the demand channel, it is anticipated that, through the expectations channel, the tight monetary policy will make a solid contribution to the disinflation process by positively influencing inflation and exchange rate expectations. Furthermore, the reduced uncertainty and the improved expectations will enable economic units to make long-term projects and investment decisions more confidently. As a result, the efficient allocation of resources will be achieved, leading to increased productivity as well as strong and sustainable growth.

In addition to demand and expectation channels, the macroprudential policies, which have been simplified and converged to their primary objectives, and the monetary tightening will strengthen the monetary transmission by increasing the demand for TL-denominated financial assets. It is assessed that, in addition to increasing demand for TL-denominated financial assets, strengthening the CBRT's international reserves through effective reserve policies will improve exchange rate expectations, and in turn, this will improve inflation expectations. The strengthening of demand for TL-denominated financial assets and the positive outlook in exchange rate expectations are also anticipated to reduce the demand for gold as a store of value, contributing to the improvement in the current account balance and the balancing of the growth composition. In sum, it is assessed that the disinflation process will commence in 2024 as the improvement in expectations, the balancing of the composition of the growth and the stability of the Turkish lira reinforce each other (Figure 1).

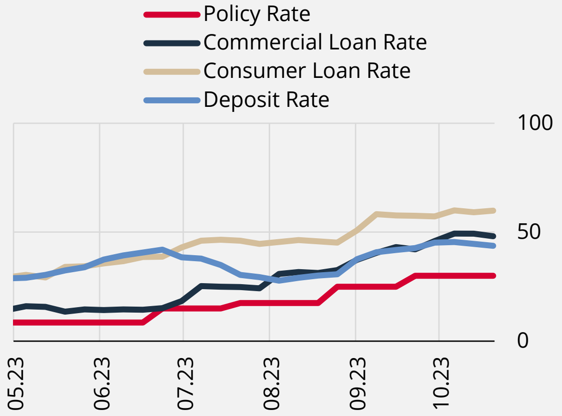
Figure 1: Simplified Monetary Transmission Mechanism*



* Monetary transmission mechanism is simplified such that only featured transmission channels in this Box are provided.

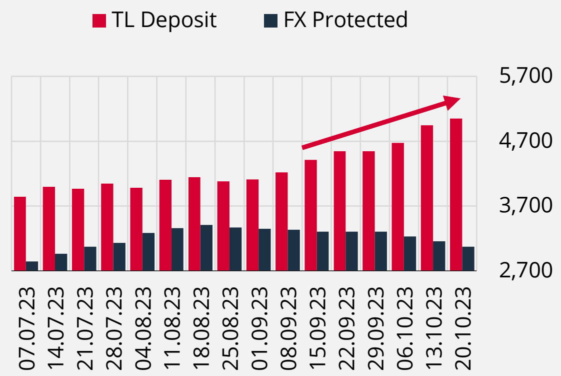
The monetary tightening that has been decisively implemented since June will cumulatively affect demand, savings, and pricing behavior over the upcoming several quarters. In this respect, the full effect of monetary tightening discussed here will be gradually observed contingent on other economic developments. In this regard, some initial effects have started to appear according to some leading indicators. The changes in financial markets are more pronounced. Market interest rates have moved in line with the policy targets (Chart 3), while the balance of Turkish lira-denominated deposits has increased, and balances of foreign currency and foreign exchange-protected deposits has started to decrease (Chart 4). Consumer loan growth has shown a declining trend with the implementation of selective credit tightening measures in addition to policy rate hikes (Chart 5). The CBRT reserves show an increasing trend (Chart 6). This supports the scheme that the simplified transmission mechanism shown in Figure 1 is currently operational regarding financial variables. On the other hand, the initial effects of the transmission mechanism on real activity have started to become evident though they are less pronounced. Domestic demand indicators, which remained strong since the second half of 2022, started to balance in the third quarter of 2023 (Chart 7). Additionally, with the balancing of domestic demand, imports have shown a declining trend in the third quarter, and the foreign trade balance has started to exhibit a better outlook (Chart 8).

Chart 3: Interest Rates (Annual, %)



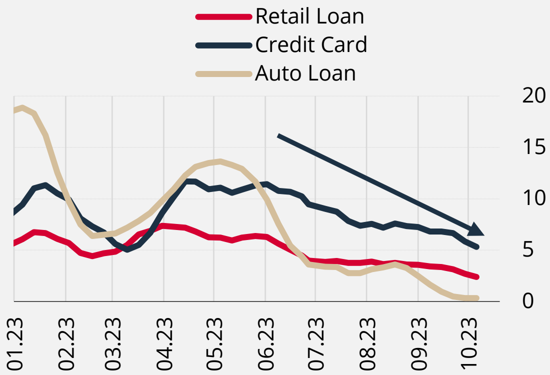
Source: CBRT.

Chart 4: Deposits (Billion TL)



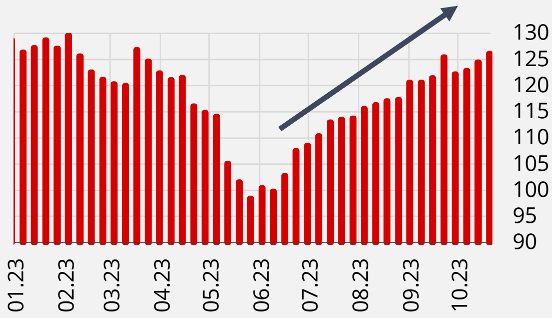
Source: CBRT.

Chart 5: Consumer Loan Rate Growth (4-Weeks-Moving Average of 4-Week Growth, %)



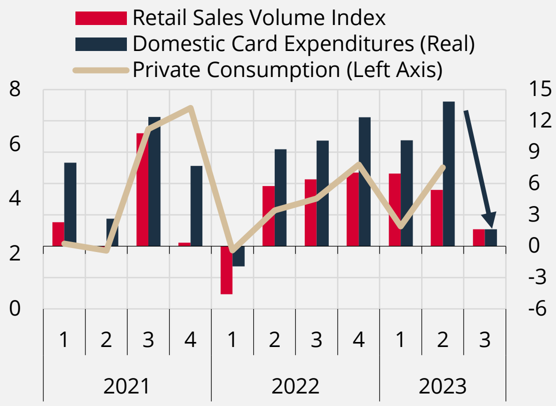
Source: CBRT.

Chart 6: CBRT International Reserves (Gross, Billion USD)



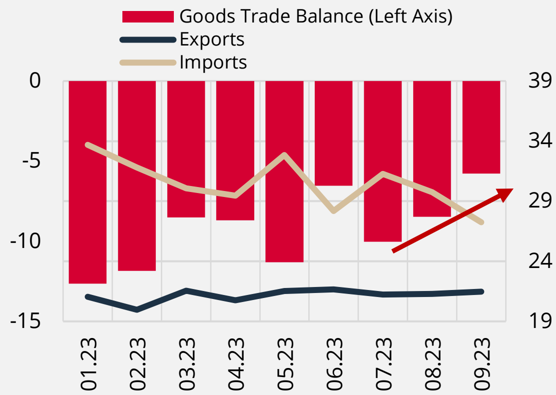
Source: CBRT.

Chart 7: Consumption Indicators (Adjusted for Seasonal and Calendar Effects, Quarterly % Change)



Source: BKM, CBRT, TURKSTAT.

Chart 8: Foreign Trade Balance, Imports and Exports (Adjusted for Seasonal and Calendar Effects, Billion USD)



Source: CBRT, TURKSTAT.

References

CBRT (2013). Parasal Aktarım Mekanizması (in Turkish), available at https://www.tcmb.gov.tr/wps/wcm/connect/TR/TCMB+TR/Main+Menu/Yayinlar/Kitap%2C+Kitapciklar+ve+Brosur/.