1.Overview

Economic activity remained strong in the third quarter of 2021. Gross Domestic Product (GDP) grew by 7.4% year-on-year and 2.7% quarter-on-quarter in the third quarter thanks to the easing of restrictions prompted by faster vaccination, and the significant rebound in tourism. On the production side, industrial and services sectors were the main drivers of annual and quarterly growth, whereas construction and agricultural sectors weighed on quarterly growth. On the expenditure side, the main driver of quarterly growth was domestic demand. Domestic demand made a larger contribution on the back of private consumption expenditures as well as the reopening-driven recovery in sectors that were severely hit by the pandemic. Exports and imports increased on a quarterly basis, and net exports contributed by 0.1 and 6.8 percentage points to quarterly and annual growth, respectively.

Fourth-quarter indicators suggest that economic activity remained strong thanks to domestic and external demand. Adjusted for seasonal and calendar effects, the Industrial Production Index (IPI) increased by 0.7% and 3.3% month-on-month in October and November, respectively. Thus, rising by 3.2% from the third quarter in the October-November period, the IPI continued to trend upward in the fourth quarter. The spread of vaccination throughout the society helps revive pandemic-stricken services, tourism and related sectors, and leads to a more balanced composition in economic activity. Higher external industrial turnover indices indicate that external demand continued to support industrial production in the fourth quarter. In line with the outlook for economic activity, the labor market continued to improve in October and November.

Despite the continued increase in exports and the strong recovery in services revenues, the current account balance recorded a deficit in November due to the upsurge in imports. Exports maintained their uptrend in the last quarter of 2021. On the other hand, despite the decline in the real exchange rate index, imports went up amid relatively strong economic activity and rising energy prices. The quantity-based rebalancing in external trade continued in real terms. Seasonally adjusted services revenues regained pre-pandemic levels following the increase in the number of tourists prompted by the removal or relaxation of most travel restrictions due to widespread vaccination. An indicator of the long-term trend, the 12-month cumulative current account balance, continued to improve in November, albeit at a slower pace.

The global risk appetite receded in the current reporting period due to higher global inflation and major central banks hinting at monetary policy normalization. Emerging economies (EMEs) continued to witness portfolio inflows to stock markets but have faced significant outflows from GDDS markets, especially since mid-November. Turkish stock markets continued to attract portfolio inflows in November, but both GDDS and stock markets suffered outflows in December. While EME risk premiums fluctuated in this period, Turkey's risk premium remained above those of EMEs. In the current reporting period, the exchange rate volatility implied by options increased in EMEs. After having risen significantly since mid-November, the volatility of the Turkish lira declined markedly thanks to the policy steps taken in December.

The increase in corporate loans in the final quarter of 2021 was the main driver of total loan growth. Although policy rate cuts brought banks' domestic funding costs down, deposit rates diverged from the policy rate by increasing slightly after the FX-Protected TL Deposits program was introduced in December. Accordingly, except for general-purpose loans, loan rates fell in tandem with policy rate cuts, but increased again as deposit rates went up. The pace of loan growth converged to historical averages in the fourth quarter.

Consumer inflation ended 2021 at 36.08%, and annual inflation increased in all subcategories. Exchange rate developments were one of the main drivers of the rise in inflation over the final quarter of the year. The strong economic activity in the fourth quarter, higher import prices and international food prices as well as supply-side factors such as agricultural drought, supply chain disruptions and transportation costs that remained high despite a partial recovery, continued to affect the inflation outlook adversely. Producer prices soared by 79.89% in 2021. This was largely due to exchange rate developments as well as rising commodity prices, especially for energy, and supply constraints. While higher producer prices put significant pressure on consumer prices, the pricing behavior for certain product categories deteriorated beyond what higher costs imply. In 2021, there was also an increase in the inflation trend, which drove the annual inflation rates of core inflation indices B and C up to 34.89% and 31.88%, respectively.

The CBRT kept the policy rate constant from April to August 2021, but then lowered it in the September-December period. The CBRT delivered a front-loaded and strong monetary tightening in March 2021 by increasing the policy rate from 17% to 19%. In the following period, the CBRT communicated that the monetary stance would continue to be determined at a degree of tightness that would restore the disinflation process as soon as possible and ensure the achievement of medium-term targets. Thus, the policy rate was kept unchanged from April to August. At its MPC meetings in September, October and November, the CBRT evaluated the analyses decomposing the effects of demand factors that monetary policy could affect, core inflation developments and supply shocks, and cut the policy rate by a total of 400 basis points. In December, the CBRT decided to complete the use of the limited room implied by transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases, and lowered the policy rate by 100 basis points. Hence, the policy rate has fallen to 14% as of the end of 2021.

The CBRT kept the policy rate constant at its January meeting. At its January meeting, the CBRT stated that the increase in inflation in the recent period was driven by distorted pricing behavior due to unhealthy price formations in the foreign exchange market, supply-side factors such as the rise in global food and agricultural commodity prices, supply constraints, and demand developments, and added that it expected the disinflation process to start on the back of measures taken for sustainable price and financial stability along with the decline in inflation owing to the base effect.

1.1. Monetary Policy Decisions

At its November meeting, the CBRT lowered the policy rate by 100 basis points after examining the decomposed effects of demand factors that monetary policy could affect, core inflation developments and supply shocks. In the summary of the November meeting, the recent rise in inflation was attributed to supply-side factors such as rising food and import prices, especially in energy, and supply constraints, increased administered prices and demand developments. Additionally, the Bank expected the transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases to persist through the first half of 2022, and stated that it would consider completing the use of the limited room implied by these factors in December. The Bank also underlined that the revision in the monetary policy stance began to affect commercial loans positively and developments in consumer loans were closely monitored.

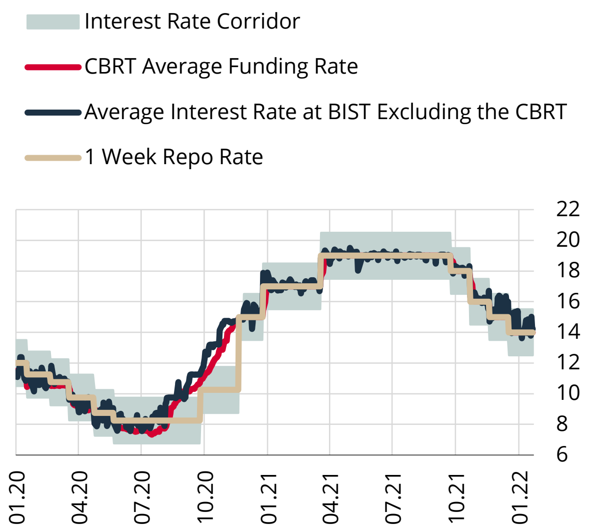
In December, the CBRT intervened directly in the market via selling transactions due to unhealthy price formations in exchange rates and started to conduct transactions at the BIST Derivatives Market (VIOP). The CBRT intervened directly in the market five times during the 1-17 December period via selling transactions due to unhealthy price formations in exchange rates. Thanks to policy decisions taken in December (Table 1.1), the volatility in exchange rates declined.

In the last meeting of 2021, the CBRT reduced the policy rate by 100 basis points and decided to complete the use of the limited room implied by transitory effects of supply-side factors and other factors beyond monetary policy's control on price increases. It was announced in the Summary of the December MPC Meeting that inflation was expected to follow a volatile course in the short term due to various supply and demand-side factors, with exchange rates, commodity prices and administered prices in the lead. However, it was underlined that a monetary stance to ensure the return of inflation to its downward trend once temporary effects disappear, would serve as a significant buffer against external and temporary volatilities in the context of inflation expectations, pricing behavior and financial market developments. It was also stated that cumulative effects of the recent policy decisions would be monitored in the first quarter of 2022 and during this period, all aspects of the policy framework would be reassessed in order to create a foundation for sustainable price stability.

In January, in view of the projection that the disinflation process will start on the back of measures taken for sustainable price and financial stability along with the decline in inflation owing to the base effect, the CBRT decided to keep the policy rate unchanged. The CBRT emphasized that while the cumulative impact of the recent policy decisions was monitored, to create a foundation for sustainable price stability, the comprehensive review of the policy framework was conducted with the aim of prioritizing the Turkish lira in all policy tools of the CBRT (Box 1.1).

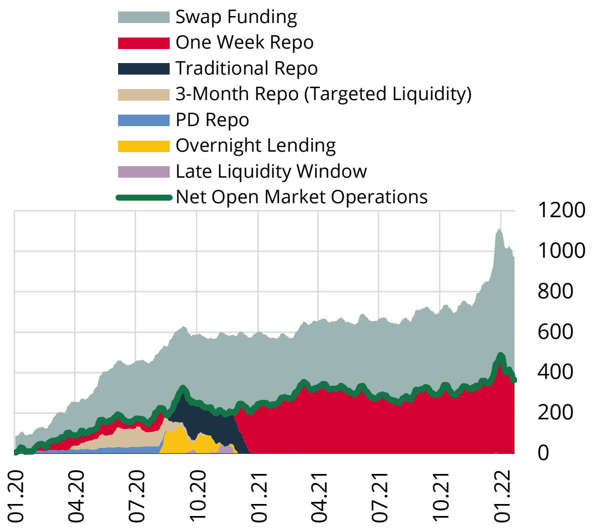
In the current reporting period, the CBRT continued to provide funding within a simple operational framework through OMO and swap transactions, and the overnight interest rates materialized around the CBRT policy rate. Owing to the CBRT's predictable liquidity management framework, BIST overnight repo rates continued to hover around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TRY 425 billion as of 28 October 2021, increased to TRY 603 billion as of 21 January 2022. In the same period, the net OMO funding rose to TRY 368 billion from TRY 314 billion (Chart 1.1.2).

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



Sources: BIST, CBRT.

Chart 1.1.2: CBRT Open Market Operations and Swap Transactions (One-Week Moving Average, TRY Billion)



Source: CBRT.

Table 1.1: Monetary Policy Implementations

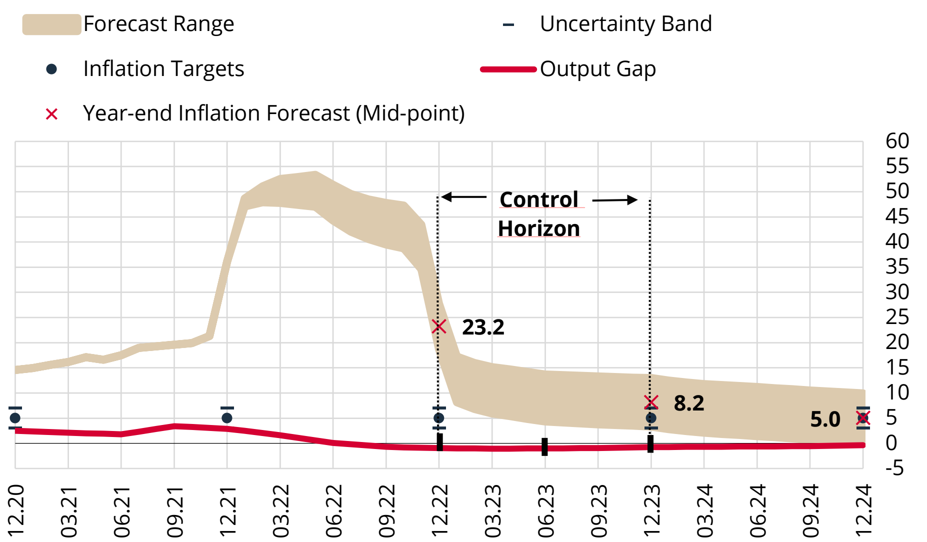
Date	Institution	Policy Decision
8 November 2021	CBRT	▪ To enhance the operational flexibility of banks in TRY and FX liquidity management, banks operating in the TRY Currency Swap Market and/or TRY Currency Swap Auctions (Traditional Method) were allowed to conclude their transactions as mutual deposits instead of swaps on their demand.
9 November 2021	CBRT	▪ The upper limit of the facility for holding standard gold for Turkish lira reserve requirements was decreased from 15% to 10%. It was announced that this facility would be gradually decreased and terminated. In addition, the reserve requirement ratios for FX deposits/participation funds were increased by 200 basis points for all maturity brackets.
1 December 2021	CBRT	▪ The CBRT directly intervened in the market via selling transactions due to unhealthy price formations in exchange rates and conducted transactions at Borsa Istanbul Derivates Market (VIOP).
3 December 2021	CBRT	▪ The CBRT directly intervened in the market via selling transactions due to unhealthy price formations in exchange rates.
10 December 2021	CBRT	▪ The CBRT directly intervened in the market via selling transactions due to unhealthy price formations in exchange rates.
13 December 2021	CBRT	▪ The CBRT directly intervened in the market via selling transactions due to unhealthy price formations in exchange rates.
17 December 2021	CBRT	▪ The CBRT directly intervened in the market via selling transactions due to unhealthy price formations in exchange rates. ▪ All remuneration rates determined in line with the practice of additional remuneration rate applied to TRY-denominated required reserves to increase the share of TRY in the total deposit/participation funds in the banking system were reduced by 100 basis points.
21 December 2021	CBRT	▪ It was decided to provide support to resident real persons, who already had an FX deposit account or FX participation fund denominated in US dollars, euros or British pounds by 20 December 2021, if they convert their accounts into TL time deposit accounts/participation funds (with maturities of 3, 6 and 12 months). ▪ In order to help exporting and importing companies to manage exchange rate risk, it was decided to carry out TL-settled foreign exchange forward sales with maturities of 1 month and 3 months at the CBRT via auctions and at the BIST Derivatives Market (VIOP).
29 December 2021	CBRT	▪ To support financial stability by increasing the share of Turkish lira in total deposits/participation funds in the banking system, it was announced with the Press Release No. 62 dated 21 December 2021 that deposit and participation fund holders would be provided with incentives in the event that they converted their FX deposit accounts and participation funds into TL time deposit accounts. Through this announcement, it was decided to provide incentives to deposit and participation fund holders in the event that they convert their gold deposit accounts and participation funds into TL time deposit accounts.

1.2 Medium-Term Projections

In the fourth quarter of 2021, consumer inflation and the B index reached 36.08% and 34.89%, materializing well above the forecast range of the October Inflation Report. The deviation in forecasts was driven by exchange rate developments. Sharp depreciations in the Turkish lira accompanied by high levels of exchange rate volatility impacted the pricing behavior and weighed on the exchange rate pass-through. On the other hand, the brisk course of aggregate demand conditions, high levels of international import prices, global supply problems and the rise in inflation expectations had an adverse effect on consumer inflation through the demand, cost and expectation channels.

The monetary policy stance will be decided with the focus on evaluating the sources of the risks to inflation, their permanency and how they can be controlled by monetary policy, targeting sustainable price stability with a solid approach. The disinflation process is expected to start on the back of measures taken for sustainable price and financial stability along with the decline in inflation owing to the base effect. Accordingly, inflation is projected to be 23.2% at the end of 2022 and fall to 8.2% at the end of 2023 before stabilizing around 5% in the medium term. With a 70% probability, inflation is expected to be between 18.6% and 27.8% (with a mid-point of 23.2%) at end-2022, and between 3.4% and 13.0% (with a mid-point of 8.2%) at end-2023 (Chart 1.2.1).

Chart 1.2.1: Inflation and Output Gap Forecasts* (%)



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

On account of increased uncertainties surrounding global economic activity due to the omicron variant, the external demand outlook has been revised slightly downwards compared to the previous reporting period. The omicron variant, which has recently spread rapidly with growing effects, has caused an unprecedented increase in the number of cases globally, and particularly in Europe and North America. However, because of the reduced risk of hospitalization caused by the new variant and the increase in vaccination rates, countries have not resorted to lockdown measures that would impede economic activity despite the increase in the number of cases. Therefore, although the increased number of cases affect growth prospects negatively by keeping the future risks to production activities alive, this effect is judged to remain quite limited. On the other hand, global inflation climbed to historic highs due to the imbalances between supply and demand, bottlenecks in production, and the rise in international commodity prices. It is considered that the increase in inflation, which was expected to be temporary by global central banks, will be more permanent than initially anticipated, as supply constraints and disruption in supply chains persist. On the other hand, monetary policy communication of central banks in advanced economies varied with their diverse outlook for economic activity, labor market and inflation expectations, while they still continue their supportive monetary stances and asset purchase programs.

Due to the current monetary policy framework and macroprudential measures, aggregate demand conditions are expected to follow a course close to their potential in the upcoming period. Leading indicators suggest that domestic economic activity remains strong, with the help of robust external demand. It is considered that fluctuations in financial markets will not have an immediate decelerating impact with regard to the course of economic activity in 2022 contrary to past experience, and thus, domestic demand will moderately converge to its potential. As a matter of fact, high frequency data also do not indicate a sudden weakening for early 2022. Meanwhile, foreign demand conditions are expected to remain supportive throughout the year, and it is thought that exports of goods and services, particularly tourism activities, will continue to affect economic activity positively. The loan-deposit spread, indicating the lending tendency of banks, increased compared to the previous reporting period. An evaluation of inflation developments reveals that the recent exchange rate developments, increases in domestic energy prices, the lingering adverse course in international commodity prices and supply problems becoming more evident once again have driven producer prices significantly upwards. Therefore, cost pressures on consumer prices continue. Once these effects arising from transitory factors disappear, inflation is expected to assume a downward trend. The effects of the adjustment in both the macroprudential policies and the monetary policy on credit growth and composition are expected to contribute to the disinflationary process. Moreover, additional inflation to be led by the minimum wage and increases in administered prices feed the upside risks to the short-term inflation outlook. A monetary stance to ensure the return of inflation to its downward trend once temporary effects disappear, will serve as a significant buffer against external and temporary volatilities in the context of inflation expectations, pricing behavior and financial market developments. On the back of measures taken for sustainable price and financial stability, the inflation expectations, pricing behaviors and volatilities in financial markets will recover, and together with the base effect the disinflation process is expected to start.

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 the baseline projections and the associated monetary policy stance are as follows.[1]

Despite the rise in the number of cases arising from the omicron variant, risks to economic activity remained on the upside thanks to increased vaccination rates and the experience gained in keeping the activity on under pandemic conditions. The global growth outlook deteriorated slightly due to the concerns and uncertainty related to the new variant, however limited pandemic measures contained adverse effects. Meanwhile, domestic economic activity remains strong. The speeding up of vaccination and the easing of travel restrictions on Turkey have facilitated the recovery in services, tourism and related sectors, which had been adversely affected by the pandemic, and led to a more balanced composition in economic activity. Due to the increased capacity need in the industrial sector, the investment tendency remains high. Changes in the number of cases and deaths due to the pandemic, developments regarding new variants and pandemic waves, and the impact of these developments on domestic and international demand conditions are closely monitored.

Pressures on producer prices grow further. The cumulative effects of the depreciation in the Turkish lira, high commodity prices, supply constraints and transportation costs are the primary factors underlying these pressures. Additionally, energy market developments and price adjustments in electricity and natural gas for producers are monitored in this context.

High levels of exchange rates and exchange rate volatility were the key determinants of the rise in inflation in the last quarter. Exchange rate developments are the most important risk factor to be monitored closely in the period ahead. It is expected that market volatility will decline with the help of the monetary policy stance and the FX-protected deposit facility, paving the way for increased predictability. However, indicators such as the exchange rate volatility and pass-through, and currency substitution tendency will be monitored closely.

[1] Evaluations of how and through which channel these risks may affect the inflation forecasts cited in the previous section are summarized in Table 3.3.1.

Recent readings suggest that the deterioration in pricing behavior increases upside risks to inflation. More frequent price revisions, along with the resulting decrease in average price spells, stand out as the main factors that give impetus to inflation. Moreover, the increased indexation to exchange rates also increases the pass-through from exchange rates to consumer inflation significantly.

Survey-based indicators and inflation break-evens suggest a rise in inflation expectations. In addition to expectations, inflation uncertainty has been increasing. The volatility in financial markets, pricing behavior and the high levels of inflation pose an upside risk for the upcoming period through expectations.

As global inflation is speeding up, monetary policy communication of central banks in advanced economies varies. Still, they continue their supportive monetary stances and asset purchase programs. A possible tightening scenario may affect financial markets through capital flows and global risk appetite. On the other hand, the impact of such risks through the portfolio flows channel towards Turkey are judged to prove to be relatively limited, considering the current levels of non-residents' portfolio positions.

First deposit rates, then loan rates have slightly diverged from the policy rate due to the FX-protected deposit facility. It is expected that credit growth, which remained quite strong in the last quarter, will return to a moderate course and thus contribute to the disinflationary path. In addition to macroprudential measures, the effects of the adjustment in the monetary policy on loan growth and composition will also be monitored. The composition of loan growth affects the inflation outlook through aggregate demand, current account balance, external financing, and risk premium channels. In this respect, indicators of credit supply and demand will be monitored closely.

The disinflation process may be delayed, should the path of administered price and tax adjustments exceed the path envisaged in this Report. Endorsement of inflation targets by all stakeholders and commitment to the price stability efforts with a common understanding and public accord, along with determination of macro policies in a coordinated manner in line with the projected disinflation path, will strengthen the effectiveness of the monetary policy.

Box 1.1

Liraization Strategy in the Policy Review Process

The primary objective of the CBRT is to achieve and maintain price stability. Structuring the financial system on Turkish lira instruments will enable a sustainable foundation for price stability. In order to achieve the ultimate goal, it is important that loans and monetary aggregates grow at a rate consistent with sustainable price stability and that the share of the Turkish lira in these aggregates is increased. In this context, the “Liraization Strategy” constitutes one of the essential elements of the CBRT's policy review process.

The liraization strategy is created with a holistic approach that focuses on the use of the Turkish lira in the system through new financial products, collateral diversification and regulations regarding liquidity management practices.

Within the scope of this strategy, the CBRT has recently implemented a set of practices. Encouraging the conversion of foreign currency and gold deposits into TL in December 2021 was an important step taken towards strengthening the preference for TL by depositors. In its first month, this facility enabled to increase the TL share in banks' balance sheets and extended the funding maturity of banks. This financial product helps support financial stability by strengthening bank balance sheets.

In line with the principle of holding only Turkish lira required reserves for Turkish lira liabilities, the facility for holding FX for TL required reserves was terminated in October 2021, and it is planned to terminate the facility for holding standard and scrap gold for Turkish lira liabilities in 2022. In accordance with the aforementioned principle, it is planned to encourage securing Turkish lira funding only with Turkish lira instruments.

The elements of liquidity management such as funding amount, instruments used, allocation in the banking system, maturity, and collateral structure are important for the efficiency of the monetary policy transmission mechanism. In this regard, the size of the OMO and swap transactions, which are the main components of Turkish lira liquidity management, their share in total CBRT funding and the collateral structure are under review within the scope of the liraization strategy.

As a first step, it was decided that banks should pledge at a higher rate of GDDS and/or lease certificates issued domestically by the Asset Leasing Company of the Turkish Treasury (ALCTT) as collateral for their transactions carried out in the CBRT Interbank Money Market. In the upcoming period, additional steps are planned to increase the use of TL-denominated assets as collateral in the funding structure. In addition, the reduction of the share of foreign currency denominated collateral pledged against the CBRT TL funding operations is on the agenda.

In March 2020, the CBRT launched the Turkish lira rediscount credit program in order to facilitate export companies' access to Turkish lira financing, to reduce foreign currency liabilities in company balance sheets, and to support employment. In September 2021, the requirement that rediscount credits are extended to net exporter companies was introduced, which strengthens the supportive role of rediscount credits for balance of payments and financial stability. By allowing rediscount credits to be used only in specified Turkish lira-denominated expenditures, it has been ensured that there will be no foreign currency demand originating from the funding by the Central Bank and that the rediscount credits are used in line with their purpose.

Within the scope of the pandemic measures, the Advance Loans against Investment Commitment was announced in June 2020, to support investments in sectors with high productivity, thereby reducing imports and boosting exports with long-term Turkish lira loans. Practices that support the potential production growth and finance this in Turkish lira constitute the essential element of the liraization strategy. Within the scope of the vision announced in the 2022-2024 Medium-Term Program, efforts are continuing to increase the effectiveness of the use of long-term Turkish Lira Advance Loans in domestic production and green investments.

Providing an effective intermediary function of financial system is only possible by bringing savings together with production, investments and exports in areas with high productivity. The use of the loans provided to the real sector by the financial system in accordance with their determined purposes is essential for financial stability and hence for the strength of the Turkish lira.

Balanced growth in commercial and retail loans is a requirement for price stability and financial stability. In this sense, the effective implementation of the intermediary function by the financial system will increase the potential growth, improve the current account balance and limit the risks to price stability. By implementing its strategy with a holistic approach, the CBRT will continue using its instruments without compromising financial stability, in order to increase the weight of Turkish lira in the balance sheets of households, corporates, banks and all other financial institutions.

Within the framework of the liraization strategy in the CBRT's policy review process, the focus of all measures to be implemented in the near, medium and long term will be to ensure the liraization of the financial system in order to maintain price stability on a sustainable basis.