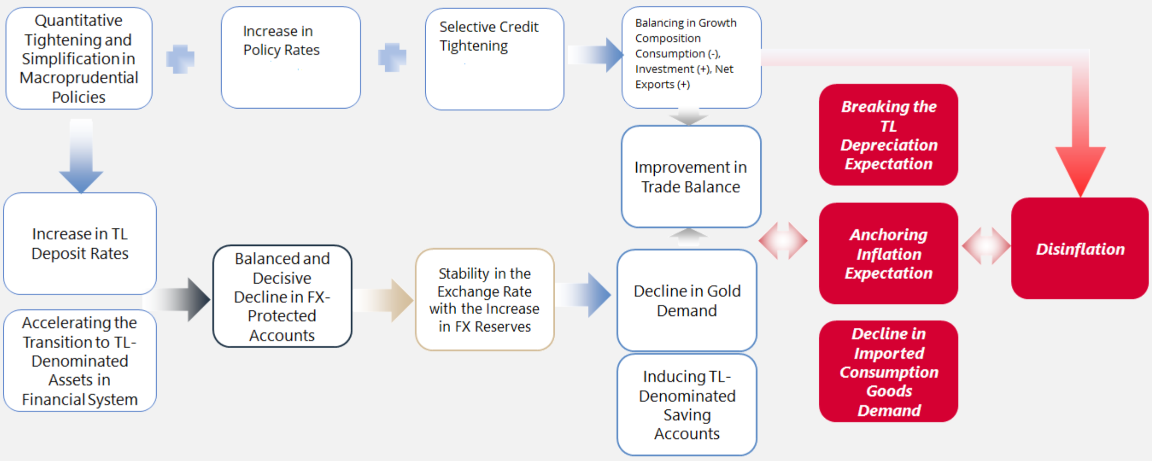
Box 3.2

Monetary Transmission Mechanism and Key Indicators of Disinflation Process

The CBRT closely monitors key indicators of inflation and the underlying trend of inflation and decisively utilizes its policy toolkit in line with the fundamental objective of price stability so as to create the economic and financial conditions that will ensure a permanent fall in inflation. Within the scope of the integrated policy approach, in addition to interest rate hikes, selective credit and quantitative tightening decisions are supported by the simplification of the micro and macroprudential framework. It is assessed that the CBRT has reached a level of monetary tightness consistent with the objectives of stabilizing excesses in consumption demand, increasing the demand for TL-denominated financial assets, anchoring inflation expectations and permanently enhancing the efficiency of the monetary transmission mechanism, which will closely determine the future course of inflation, and that the (aforementioned) monetary tightness will be maintained as long as necessary.

The monetary transmission mechanism is a concept that explains the channels through which and to what extent the monetary policy affects inflation. The disinflation process can be established through the effectiveness of the policy rate and other monetary policy instruments operating through different channels on factors such as domestic demand, exchange rates, financial markets, credit and inflation expectations. Therefore, a detailed analysis of the effectiveness of transmission channels is critical in determining the monetary policy stance required for a successful disinflation process. This box focuses on the effectiveness of the transmission channels related to demand and the financial variables shown in Figure 1, which are expected to accomplish disinflation in 2024.

Figure 1: Simplified Monetary Transmission Mechanism*



* Monetary transmission mechanism is simplified such that only transmission channels covered in this box are provided.

As monetary tightening and macroprudential policies are reflected on financial conditions, domestic demand is expected to stabilize. In addition to interest rate hikes, quantitative tightening and selective credit policies aim to shift the composition of growth from consumption to investment. The stabilized domestic demand is expected to reduce imports and lead to a growth composition in which the contribution of net exports will increase. By reducing the import demand for gold, the goal is to achieve a moderate increase in imports. Accordingly, it is possible to eliminate excessive inflation without exerting significant pressure on growth. This is expected to contribute to both improving exchange rate expectations and anchoring inflation expectations.

The tightening steps are expected to strengthen the monetary transmission mechanism by permanently increasing the demand for TL-denominated financial assets. Moreover, the current account balance and financing conditions that will improve with the decisive monetary tightening process are expected to support the stability in the FX market and have a positive impact on exchange rate and inflation expectations. On the other hand, the demand for gold, which is considered as a store of value, is expected to decline as the demand for Turkish lira assets increases. This is expected to strengthen the improvement in the current account balance and support the rebalancing in the growth composition.

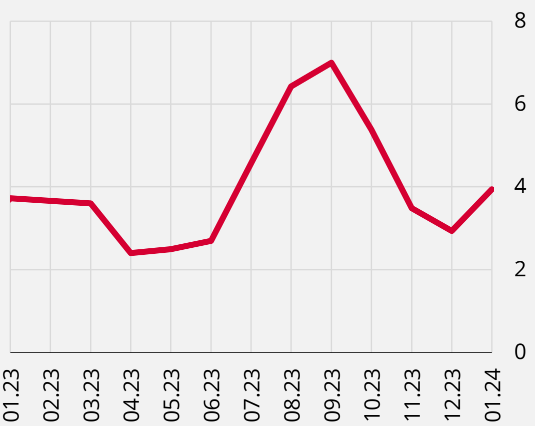
As the monetary tightening is reflected on financial conditions, the level of monetary tightness required for disinflation in 2024 is believed to have been reached. Market interest rates are in line with tight monetary policy targets, leading to an increase in Turkish lira deposits and a decline in FX-denominated and FX-protected deposits (Chart 4). Loan rates are also in line with the targeted level of financial tightness (Chart 3). Although loan growth increased in December due to the anticipated wage revisions, annual loan growth continues to normalize (Chart 5). CBRT reserves continue to increase (Chart 6).

Although recent price cuts and campaigns have curbed the fall in demand, the rebalancing in domestic demand indicators continues, as does the improvement in the gold balance that started in the third quarter of 2023 due to the impact of monetary tightening on financial conditions (Chart 2). On the other hand, wage hikes are likely to curb the fall in demand to some extent in the first quarter.

Seasonally adjusted data suggest that the underlying trend of inflation declined. However, the underlying trend of inflation posted an uptick in January, in line with the projections. The underlying trend indicator, which is calculated by taking the average of seven different indicators, decelerated significantly compared to the end of the previous quarter (Chart 1). On the back of these developments, inflation expectations continue to decline. In January, the median values of 12- and 24-month-ahead CPI inflation expectations shifted to the left compared to the previous reporting period, indicating a recovery in the distribution of expectations (Charts 7 and 8).

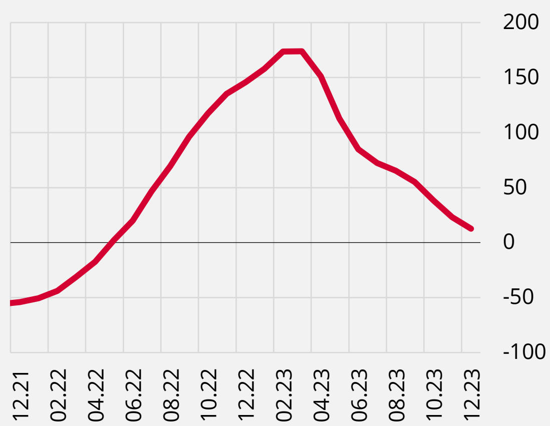
It is observed that the channels of the monetary transmission mechanism related to financial variables work more effectively. The demand channel of the transmission mechanism, on the other hand, is considered as a risk factor for the disinflation path. Therefore, it is critical to maintain monetary tightness as long as needed in order to ensure a permanent disinflation.

Chart 1: Average of Underlying Trend of Inflation* (Seasonally Adjusted, Three-Month Average)



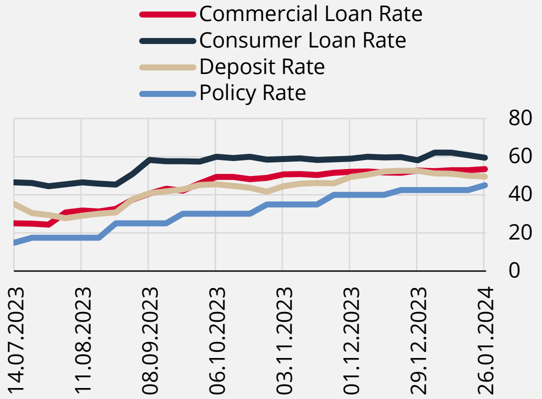
Source: CBRT.
* Average underlying trend of Inflation, calculated as the average of B and C indices, SATRIM, Median, the index excluding most volatile items, indicators produced by principal component analysis and dynamic factor models.

Chart 2: Gold and Consumer Goods (Annual % Change, Three-Month Moving Average)



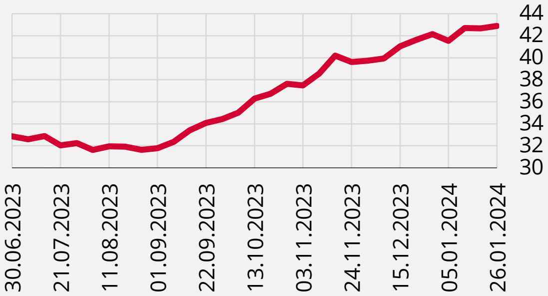
Source: CBRT, TURKSTAT.

Chart 3: Interest Rates (Annual, %)



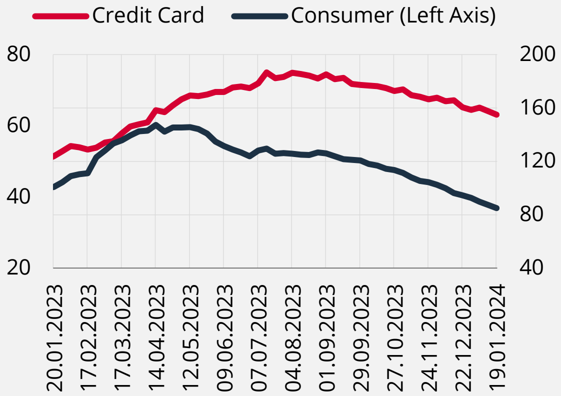
Source: CBRT.

Chart 4: Share of Turkish Lira Deposits* (%)



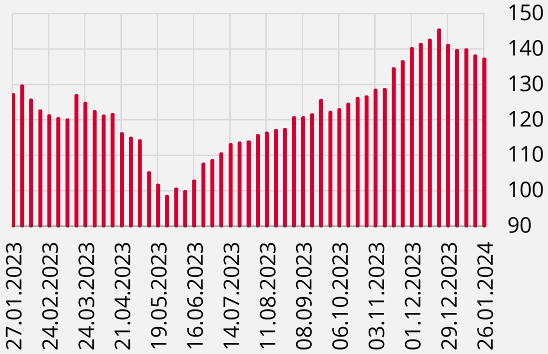
Source: BRSA.
* Share of Turkish lira deposits calculated by dividing the sum of TL deposits, FX-protected TL deposits and participation accounts to the sum of total deposits.

Chart 5: Chart 5: Credit Cards and Consumer Loans (Annual Growth, %)



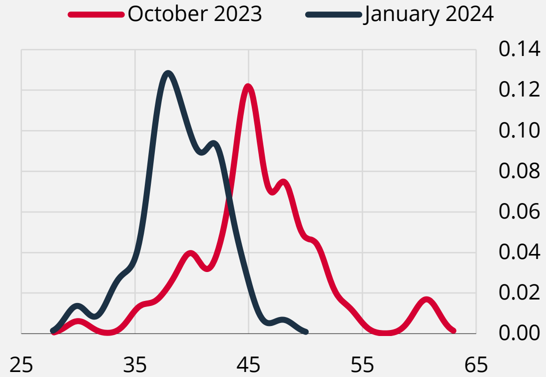
Source: CBRT.

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



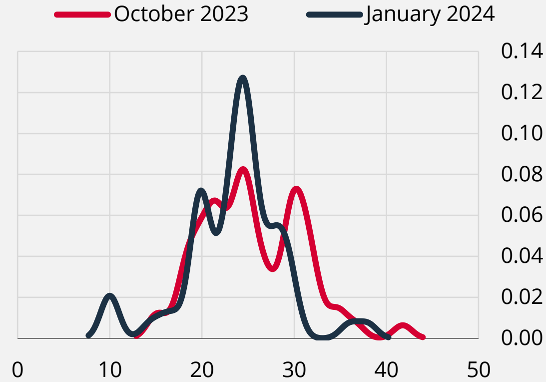
Source: CBRT.

Chart 7: 12-Month-Ahead Inflation Expectations of the Survey of Market Participants*



Source: CBRT.
* Kernel probability density functions are calculated using the responses to the CBRT Survey of Market Participants. The horizontal axis indicates the annual CPI inflation expectation, while the vertical axis indicates the probability density attributed to this level.

Chart 8: 24-Month-Ahead Inflation Expectations of the Survey of Market Participants*



Source: CBRT.
* Kernel probability density functions are calculated using the responses to the CBRT Survey of Market Participants. The horizontal axis indicates the annual CPI inflation expectation, while the vertical axis indicates the probability density attributed to this level.