1. Overview

Economic activity followed a strong course in the last quarter of 2020, largely in line with earlier predictions. GDP increased by 5.9% on an annual basis and 1.7% on a quarterly basis in the last quarter of 2020. Domestic demand recorded a sharp increase excluding construction sector indicators. Private consumption demand remained strong spreading widely across goods and services, while public consumption continued to support economic activity. Despite an upsurge in machinery and equipment investments, investment expenditures weighed on growth, due to the significant contraction in construction investments. With the partial recovery in tourism and the strong course of goods exports, exports of goods and services increased rapidly and net exports made a positive contribution to quarterly growth.

Data for the first quarter indicated that economic activity remained strong and aggregate demand conditions were at a more inflationary level than previously envisaged. Economic activity gained strength due to the upward trend in loan growth since late January and the easing of pandemic restrictions in early March. Industrial production and retail sales recorded a rapid increase in the January-February period compared to the previous quarter and remained above their long-term trends. On the other hand, the outlook for the pandemic-stricken service sectors is relatively weak. Sales and survey indicators point to a strong consumption and investment demand in the first quarter and an increased use of loans for investment. The improvement in investment tendency in the manufacturing industry was widespread across scales. However, risks to economic activity prevail on both sides due to the course of the pandemic and the vaccination process.

Notwithstanding the rise in exports and the fall in gold imports, strong domestic demand and commodity prices continue to adversely affect the current account balance. The strong export momentum, having been driven mainly by the European region in the last quarter of 2020, continued in the first quarter, spreading across regions and sectors. Besides higher export prices, the positive outlook in global manufacturing industry activity contributed to this development. On the other hand, despite the decline in gold imports, brisk domestic demand and rising international commodity prices are having an adverse impact on the import bill. There remain risks to tourism revenues as restrictions have been tightened due to the rapid spread of the coronavirus at home and abroad.

A price stability-oriented tight monetary policy stance is of critical importance for a lasting improvement in country risk premium and external financing opportunities, considering the reflections of the volatile course of the global risk appetite on the Turkish economy. Having gradually increased since November 2020, portfolio inflows continued in the first two months of 2021. However, the heightened financial market volatility in March, triggered by the increase in US long-term bond yields, led to portfolio outflows from emerging economies, including Turkey. In the following period, the mounting uncertainty over the domestic monetary policy outlook and Turkey's increased risk premium led to further portfolio outflows from Turkey. As fluctuations in global risk appetite pose more risks to emerging economies, maintaining the price stability-oriented tight monetary policy stance will act as an important buffer against such volatilities.

Demand and cost factors, exchange rate developments, supply constraints in some sectors, and high levels of inflation expectations continue to pose risks to the pricing behavior and inflation outlook. Consumer inflation was 16.2% in the first quarter of 2021, and annual inflation continued to rise throughout the first quarter, as projected. Accordingly, inflation was in line with the forecasts in the January Inflation Report. Producer inflation continued to climb amid the ongoing rise in international commodity prices, supply constraints in some sectors and strong demand conditions. Thus, the pressures on consumer prices from producer prices became stronger. Survey-based inflation expectations increased in March and April, after declining in January and February. Inflation compensations derived from bond yields have also registered a marked increase recently. Despite the upward trend in international oil prices, the sliding scale system was key in curbing inflation, given the direct and indirect effects of fuel prices. Against this background, annual inflation of core inflation indicators increased, while their trends remained high despite some decline.

The decelerating impact of the current monetary stance on credit and domestic demand is envisaged to become more significant in the upcoming period. After having decelerated due to tightening financial conditions, loan growth has seen some pickup since the end of January. Commercial loans have been moderate recently, whereas retail loan growth continues to accelerate despite tightening financial conditions. The cumulative effects of the previous year's rapid credit expansion continued to support domestic demand in the first quarter of 2021, but starting from the second quarter, the slowdown in net credit utilization and domestic demand is expected to gradually become more evident amid tightening financial conditions. In an environment in which the importance of external financing conditions rises due to the volatile global risk appetite and the current account deficit, it is essential for price stability and financial stability that loans grow at a moderate pace and with a reasonable composition.

The CBRT kept the policy rate constant in February, but strengthened the communication regarding the tight monetary policy stance and reiterated the emphasis on delivering additional monetary tightening if needed. In the January Inflation Report, it was projected that the effects of the strong monetary tightening in November and December would become significant in the upcoming period, and demand and cost factors that affect inflation would thus gradually weaken. At the Monetary Policy Committee (MPC) meeting in February, the CBRT's assessment was that domestic demand conditions, increasing exchange rates and international food and other commodity prices and high levels of inflation expectations continued to affect the pricing behavior and inflation outlook adversely. Accordingly, the MPC kept the policy rate unchanged in February, taking into account the end-2021 forecast target. However, the MPC strengthened the message that the tight monetary policy stance would be maintained decisively for an extended period until strong indicators point to a permanent fall in inflation and price stability, and repeated January's forward guidance regarding the delivery of additional tightening if needed.

Considering the medium-term inflation outlook, the CBRT decided to implement a strong front-loaded monetary tightening in March, and maintained its tight policy stance in April. In the period following the January Inflation Report, demand and cost-side factors affecting the inflation outlook necessitated additional tightening in monetary policy. Economic activity followed a stronger course compared to the outlook presented in the January Inflation Report. Domestic demand conditions, cumulative cost effects, in particular the exchange rate effects, increasing international commodity prices and high levels of inflation expectations continued to affect the inflation outlook adversely. Thus, core inflation trends remained high and inflation expectations began to rise. The projected gradual waning in demand and cost factors was delayed by the upward trend in credit growth and the increase in import costs. Considering the upside risks to inflation expectations, pricing behavior and the medium-term inflation outlook associated with these developments, the CBRT decided to implement a front-loaded and strong additional monetary tightening. The CBRT kept its policy rate constant in April, citing ongoing risks to the inflation outlook.

1.1 Monetary Policy Decisions

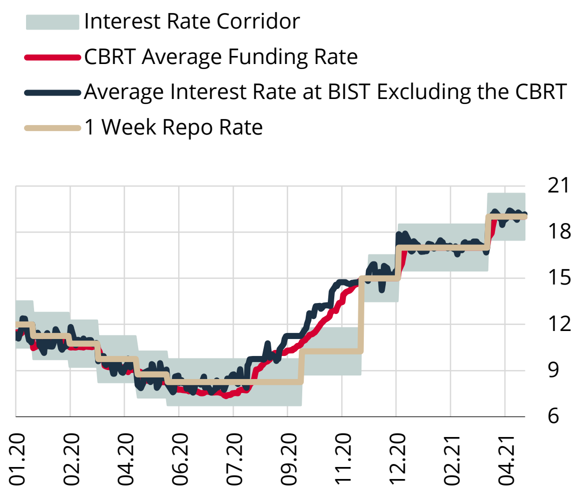
In the February MPC decision, the CBRT emphasized that the balance between the monetary policy rate and actual/expected inflation would be sustained decisively to maintain a strong disinflationary effect until permanent price stability and the 5% target were reached. In this meeting, the MPC maintained its projection that the decelerating impact of the strong monetary tightening on credit and domestic demand would become more significant in the following period; hence the effects of demand and cost factors on inflation would wane gradually. Accordingly, the MPC decided to keep the policy rate constant at 17% and maintain the tight monetary policy stance decisively, taking into account the end-2021 forecast target, for an extended period until strong indicators point to a permanent fall in inflation and price stability. The CBRT also noted that there had been some decline in loan and deposit rates recently, and that Turkish lira reserve requirements needed to be increased in order to enhance the effectiveness of the monetary transmission mechanism (Table 1.1). Yet, it was emphasized that the policy rate is the sole instrument to determine the monetary policy stance, while it was also underlined that the reserve requirement ratio is a tool that affects the transmission of the monetary stance determined by the policy rate to deposit, loan and other money markets.

Considering the upside risks to inflation expectations, pricing behavior and the medium-term inflation outlook, the CBRT decided to implement a front-loaded and strong additional monetary tightening in its March meeting. While the policy rate was increased to 19% from 17%, the CBRT reiterated that the tight monetary policy stance would be maintained decisively for an extended period until strong indicators point to a permanent fall in inflation and price stability. The CBRT noted that while it maintained the expectation that the decelerating impact of the monetary tightening on credit and domestic demand would become more significant, the projected gradual waning in demand and cost factors was being delayed by the recent upward trend in credit growth and increase in import costs.

In the April MPC meeting, the CBRT kept the policy rate unchanged and envisaged that the decelerating impact of the current monetary stance on credit and domestic demand would become more significant in the upcoming period. The tight monetary policy stance was maintained, and the one-week repo auction rate was kept constant at 19%. The Committee underscored that the policy rate would continue to be determined at a level above inflation to maintain a strong disinflationary effect until strong indicators pointed to a permanent fall in inflation and the medium-term 5% target was reached.

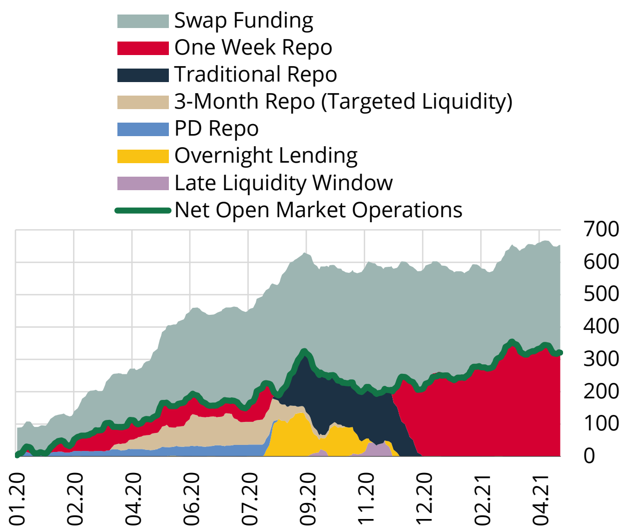
In the current reporting period, the CBRT continued to provide funding within a simplified operational framework through OMO and swap transactions, and the overnight interest rates materialized around the CBRT policy rate. Following the simplification of the operational framework as of the end of November, the liquidity composition also became simplified as the traditional repo auctions of the previous period matured. In the current reporting period, the funding need of the system continued to be met through TL currency/gold swap transactions at the CBRT and BIST, in addition to the OMO funding. Owing to the CBRT's simplified and predictable liquidity management framework, BIST overnight repo rates hovered around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TRY 312 billion as of 29 January 2021, increased to TRY 326 billion as of 22 April 2021. In the same period, the net OMO funding posted a larger increase compared to swap funding, reaching TRY 314 billion from TRY 273 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, Billion TRY)

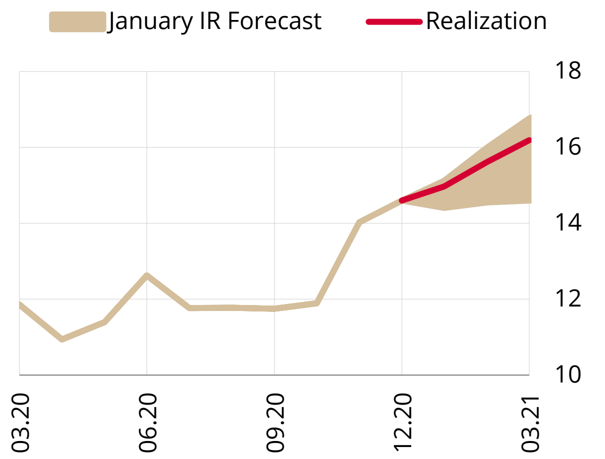


Source: CBRT.

1.2 Medium-Term Projections

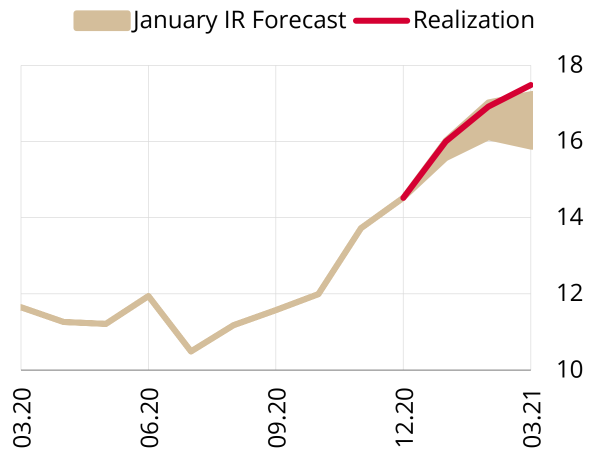
In the first quarter of 2021, consumer inflation stood at 16.2%, materializing close to the upper bound of the forecast range in the January Inflation Report. However, given the revision in basket weights, it displayed a course consistent with the forecasts. In this period, annual inflation of the B index, which is one of the core indicators, remained above projections (Charts 1.2.1 and 1.2.2). Due to the rise in international commodity prices, strong demand conditions, supply constraints, high inflation expectations, and cumulative exchange rate effects, inflation continued to increase.

Chart 1.2.1: January CPI Inflation Forecast and Actual Inflation* (%)



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

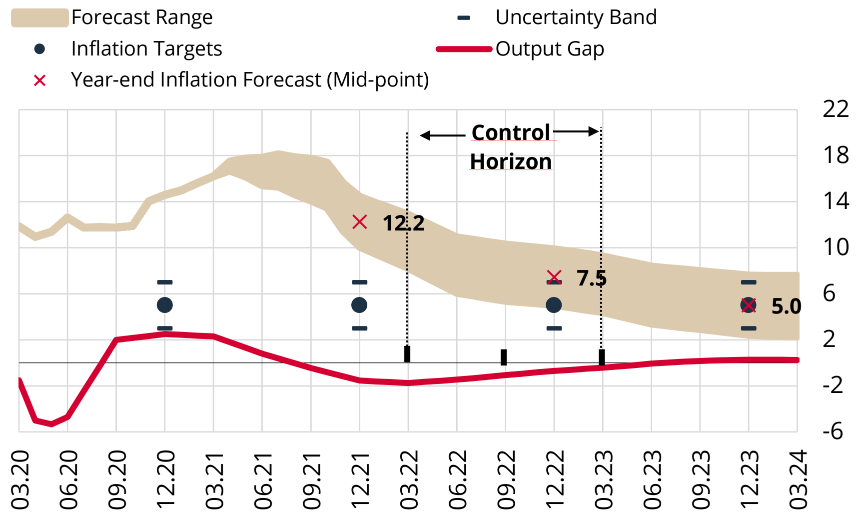
Chart 1.2.2: January Forecast and Actual Rates for Inflation Excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold (B Index)* (%)



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

Based on the assumptions for crude oil, import and food prices as well as short-term projections, and under the scenario in which the policy rate would continue to be determined at a level above actual and expected inflation to maintain a strong disinflationary effect, year-end inflation forecasts for 2021 and 2022 have been revised upwards. Accordingly, inflation is projected to be 12.2% at the end of 2021, and fall to 7.5% at the end of 2022 before stabilizing around 5% in 2023, which is the medium-term target. With a 70% probability, inflation is expected to be between 10.0% and 14.4% (with a mid-point of 12.2%) at end-2021 and between 5.0% and 10.0% (with a mid-point of 7.5%) at end-2022 (Chart 1.2.3).

Chart 1.2.3: Inflation and Output Gap Forecasts*



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

Forecasts are based on the assumption that there will be no further negative shocks to global growth and the external demand outlook due to the pandemic, and no additional deterioration will be observed in the global risk appetite. The improvement in the global growth outlook driven by expansionary monetary and fiscal policies as well as by progress in the deployment of vaccinations brought about an increase in global inflation expectations. Global inflationary pressures have a potential to cause an earlier-than-currently projected tightening in monetary policies. The world has entered a period marked by increased data-sensitivity and related volatilities in global financial markets. In this context, maintaining the tight monetary policy stance in Turkey until there are strong indicators that point to a permanent fall in inflation will contribute to limiting the possible adverse effects of global financial market volatilities on the country risk premium.

Following the strong course of economic activity in the first quarter of the year, a moderate trend is expected in the subsequent period with the decelerating impact of the monetary stance on credit and domestic demand becoming more significant. The underlying trend of economic activity was strong in the first quarter, and aggregate demand conditions continued to be at inflationary levels. While the impact of the front-loaded and strong additional monetary tightening delivered in March on credit and domestic demand is expected to become pronounced in the upcoming period, risks for economic activity exist in either direction depending on the progress of the pandemic and the vaccination rollout. On the other hand, annual inflation may remain elevated for a couple of months due to recent exchange rate movements and supply-side inflationary factors that are highly effective in the short run. Supply constraints that became more evident in some sectors and exchange rate developments cause producer inflation to remain on the rise. On the administered prices front, the raw milk reference purchase price and bread prices as well as the tax adjustments in the services sector and tobacco products will play a decisive role in the short-term inflation outlook. In addition, as the effects of the monetary stance are projected to grow more pronounced on demand conditions, the output gap is expected to contribute to disinflation by the third quarter of the year. Against this backdrop, the policy rate will continue to be determined at a level above actual and expected inflation to maintain a strong disinflationary effect until strong indicators point to a permanent fall in inflation and the medium-term 5% target is reached.

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]

The rise in the country risk premium, volatility in financial markets and portfolio outflows increase risks to external financing opportunities. The course of the pandemic and the uncertainties regarding the effect of the vaccination process on the tourism sector make these risks more pronounced through the current account balance. Developments that will adversely affect the external financing outlook pose a downside risk to growth and an upside risk to inflation via exchange rates.

Risks to economic activity exist in both directions depending on the course of the pandemic at home and abroad, and the vaccination process. Clampdown decisions following the increase in the number of cases will slow down economic activity in the short run. Meanwhile, the faster-than-expected vaccination in the country and abroad may support the improvement in domestic services sectors through the exports of goods and services. The weight of likely upcoming decisions and measures regarding restrictions on the macro economy makes it harder to measure the output gap and unit labor costs for reasons such as adaptation to new circumstances and sectoral divergences, and increases the inflation forecast uncertainty.

Year-end and medium-term inflation expectations have increased due to recent developments in exchange rates. The survey-based indicators and inflation break-evens point to an increase in inflation expectations as well as in inflation uncertainty. The volatility in financial markets poses a risk to pricing behavior and the inflation outlook.

The ongoing disruptions in supply chains keep the supply-side risks to inflation alive. Global supply problems and rises in freight costs, as well as the increase in import prices, cause producer prices to hover at considerably high levels. The pass-through from producer prices to consumer prices, along with the reasons thereof, are closely monitored.

[1] Evaluations of how and through which channel these risks may affect the inflation forecasts cited in the previous section are summarized in Table 3.2.2 in Chapter 3.

The recovery in global demand and the rise in inflation expectations are driving long-term bond yields up and having an effect on exchange rates through capital flows. The world has entered a period marked by increased data-sensitivity and related volatilities in global financial markets. Likely changes in expectations regarding advanced economy monetary policies on the back of data flows may lead to volatility in the global risk appetite and capital flows towards emerging economies.

The current high levels of international commodity prices continue to pose an upside risk to the inflation outlook. The pace and the scale of the easing of supply restrictions by oil-producing countries will determine the course of oil prices in the upcoming period. Secondary effects of supply-side inflationary factors on expectations and their interaction with financial indicators will be monitored closely.

The tightening of financial conditions is anticipated to decelerate the net credit utilization and the domestic demand as of the second quarter. However, factors which may push credit growth upwards and curtail the transmission of the tight monetary stance may deteriorate the inflation outlook via total demand, current account balance, external financing, and risk premium channels.

The disinflation process may be delayed, should the path of administered prices and tax adjustments exceed the path envisaged in this Report due to the increase in public financing needs as a consequence of measures to contain the effects of the pandemic on economic activity as well as inflationary pressures driven by import costs. 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.

Table 1.1: Monetary Policy Actions

Date	Institution	Policy Decision
24 February 2021	CBRT	▪ In line with its main objective of price stability, the Central Bank of the Republic of Turkey revised the reserve requirement regulation to improve the effectiveness of the monetary transmission mechanism. Accordingly: (i) TL reserve requirement ratios were increased by 200 basis points for all liability types and maturity brackets; (ii) The upper limit of the facility for holding FX was decreased from 30% to 20% of TL reserve requirements; and (iii) The upper limit of the facility for holding standard gold was decreased from 20% to 15% of TL reserve requirements. ▪ Additionally, the remuneration rate applied to TL-denominated required reserves was increased by 150 basis points to 13.5%.
19 March 2021	CBRT	▪ The Turkish lira interest rate applied on the CBRT Turkish Lira Currency Swap Market and the Turkish Lira Gold Swap Market was raised to 19% from 17%.