TÜRKİYE CUMHURİYET
MERKEZ BANKASI

HEAD OFFICE

ANKARA, 01 February 2021

Please refer to:
TCMB: 98422658-

Lütfi ELVAN
MINISTER OF TREASURY AND FINANCE
ANKARA

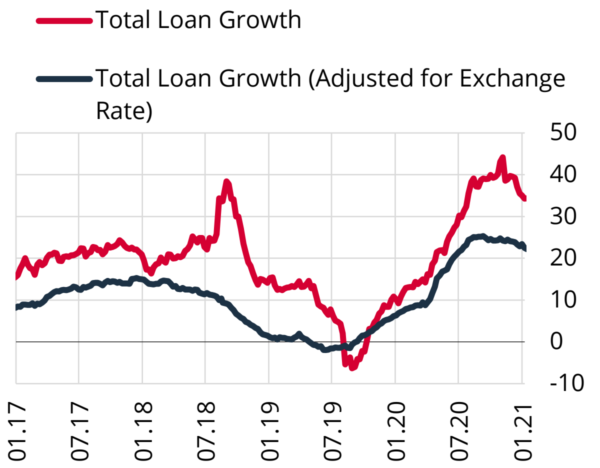
Under the explicit inflation targeting regime that the Central Bank of the Republic of Turkey (CBRT) has been implementing since early 2006, when the inflation significantly deviates from the target or a possibility thereof arises, the "accountability" mechanism steps in pursuant to Article 42 of the CBRT Law. In this context, the Central Bank of the Republic of Turkey (CBRT) is accountable for reporting to the Government and announcing to the public the reasons for the deviation from the inflation target and the necessary measures to be taken. 2020 year-end inflation was above the uncertainty band. This document elaborates on the reasons for the deviation of inflation from the target, and explains the measures already taken and to be taken to bring inflation back on track with the target.

Factors Affecting Inflation in 2020

The policy rate cuts, which started in July 2019, continued and comprehensive liquidity measures were taken in the first half of 2020 to contain the adverse effects of the Covid-19 pandemic. In addition to the monetary policy rate cuts and targeted liquidity facilities offered to the banking sector, the Banking Regulation and Supervision Agency's Asset Ratio Rule aiming to encourage banks to extend loans and purchase securities was effective from the beginning of May, and it reinforced the expansionary macro policy stance.

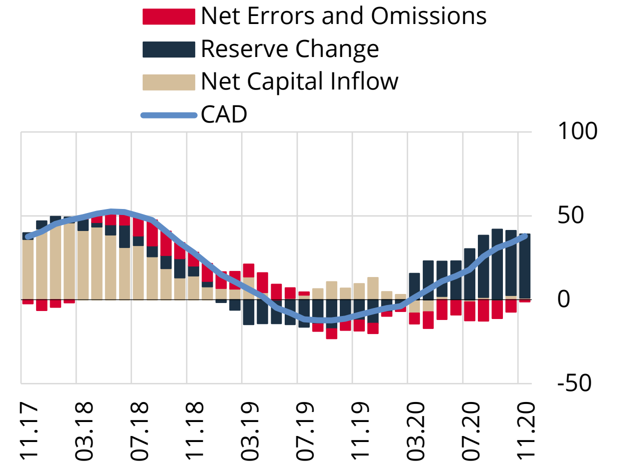
The annual credit growth accelerated as of the second quarter, leading to an expansion even beyond the rapid credit expansion of 2017 driven by the Credit Guarantee Fund (Chart 1). This strong credit expansion was visible in consumer loans led by general purpose and housing loans, as well as in corporate loans. Although the rapid improvement in credits and monetary aggregates, thanks to monetary and financial policies, has supported the rapid recovery in economic activity, it spawned adverse effects on current account balance, external financing facilities and the inflation outlook. Despite the improvement in exports of goods, the current account deficit widened rapidly due to the decline in tourism revenues and the rise in imports. In addition to global uncertainties, the deterioration in inflation expectations has led to a stronger dollarization trend. In this period, residents' demand for FX and gold rose pushing gold imports above historical averages and made a negative impact on the external balance. On the back of increasing macrofinancial risks and deterioration in expectations, high levels of foreign capital outflows from portfolio and swap markets were observed. The simultaneous acceleration in the dollarization trend in domestic deposits and the corporate sector's tendency to decrease FX liabilities contributed further to the increase in external financing needs. Thus, the external imbalances led by domestic demand-driven rapid growth have caused an upswing in country risk premium and lied heavy on exchange rates and reserves (Chart 2).

Chart 1: Credit Growth (Annual, %)



Source: CBRT

Chart 2: Financing of Current Account Deficit (12-Month Cumulative, Billion USD)



Source: CBRT.

In 2020, demand-side factors underpinned by strong credit impulse became an important driver of inflation via direct and indirect channels. On one hand, inflation pressures increased in the sectors with strong demand conditions. On the other, the rapid economic recovery owing to credit expansion, which led to an adverse loop among reserves, risk premium, dollarization and inflation expectations played an important role in the rise in inflation via the exchange rate channel. On the back of the global economic recovery in the second half of 2020, prices of oil, industrial metals and agricultural commodities increased significantly and affected inflation via energy, core goods and food groups. Indicators pertaining to the underlying trend of inflation and pricing behavior point that core inflation is still high and price increases are spread across a wide range of sectors.

Consumer inflation ended 2020 at 14.6% and remained outside the uncertainty band around the 5% target. Both demand and cost factors contributed to the rise in inflation. After being flat around 12% in the first quarter of the year, as a consequence of the pandemic, consumer inflation declined to 10.94% in April, the lowest level of the year. In the second half of the year, however, both direct and indirect channels of the strong credit impulse were the main determinants of inflation.

The rapid economic recovery driven by the buoyant volume of expansion in monetary aggregates and credits not only pushed up demand-side inflationary pressures but also caused a significant deterioration in the current account balance. Reserves bottomed out due to capital outflows and increasing external financing needs. The negative spillovers of this unfavorable outlook on the sovereign risk premium, dollarization and inflation expectations led to depreciation of the Turkish lira to and take an instrumental role in the rise in inflation. Exchange rate developments and higher commodity prices as well as strong demand conditions and supply constraints evident in some sectors caused producer inflation to soar in the second half of the year and to end 2020 at 25.15%.

The impact of the divergence across sectors in 2020, due to pandemic dynamics and the macro policy mix, were evident on inflation. Goods and services categories reflecting weak demand conditions due to the pandemic restrained consumer inflation, whereas inflation remained high in categories where the pass-through from credit and exchange rate developments were relatively high. Thus, inflation was 15.87% for goods and 11.66% for services.

In 2020, the Turkish lira depreciated by 25% against the currency basket. This depreciation was evident across all subcategories, core goods in particular, which exhibit a high exchange rate pass-through. After materializing at 8.18% in the first quarter of the year, core goods inflation surged to 17.24% at the end of the year. Durable goods were the main driver of the increase in core goods inflation. Inflation in durable goods (excluding gold) increased from 11.39% in the first quarter to 30.4% at the end of the year.

Food prices also played an important role in the rise of inflation. Processed food inflation, which was 16.08% at the beginning of 2020, fluctuated throughout the year and ended up at 15.52%. Unprocessed food inflation, on the other hand, displayed a much more negative outlook. Standing at 2.22% in January, unprocessed food inflation ended the year at a high level of 26.34%. Despite the weak course of tourism, cumulative exchange rate effects and the rise in international agricultural commodity prices were instrumental on the rise in food prices.

Services inflation remained rigid around 11-12% throughout the year. Pandemic-related mobility restrictions weakened activity in many sectors, primarily the accommodation and catering services, recreation and culture, transport, and educational services. Although demand conditions had a downward effect on inflation in some services groups, the pandemic-driven increase in unit costs restrained the fall. Tax cuts introduced for some sectors throughout the year partially eased inflationary pressures as well. In this period, significant price increases were observed in sectors with higher exchange rate pass-through, such as maintenance and repair, and health services. The increase in services inflation in the last two months of the year was mainly driven by food prices and cumulative exchange rate effects.

Meanwhile, inflation-restraining developments came into focus in 2020, during which sectoral divergences became evident. Energy, along with the alcoholic beverages and tobacco group pulled consumer inflation down significantly. Alcoholic beverages and tobacco inflation pursued a favorable course due to base effects. After posting a noticeable decline in April as the effects of the pandemic crystalized, oil prices trended upwards in response to the gradual normalization steps all over the world. Nevertheless, they remained below their pre-pandemic levels. The US dollar-denominated oil prices declined by 34% in 2020 compared to the previous year. Thus, energy inflation was 5.64% in spite of the depreciation of the Turkish lira and contributed marginally to consumer inflation. Inflation remained relatively low in subcategories such as clothing, accommodation, education, recreation and culture, and transport services where demand remained weak due to the pandemic.

Domestic demand conditions, cumulative cost effects- particularly through exchange rates-, increasing international food and other commodity prices, supply constraints that became more pronounced in certain sectors and high levels of inflation expectations continue to affect the pricing behavior and inflation outlook adversely.

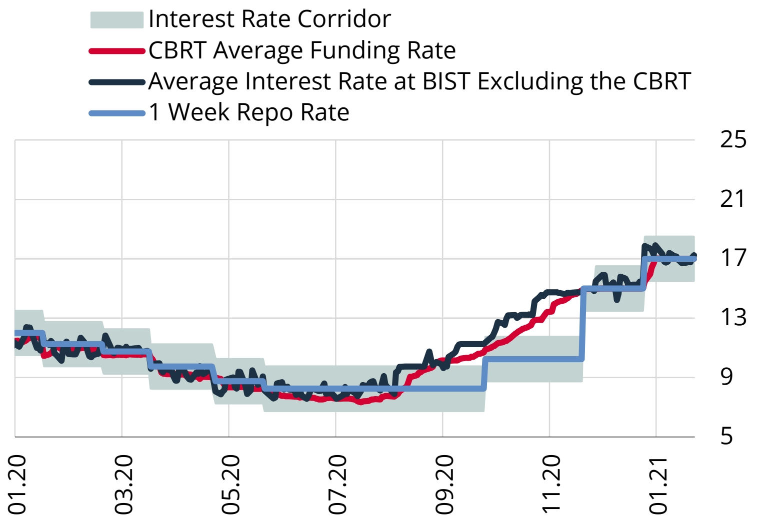
Measures Taken to Reach the Inflation Target

CBRT started to take the necessary steps to tighten the pandemic-specific policies in August in order to contain inflation expectations and risks to the inflation outlook. Nevertheless, the strong demand conditions due to cumulative effects of the rapid credit expansion, continued to roll adversely over the current account balance and inflation outlook in the second half. The CBRT introduced a clear and strong monetary tightening in order to eliminate risks to the inflation outlook, contain inflation expectations and rapidly restore the disinflation process, thereby raising the policy rate to 15% from 10.25% in November (Chart 3). Moreover, the CBRT decided to adopt a simple operational framework to enhance transparency and predictability, and to provide all short-term funding at the one-week repo rate, i.e., the main policy rate. Accordingly, on 20 November 2020, the CBRT started to provide funding via one-week quantity repo auctions, the main monetary policy tool, instead of traditional-method repo auctions with one-month maturity and the previously employed Late Liquidity Window (LLW) facilities.

MPC assessed the need for a reserve requirement policy revision in order to enhance the effectiveness of the monetary transmission mechanism in line with the primary objective of price stability in its November meeting. Accordingly, the CBRT decided to repeal the reserve requirement practice that linked the reserve requirement ratios and remuneration rates to real loan growth rates, and apply the same reserve requirement ratios and remuneration rates to all banks. The simplification of the reserve requirement policy contributed to increasing the transparency and predictability of the monetary policy. Moreover, changes in Turkish lira and foreign currency reserve requirement ratios supported the CBRT's monetary stance and the effective functioning of the monetary transmission mechanism.

Hacı Bayram Mah. İstiklal Cad. No:10 06050 Ulus Altındağ / ANKARA
Tel: +90 (312) 507 50 00 Fax: + 90 (312) 507 56 40
E-mail: iletisimbilgi@tcmb.gov.tr Swift: tcmbtr2a
Web: http://www.tcmb.gov.tr
Registered E-mail: merkezbankasi@hs02.kep.tr

Chart 3: CBRT Rates and Short-Term Interest Rates (%)



Source: BİST, CBRT.

The strong communication regarding monetary policy tightening and price stability had positive implications for the markets, thereafter improving financial indicators. Enhancing policy predictability by adopting a price stability-oriented and simple operational framework has led to a fall in the risk premium, exchange rate volatility and long-term interest rates, and a rise in capital inflows since November.

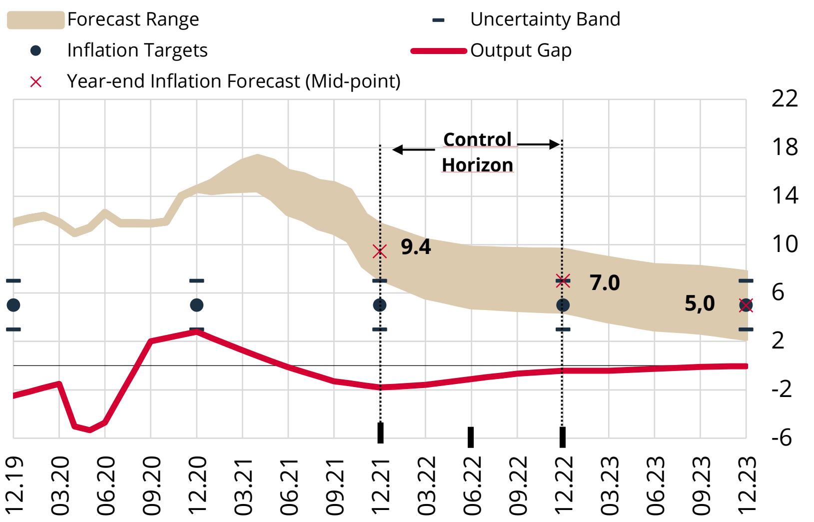
The CBRT delivered a strong monetary tightening in December, taking into account the end-2021 forecast target. The one-week repo auction rate, i.e., the policy rate, was increased to 17% from 15%. The developments in international commodity prices, supply constraints that became more discernible in certain sectors, and the minimum wage and administered prices in the period following the December MPC decision shaped the CBRT's evaluations of the inflation outlook for 2021. Accordingly, in January MPC meeting, the CBRT strengthened the tight monetary policy stance via its forward guidance stating that the tightness of the monetary policy stance will be maintained decisively "for an extended period" until strong indicators point to a permanent fall in inflation and price stability and that "additional monetary tightening will be delivered if needed".

The decelerating impact of the strong monetary tightening implemented in November and December MPC meetings on credit and domestic demand is expected to become more significant; hence the effects of demand and cost factors on inflation are envisaged to wane gradually.

TÜRKİYE CUMHURİYET MERKEZ BANKASI

Accordingly, inflation is projected to be 9.4% at the end of 2021, and fall to 7% at the end of 2022 before stabilizing around 5% in 2023, which is the medium-term target. Inflation is expected to be between 7.3% and 11.5% (with a mid-point of 9.4%) at the end of 2021 and between 4.6% and 9.4% (with a mid-point of 7%) at the end of 2022 with a 70% probability (Chart 4).

Chart 4: Inflation and Output Gap Forecasts*



Sources: CBRT, TURKSTAT.

* Shaded area denotes the 70% confidence interval for the forecast.

Forecasts are produced under the assumption that monetary policy will be tight enough to ensure that inflation remains in line with the 2021 and 2022 forecast targets. It is also assumed that a pandemic-led negative shock to global growth as well as the external demand outlook will not occur once again and that the recovery in Turkey-specific risk perceptions will continue amid the improvements in the global risk appetite. In the forecast path for 2021; wages, food prices and international commodity prices have an upward effect on inflation, whereas administered prices and inflation expectations are assumed to have a downward effect. In view of this interaction, the strong impact to be generated by the tight monetary stance is projected to bring inflation down to 9.4% by the end of 2021. Yet, upside risks on these forecasts remain significant. Hence, maintaining the strong and tight monetary policy stance becomes inevitable.

Monetary Policy Strategy to Reach Price Stability

The main principles of the monetary policy that will be implemented in pursuit of the price stability objective are outlined in the Monetary and Exchange Rate Policy document published on 16 December as follows: (i) Implementing full-fledged inflation targeting regime decisively within a simple operational framework. (ii) Adopting a tight and decisive monetary policy stance with a priority and focus of price stability. (iii) Strengthening communication by adhering to the transparency, predictability and accountability principles. (iv) Implementing the floating exchange rate regime. (v) Strengthening foreign exchange reserves and using all available instruments to this end under appropriate conditions in a transparent way and within a specific plan when the predetermined strategic criteria are met. (vi) Safeguarding financial stability as well as price stability.

In an inflation targeting regime, central banks aim to control the future inflation with a medium-term perspective by taking into account the transmission lags of the monetary policy. Since monetary policy decisions influence aggregate demand and inflation with a lag, it is more effective to set the policy stance in line with inflation forecasts. In this regard, the forecasts announced in Inflation Reports are also “forecast targets” and interim targets by serving as references to inflation expectations. In other words, to steer expectations more efficiently while converging to the medium-term inflation target, the reference values that will guide economic units regarding the future trend of inflation are the inflation forecasts for the short term and the inflation target for the medium term.

Considering the current levels of inflation together with the upside risks, it is clear that we are significantly away from the 5% target. The forecasts in the January Inflation Report show that the inflation target of 5% is attainable in 2023. Thus, the tight and cautious monetary policy stance should be maintained resolutely for a long time until 2023, the year when it is expected to achieve the 5% target.

In order to reach the medium term 5% target, a full-fledged inflation targeting will be implemented. Within this period, evolution of inflation around the envisaged forecast path will be continuously and closely monitored. Accordingly, until the target of 5% is reached, the level between the realized and expected inflation rate path and the monetary policy rate path will be set considering a strong disinflationary balance; and this balance will be sustained. Besides the current information set, if any new information arrives pointing at the risk of inflation expectations and pricing behavior diverging from the medium-term target path, additional front-loaded and decisive tightening will be implemented. Accordingly, indicators for the underlying trend of inflation and pricing behavior, diffusion indices, demand and cost factors and inflation expectations will be monitored closely for their compatibility with the targets in the forecast horizon.

This tight monetary policy stance will contribute to the decline in the country risk premium, encouragement of Turkish lira savings, beginning of reverse currency substitution, foreign exchange reserves to enter into an increasing trend and a perpetual decline in financing costs. This will not only foster macroeconomic and financial stability, but it will also enable the adjustment of the level of monetary tightening under these circumstances.

The fiscal consolidation to be ensured through the strengthening of the coordination between monetary and fiscal policies as part of the strong policy coordination in pursuit of the medium-term target of 5% will provide a key input to achieve inflation targets. Accordingly, sustaining the fiscal discipline in a decisive manner continues to be a critical priority. In addition to the fiscal stance, determining the administered prices and tax adjustments, income policy and public borrowing strategy in line with the monetary policy targets will support our fight against inflation. Besides, the reform steps to be taken in the field of law and economy will make a significant contribution to the disinflationary process through the expectations channel.

Continuing with structural reforms to curtail the inertia and volatilities in inflation will contribute to price stability and social welfare, in turn. In this context, the CBRT will maintain its efforts to analyze structural factors, develop policy recommendations and raise awareness for the importance of disinflation among related stakeholders and the public.

On the other hand, there will also be steps to improve the credibility of the monetary policy via improvement and increase in transparency, predictability and accountability in the design and implementation of the monetary policy.

As a result, the Central Bank will continue to use all available instruments in pursuit of the price stability objective completely, promptly, effectively, strongly and decisively. Meanwhile, the inflation-targeting regime mainly relies on focusing and commitment of all layers of the society on price stability as well as the decisive steps to be taken by the decision-makers and policy-makers. Accordingly, an explicit, truthful and effective cooperation and communication policy will be implemented to make this process endorsed by all parties.

The January 2021 Inflation Report, published on 28 January 2021 on our website, is enclosed for your information to provide a comprehensive account of the developments regarding inflation and monetary policy as well as our medium-term forecasts.

Yours sincerely,

CENTRAL BANK OF THE REPUBLIC OF TURKEY
Head Office

Naci Ağbal Governor	Dr. Uğur Namık Küçük Deputy Governor

Enc: January 2021 Inflation Report

CENTRAL BANK OF THE REPUBLIC OF TURKEY
TRADE REGISTRY NO: 269
CAPITAL: TRY 25,000
HEAD OFFICE, ANKARA

Hacı Bayram Mah. İstiklal Cad. No:10 06050 Ulus Altındağ / ANKARA
Tel: +90 (312) 507 50 00 Fax: + 90 (312) 507 56 40
E-mail: iletisimbilgi@tcmb.gov.tr Swift: tcmbtr2a
Web: http://www.tcmb.gov.tr
Registered E-mail: merkezbankasi@hs02.kep.tr