1. Overview

Despite the restraining effects of the pandemic, economic activity remained strong in the first quarter of 2021, and aggregate demand conditions hovered above their long-term trends. GDP increased by 7% on an annual basis and by 1.7% on a quarterly basis in the first quarter. The industry and construction sectors were the main determinants of quarterly growth from the production side. The services sector made a limited contribution to growth owing to the pandemic-led restrictions. On the expenditures side, while final domestic demand had a dampening effect on growth due to shrinking private consumption amid pandemic restrictions and tightening financial conditions, total investments and net exports made a positive contribution.

Data for the second quarter suggest that economic activity has been strong. Domestic demand decelerated in the second quarter due to the tightening in financial conditions, and pandemic restrictions. After having receded in April, industrial production increased in May. High-frequency data such as turnover and retail sales volume indices confirm that the slowdown in economic activity was driven by domestic demand due to pandemic measures. Consumption demand diverged across sectors in response to the pandemic-related restrictions. In April, the services turnover index had declined significantly due to accommodation and food and beverage services, but this decline was somewhat compensated for in the subsequent period in food and beverage services in particular. On the other hand, the tightening in financial conditions restrained the demand for durable goods. As a matter of fact, survey-based indices for orders and the domestic sales data for durable consumption goods suggest that the tightening in financial conditions has restrained consumption demand. Despite the deceleration in domestic demand, external demand has remained strong. This points to a rebalancing in the composition of economic activity in terms of domestic and external demand.

Despite the negative effect of the rise in international commodity prices, the external balance improved due to the strong uptrend in exports, the slowdown in credit growth amid the tightening of financial conditions, and the fall in gold imports. On the back of the recovery in the global economy and the rise in export prices, exports continued to soar in the second quarter of the year, and exports to both Europe and non-European countries increased. Meanwhile, despite the rise in international commodity prices, imports remained relatively flat in the second quarter on account of the slowdown in credit growth and the significant fall in gold imports. The decelerating impact of the tight monetary policy on credit and domestic demand has been influential on the course of imports. Services income declined in the first half of the year due to the pandemic-led restrictions. It is expected that services income will increase in the second half of the year parallel to a more positive outlook for tourism as the vaccination rollout gains pace and pandemic restrictions are eased in the country. The current account is expected to post a surplus in the rest of the year due to the strong upward trend in exports, and the strong progress in the vaccination program stimulating tourism.

In a period in which global inflation developments increase data-sensitivity in monetary policies and the global financial markets, Turkey's risk premium has declined. The CBRT's clear communication that it would make its monetary policy decisions to ensure a permanent fall in inflation, followed by its adherence to this tight stance, affected the country risk premium favorably. Additionally, the strong progress in the vaccination program stimulating tourism activities in Turkey was another factor that affected investor sentiment favorably. A comparison with the previous reporting period suggests that Turkey has attracted portfolio inflows in the current reporting period in line with the relatively improved risk sentiment. While the current tight monetary policy keeps demand-side factors under control by containing loans and domestic demand, it also supports the improvement in the current account balance. Nevertheless, the outlook for monetary policies in advanced economies and global risk appetite keep the risks to the portfolio flows towards emerging economies in place.

In the second quarter, while aggregate demand conditions displayed a milder outlook, the rise in international food and commodity prices, exchange rate developments, and the course of inflation expectations affected the inflation outlook negatively. Consumer inflation remained consistent with April Inflation Report forecasts in April and May, but it hovered close to the upper bound of the forecast band in June, reaching 17.53% in this quarter, due also to the controlled normalization. Annual producer inflation increased further in this quarter amid exchange rate developments, cumulative increases in international commodity prices and lingering supply constraints in some sectors. Survey-based inflation expectations rose in the second quarter. In spite of a slight decline in the recent period, market-based expectations have remained high relative to their historical averages. Despite the rise in crude oil prices and the depreciation of the Turkish lira, the sliding scale system continued to reduce the resulting inflationary effect. In the second quarter, the annual inflation rates of core indicators increased compared to the first quarter, and their trends remained high despite some decline.

A milder and more balanced growth in personal loans is critical to curb risks to the inflation outlook and external balance. While the decelerating impact of the monetary tightening on credit has begun to be observed, short-term trends indicate that personal loan utilization increased notably in early June. This increase is mainly attributed to the reopening and deferred demand. Accordingly, the CBRT closely monitors the effects of the monetary policy stance and macroprudential measures.

The CBRT communicated that it would continue to determine the monetary stance at a degree of tightness that will restore the disinflation process as soon as possible and ensure achievement of medium-term targets. As a reflection of this stance, the CBRT kept the policy rate constant in the current reporting period. Moreover, it emphasized in its decisions that the current monetary policy stance would be maintained until the significant fall in the April Inflation Report's forecast path was achieved. Thus, market expectations started to become more aligned with the policy stance envisaged in the April Inflation Report. Additionally, the CBRT gave forward guidance that the policy rate would be set at a level above inflation during the disinflation process.

Taking into account the high levels of inflation and inflation expectations, the CBRT has kept the policy rate constant since April, thereby maintaining the tight monetary policy stance. The decelerating impact of the monetary tightening on credit and domestic demand is being observed. However, the demand and cost factors driving inflation remain significant. The CBRT judged that, in addition to the recent increases in import prices and administered prices, demand conditions, supply constraints in some sectors, possible volatility in inflation during the summer due to the reopening, and high levels of inflation expectations continued to pose risks to pricing behavior and the inflation outlook, and therefore maintained its tight stance in monetary policy.

While various supply and demand side factors, with import prices and administered prices in the lead, might have an effect on inflation in the short term, it is assessed that the current monetary policy stance is tight enough to prevent repercussions on the underlying trend. On the other hand, the impact of possible short-term volatilities in inflation on the underlying trend will be monitored closely for the monetary policy stance. While the current tight monetary policy keeps demand-side factors under control by containing loans and domestic demand, it also supports the improvement in the current account balance.

1.1 Monetary Policy Decisions

In the May-July period, the CBRT kept the policy rate unchanged at 19%. The communication regarding the monetary policy outlook contributed to better alignment of market expectations with the outlook in the April Inflation Report. It was emphasized in the summary of the May MPC meeting that the decelerating impact of the monetary tightening on credit and domestic demand began to be observed but demand and cost factors, supply constraints in some sectors, and high levels of inflation expectations continued to pose risks to the pricing behavior and inflation outlook. Against this background, it was noted that the current monetary policy stance would be maintained until the significant fall in the April Inflation Report's forecast path was achieved. It was also added that consumer loans, along with commercial loans, exhibited a milder course, and that the CBRT was closely monitoring the durability of this development for macroeconomic stability.

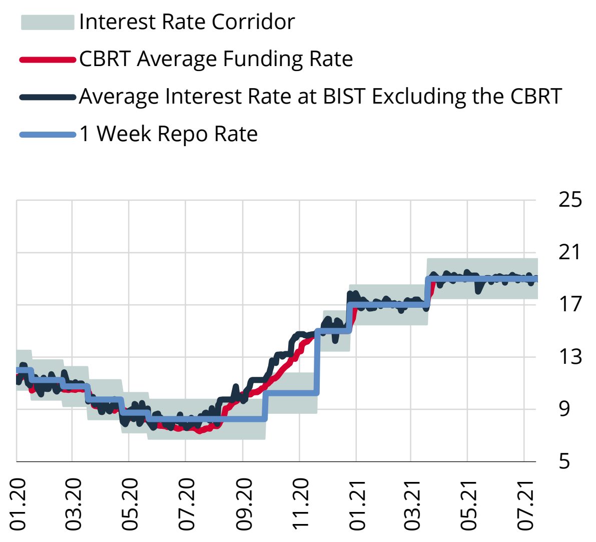
In June, the CBRT stated that loan growth exhibited a mild course owing to the implemented monetary tightening and underlined that the course and composition of loans were closely monitored for macroeconomic stability. It was also noted that the rising global inflation and inflation expectations were leading to fluctuations in international financial markets.

With a press release on 1 July 2021, the CBRT announced that it had revised the reserve requirement regulation to improve the effectiveness of the monetary transmission mechanism in line with its main objective of price stability. The CBRT increased the reserve requirement ratios for FX deposits/participation funds by 200 basis points for all maturity brackets, and announced that the facility for holding FX for Turkish lira reserve requirements would be terminated in October after gradually decreasing its upper limit. The other regulations announced via the same CBRT press release are intended to encourage banks to steer away from FX deposit accounts towards Turkish lira deposits in their balance sheets. On the same date as the CBRT's press release about the course and composition of loans that it closely monitors for macroeconomic stability, the BRSA also introduced a set of decisions (Table 1.1). The coordinated manner in which the BRSA regulations accompany the CBRT's reserve requirement steps will contribute to a balanced loan growth and the effective functioning of the transmission mechanism.

Drawing attention to the increases in import prices and administered prices, demand conditions, supply constraints in some sectors and possible volatility in inflation during the summer due to the reopening, the CBRT maintained its current tight stance in the July MPC meeting. In this meeting, the CBRT reiterated its message that the decelerating impact of the monetary tightening on credit and domestic demand was being observed. It also emphasized that in addition to the increases in import prices and administered prices, demand conditions, supply constraints in some sectors, possible volatility in inflation during the summer due to the reopening, and high levels of inflation expectations continued to pose risks to the pricing behavior and inflation outlook. The CBRT kept the policy rate unchanged at 19%, and underlined once again that the current tight monetary policy stance would be maintained decisively until the significant fall in the April Inflation Report's forecast path was achieved. It also added that while commercial loan growth exhibited a mild course, it would monitor the effects of the implemented macroprudential measures on personal loans, which recently displayed a rise due to the reopening and deferred demand.

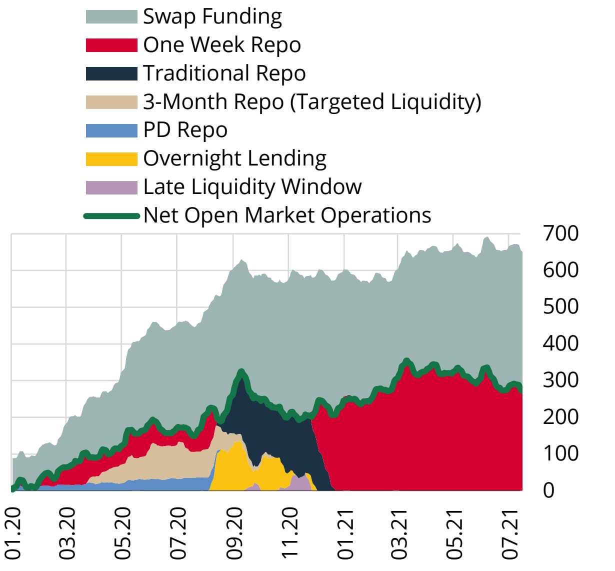
In the current reporting period, the CBRT continued to provide funding within a simplified operational framework through OMO and swap transactions, and the overnight interest rates materialized around the CBRT policy rate. Owing to the CBRT's predictable liquidity management framework, BIST overnight repo rates continued to hover around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TRY 336 billion as of 30 April 2021, increased to TRY 380 billion as of 19 July 2021. In the same period, the net OMO funding registered a decline from TRY 337 billion to TRY 274 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.

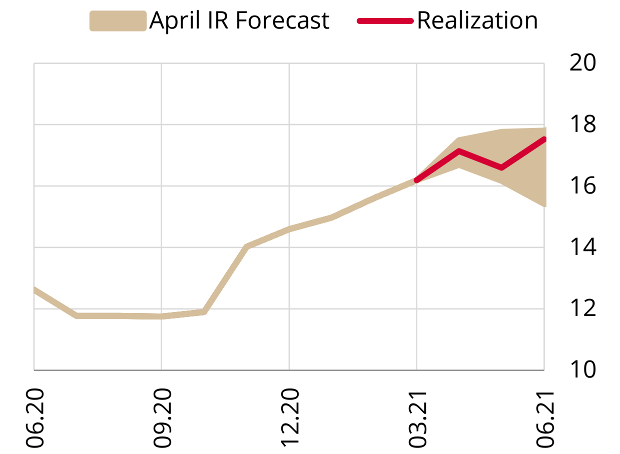
Table 1.1: Monetary Policy Implementations

Date	Institution	Policy Decision
1 July 2021	CBRT	▪ The upper limit of the facility for holding FX for Turkish lira reserve requirements was decreased from 20% to 10%. It was announced that the said facility would be terminated by the maintenance period starting on 1 October 2021. ▪ Reserve requirement ratios for FX deposits/participation funds were increased by 200 basis points for all maturity brackets. ▪ Additionally, it was decided that FX deposits/participation funds available as of 25 June 2021 and converted to Turkish lira deposits/participation funds after this date would be exempt from reserve requirement liabilities, ▪ Additional remuneration rate would be applied to Turkish lira-denominated required reserves to increase the share of Turkish lira in the total deposits/participation funds in the banking system.
1 July 2021	BRSA	Under the macroprudential measures taken in coordination with relevant institutions, it was decided to ▪ Change the maturity caps and loan-to-value ratios of some consumer loans as well as the installment caps for credit card transactions, ▪ Increase the risk weights of personal credit cards and general-purpose loans.

1.2 Medium-Term Projections

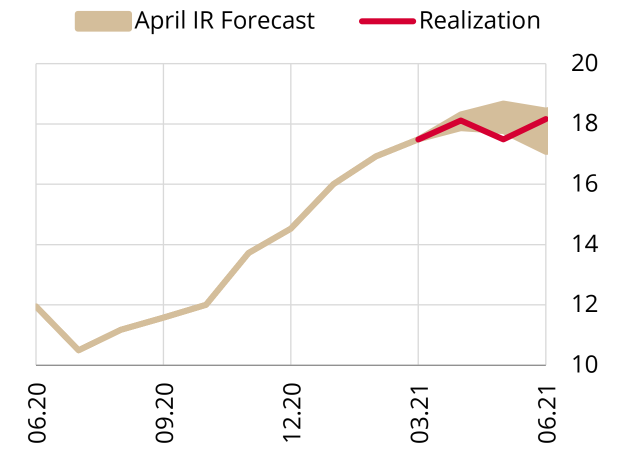
In the second quarter of 2021, consumer inflation stood at 17.53%, materializing close to the upper bound of the forecast range of the April Inflation Report. In this period, annual inflation of the CPI and the B index, which is one of the core indicators, were broadly consistent with projections (Charts 1.2.1 and 1.2.2). In the second quarter, inflation continued to increase due to exchange rate developments, cumulative effects of the rise in international food, energy and commodity prices, supply constraints in some sectors, deferred cost increases, and the recent disruptions in the global supply chain.

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



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

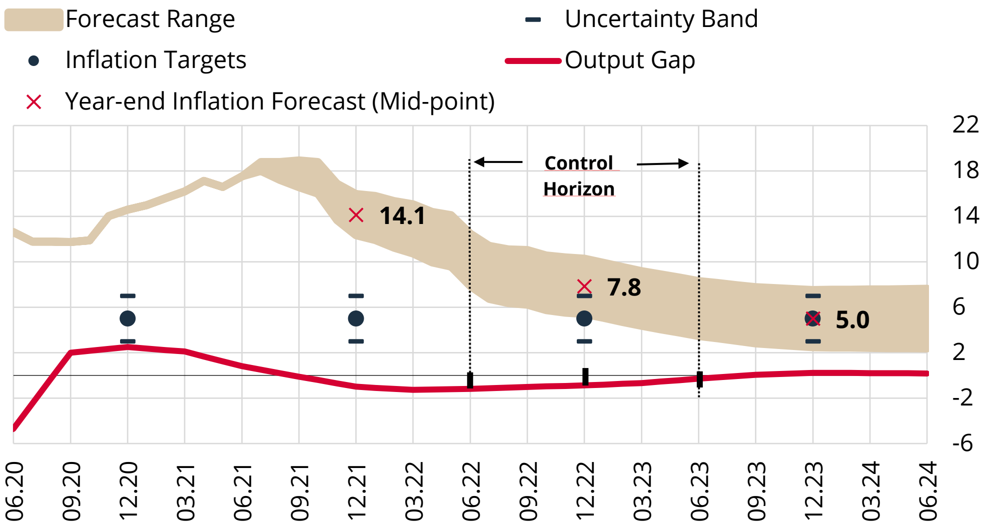
Chart 1.2.2: April Forecast and Actual Rates for Inflation Excl. Unprocessed Food, Energy, Alcohol-Tobacco and Gold (B Index)* (%)



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

Based on main assumptions and short-term projections, and under the scenario in which the policy rate would continue to be determined at a level above inflation to maintain a robust disinflationary effect, inflation is projected to gradually converge to the targets. Accordingly, inflation is projected to be 14.1% at the end of 2021 and fall to 7.8% at the end of 2022 before stabilizing around 5% in 2023, the medium-term target. With a 70% probability, inflation is expected to be between 12.2% and 16.0% (with a mid-point of 14.1%) at end-2021 and between 5.4% and 10.2% (with a mid-point of 7.8%) 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 the outlook for global growth and external demand has been better than in the previous reporting period amid a rapid vaccination rollout, but rising global inflation and inflation expectations continue to have a significant impact on international financial markets. This outlook points to heightened uncertainty and slightly tightening global financial conditions compared to the previous reporting period. Thanks to the improved recovery in demand amid expansionary monetary and fiscal policies and a fast vaccine rollout, the global growth outlook increased global inflation expectations. Signs of a rise in global inflation and the recovery in economic activity increased the possibility of a sooner-than-expected monetary policy normalization. Higher yields in advanced economies led to outflows from emerging economies, which may translate into heightened volatility. In this context, maintaining a tight monetary policy stance until strong indicators point to a permanent fall in inflation will limit the possible adverse effects of global financial market volatilities on the country's risk premium.

As the decelerating impact of the monetary stance on loans and domestic demand has become more evident, aggregate demand conditions are likely to display a more moderate course in the second half of the year. In the first quarter of 2021, economic activity remained above trend despite the restrictive effects of the pandemic. Economic activity was strong in the second quarter of the year, whereas domestic demand lost some momentum in April and May due to lockdowns and tight financial conditions. On the other hand, the acceleration of the domestic vaccination rollout facilitates the recovery in services and tourism sectors, which have been adversely affected by the pandemic, and leads to a more balanced composition in economic activity. Additionally, the strong demand from Turkey's trade partners supports economic activity through the export channel. Rising commodity prices, exchange rate changes, and global supply chain disruptions are the main drivers of producer inflation. Thus, cost pressures are observed on consumer prices. Moreover, there might be some volatility in inflation over the summer months due to the reopening. The course of administered prices also affects the short-term inflation outlook. Therefore, 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.

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 developments regarding the vaccine rollout in Turkey and abroad add to the upside risks to economic activity. The worldwide speeding up of the vaccination rollout, especially in developed countries, supports the global economic recovery. With gradual normalization, domestic economic activity is following a strong course. In this regard, economic activity is expected to show a more balanced composition of growth in the second half of the year, while services and tourism sectors might start seeing some recovery. The rebound in tourism amid faster vaccinations is likely to accelerate the improvement of the current account balance. However, it should be noted that the possibility of some coronavirus variants causing a spike in new cases and fueling another wave of the pandemic has not been ruled out.

Together with the recovery in global demand, factors such as rising commodity prices, pent-up consumption and supply constraints drive global inflation higher. The Fed's communication shifted towards a more hawkish tone at its last meeting. Both the upward trend in global inflation and expectations for the Fed's actions led to a tightening of monetary policies across emerging economies. This outlook may have an impact on financial markets and exchange rates through capital flows and the global risk appetite.

High international commodity prices continue to pose an upside risk to the inflation outlook. Oil prices continued to rise due to the rapid recovery in demand and the OPEC+ countries' failure to reach a deal to increase output, and saw only a brief decline following the agreement on 18 July 2021. In the upcoming period, commodity prices will likely reflect the normalization that will occur when the pandemic no longer poses a threat thanks to a rapid vaccination program. The secondary effects of supply-side factors on inflation expectations and their interaction with financial indicators are monitored closely.

Ongoing disruptions in the supply chain keep the supply-side risks to inflation alive. Global supply constraints and higher freight costs put upward pressure on producer prices. The pass-through from producer prices to consumer prices as well as the reasons thereof are monitored closely.

Although the country risk premium and the implied exchange rate volatility have decreased, they are still high compared to peer economies. Developments that will adversely affect the external financing outlook pose a downside risk to growth and an upside risk to inflation through exchange rates and expectations channels.

Year-end and medium-term inflation expectations remain high. Survey-based indicators and inflation break-evens indicate that inflation expectations have increased. Volatile financial markets pose a risk to pricing behaviors and the inflation outlook.

Commercial loans continue to follow a moderate course on the back of monetary tightening. July's macroprudential measures for personal loans are expected lead to tighter lending standards and limit loan demand. Factors that may push loan growth upward and curtail the transmission of the tight monetary stance may deteriorate the inflation outlook via aggregate demand, the current account balance, external financing and risk premiums. In this context, indicators for loan supply and loan demand will be monitored closely.

The disinflation process may be delayed, should the path of administered prices 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.

[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 in Chapter 3.