# 1. Overview

***The strong growth trend in economic activity observed in the first quarter of 2022 continued in the second quarter as well.*** In the second quarter, Gross Domestic Product (GDP) increased by 7.6% year-on-year and 2.1% quarter-on-quarter. Similar to the first quarter, the main drivers of annual growth in the second quarter were services and the industrial sector, and private consumption continued to contribute to growth, particularly with the contribution of services items. Meanwhile, alternative indicators show that demand from the expenditure side is fragmented across groups. In this period, as in previous quarters, the uptrend in machinery-equipment investments was maintained, while the decrease in construction investments limited the contribution of total investments to annual growth.

***The rising share of sustainable components in the composition of growth supports the rise in employment.*** The annual rise in machinery-equipment investments, which is one of the drivers of potential growth, has continued for eleven successive quarters since the last quarter of 2019. Moreover, the growth-inducing effect of net exports, which supports the current account balance positively, continued in the second quarter as well. In the second quarter, the contribution of machinery-equipment investments and net exports to annual growth was 2.2 and 2.7 percentage points, respectively. Thus, the shares of these components in national income reached historically high levels. The positive impact of strong growth on employment continued in the second quarter as well. While the seasonally adjusted total unemployment rate decreased to 10.6% in the second quarter, the average for July-August decreased by 0.8 points to 9.8% compared to the previous quarter. In the said period, employment growth lost momentum compared to the uptrend observed in the first half of the year and was recorded at 0.4% (approximately 116 thousand people) on a quarterly basis. On the other hand, the seasonally adjusted participation rate decreased by 0.4 points to 52.8%, contributing to the decrease in the unemployment rate.

***Leading indicators show that economic activity, which was strong in the first half of the year, decelerated also due to the weakening in foreign demand.*** In the July-August period, the seasonally adjusted Industrial Production Index (IPI) decreased by 3.9% compared to the second quarter. In this period, the decrease in production was observed across all sectors, excluding vehicles. While industrial turnover indices point to a decrease in both domestic and foreign demand in the third quarter, the quarterly retail sales volume index continued to increase, albeit at a slower pace. An analysis of demand components suggests that the final domestic demand, which increased on a quarterly basis in the second quarter, decreased slightly in the third quarter. In this period, the decline in foreign demand due to the slowdown in global growth is expected to limit the contribution of net exports to growth. In line with the expected slowdown in economic activity, it is predicted that the rise in total employment will lose momentum in the third quarter, and employment in related industrial sectors may slow down due to the decrease in exports.

***Despite the strong contribution of the balance of services, the annualized current account deficit continued to increase due to the limited slowdown in exports and high course of energy and gold imports.*** While the weakening effect of growing geopolitical risks on economic activity continues globally, leading indicators signal that the risk of a global economic recession has increased. The strong exports trend in the first half of 2022 lost some momentum in the third quarter due to the weakening in foreign demand. Exports to Europe, Turkey's main export market, which were strong in the first half of the year and contributed to the overall export growth, slowed down slightly on an annual basis in the third quarter. However, total exports remained high after the pandemic. Imports, on the other hand, continued to rise because of the high level of energy prices and recently accelerated gold imports. The decrease in international commodity prices led to a limited decline in both export and import prices in the third quarter. Excluding price effects, the quantity of exports decreased, while that of imports increased. The decline in the volume of exports is attributed to the deceleration in economic activities in main export markets. Services revenues maintained its uptrend with the contribution of travel and transportation revenues and continued to support the current account balance. As of August, travel and transportation revenues were above the pre-pandemic levels of 2019. Twelve-month cumulative figures suggest that travel revenues reached USD 31.7 billion, while transportation revenues stood at USD 33.1 billion. Meanwhile, when foreign trade developments are taken into consideration, it is observed that the annualized current account deficit continued to increase in August. Excluding gold and energy, the ongoing rise in the 12-month cumulative current account surplus is important as it shows the impact of energy prices, which are still high compared to 2021 despite some decline, on the current account balance.

***The elevated level of global inflation, the increased concerns over a recession in advanced economies and expectations of deceleration in economic activity across countries caused a significant decline in the global risk appetite in the current reporting period.*** Lingering geopolitical risks and fluctuating commodity prices have weakened the expectations of a recovery in the global risk appetite. The volatility in long-term bond rates in advanced economies and the course of global financial conditions keep the risks to portfolio flows to emerging market economies (EM) alive, and cause outflows from bond markets in particular. In this period, capital flows to Türkiye displayed a trend similar to that of emerging economies.

***Loan growth, which showed a rapid acceleration in the second quarter, decelerated in the third quarter on the back of macroprudential measures, but in real terms, it continued to hover above the averages of previous periods.*** According to the results of the Bank Loans Tendency Survey (BLTS), banks' foreign funding conditions became tighter in the third quarter, while banks' domestic funding costs remained low on the back of the CBRT's policy rate cut by 350 basis points in total during the August-October period. Commercial loan interest rates have declined owing to the implementation obliging banks to hold securities at varying ratios according to the commercial loan interest rates and the difference between commercial loan rates and policy rate has decreased. In the same period, consumer and vehicle loan rates slightly decreased as well. While the rapid acceleration in loans was replaced by a more balanced course with the effect of macroprudential measures introduced in the third quarter, inflation-adjusted loan growth is still above the long-term averages.

***Annual consumer inflation, which was 83.45% in the third quarter of 2022, was close to the mid-point of the forecast range presented in the July Inflation Report, while annual inflation decreased in the energy group, remained almost flat in food and increased in other subgroups.*** In this period, in tandem with the global outlook, commodity prices excluding natural gas, and international transportation costs decreased, and supply constraints eased compared to previous periods while the nominal depreciation in the Turkish lira remained limited. Natural gas prices, which stayed elevated due to geopolitical developments, coupled with electricity prices, have put pressure on inflation both directly and indirectly. Aggregate demand conditions were more moderate compared to the previous quarter, and following the normalization trend in loan supply, they showed a decline in line with the projections in the July Inflation Report. Foreign demand also contributed to this decline. Against this background, monthly changes in B and C indices slightly slowed, while annual inflation continued to increase. Compared to the previous reporting period, there was a limited slowdown in indicators regarding the underlying trend of inflation in this quarter.

## 1.1 Monetary Policy Decisions

***Considering that financial conditions should be supportive to preserve the growth momentum in industrial production and the positive trend in employment in a period of increasing global uncertainties, the CBRT cut the policy rate by 100 basis points in August and September, and by 150 basis points in October.*** At its meetings of August and September, the Monetary Policy Committee (MPC) emphasized escalating geopolitical risks and weakening global economic activity. Despite the foreign demand-driven strong growth trend in Türkiye in the first half of the year and positive employment developments compared to peer economies, the leading indicators for the third quarter point to a loss of momentum in economic activity caused by external demand. Under the circumstances of increased uncertainties in global growth, the CBRT decided to reduce the policy rate by a total of 350 basis points in August, September and October in order to support financial conditions to sustain the structural gains in domestic economic activity and employment developments.

***The CBRT has strengthened its integrated policy framework with macroprudential measures since the second quarter of 2022.*** Within the framework of its targeted loan policy, the CBRT closely monitors the growth rate, composition and the use of loans to support economic activity, as well as the spread between the policy rate and loan interest rates to increase the effectiveness of the monetary transmission mechanism. Accordingly, macroprudential policies were strengthened and continued to be implemented during the previous reporting period.

***In August, the CBRT took new steps to increase the effectiveness of its reserve requirement implementation applied to loans.*** In this context, the CBRT decided to replace the reserve requirement maintenance applied at 20% by maintenance of securities at 30% for banks, and to make TL commercial loan types, for which maintenance of securities is not required, available against expenditure. Additionally, for commercial loans to be extended from 20 August 2022 until the end of 2022, it was decided that securities would be maintained based on 20% of the loan amount to be extended at an annual compound interest rate 1.4 times higher than the CBRT's annual compound reference rate, and 90% of the loan amount to be extended at an annual compound interest rate 1.8 times higher than the CBRT's annual compound reference rate (Table 1.1.1).

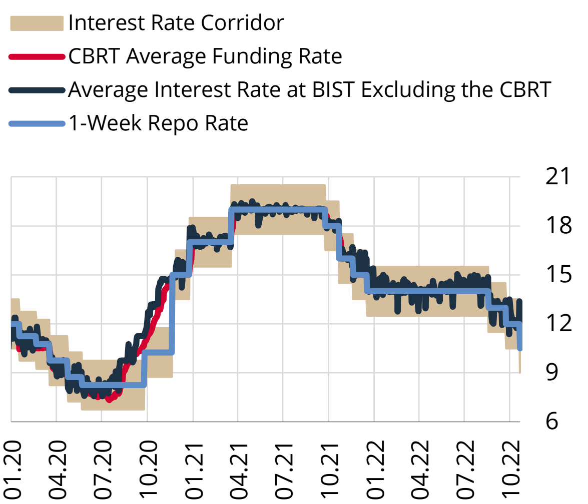
***As part of the liraization strategy, the CBRT introduced new regulations in August to increase the share of Turkish lira assets in the collateral system and to ensure maintenance of additional required reserves for foreign currency deposits/participation funds.*** Effective as of 2 September 2022, the collateral discount rate for indexed securities and assets subject to collateral in foreign currency and gold was increased from 50% to 60%. Effective from the same date, in addition to the real person conversion rate, the legal person conversion rate was included as a target condition for maintaining additional required reserves for foreign currency deposits/participation funds based on the real person conversion rate, and the target values were raised (Table 1.1.1).

***In September, the CBRT revised the terms of rediscount credits and lifted the exemption from the requirement of keeping in blocked accounts the rediscount credits for export and foreign exchange earning services utilized via the Turk Eximbank.*** Additionally, repayments in Turkish lira at the CBRT's buying rates were allowed for foreign currency rediscount credits. Besides, the CBRT decided to apply the condition of lending against expenditure - a requirement of the securities maintenance facility - to Small and Medium-Sized Enterprises (SME), export and investment loans above TL 50,000 that were previously not subject to the securities maintenance implementation. Accordingly, investment, export and SME loans were excluded from this regulation on condition that they were to be used in the expenditure areas specified.

***After the implementation of macroprudential measures, the growth rate and composition of loans showed changes in line with targeted loan policies.*** The share of consumer loans in TL-denominated loans continued to decrease, while the share of investment and export loans in commercial loans continued to increase. Additionally, as a positive reflection of the CBRT's targeted loan policy, the amount and share of SME loans in total loans increased. The CBRT closely monitors the balancing between policy rates and loan, bond and deposit rates for the effectiveness of the monetary transmission mechanism. After the measures taken, loan rates receded, especially in commercial loans, while the spread between commercial loan rates and policy rate decreased, and government domestic debt securities (GDDS) yields decreased in all maturities.

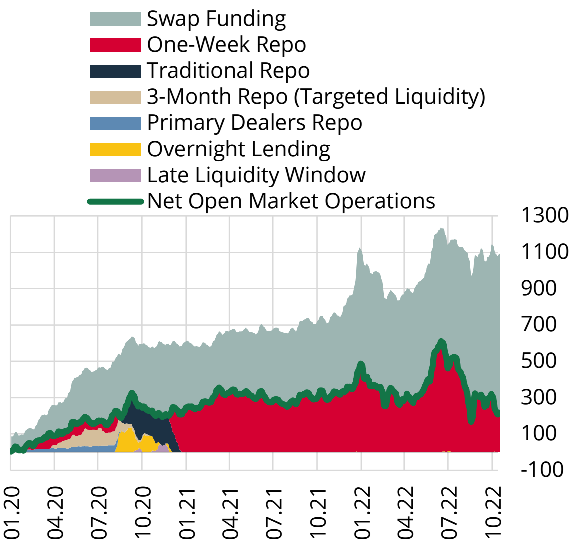
***In the current reporting period, the CBRT maintained the simple operational framework in its monetary policy, provided funding through Open Market Operations (OMO) and currency swaps, and overnight interest rates hovered around the CBRT policy rate.*** Owing to the CBRT's predicable liquidity policy, Borsa Istanbul (BIST) overnight repo rates continued to hover around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TL 724 billion as of 28 July 2022, increased to TL 875 billion as of 21 October 2022. In the same period, the net OMO funding decreased to TL 256 billion (Chart 1.1.2).

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




Sources: BIST, CBRT.

**Chart 1.1.2: CBRT OMO and Swap Transactions** (One-Week Moving Average, TL Billion)




Source: CBRT.

**Table 1.1.1: Monetary Policy Implementations**

| Date | Policy Decision |
|---|---|
| **18 August 2022** | ▪ The MPC decided to reduce the policy rate (one-week repo auction rate) from 14% to 13%. |
| **20 August 2022** | ▪ For loans subject to reserve requirements stated in the press release of 23 April 2022, the CBRT decided that:<br>• The reserve requirement maintenance ratio applied at 20% would be replaced by maintenance of securities at 30% for banks to enhance the efficiency of the implementation.<br>• Securities equaling the loan amount exceeding the loan growth rate of 10% as of 30 December 2022 compared to 29 July 2022 would be maintained for a period of one year.<br>• For TL-denominated commercial loans that are not subject to the securities maintenance implementation, lending would be allowed against expenditures starting from 1 October 2022.<br>• For all commercial loans to be extended from 20 August 2022 until the end of 2022, securities will be maintained based on:<br>• 20% of the loan amount to be extended at an annual compound interest rate 1.4 times higher than the CBRT-released annual compound reference rate, and<br>• 90% of the loan amount to be extended at an annual compound interest rate 1.8 times higher than the CBRT-released annual compound reference rate. |
| **23 August 2022** | ▪ Effective from 2 September 2022, the collateral discount rate for indexed securities and assets subject to collateral in foreign currency and gold was increased from 50% to 60%. |
| **30 August 2022** | ▪ Effective from the calculation date of 2 September 2022, an additional 3% commission per annum (over the reserve required amount that should be maintained for FX deposit/participation fund liabilities) would be applied to banks with a TL deposit/participation fund share below 50% in real or legal person deposits. |
| **31 August 2022** | ▪ Effective from the calculation date of 2 September 2022, in addition to the real person conversion rate, the legal person conversion rate was included as a target condition for maintaining additional required reserves for foreign currency deposits/participation funds based on the real person conversion rate, and the target values were raised. Accordingly, it was decided to apply:<br>• an additional 5 points of reserve requirement to banks at which the conversion rate for either real or legal persons (whichever lower) was below 10%,<br>• an additional 3 points of reserve requirement to banks at which the conversion rate for either real or legal persons (whichever lower) was between 10% and 20%. |

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| **31 August 2022** | ▪ Advance Loans against Investment Commitment were revised to include the following interest discount options:<br>• SME status<br>• Development level of the region subject to investments<br>• Use of domestically produced machines<br>• External financing to a certain ratio |
| **7 September 2022** | ▪ The exemption for the condition of keeping in blocked accounts the amount of rediscount credits for export and FX- earning services utilized via the Turk Eximbank was lifted for the purpose of uniformity in implementation.<br>▪ Repayments for FX-denominated rediscount credits were allowed to be made in Turkish lira at the CBRT's FX buying rates announced one business day before the due date. |
| **22 September 2022** | ▪ The MPC decided to reduce the policy rate (one-week repo auction rate) from 13% to 12%. |
| **23 September 2022** | ▪ The Communiqué (No. 2022/26) Amending the Communiqué on the Procedures and Principles Regarding the Fees to be Charged by Banks to Commercial Customers (No. 2020/4) published in the Official Gazette stated that:<br>• the maximum loan disbursement fee of 1.1% to be imposed on loans with a maturity of less than one year would take into consideration the term-to-maturity and be reduced proportionally, and<br>• the maximum annual limit of 0.25% on loan allocation fees would be applied at half the rate for limit renewals. |
| **27 September 2022** | ▪ The lending against expenditure condition for securities maintenance would be applied to SME, export and investment loans above TL 50,000 that are not subject to securities maintenance, and there would be a gradual transition. Accordingly;<br>• as of 1 October 2022, investment loans, and<br>• as of 29 October 2002, export and SME loans<br>would be excluded from securities maintenance, provided that they are used in specific areas of spending. |
| **30 September 2022** | ▪ The first paragraph of Article 4 of the Communiqué on Supporting the Conversion to Turkish Lira Deposits and Participation Accounts (No. 2021/14) published in the Official Gazette was amended as "The foreign currency deposit account and participation account balances denominated in US dollars, euros and British pounds that domestic resident real persons have at banks and domestic resident legal entities have on any date between 31/12/2021 and 30/9/2022 at banks are converted into Turkish lira at the conversion rate upon the request of the account holder." |

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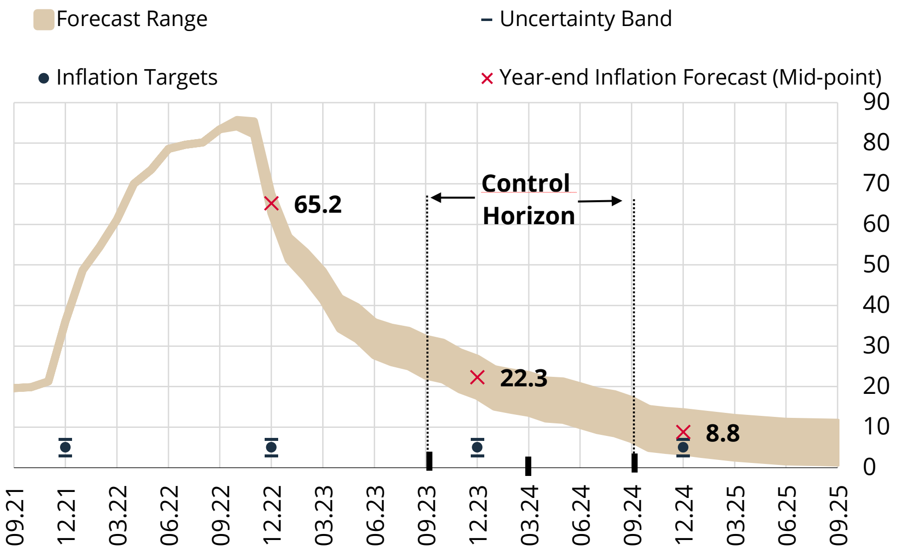
| **18 October 2022** | ▪ With the revision to foreign currency liabilities in securities maintenance:<br>• the securities maintenance ratio was changed to 5% as of 28 October 2022.<br>• Starting 30 December 2022, securities will be maintained based on the targets of the Turkish lira deposits share, instead of the conversion rate.<br>• There will be a gradual transition of three months for both changes. |
| **20 October 2022** | ▪ The MPC decided to cut the policy rate, i.e. the one-week repo auction rate, from 12% to 10.5%. |

## 1.2 Medium-Term Forecasts

***Having ended the third quarter of 2022 at 83.45% and 74.63%, respectively, CPI and B-index inflation remained within the forecast range presented in the July Inflation Report.*** The third-quarter downtrend in non-energy commodity prices and international transportation costs helped alleviate supply constraints. The effects of the policy measures taken under the liraization strategy were more evident in this period, and the Turkish lira was one of the currencies that diverged positively by remaining relatively stable, whereas many other currencies experienced significant depreciation amid the declining global risk appetite. Moreover, data for the third quarter point to a more moderate course in domestic demand. Thanks to macroprudential measures, credit growth has become more balanced as of the third quarter, and thus, the financing cost channel seems to function more efficiently. Hence, inflation was in line with the July Inflation Report projections.

***Inflation is projected to be 65.2% by the end of 2022, and remain on a downward trend by falling to 22.3% by the end of 2023 and 8.8% by the end of 2024***. In line with the main objective of achieving sustainable price stability, the monetary policy stance is determined by considering the continuity of production, the growth rate, composition and utilization purposes of credits, the components of the current account balance and healthy pricing in the foreign exchange market. Forecasts point to a gradual decline in the underlying trend of inflation in 2023 and beyond. The disinflation path implied by the forecasts is based on the assumption that commodity prices will gradually converge to their historical averages due to slowing global demand amid tighter financial conditions, and therefore FX-denominated import prices will decline. On the other hand, a relatively high but moderate course is foreseen in energy prices. Under these external conditions, with the stabilizing effects of the macroprudential measures on credits taken under the liraization strategy and as a result of the implementation of the policy mix, the potential supply will be supported through the financing cost channel while the stable course of the foreign exchange market and the improvement in inflation expectations are expected to bring normalization in the pricing behavior. Accordingly, with 70% probability, inflation is expected to be between 62.8% and 67.6% with a mid-point of 65.2% at end-2022; between 17.7% and 26.9% with a mid-point of 22.3% at end-2023; and between 4.0% and 13.6% with a mid-point of 8.8 % at end-2024 (Chart 1.2.1).

**Chart 1.2.1: Inflation Forecast*** (%)




Sources: CBRT, TURKSTAT.
* Shaded region denotes the 70 percent confidence interval for the forecast.

***Forecasts are based on an outlook in which the slowdown in global economic activity becomes more pronounced, global inflation remains elevated and global financial conditions are tighter than in the previous reporting period***. Leading indicators suggest that the global economic outlook continues to weaken further. Accordingly, global growth forecasts for 2023 have been revised significantly downwards, and global recession is now considered to have become an important risk factor. In line with this outlook, international commodity prices are projected to decline in the upcoming period. Meanwhile, global inflation is expected to remain elevated, and financial conditions are expected to weigh on global demand.

***Credit growth is expected to follow a more balanced course in the upcoming period thanks to credit, collateral and liquidity policies, the evaluation processes of which have been completed, and the strengthened macroprudential policy set.*** Assuming that public finance developments are in line with the Medium-Term Program (MTP) forecasts and fiscal discipline is maintained, the ongoing stabilizing effects of macroprudential measures on loans are expected to support the recent improvement in pricing behavior. This support will happen both on the supply side, through lower financing costs and targeted loans ensuring continued production and preserving export capacity, and on the demand side, through healthy pricing in FX markets and restricting excessive consumption and import demand. In this regard, the credit growth rate is expected to affect aggregate demand conditions in line with the supply potential of the economy. As the effects of all these factors on the disinflationary process through costs, the supply-demand balance, the current account balance and exchange rate stability become more evident, inflation expectations are expected to contribute further to the decline in the underlying trend of inflation.

***In a period of heightened global uncertainties, it is important for the monetary policy strategy that domestic financial conditions support the supply potential.*** In this context, the use of loans in targeted areas at affordable costs, which will enable them to turn into investments that increase production capacity, contributes to the strengthening of the supply potential. However, macroprudential measures were gradually increased against the sudden acceleration in the consumer and commercial loan growth in the second quarter of 2022. In this context, it is observed that loan growth started to normalize in the third quarter due to the adopted measures. Financing costs, which continue to decline with macroprudential measures that strengthen monetary transmission, will also contribute to the continuity of supply. The more extensive use of credits and the increase in the share of investment and export loans in corporate loans through targeted loans also supports this channel.

***Production and investment-oriented policies and the improvement in the current account balance are expected to contribute to the ongoing stability in FX markets and the disinflation process***. The projected slowdown in external demand adds to risks to the current account balance, while the moderate course of energy and commodity prices during the forecast period is expected to contribute positively to the current account balance, especially in 2023. Meanwhile, the increased export capacity through targeted credits incentivizing production and investments in the medium term supports the post-pandemic structural transformation in exports. The stable course of the FX market is expected to continue due to the measures taken under the liraization strategy. Additionally, the expected decline in international energy and commodity prices is expected to contribute further to the disinflation process through the cost and the current account channels.

## 1.3 Key Risks to Forecasts

***The outlook underlying the MTP projections presented in the Inflation Report is based on the MPC's judgments and assumptions.*** The major downside and upside macroeconomic risks that may lead to a change in baseline projections and the associated monetary policy stance are as follows.[1]

***In this current reporting period, the key risk factors to economic activity and inflation have been uncertainties regarding the global inflation and growth.*** Global inflation remains high due to soaring energy prices, and the supply-demand mismatch accompanied by rigidities in the labor market. The likelihood of a slower-than-expected decline in the core inflation trend in advanced economies puts pressure on financial conditions. On the other hand, leading indicators signal an elevated risk of a recession in the global economy. Mounting concerns over energy supply driven by geopolitical risks and the tightening in global financial conditions have led to a downward revision in the global growth forecasts for the upcoming year, for the euro area, in particular. The negative course of the global risk appetite in the current reporting period adds to the volatility in financial markets. Moreover, in the upcoming period, the increased possibility of divergence in economic conditions and problems among advanced economies brings additional risks to global economic activity and financial conditions.

***While concerns over the global demand outlook on energy commodity prices keep the downside risks brisk, persisting geopolitical risks as well as the supply-limiting measures taken by OPEC+ countries pose upside pressures.*** Due to the Russia-Ukraine conflict and the OPEC+ countries' decisions to cut down on oil production, the negative course in energy prices persists. This causes upside risks on inflation forecasts to remain brisk. Although supply chain disruptions have recently been eliminated to some extent, pressures on producer prices are in place due to the supply shock driven by the Russia-Ukraine conflict. Moreover, the pressure on commodity prices led by expectations for a global recession is likely to have positive effects on inflation and the current account balance. However, the increased possibility of a global recession makes the downside risks on foreign demand more pronounced compared to the previous reporting period, posing a risk for the current account balance outlook. There are three factors that potentially balance the risks on the current account balance. The first one is the role that our country can play in regional energy distribution, as is the case in grain supply, and the rise in the share of domestic energy resources. The second is Türkiye's ability to substitute for probable energy-based production losses in Europe, as has been the case for a while, due to the supportive nature of the policy mix regarding the continuity of supply. The third factor is that in case of a deeper slowdown in global demand than anticipated, it entails supportive effects on the current account balance through domestic demand and global commodity prices.

***Credit growth rate and the targeted use of accessed funds for economic activity are important to sustainable price stability.*** In addition, upon sizeable widening, the policy-loan spread has recently been balanced thanks to the announced macroprudential measures, which is closely monitored. Inflation expectations and the underlying trend of inflation remain high. Therefore, a sudden acceleration that may occur in loans despite the measures in effect poses an upside risk to inflation forecasts. Accordingly, the macroprudential policy set will be further strengthened with additional measures when needed.

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[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.