1.Overview

Consumer inflation stood at 64.8% at the end of 2023 and ended the year in line with the mid-point of the forecast range presented in the previous Inflation Report. This outlook was maintained in January as the inflation realization was in accordance with the projections. The underlying inflation, which decelerated from September through the reporting period, recorded a temporary increase in January. While the impact of the macroeconomic shocks that emerged in the middle of the year weakened in the last quarter of the year, exchange rates followed a relatively stable course. Commodity prices declined led by the energy group, and global supply conditions remained in line with their historical averages throughout the fourth quarter prior to the escalation of geopolitical problems in January. The effects of monetary tightening on financial conditions and domestic demand had positive implications for inflation expectations and price-setting behavior. Inflation expectations decreased, and the consensus around the central tendency grew stronger in the distribution of expectations. Against this background, price-setting behavior of firms also started to improve slightly, and the frequency of price changes in the monitored product groups decreased while the diffusion index for core goods, durable goods in particular, posted a decline. Although aggregate demand conditions continue to weaken on the projected path, they still feed into inflation. In the last quarter of the year, as the limits for free use of natural gas were exceeded due to seasonal conditions, prices included in the index rose as projected despite no change in consumer natural gas tariffs. Time-dependent pricing and backward-indexation behavior as well as the high wage sensitivity prevalent in the services sector caused the services inflation to persist in the last quarter of the year. Following these developments, the monthly price increase strengthened in January with temporary effects arising from the minimum wage, tax and administered price adjustments and the developments in services items with time-dependent pricing behavior.

Indicators of the underlying monthly inflation declined in the last quarter at a faster pace than forecasted in the previous Report but increased in January as expected. In the last quarter, seasonally adjusted monthly increases in core indicators, which had increased substantially in the third quarter of the year, fell below the course recorded in the first half of 2023. Alternative statistical indicators such as median inflation and SATRIM, and model-based indicators confirmed that the underlying monthly inflation slowed markedly in the last quarter. Three-month averages of seasonally adjusted core inflation indicated a more favorable inflation course than projected in the previous Inflation Report. In sum, the underlying inflation decelerated significantly in the last quarter of the year as the impact of monetary tightening started to kick in and cost-side pressures, which intensified in the third quarter, largely passed through to prices. Core goods prices were the main driver of the slowdown in core inflation indicators in this period. The deceleration in the underlying inflation was interrupted in January due to wage adjustments and the items with high time-dependent price-setting tendency. It is projected that the deceleration in the underlying inflation will prevail again starting from February, and underlying inflation in the first half of the year will converge to 2023Q4 readings.

Inflation is projected to be 36% at the end of 2024 and fall to 14% at the end of 2025. Consumer inflation was 64.8% in 2023, close to our forecast of 65% in the previous reporting period. Medium-term forecasts are based on an outlook that the CBRT's tight monetary stance, which reflects the CBRT's commitment to intermediate targets, affects price-setting behavior via monetary transmission channels. Under this monetary stance, previous Report’s year-end forecasts were maintained. Balancing factors were effective in maintaining the year-end forecasts. The course of underlying trend of inflation and developments in oil and import prices have favorably affected year-end inflation forecast for 2024. On the other hand, due to higher-than-expected wage increases and earthquake-related public expenditures, the rebalancing of demand is expected to continue, but reaching the level projected in the previous Report a quarter later, and unit labor costs are expected to be higher. Commodity prices, oil in particular, and food prices with relatively higher volatility continue to pose uncertainty on forecasts.

It is projected that headline inflation will increase throughout the first half of 2024 and decline steadily as of the second half of the year. In addition to the policy rate hikes, quantitative tightening, selective credit tightening policies and simplification steps in the macroprudential framework affect financial conditions by reinforcing the monetary transmission. Domestic demand continues to rebalance amid slower consumer loan growth excluding credit cards and increased demand for Turkish lira savings instruments. However, with wage policy and earthquake-related public spending supporting demand, the rebalancing is envisaged to reach the level projected in the previous Report with a delay of a quarter. Medium-term projections are based on an outlook in which the the tight monetary policy stance will be maintained until the inflation outlook displays a significant improvement, quantitative tightening and macroprudential policies to reduce volatility in credit supply and deposit rates will strengthen the monetary transmission, and the level of monetary tightness will be adjusted in case of a deterioration in the inflation outlook. This tight monetary policy stance is assessed to reinforce the rebalancing in domestic demand and the gradual improvement in the current account balance, albeit with a delay compared to the previous Report. Additionally, it is projected that decisive and sustained adherence to monetary tightening will lead to a slowdown in monthly inflation and an improvement in inflation expectations, which are highly sensitive to inflation realizations, thereby improving the underlying trend of inflation.

Economic activity displayed a limited quarter-on-quarter growth in the third quarter of 2023, and pointed to a start of rebalancing in domestic demand as a result of monetary tightening. In the third quarter, GDP increased by 5.9% on an annual basis, while quarterly growth decelerated and stood at 0.3%. On the expenditures side, final domestic demand decelerated amid the contraction in private consumption and remained almost flat on a quarterly basis, while net exports contributed positively to quarterly growth for the first time after four quarters. On the production side, the industrial sector value added became the main driver of quarterly growth.

Indicators for the last quarter of 2023 point to a slowdown in domestic demand on an annual basis. As of November, the retail sales volume index increased further in the last quarter on an annual basis, albeit at a slower pace, while it declined slightly on a quarterly basis. Card expenditures indicate that consumption demand rose further on a quarterly basis in the last quarter of the year, when discount campaigns intensified, and that the rate of increase slowed down on an annual basis. On the other hand, it is evaluated that wage revisions in January contribute to the resilience in demand. In fact, the Business Tendency Survey (BTS) data suggest that registered orders from domestic market increased in January again. Adjusted for seasonal and calendar effects, industrial production posted a quarterly decline of 1.3% in the last quarter as of November. Similarly, employment growth was also limited in this period. As of November, seasonally adjusted employment increased by 0.3% (80,000 people) on a quarterly basis. Meanwhile, the seasonally adjusted labor force participation rate fell by 0.2 percentage points to 53.0%. Thus, in the last quarter, unemployment rate decreased by 0.4 points quarter-on-quarter to 8.8%. High-frequency data suggest that demand in the labor market lost some strength in January.

Amid the robust course of services balance coupled with the fall in the foreign trade deficit, the current account deficit declined in the last quarter of 2023. Despite the deterioration in the primary balance, the current account deficit, adjusted for seasonal and calendar effects, declined in the last quarter on account of the narrowing foreign trade deficit as well as the strong contribution of the services balance. Meanwhile, in the second half of the year, which is marked by tight monetary policy implementation, reserves increased as net capital inflows hovered above the current account deficit. As of November, the surplus in the services balance remained high in the last quarter of 2023 due to the sustained high level of the surplus in the travel revenues balance adjusted for seasonal and calendar effects accompanied by the flat course of the transport revenues balance. In this quarter, the foreign trade deficit adjusted for seasonal and calendar effects narrowed due to the limited fall in imports and the rise in exports. Thanks to the adoption of measures and the tight monetary policy, imports of unprocessed gold decreased and exports of unprocessed gold increased. In the last quarter, the quantity of exports climbed up while the quantity of imports went down along with the decline in imports of unprocessed gold, and hence the foreign trade balance improved despite the fall in the terms of trade.

The downtrend in global headline inflation accelerated in the fourth quarter with the contribution of energy prices, while core inflation declined further. Accordingly, central banks of advanced economies have mostly completed their tightening process. In advanced economies, amid tighter global financial conditions, core inflation receded from the range of 4-5%, marked by a notable stickiness previously, to the 3.5-4% band. Meanwhile, core inflation also dropped across emerging economies compared to the previous reporting period. With the decline in core inflation, central banks in advanced economies have revised their communication stating that the current level of policy rates is sufficient for their inflation targets, while the timing and pace of rate cuts have gained importance. On the other hand, rate cuts continued in emerging economies amid further improvement in the inflation outlook. However, as inflation hovers above the inflation targets and labor market-driven inflationary risks remain brisk, central banks are likely to continue to cut rates to ensure a sustained disinflation process, and monetary tightness is expected to be maintained on a global scale.

The global risk appetite improved in the reporting period, and the monetary tightening process supported the positive divergence of Türkiye's financial indicators from those of peer countries. With the pricing of the fact that the tightest period for global financial conditions had been left behind, the risk appetite towards emerging economies registered a recovery. Against this backdrop, risk premium indicators in emerging economies declined, while Türkiye's CDS premium recorded a higher fall than that of peer countries by declining to 325 basis points. Meanwhile, the exchange rate volatility of the Turkish lira decreased further, more markedly in longer maturities, and one-month and 12-month implied exchange rate volatility fell below 7% and 21%, respectively. On the back of monetary tightening and simplification steps, the CBRT's gross international reserves continued to increase and reached USD 137.2 billion as of 26 January. In the current reporting period, government domestic debt securities (GDDS) yields increased in shorter maturities in line with the higher policy rate but receded in medium and longer maturities.

Financial conditions tightened as a result of the monetary policy decisions. Regulations towards increasing the share of Turkish lira deposits, quantitative tightening decisions supporting the monetary tightening process and steps taken to simplify the macroprudential framework continue to strengthen the transmission mechanism and improve the funding composition of the banking system. It is observed that, commercial loan growth stabilized as a result of the tightening effects of monetary policy on the credit market, while strategic investments that will improve the current account balance continue to be supported. The annual growth rate of total loans adjusted for exchange rates decreased by 3.7 percentage points to 34.4% in the fourth quarter. The annual growth rate of consumer loans decreased to 39.7%. Credit cards displayed a more persistent outlook, reflecting the campaigns spurring demand yet its annual growth rate continued to decrease in the final quarter of the year. The balancing process in the growth of retail loans, which were buoyant amid wage hikes in late December and January, is closely monitored. In the current reporting period, the rise in demand for the Turkish lira supported the monetary policy transmission. Deposit rates rose significantly by an average of 6.28 percentage points across all maturities, and while the outflow from FX-protected deposits accelerated, the share of Turkish lira deposits increased by 5.39 percentage points to 42.9% compared to the previous reporting period.

1.1 Monetary Policy Decisions

The CBRT continued to strengthen the monetary tightening process that it started in June in order to bring high inflation under control and establish the disinflation course as soon as possible. The CBRT raised the policy rate from 35% to 45% in the November-January period, noting that inflationary pressures were alive due to domestic demand, stickiness in services prices and geopolitical risks. Moreover, the CBRT also assessed that the monetary tightening has started to be reflected on financial conditions, and domestic demand was moderating as projected. Meanwhile, it was stated that the external financing conditions, the current account balance and demand for Turkish lira-denominated assets contributed to exchange rate stability and the effectiveness of monetary policy. It was also highlighted that inflation expectations and pricing behavior started to show signs of improvement, and a decline in the underlying trend of monthly inflation was observed.

In line with the forward guidance that was initiated in November, the CBRT slowed down the pace of monetary tightening in December and noted in January that the level of monetary tightness required to establish the disinflation course was achieved. In November, the CBRT raised the policy rate from 35% to 40% and provided forward guidance that it would slow down the pace of rate hikes in the coming months. In December, the CBRT shared its anticipation with the public that the tightening cycle would be completed as soon as possible and slowed down the pace of monetary tightening by raising the policy rate to 42.5%. In January, the CBRT raised the policy rate by an additional 250 basis points to 45%, stating that the level of monetary tightening required for disinflation had been reached. However, taking into account the lagged impact of monetary tightening, the CBRT noted that the level of monetary tightness achieved would be maintained as long as needed. Moreover, it was stated that the current level of the policy rate would be maintained until there was a significant decline in the underlying trend of monthly inflation and inflation expectations converged to the projected forecast range. It was also noted that the stance of monetary policy would be reassessed if notable and persistent risks to inflation outlook emerged.

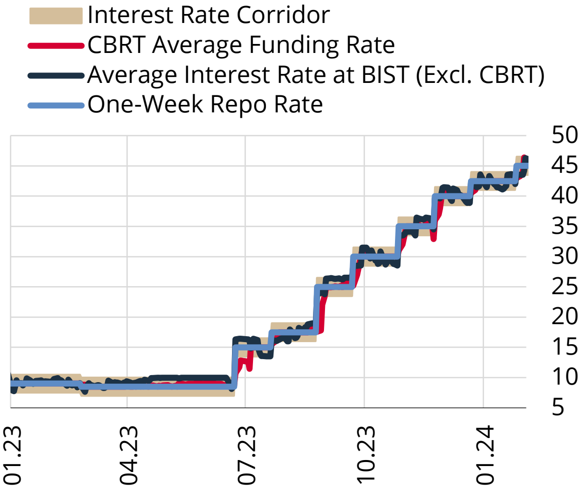
To support monetary tightening, the CBRT continues to take quantitative tightening decisions to eliminate excess Turkish lira liquidity. With these decisions, the policy rate, which is the main policy instrument, affected monetary and financial conditions and expectations, while excess Turkish lira liquidity was stabilized, and the effectiveness of the monetary policy was enhanced. Moreover, the CBRT decided to hold Turkish lira deposit buying auctions as of 22 December 2023 to strengthen the monetary transmission mechanism and increase the diversification of the sterilization instruments. The amounts in deposit buying auctions held as of the mentioned date are adjusted according to liquidity projections, and excess Turkish lira liquidity is sterilized via one-week auctions. Meanwhile, the CBRT continued to make arrangements to strengthen its credit programs to mitigate the lagged effects of monetary tightening on strategic investments and the export potential. Moreover, in tandem with monetary tightening, with the arrangements towards increasing the share of Turkish lira deposits, the CBRT strengthened the transmission mechanism and improved the funding composition of the banking system.

The existing micro and macroprudential framework was continued to be simplified to increase the functioning of market mechanism and strengthen macro financial stability. The CBRT continues to phase out the practice of securities maintenance for FX liabilities. Accordingly, the securities maintenance ratio for FX liabilities was reduced from 5% to 4%. Moreover, the temporary practice of maintaining securities based on loan growth, which expired at end-2023, and the exemption of earthquake zone loans from the securities maintenance requirement were extended until June 2024. In line with the simplification process, the CBRT strengthens the monetary transmission mechanism through macroprudential policy against any potential excess volatility in credit supply and deposit rates. Accordingly, in order to strengthen the monetary transmission mechanism, increase the share of Turkish lira deposits and support the transition from FX-protected deposits to Turkish lira deposits, reserve requirements of eligible deposit banks maintained for their Turkish lira deposit and FX-protected deposit accounts with a maturity longer than one month are subject to remuneration every three months.

The CBRT implements selective credit policies in such a way to facilitate both access to credit and financing costs, also taking into account the macro financial balance. To sustain price stability, the CBRT continues to support technological transformation to improve the current account balance, strategic investments to contribute to supply continuity, and exports. The Advance Loans against Investment Commitment (ALAIC) program, which aims to utilize long-term and low-cost resources in areas that support macro financial stability, was continued to be implemented with its renewed structure that highlights its contribution to price stability as well as the technological value added and strategic nature of investments. Accordingly, taking into account the technology/strategy score of the firms' investment projects with a minimum total investment amount of TRY 1 billion was deemed eligible for allocation of ALAIC via intermediary banks, and the interest rate for loans, which would be extended with a maximum maturity of 10 years, was set between 30% and 15%, depending on the technology/strategy score as well as the ratio of external financing for the investment and the financial soundness assessment. The new ALAIC program was allocated an annual limit of TRY 100 billion and a total limit of TRY 300 billion over the course of three years. The CBRT took new actions to support exporters' access to finance and financing conditions. Accordingly, a cap was set for the total interest cost of rediscount credits for export and FX earning services, and the maximum discount rate for rediscount credits for export and FX-earning services was kept constant at 25.93%.

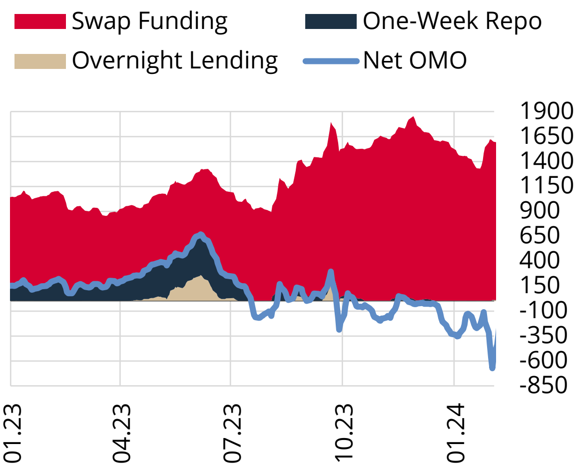
The CBRT provided funding mostly through currency swap transactions, and the share of Open Market Operations (OMO) in funding decreased significantly. In the current reporting period, overnight rates moved within the CBRT interest rate corridor depending on liquidity conditions in the market. The amount of currency swap transactions, which was TRY 1.59 trillion as of 31 October 2023, increased to TRY 1.78 trillion on 23 November 2023, before falling to TRY 1.45 trillion as of 2 February 2024. In the same period, net OMO funding remained in negative territory due to exchange rate difference payments to FX-protected deposits, the CBRT's FX transactions and government expenditures, and the amount of OMO sterilization has posted significant increases as of mid-December (Chart 1.1.2). As a matter of fact, on 2 February 2024, net OMO funding was TRY -122.1 billion, while TRY 118.1 billion of the temporary excess liquidity in the market was sterilized through one-week deposit auctions. The withdrawal of excess liquidity through Turkish lira deposit buying auctions held since 22 December ensured a gradual decline in the amount of overnight sterilization and was influential on the overnight repo rates to remain close to the CBRT's weighted funding rate (Chart1.1.1, Box 1.1).

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



Source: BIST, CBRT.

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



Source: CBRT.

Box 1.1

Evaluation of Quantitative Tightening Steps

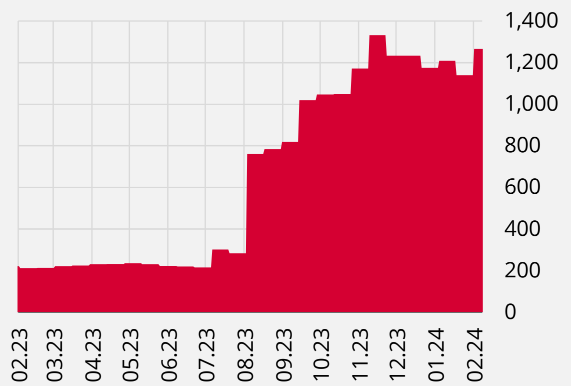
The CBRT started the monetary tightening process in the second half of 2023 to establish disinflation as soon as possible, to anchor inflation expectations and to control the deterioration in pricing behavior. Turkish lira liquidity developments are closely monitored to ensure the level of monetary tightness required for the permanent establishment of price stability, and monetary transmission is strengthened through quantitative tightening decisions.

Short-term market interest rates play an important role in the first stage of the monetary transmission mechanism. In the traditional inflation targeting regime, it is desirable for overnight market rates to be close to the policy rate to control long-term interest rates. For this purpose, central banks implement active liquidity management and take quantitative tightening steps when necessary. Central banks can ensure that market interest rates are in line with monetary policy through the decisions they make regarding the level of liquidity in the banking system (Ganley, 2002; Von Heideken and Sellin; 2014). In this context, the recent liquidity steps taken by the CBRT aim to increase the effectiveness of the monetary transmission mechanism.

As of the second half of 2023, due to exchange rate difference payments stemming from FX-protected accounts and FX transactions against Turkish lira, there has occasionally been an excess Turkish lira liquidity in the system, and the CBRT has become a net borrower in OMO. The CBRT has many policy tools to sterilize the excess liquidity that may occur in the market (Table 1). As a matter of fact, the excess liquidity has been sterilized by various tools to increase the effectiveness of the monetary transmission mechanism. In this context, a total of TRY 1 trillion was sterilized from the system with the increases in required reserve ratio made within the scope of quantitative tightening in July, September and November 2023 (Chart 1). The funding need of the system, which was TRY 926 billion in mid-July 2023 before the increase in required reserve ratio, reached TRY 1,269 trillion as of December 21, 2023 (Chart 2). Following the quantitative tightening steps taken regarding reserve requirements, the CBRT started to organize Turkish lira deposit buying auctions by increasing the variety of sterilization tools used to strengthen the monetary transmission mechanism, following the announcement made on 21 December 2023.

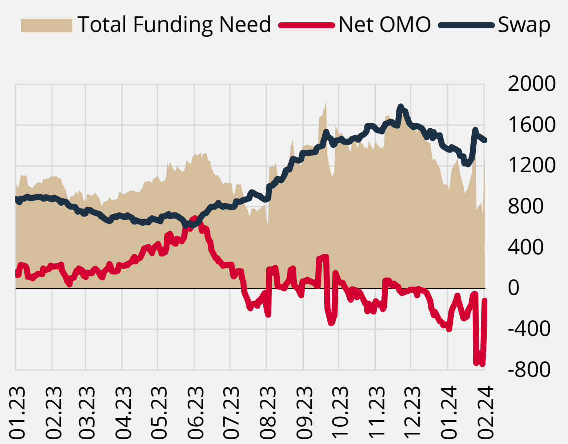
The CBRT continued the quantitative tightening process through the regulation made regarding the reserve requirements within the scope of its announcement dated 30 January 2024. While the required reserve ratios for FX-protected accounts were reduced, the additional reserve requirement ratio established in Turkish lira for FX accounts was increased. The net effect of the regulation was a tightening of TRY 125.8 billion.

Chart 1: Turkish Lira Required Reserve Level (TRY Billion)



Source: CBRT.

Chart 2: Funding Need of the System and CBRT's Funding (TRY Billion)



Source: CBRT.

Table 1: Sterilization Tools of the CBRT

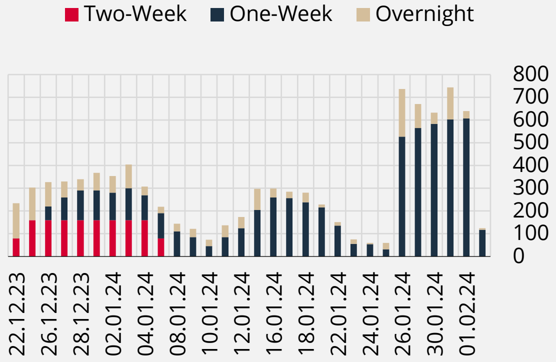
	Policy Tool	Maturity	Effect	Frequency
Required Reserve Regulations	TL Denominated Required Reserve Facility for TL Denominated Liabilities	14 Days	Permanent	Two-Week Average
	TL Denominated Required Reserve Facility for Foreign Currency Denominated Deposits/Participation Funds	14 Days	Permanent	Two-Week Blocked
Market Operations	TL Deposit Buying Transactions in the CBRT Interbank Money Market	Overnight	Temporary	Daily
	Repo/Reverse Quotation Transactions against Lease Certificates	Overnight	Temporary	Daily
	Repo/Reverse Repo Transactions in BIST Repo Market	Overnight	Temporary	Daily
	TL Deposit Buying Auctions	Up to 91 days	Temporary	When necessary
	Reverse Repo Auctions	Up to 91 days	Temporary	When necessary
	Issuance of Liquidity Bills	Up to 91 days	Temporary	When necessary
	Outright Sales Transactions	-	Permanent	When necessary

Evaluation of Turkish Lira Deposit Buying Auctions

Since 22 December 2023, the CBRT has been sterilizing the excess liquidity in the system by conducting one and two-week Turkish lira deposit buying auctions in addition to its overnight sterilization. As temporary excess liquidity in the system has declined since this date, the amount of funds withdrawn through deposit buying auctions has also decreased and reached TRY 32 billion as of 25 January 2024. As a result of the calculation of required reserves maintained for Turkish lira liabilities on a two-week average basis, a significant increase in the excess liquidity level was observed on 26 January 2024 due to the change in the required reserve balances during this period, and while TRY 527 billion was sterilized through the deposit buying auctions on the said day, TRY 210 billion liquidity was withdrawn over the overnight maturity. As of 2 February, the level of excess liquidity decreased as the reserve requirement maintenance period started and the increase in required reserve ratio went into effect, and TRY 118.1 billion was withdrawn through deposit buying auctions, while TRY 6.5 billion was sterilized through the overnight term. Withdrawal of excess liquidity through TL deposit buying auctions with a term longer than overnight maturity has enabled the overnight sterilization amount to gradually decline, despite the increasing Turkish lira liquidity surplus in the system since mid-December (Chart 3). With the CBRT's overnight sterilization amount falling to reasonable levels, the overnight transaction volume at the BIST Repo-Reverse Repo Market, where the benchmark overnight repo rates are established, remained at plausible levels, thereby supporting the effective functioning of the money market.[1] In September, when the total OMO sterilization amount exceeded TRY 300 billion, BIST Repo-Reverse Repo Market overnight transaction volume declined gradually and reached TRY 28 billion on 28 September 2023. On the other hand, the average total OMO sterilization amount exceeded TRY 300 billion during the deposit buying auctions period, while BIST Repo-Reverse Repo Market overnight transaction volume was TRY 120 billion on average (Chart 4).

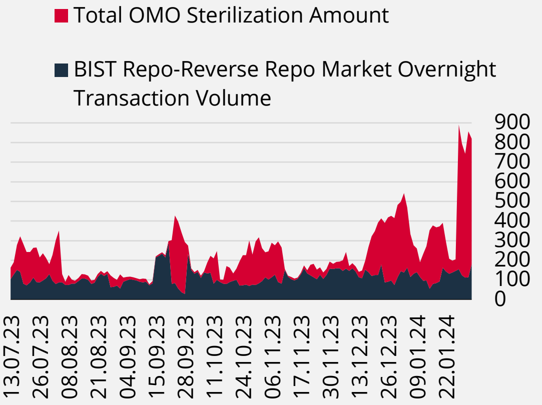
[1] Von Heideken and Sellin (2014) report that excess liquidity in the system causes banks to reduce their transactions in the overnight market and may negatively affect the functioning of money markets by reducing their incentives for effective liquidity management.

Chart 3: Total OMO Sterilization Amount (TRY Billion)



Source: CBRT.

Chart 4: Total OMO Sterilization and BIST Repo-Reverse Repo Market Overnight Transaction Volume (TRY Billion)

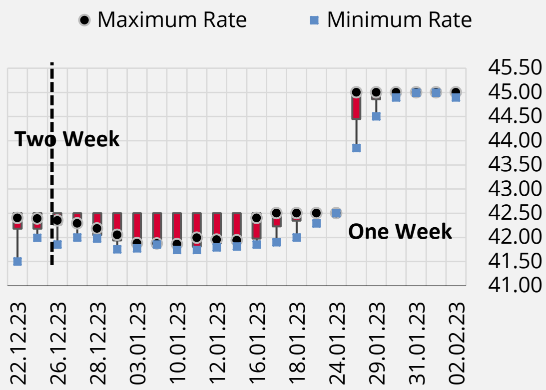


Source: BIST, CBRT.

The detailed analysis of the auctions shows that the auction bids are spread far apart in the first days of the one- and two-week auctions, whereas the bids converge to each other later on. The weighted average interest rates in deposit buying auctions were realized at levels close to the CBRT's policy rate (Chart 5).

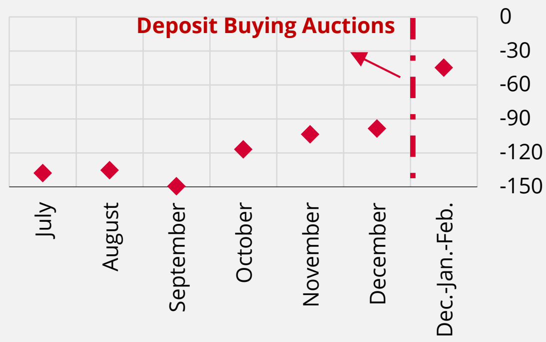
Reducing the CBRT's overnight sterilization amount through OMO to reasonable levels had positive effects on BIST Repo-Reverse Repo Market transaction volumes and also improved the transmission of the CBRT's monetary policy stance to overnight interest rates. As a result of the withdrawal of excess liquidity through deposit buying auctions with a term longer than overnight maturity, BIST Repo-Reverse Repo Market overnight repo interest rates remained close to the CBRT's policy rate. Analyzing the days when net sterilization exceeded TRY 50 billion, it can be seen that deposit buying auctions significantly closed the gap between BIST overnight interest and the CBRT's policy rate (Chart 6).

Chart 5: Bids Received for TL Deposit Buying Auctions* (%)



Source: CBRT.
* The end of the bars in the chart shows the CBRT policy rate, and the other end shows the average interest rate in the auction.

Chart 6: BIST Overnight Repo Rate and CBRT Policy Rate Difference* (% Points)



Source: BIST, CBRT.
* Days when the excess liquidity sterilized by OMO is over TRY 50 billion.

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