1.Overview

Consumer inflation ended 2022 at 64.3%, within the forecast range presented in the October Inflation Report, and below the forecast mid-point. The rise in consumer prices continued to lose pace due to the normalization in natural gas prices, the moderate course of other commodity prices, easing supply constraints and transportation costs, and slowing global demand. In the last quarter, external demand weakened further, and aggregate demand conditions became milder. On the other hand, the relatively strong course of domestic demand affected price increases in some durable goods. The favorable outlook in commodity markets excluding industrial metals alleviated cost pressures, while the steady course of exchange rates was another factor that slowed consumer price increases. In line with these developments, the seasonally adjusted data indicate that the quarterly price increase in core goods lost momentum, while prices in the energy group continued to rise moderately. Meanwhile, the deceleration in services prices was more limited, as expected. Against this background, monthly increases in B and C indicators weakened, and their annual inflation declined.

Inflation is projected to be 22.3% at the end of 2023 and sustain the downward trend by falling to 8.8% at the end of 2024 and to 5% at the end of 2025. Inflation Report forecasts, which are interim targets, are preserved from the previous reporting period. Inflation and the main assumptions underlying forecasts are realized in line with the previous Report's projections. The slowdown in global economic activity will continue in the first half of 2023, and the recent moderate course of commodity prices, especially energy, will remain in place in the upcoming period. It is expected that the policy mix implemented as part of the Liraization Strategy will support the structural demand for the Turkish lira (TL). Additionally, forecasts are based on an outlook in which the targeted loan and interest rate policies will restore monetary stability, strengthen monetary transmission, continue to support potential supply through the financing cost channel, and contribute positively to the supply/demand balance. Accordingly, the improvement observed in pricing behavior and inflation expectations is expected to continue during the forecast period.

Economic activity lost momentum in the third quarter of 2022 due also to the weakening foreign demand, but growth was strong in the first three quarters of the year. In the third quarter, Gross Domestic Product (GDP) increased by 3.9% on an annual basis, while the year-on-year growth was recorded at 6.2% in the first three quarters. The main driver of annual growth in the third quarter was the services sector, while the contribution of the industrial sector to growth remained limited due also to the weakening foreign demand. In this period, the share of sustainable components such as machinery-equipment investments and net exports in the composition of growth remained high. Indicators for the last quarter of the year suggest that despite the relatively strong course of domestic demand, the slowdown in growth continued due to the foreign demand. Accordingly, foreign demand-driven pressures on the manufacturing industry have taken a limited toll on domestic demand and the supply capacity at this point. The impact of the deceleration of economic activity on the labor market was also limited, and employment growth remained robust in the last quarter of 2022. Leading indicators and high-frequency data indicate that the upward trend in employment is maintained.

Despite the strong contribution of the balance of services, the annualized current account deficit continued to increase due to the high course of energy and gold imports. In the third quarter, geopolitical developments and the policies pursued by major central banks caused exports to lose momentum by adversely affecting external demand, especially from the European Union (EU), Türkiye's main export market. Recently, exports have partially recovered on the back of increased demand, mostly from the Commonwealth of Independent States (CIS) countries, and the decline in exports lost momentum on a quarterly basis. Total imports, on the other hand, decreased quarter-on-quarter due to the fall in energy prices and the decline in imports excluding gold and energy. Meanwhile, the impact of imports of gold and consumption goods on total imports increased. Services revenues maintain their strong outlook with the contribution of transportation and tourism activities throughout the year. The current account balance adjusted for price and cyclical effects continued to post a surplus.

The Turkish lira remained stable, and exchange rate volatility continued to decline, displaying a favorable performance compared to peer economies. While global economic activity remained sluggish and geopolitical risks persisted, the relative improvement in global financial conditions led to a partial recovery in risk appetite. Türkiye's risk premium declined significantly, and exchange rate volatility continued to fall, displaying a favorable performance compared to peer countries. On the other hand, yields on Government

Domestic Debt Securities (GDDS) continued to decline across all maturities due to lower inflation expectations accompanied by the securities maintenance, liquidity and collateral management implementations of the Central Bank of the Republic of Türkiye (CBRT).

Even though commercial loan growth increased slightly in the last quarter of 2022, it remained moderate amid macroprudential measures, while retail loan growth rose further on the back of personal loans and personal credit cards. In the second quarter of the year, commercial loan rates converged considerably to the policy rate as a result of the steps taken to support the effectiveness of the monetary transmission mechanism. Meanwhile, due to the CBRT's targeted loan policy actions to ensure that loans support both potential growth and the current account balance under the integrated policy framework, the share of investment and export loans as well as Small and Medium-Sized Enterprises (SMEs) loans in total TL commercial loans recorded a marked increase in 2022.

1.1 Monetary Policy Decisions

Considering that financial conditions should be supportive of the sustainability of the growth momentum in industrial production and of the positive trend in employment in a period of increased uncertainties over global growth as well as escalated geopolitical risks, the CBRT cut the policy rate by 150 basis points in November and kept it unchanged in December and January. At its November meeting, the Monetary Policy Committee (MPC) highlighted the probable effects of global uncertainties and risks on investment and production capacity. The MPC assessed that the financing costs of companies' production should be set at reasonable levels in order to minimize the adverse effects via a proactive approach, thereby maintaining the supply continuity and the current surplus capacity. Accordingly, the CBRT decided to reduce the policy rate by 150 basis points. In December, assessing that the current policy rate was adequate in view of the increasing risks to global demand, the CBRT decided to end the interest rate cut cycle that started in August and accordingly kept the policy rate unchanged in December and January.

To re-shape price stability within a sustainable structure, the CBRT has strengthened its integrated policy framework that prioritizes the Turkish lira in all policy tools with macroprudential measures. The main elements of the CBRT's integrated policy framework that complement the policy rate have been the increasing of the weight of the Turkish lira in the financial system through liraization steps, diversified reserve management, and targeted loan and liquidity practices.

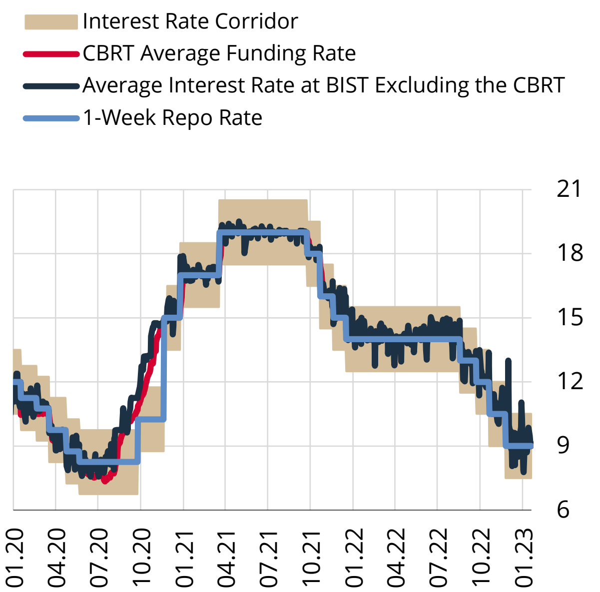
In December, the CBRT made an amendment to rediscount credits extended by the Turk Eximbank and other commercial banks to exports and FX-earning services, and raised the rediscount credit utilization limits for SMEs on a firm-by-firm basis. Moreover, firms were allowed to use TL-denominated rediscount credits for expenditures related to import payments.

With amendments made to securities and reserve requirement implementations in December, in addition to banks, other financial institutions were also included in the scope of the securities regulation. Factoring companies were required to maintain securities according to the interest rate they applied to TL-denominated factoring receivables. Moreover, the period of the implementation that stipulates banks to maintain securities based on loan interest rate and loan growth rate has been extended until 29 December 2023, and the scope of assets and liabilities of banks subject to the securities maintenance implementation has been expanded.

The CBRT continued to take steps to enhance the effectiveness of the liraization process. In November, the annual commission rate, which was 3% for banks that failed to meet the conditions for the TL share of required reserves to be established for FX deposits/participation fund liabilities, was increased to 8% as of the calculation date of 23 December 2022, and the rate was differentiated based on the share of TL deposits/participation funds. The commission rate, which was 5% for reserve requirements for FX-denominated deposit/participation fund liabilities, was terminated as of the calculation date of 23 December 2022. The targets for liraization have been renewed, and accordingly, the securities maintenance ratio was raised from 5% to 10% starting from 24 February 2023. It was decided that banks, which exceeded the 60% target in TL deposit ratio for real and legal persons would be subject to a discounted securities maintenance ratio. Accordingly, a discount of 5 percentage points will be applied to banks with a TL deposit ratio between 60% (inclusive) and 70%, and a discount of 7 percentage points will be applied to banks with a TL deposit ratio above 70%. In order to encourage maturity extension of TL deposits, the CBRT has decided to set reserve requirement ratios at zero percent for TL deposit accounts with maturities longer than three months and for the increase in FX liabilities with maturities longer than six months provided directly from abroad. The CBRT continued to develop complementary liquidity policies and raised the discount rates on indexed securities and FX and gold-denominated assets subject to collateral from 60% to 70% as of 9 January 2023.

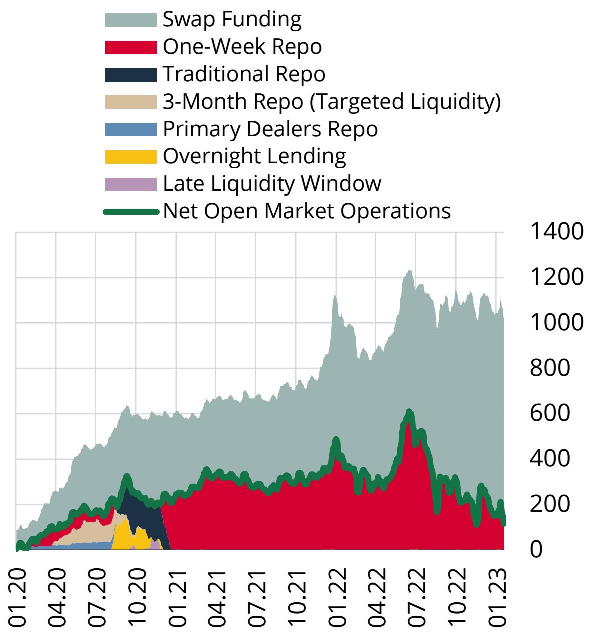
The CBRT provided funding through Open Market Operations (OMO) and currency swaps, and overnight interest rates hovered around the CBRT policy rate. Owing to the CBRT's predictable liquidity policy, Borsa Istanbul (BIST) overnight repo rates continued to hover around the CBRT policy rate (Chart 1.1.1). The amount of swap transactions, which was TRY 896.5 billion as of 27 October 2022, increased to TRY 900.2 billion as of 19 January 2023. In the same period, the net OMO funding decreased to TRY 127.5 billion (Chart 1.1.2).

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.