1.Overview

Annual consumer inflation decreased by 12.3 points to 38.2% in the second quarter of 2023, while monthly price increases strengthened again in June. In the current reporting period, persistence of services sector inflation and the unfavorable course of food prices were the leading drivers of monthly price increases, and the relatively stable course of the Turkish lira (TL) in April and May was replaced by a significant depreciation in June. The fall in energy prices in April became more pronounced in May due to the free allowance of natural gas to consumers for one month, affecting headline inflation favorably. In the second quarter of the year, the decline in commodity prices and global transportation costs continued, and supply constraint indicators remained below their historical averages. In addition, supply-demand mismatches in some goods and services caused by the disasters were short-lived. While domestic demand was brisk, credits supported demand conditions throughout the quarter. In line with these developments, prices remained flat in May but posted a strong increase in June. Meanwhile, seasonally adjusted monthly increases in the B and C indices trended upwards throughout the quarter.

Inflation is projected to be 58.0% at the end of 2023, and fall to 33.0% at the end of 2024 and to sustain the downtrend by receding to 15.0% by the end of 2025. The 35.7 points of revision to end-2023 projections in the current reporting period is higher than that in the previous reporting periods. Firstly, cost and demand pressures exerted by the depreciation of the TL as well as wage and tax adjustments pushed inflation significantly upwards. In addition, the assumption for food inflation, particularly due to the unprocessed food prices that are beyond the realm of monetary policy, has been revised strongly upwards compared to the previous reporting period. The forecast deviation and change in forecasting approach of the Central Bank of the Republic of Türkiye (CBRT) have also played a role in this revision. On the other hand, assumptions for global growth and commodity prices have been consistent with the previous reporting period. In this context, it is projected that inflation will increase in the remainder of 2023 also driven by strong demand and cost pressures but assume a downtrend in 2024 on the back of the monetary stance that will be tightened gradually until a significant improvement in inflation is achieved.

The revised inflation forecasts have been based on a policy framework in which the monetary stance that will ensure convergence of inflation to the 5% target in the medium term will be implemented decisively. It is assessed that the monetary tightening and the gradual simplification of the current micro and macroprudential framework will improve the monetary transmission mechanism. For the rest of the year, tourism is expected to be strong, exports to remain flat, and growth to be close to historical averages. A monetary policy stance that will not allow room for unstable demand to exert pressure on price stability will help anchor inflation expectations and control the deterioration in pricing behavior. The forecasts are based on a framework in which the growth rate and composition of credits will ensure price stability and financial stability, and thus financial conditions will be in line with the projected disinflation process. The simplification process of the micro and macroprudential framework that will be carried out in coordination with the gradually strengthened monetary tightening will increase the effectiveness of market mechanisms and strengthen monetary transmission. Accordingly, a monetary policy outlook in which macro financial stability will support price stability has been taken into account.

Despite earthquake-induced effects, economic activity remained strong in the first quarter of 2023 on the back of domestic demand. In the first quarter, despite the effects of the earthquake, Gross Domestic Product (GDP) increased by 4.0% on an annual basis, and by 0.3% in seasonally and calendar-adjusted terms compared to the previous quarter. In this period, the main driver of annual growth was domestic demand with a contribution of 6.8 points whereas net exports had a downward effect of 2.8 points. The industrial sector had a negative contribution of 0.1 points to growth on an annual basis due to weak external demand, while the services sector stood as the main driver of growth on the production side with a contribution of 5.2 points.

Indicators for the second quarter suggest that domestic demand continued to be stronger than external demand. As of May, industrial production increased by 1.4% compared to the first quarter, showing that the negative effects of the earthquake on production were offset. On the other hand, the retail sales volume index rose substantially by 4.6% on a quarterly basis in May, while the upward trend in real domestic card expenditures continued with further acceleration in the second quarter. Employment growth, which slowed in the first quarter due to the disaster, gained pace in the second quarter, and as of May, seasonally adjusted employment was up by 0.9% (298,000 people) on a quarterly basis, exceeding its pre-earthquake

level. Meanwhile, the labor force participation rate increased by 0.3 points compared to the previous quarter, and stood at 53.7%. Thus, the unemployment rate dropped by 0.2 points quarter-on-quarter to 9.8%.

Despite the strong course of services balance and the decline in energy imports, the annualized current account deficit continued to widen amid high gold imports and the rise in the foreign trade deficit. In the second quarter, quarterly growth of seasonally adjusted exports was limited to 0.5% due to the relatively flat external demand. Recent data suggest that the impact of the disaster on exports has largely disappeared while seasonally adjusted imports declined quarter-on-quarter in line with the decrease in energy imports. In the first half of the year, energy imports fell by 24.6% year-on-year to USD 36 billion. Meanwhile, high gold imports and vigorous consumption goods imports due to the strong domestic demand restrained the decline of imports on a quarterly basis. In fact, in the first half, gold imports increased by USD 11.4 billion year-on-year to USD 16.6 billion. In the same period, imports of consumption and investment goods rose by 62.3% and 33.9% year-on-year, respectively. The services revenues, which remained strong on the back of travel and transportation revenues, continued to support the current account balance throughout the year. In the first five months of the year, travel and transportation revenues increased by USD 2.5 and 1.5 billion to USD 14.1 and 13.8 billion, respectively in year-on-year terms and rose to their historical highs on an annualized basis.

Despite a continued decline in inflation in both advanced economies and emerging economies in the current reporting period, global inflation remains elevated, while the persistence in core indicators supports the expectations that this downtrend will lose momentum in the period ahead. Consumer inflation figures of advanced and emerging economies fell to 4.24% and 5.11%, respectively, from 5.65% and 6.90% in the previous reporting period. However, inflation continues to hover significantly above the average target rate of 2% in advanced economies and 3.5% in emerging economies. On the other hand, core inflation, which remained sticky due to the strong course of labor markets and domestic demand, receded to 4.83% from 5.10% in advanced economies, and to 5.61% from 6.85% in emerging economies in the reporting period.

Despite the recent downward trend in global inflation owing to favorable energy and commodity prices, the strong course of labor markets keeps wage pressures and the global demand brisk, and the limited decline in core inflation indicators supports the expectation that central banks will remain tight for a protracted period. As the tightening steps were transmitted to market conditions, central banks' emphasis on tightening in financing and credit conditions grew stronger. The US Federal Reserve (Fed) decided to leave its policy rate unchanged at its June meeting for the first time in its monetary tightening policy that started in March 2022. It was underlined that this decision pointed to the continuation of the rate hike process but at a slower pace. At their meetings of May and June, the European Central Bank (ECB) and the Bank of England (BoE) also hiked rates by a total of 50 and 75 basis points, respectively, thereby maintaining their tight monetary policy stances.

While the outlook for global growth remained flat, the signals of a slower-than-expected tightening in advanced economies suppressed global volatilities. While the risk premium indicators of emerging economies decreased in parallel to the recovery in risk appetite, Türkiye's credit default swap (CDS) premium increased due to domestic uncertainties and reached 703 basis points in May, which is the peak level of this year, but it has started to decline since June and receded to 435 basis points as of 25 July. However, Türkiye's CDS premium continued to hover significantly above its 10-year average of 350 basis points. In May, the 1-month and 12-month implied volatilities of the TL rose to 56.87 points and 46.77 points, respectively, but declined to 20.18 points and 29.99 points as of 25 July. Having receded to USD 98.5 billion in May, the CBRT's gross reserves displayed a strong upward trend following June and rose to USD 113.1 billion as of 14 July.

Having accelerated in the previous reporting period, loan growth remained robust in the second quarter of 2023. Despite the deceleration led by commercial loans in June, loan growth, which poses a risk to inflation by boosting domestic demand, was above historical averages in the second quarter of 2023 due to retail loans. The annual growth rate of retail loans has reached 80%. The recent growth in retail loans is driven by credit card expenditures, which have reached an annual growth rate of 186.6%. Meanwhile, the spread between deposit rates and the CBRT weighted average funding rate, which widened due to the securities maintenance regulation based on banks' TL deposit shares and the conversion rate of their

foreign exchange (FX) deposits to TL deposits, declined from its peak of 22.17% in the week of the June MPC meeting to 12.83% as of 14 July.

1.1 Monetary Policy Decisions

In view of the inflation outlook and upside risks, the CBRT assessed that the current monetary policy framework should be made more effective to bring inflation down to the medium-term target of 5%. At the June Monetary Policy Committee (MPC) meeting, a significant change was made in the policy stance considering the necessity to create the monetary and financial conditions to ensure a decline in the underlying trend of inflation and reach the medium-term target of 5%. The meeting underlined the importance of achieving price stability with regard to macroeconomic stability and financial stability in particular. It was decided to strengthen the monetary tightening through actions as much as needed in a timely and gradual manner. Envisaging that this monetary tightening process will continue until a significant improvement in the inflation outlook is achieved, the CBRT raised the policy rate from 8.5% to 15% at the June meeting and to 17.5% at the July meeting. In addition, decisions were made on quantitative tightening and selective credit tightening to support the monetary policy stance.

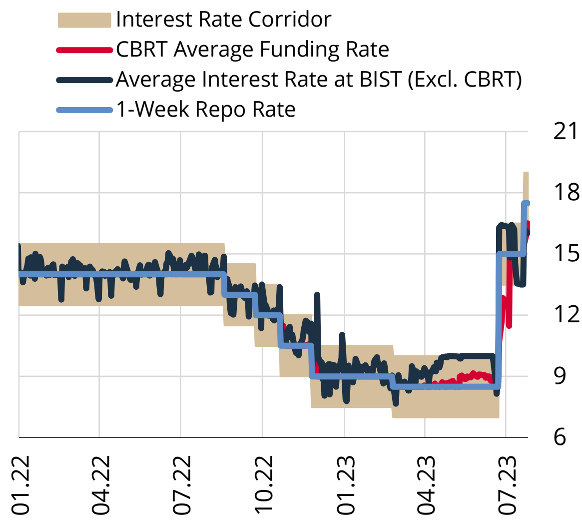
The CBRT evaluated that the monetary tightening process should continue to establish disinflation as soon as possible, anchor inflation expectations and control the deterioration in pricing behavior. In consideration of the need to update the current micro and macroprudential framework to support macro financial stability and increase the functionality of market mechanisms, the CBRT adopted a policy of simplification. In this context, the CBRT decided to implement a gradual simplification policy for a smooth transition. Moreover, it was stated that the pace and sequence of the transformation in the simplification process would depend on impact analyses. Accordingly, impact analyses will be conducted for all components of this framework from a holistic perspective, including their impacts on inflation, interest rates, exchange rates, reserves, expectations, securities and financial stability. Meanwhile, it was underlined that foreign direct investment, the notable improvement in external financing conditions, the continued increase in foreign exchange reserves and the improvement in the current account balance driven by rising tourism revenues would contribute significantly to price stability.

The current micro and macroprudential framework is being simplified in a way to increase the functionality of market mechanisms and foster macro financial stability. The MPC has decided that the simplification policy will be gradual to ensure a smooth transition. Accordingly, securities maintenance ratios were simplified and lowered. The target ratios for the share of TL deposits, which is the base for the implementation of additional securities maintenance ratio, the additional reserve requirement ratio and the commission on foreign currency reserve requirements were reduced from 60% to 57%. The conversion practice for securities maintenance was simplified, and changes were introduced to encourage conversion from FX-protected accounts to TL deposits with maturities longer than three months. In the calculation of the share of TL deposits, the multiplier has been set at 1.5 for TL deposits with maturities longer than three months when converted from FX-protected accounts at maturity. Moreover, to increase the functionality of the market mechanism, it has been decided to simplify the securities maintenance practice based on interest rates, and accordingly to remove the first tier for TL commercial loans excluding export and investment loans and to apply the interest rate threshold as a single tier.

Selective credit and quantitative tightening steps have been taken to support the tightening process. In this context, a reserve requirement ratio of 15% was introduced for FX-protected accounts. To complement the steps supporting the tightening process, it was decided to set the monthly growth limit for TL commercial loans (excluding export, investment, agriculture and tradesmen loans) at 2.5%, which was previously 3% under the securities maintenance practice based on loan growth. To support the efficient use of financial resources, the growth limit for vehicle loans was set at 2%, down from 3%. Moreover, to control inflation and to balance domestic demand, the monthly maximum interest rate applied to credit card cash utilization and overdraft accounts was raised. Export and investment loans as well as loans for the earthquake zone were exempted from all credit-restricting measures. Moreover, daily limits for rediscount credits have been increased in order to support exporters' access to finance, the conditions for utilization of rediscount credits have been eased, and it has been decided that small and medium-sized enterprises' share in rediscount credits is to be increased and export performance is to be taken into account while extending credits.

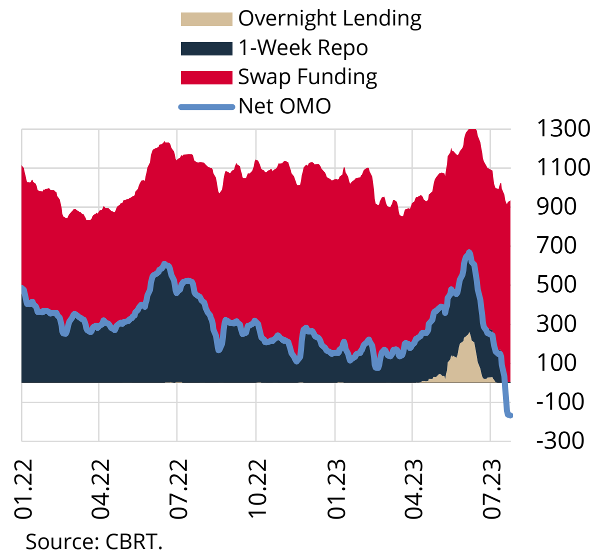
The CBRT provided funding through Open Market Operations (OMO) and currency swap transactions. While overnight rates generally hovered around the CBRT overnight lending rate during the reporting period, they have declined since mid-July and approached the CBRT overnight borrowing rate. The amount of currency swap transactions, which was TL 680.4 billion as of 28 April 2023, increased to TL 907.1 billion as of 26 July 2023. In the same period, the net OMO funding declined to TL -121.5 billion (Chart 1.1.1 and Chart 1.1.2).

Chart1.1.1: CBRT Rates and Short-Term Interest Rates (%)



Source: BIST, CBRT.

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



Source: CBRT.