# 1. Overview

***The possibility of strengthening protectionism in global trade policies increases upside risks to global inflation.*** Labor markets normalize further, while stickiness in services inflation weakens but continues. The services sector is still the main driver of growth, while the divergence among growth prospects for advanced economies has become more pronounced. The growth outlook of Türkiye's trading partners is projected to be more favorable in 2025 compared to the previous year. However, mounting uncertainties regarding global economic and trade policies coupled with geopolitical developments strengthen downside risks to global economic activity. Lately, volatility in oil prices increased and natural gas prices rose further. Against this background, market implied policy rates suggest central banks of advanced economies will adopt a more prudent stance in lowering the level of monetary tightness.

***Amid expectations of a slowdown and monetary easing coupled with elevated geopolitical tensions, risk sentiment towards emerging market economies worsened to some extent.*** Accordingly, the emerging economies' risk premium posted an increase in the current report period, while the CDS premium of Türkiye reached 255 basis points with a more limited deterioration as of January, 31. In this period, the implied volatility of the Turkish lira receded amid the improvement both in inflation and inflation expectations. The CBRT's gross international reserves reached USD 167.6 billion as of January 24, while the composition of reserves improved further. Bond yields, on the other hand, declined across all maturities, especially in short terms due to the higher interest from domestic and foreign investors.

***Financial conditions remain tight while the share of TL in deposit composition rises further.*** The tight monetary stance coupled with supporting macroprudential measures led TL deposit rates to follow a flat course until the rate cut in December. The impact of the policy rate cut on TL deposit rates was similar to the size of the cut. In the current reporting period, the share of the Turkish lira within banks' deposit composition rose further and reached 59.9%, while the share of FX-protected (KKM) accounts receded to 5.3%. Despite the flat course in TL deposit rates until the policy rate cut, the decline in TL commercial and personal loan rates, which had started in the second quarter of 2024, continued. Meanwhile, both TL commercial and personal loan real rates are in the positive territory in terms of expected and actual inflation. In the current reporting period, the total commercial loan growth rate adjusted for the exchange rate follows a mild course, while retail loans exhibit an acceleration due to loans exempted from the loan growth limit. Real and standardized loan changes are close to long-term averages for TL commercial loans, while they are slightly above long-term averages for other loan types.

***Economic activity lost momentum in the third quarter of 2024.*** In this period, GDP increased by 2.1% on an annual basis but contracted by 0.2% quarterly, indicating a weakening in economic activity compared to the previous quarter. On the expenditures side, private consumption contributed negatively to quarterly growth, whereas net exports made a strong positive contribution. Thus, the demand composition of growth remained balanced. On the production side, the services sector remained the main driver of annual growth.

***Recent indicators suggest that domestic demand stands at disinflationary levels.*** In the last quarter of 2024, retail sales and trade sales volume indices increased on a quarter-on-quarter basis. However, the quarterly increase in the retail sales volume index is more moderate when gold is excluded. After recording a decline during the previous two quarters, sales of automobiles and white goods increased in the last quarter, exhibiting an offsetting trend. Providing insight into both the production of services and their demand, the services production index remained almost flat as of November. In the last quarter, survey data regarding manufacturing industry firms indicated that domestic market orders still hover below historical averages, notwithstanding a quarterly increase. Monthly rates of increase in card spending fell below the average of the previous quarter in October and November but accelerated to some extent in December, with seasonal effects. However, January data suggest a monthly and quarterly decline in card spending. Information on consumption expenditures obtained from interviews with firms also points to a slowdown in domestic demand in the first quarter as of January. On the production side, industrial production rose on a quarterly basis as of November. However, when the typically highly volatile sectors are excluded, recovery in industrial production is assessed to be more moderate. TURKSTAT started to publish the Index of Production in Construction in January 2025. This index indicates that the activity in the construction sector is stronger than that in industry and services amid the ongoing support of the earthquake-driven construction activities.

***Seasonally adjusted employment continued to increase in the last quarter of 2024, and the unemployment rate remained flat and below its historical average.*** However, the labor underutilization rate remained high with a quarterly rise of 1.4 points as of November, suggesting that the labor market may not be as strong as implied by the headline unemployment figure. As for wage developments, real unit wages registered a moderate decline in the third quarter. Accordingly, the ongoing rebalancing in domestic demand and the mild course of real unit wages are expected to contribute to the disinflation process.

***The improvement in the current account balance in the third quarter of 2024 stalled in the last quarter, due to the widening trade deficit, despite the strong services balance.*** In the last quarter of the year, the foreign trade deficit increased over the previous quarter in line with our forecasts. Seasonally and calendar-adjusted exports, which had decreased in the third quarter, posted a limited increase in the last quarter due in part to the relatively mild course of economic activity in Türkiye's main trade partners. On the imports front, seasonally and calendar-adjusted total imports increased in the last quarter of the year. Imports of consumption and intermediate goods made the largest contributions to this quarterly increase. However, excluding the jewelry item that contributes strongly to its rise, imports of consumption goods display a flatter course. During this period, seasonally and calendar-adjusted energy imports increased, while the increase in gold imports was higher. Terms of trade declined in the last quarter, while both export and import volumes increased, albeit to a more limited extent in exports. The strong course of the services balance continued with the contribution of travel revenues. On the financing side, inflows to the equity and government domestic debt securities markets decreased in the last quarter, while the weight of long-term items increased. In this period, reserve build-up continued, while the net errors and omissions item registered outflows. Provisional foreign trade data for January suggest a monthly fall in exports and imports, in seasonally adjusted terms. Following its increase in the last quarter of the year, imports of consumption goods remained high in January, despite a slight decline. Monthly imports of jewelry, which averaged USD 0.8 billion in the last quarter of 2024, dropped in early 2025 to around USD 0.1 billion in January. Accordingly, imports of consumption goods excluding jewelry rose.

***The disinflation process, which started in June 2024, continues. Having completed 2024 at 44.38%, annual consumer inflation maintained its downward course and receded to 42.12% in January.*** Global commodity prices, which were on a mild track in the last months of the year, posted an increase in January led by the energy group. The stable course of the Turkish lira continued during the last three-month period. Meanwhile, no significant pressure was observed in global supply conditions. Real unit wages, which are projected to have weakened in the last quarter of 2024, are expected to increase as of the first quarter of 2025. The ongoing weakening of producer inflation was interrupted in January. It is assessed that the output gap, which is estimated to have receded into negative territory in the third quarter of 2024, followed a flat course in the last three-month period, and accordingly, aggregate demand conditions remained mild in the last reporting period. Inflation expectations stayed above the projections presented in the previous Report, yet continued to decline. Increases in administered prices and the automatic tax revisions in certain items linked to producer prices had an upward impact on consumer inflation in January. According to unadjusted data, services inflation, which decelerated significantly in November and December, rose again in January led by wage adjustments as well as items with strong time-dependent price-setting and backward-indexation tendency. Despite consistently weakening, rents continued to push services inflation up. Core goods prices maintained their relatively moderate upward course during this reporting period. Price increases in fresh fruits and vegetables, which led to a significant rise in food inflation in the October-November period in 2024, remained relatively subdued in December and January. The slowdown in the underlying inflation was replaced by a temporary rise in January due to month-specific conditions, in line with the projections.

***The year-end inflation forecast is revised as 24% for 2025 but kept unchanged as 12% for 2026***. Inflation is projected to decline to 8% in 2027 before stabilizing at the medium-term inflation target of 5%. At the end of 2024 and in January 2025, consumer inflation realized close to the mid-point of the forecast range of the previous Inflation Report. In the last quarter of 2024, the underlying trend of inflation receded, and the disinflation process became more evident. While the rise in January is attributed to transitory factors specific to that period, the underlying trend is expected to continue to slow down gradually in the upcoming period. Maintaining the prudent monetary policy stance supports the disinflation process through demand, real exchange rate and expectations channels. On the other hand, due to the various factors that are relatively outside the monetary policy domain and the current data flow, the end-2025 inflation forecast is updated upwards. Changes in assumptions for unprocessed food inflation and administered prices were instrumental on this revision. Additionally, another factor that drove the inflation forecasts up was the mechanical effect that stemmed from the services sector, particularly rental and education services, weighing more heavily on the consumer price index due to the change in consumption patterns.

***Medium-term forecasts are based on an outlook in which the tight monetary policy stance would be maintained until the inflation outlook displays a sustained decline and price stability is achieved, and the coordination among economic policies would be strengthened.*** The convergence of inflation expectations to the Inflation Report forecasts in the short term and to the inflation targets in the medium term is critical for ensuring a permanent decline in inflation. A monetary policy stance that will ensure the tightness required by the projected disinflation path and a continued decline in headline inflation will support the improvement in inflation expectations in the period ahead. It is expected that on the back of macroprudential policies that support the monetary transmission mechanism, the credit growth will remain consistent with the projected disinflation path. With the cumulative effects of the monetary stance, the demand outlook is expected to contribute further to the disinflation process. Against this background, inflation will continue to decelerate in items that are highly sensitive to demand conditions. A continued moderation in pressures stemming from producer prices will help core goods inflation to remain low. With the weakening in real unit costs becoming more pronounced, the decline in the underlying trend of inflation is expected to strengthen. Lastly, in the forecast period, the continuation of a stronger coordination among fiscal and monetary policies will contribute to disinflation through demand, cost and expectation channels.

## 1.1 Monetary Policy Decisions

***The CBRT kept the policy rate constant in November and reduced it by 250 basis points each in December and January.*** Reiterating its cautious stance against upside risks to inflation, the CBRT kept the policy rate unchanged at 50% in November, and reduced it to 45% with 250 basis points cut both in December and January. Besides, the CBRT adjusted the operational framework by setting the overnight borrowing and lending rates 150 basis points below and above the one-week repo auction rate, respectively.

***The CBRT reiterated that monetary policy tools will be used effectively in case a significant and persistent deterioration in inflation is foreseen and stated that it will make its decisions prudently on a meeting-by-meeting basis with a focus on the inflation outlook.*** Stating that while inflation expectations and pricing behavior tend to improve, they continue to pose risks to the disinflation process, the CBRT underlined that the tight monetary stance will be maintained until price stability is achieved via a sustained decline in inflation. The CBRT also stated that the policy rate will be determined in a way to ensure the tightness required by the projected disinflation path taking into account realized and expected inflation and the underlying trend. Additionally, the CBRT emphasized that the decisiveness regarding the tight monetary stance is strengthening the disinflation process through moderation in domestic demand, real appreciation in the Turkish lira and improvement in inflation expectations, and stated that increased coordination of fiscal policy will also contribute significantly to this process.

***In order to strengthen the monetary transmission mechanism, the CBRT has been revising the KKM targets and reserve requirement ratios.*** Accordingly, on November 22, 2024, the TRY deposit share target for legal persons was abolished, and the total target for KKM accounts' transition to TRY and renewals was reduced from 75% to 70%. Moreover, in order to allow sterilization of TRY liquidity from the system, the reserve requirement ratios for short-term TRY deposit accounts were raised from 15% to 17%, while reserve requirement ratios for TRY-denominated required reserves that should be maintained for FX deposits were reduced from 5% to 4%. In order to support the decline in the KKM balance, on December 20, 2024, the total target for KKM accounts' transition to TRY and renewals was reduced from 70% to 60% and the minimum interest rate applicable to KKM accounts was reduced from 70% to 50% of the policy rate. Moreover, the remuneration of reserve requirements maintained for KKM accounts was terminated for new KKM accounts or for those to be renewed. On January 2, 2025, the support provided for FX or TRY deposit accounts and participation accounts of legal persons with FX liabilities was abolished. On January 20, 2025, the CBRT decided to terminate the opening and renewal of FX-protected deposit and participation accounts -converted from FX and gold- with maturities of six months and 12 months as of the same date. In order to further strengthen the monetary transmission mechanism, on February 4, 2025, the reserve requirement ratios were raised from 8% to 12% for banks' Turkish lira liabilities of funds from repo transactions from abroad, loans obtained from abroad and deposits (participation funds) from banks abroad, with maturities up to one year (including one year).

***In order to make sure that loan growth and composition are in line with the disinflation path, regulations regarding loan growth limits are being revised.*** On January 4, 2025, the monthly growth limit for foreign currency commercial loans was reduced from 1.5% to 1%, while the monthly growth limit for Turkish lira commercial loans, which was 2%, was differentiated and raised to 2.5% for SME loans and decreased to 1.5% for other commercial loans. Additionally, Turkish lira SME loans extended through the KOSGEB or in the scope of funding provided by international development finance institutions to support sustainability were exempted from the loan growth limit.

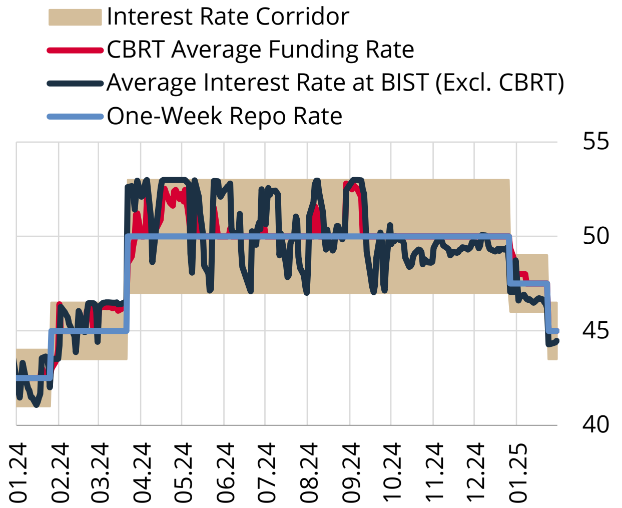
***Excess liquidity conditions in the system persist and this excess liquidity is effectively sterilized with the contribution of the additional measure taken after the January MPC meeting.*** In the current reporting period, overnight interest rates moved in line with the CBRT policy rate as a result of sterilization through various channels (Chart 1.1.1). In the current reporting period, the course of the CBRT's FX transactions and the TRY account balance of the Republic of Türkiye Ministry of Treasury and Finance (Treasury) have been important factors in the course of the level of excess liquidity in the system. Throughout the entire reporting period, the excess liquidity fluctuated around TRY 850 billion. The decline in excess liquidity in late November was mainly driven by the significant increase in the Treasury account balance, while the excess liquidity declined in late December due to foreign investors' position closures at the end of the year. Reserve requirement ratios for short-term TRY deposit accounts were increased, while the reserve requirement ratios for TRY -denominated required reserves maintained for FX deposits was decreased to be effective as of the maintenance period starting on December 6, 2024. This arrangement led to a limited decline in excess liquidity.

**The interest payment made to TRY-denominated required reserves in the current reporting period was another factor that increased the excess liquidity at the beginning of 2025.** In 2025, the rapid improvement in the CBRT's FX position and the divergence in banks' tendency to maintain TRY during the reserve requirement period led to an increase in the excess liquidity that exceeded TRY 1.5 trillion.

**After the January MPC meeting, excess liquidity in the system declined as banks significantly increased their free deposit balances, and the CBRT resumed weekly repo auctions on January 24, 2025 that had been suspended on January 17, 2025.** Moreover, the CBRT started to hold four-week deposit buying auctions as of January 24, 2025. The amount of long-term sterilization through these auctions was TRY 125.5 billion as of January 30, 2025.

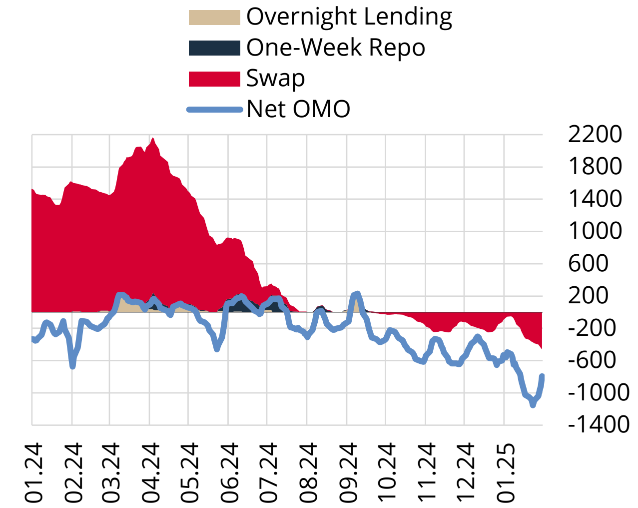
**Although the CBRT sterilizes excess liquidity in the market mainly through overnight deposit buying auctions, it also holds weekly and monthly deposit buying auctions and sell-side Turkish lira FX/gold swap auctions.** On January 30, 2025, TRY 613.8 billion, TRY 125.5 billion and TRY 33.6 billion of the excess liquidity was sterilized through overnight, monthly and weekly deposit buying auctions, respectively, while TRY 479.2 billion was sterilized through sell-side swap auctions (Chart 1.1.2).

**Chart 1.1.1: CBRT Interest 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.