1. Overview

Global inflation exhibits an outlook more consistent with targets than the previous reporting period. Labor markets normalize further while stickiness in services inflation weakens but continues. Leading indicators of global economic activity suggest that the manufacturing industry remains sluggish and the services sector is still the main driver of growth. The global growth outlook, supply side factors and geopolitical risks continue to shape commodity prices. In the reporting period, non-energy commodity prices have displayed a widespread increase while the volatile course of oil prices has been notable. Fluctuations in global demand expectations led by the People's Bank of China's policy measures and the developments in the Chinese economy, coupled with the uncertainties stemming from the US elections have affected the risk sentiment recently. Central banks lower the level of monetary tightness so as to keep up the disinflation process and contain the accumulating downside risks to growth and employment. Despite a better inflation outlook, the elevated uncertainty and brisk risks cause central banks to maintain their prudent stances.

The global risk appetite deteriorated rapidly amid geopolitical developments, concerns over recession and the Bank of Japan's surprising rate hike in early August, but improved in the subsequent period. However, due to geopolitical risks accompanied by the arising uncertainties regarding the US election process, this improvement remained limited. The Fed joined the group of major central banks initiating rate cuts, which underpinned the recovery in the global risk appetite. On the other hand, mounting tension in the Middle East accompanied by the uncertainties brought about by the US elections remain as the leading risk factors to global financial conditions. Against this background, risk premiums of emerging market economies receded to pre-August levels, while Türkiye's five-year CDS premium fell to 272 basis points as of October 25. In this period, implied volatility of the Turkish lira got higher after inflation in September exceeded expectations. The CBRT's gross international reserves reached USD 159.4 billion on October 25, while the CBRT swap funding was terminated. Including the balance of swaps totaling USD 4.6 billion lent to banks that were put into use under the scope of TL sterilization in early August, total reserves amount to USD 164 billion.

Financial conditions remain tight while the share of TL in deposit composition rises further. The efficient sterilization of the TL liquidity in the market coupled with the supporting macroprudential measures led TL deposit rates to follow a flat course in the current reporting period. The share of TL in banks' deposit composition increased further and reached 55.8% in this period. Moreover, the share of FX-protected (KKM) accounts within total deposits decreased, and the increase in FX deposits in August reversed in the following months following the decisions taken regarding KKM accounts. Having started in the second quarter of 2024, the decline in TL commercial and personal loan rates continued. On the other hand, as the disinflation process started in June, real TL commercial and personal loan rates turned positive in terms of expected and actual inflation. Accordingly, financial conditions grew tighter. Due to FX growth constraints and the falling commercial loan rates, the tendency to use TL commercial loans strengthened in the recent period. However, TL commercial loans and FX commercial loans adjusted for the exchange rate grew by a rate similar to that implied by the constraints of 2% and 1.5%, respectively and moved in accordance with our expectations. On the retail loans side, consumer loan growth in real and standardized terms hovers around long term averages, while credit card growth remains strong. Maximum contractual interest rates for personal credit cards were differentiated according to term debt balances. Accordingly, a raise in the rates imposed on cards with high term debts is expected to limit borrowing behavior and contribute to the rebalancing in domestic demand.

Annual and quarterly growth rates declined in the second quarter. In this period, GDP increased by 2.5% on an annual basis but remained flat with a quarterly growth of 0.1%, indicating a weakening in economic activity. On the expenditures side, the annual contribution of private consumption to growth declined, whereas the positive contribution of net exports continued, thus enabling a better balance among demand components. On the production side, the services sector remained the main driver of annual growth.

Indicators for the third quarter suggest that domestic demand continues to slow down, approaching disinflationary levels. In the third quarter, spending on goods excluding automobiles, which accounts for approximately half of household final consumption expenditures, increased on a quarterly basis, whereas the remaining part consisting of automobile sales and services expenditures declined. In this period, both the retail sales and the trade sales volume indices posted a quarterly rise. Notwithstanding a quarter-on-quarter fall, white goods sales maintained their course above the historical trend. Meanwhile, automobile sales increased somewhat in October after a decline in the third quarter. As of August, the services production index edged down by 0.9% quarterly. Survey data for manufacturing industry firms indicate a quarterly decrease in domestic market orders in the third quarter. Information on consumption expenditures obtained from interviews with firms also points to a slowdown in domestic demand. Although card spending remained flat in July, it registered a quarterly growth due to monthly increases in August and September. However, October data suggest a flat monthly course in card spending. On the production side, industrial production fell on a quarterly basis as of August. When the typically highly volatile sectors are excluded, the decline in industrial production in the third quarter is assessed to be less pronounced than implied by the overall index.

Seasonally adjusted employment continued to increase in the third quarter, diverging from other demand and production indicators. However, given the already high level of the labor underutilization rate despite a quarterly decline of 0.4 points as of August, the labor market may not be as strong as implied by the main indicators. As for wage developments, the rise in real unit wages continued with a significant loss of momentum in the second quarter of the year. Nevertheless, the ongoing rebalancing in domestic demand and the expected decline in real unit wages over the rest of the year are expected to contribute to the disinflation process.

The improvement in the current account balance gained momentum in the third quarter amid the significant decline in the foreign trade deficit and the ongoing strong course of the services balance. During this period, the foreign trade deficit narrowed on a quarterly basis as the decline in imports was greater than the decline in exports. Due to the modest recovery in external demand and the favorable course of the export climate index in the third quarter, the quarterly decline in seasonally and calendar-adjusted exports remained limited. This was also led by gold exports, with a carry-over of the second quarter's increase into the third quarter. On the imports side, seasonally and calendar-adjusted total imports decreased in the third quarter. Imports of consumption and intermediate goods made the largest contributions to this quarterly decline. While gold imports edged down in this period, the decline in seasonally and calendar-adjusted energy imports was more pronounced. In addition, the limited increase in the terms of trade and the rebalancing in foreign trade volumes supported the decline in the foreign trade deficit in the third quarter. All goods groups contributed to the decrease in import volumes, while the decline in the import volumes of consumption goods was more pronounced than that of other groups. The strong course of the services balance continued, with the contribution of both travel and transport revenues. The retrospective upward revision in the services balance also reduced the level of the cumulative current account deficit. On the financing side, the weight of portfolio investments decreased in the third quarter, while that of long-term items increased. In this period, reserve build-up continued, while the net errors and omissions item posted outflows. Provisional foreign trade data for October point to a limited monthly drop in exports and a rise in imports. After falling in the third quarter, imports of consumption goods increased in October in seasonally adjusted terms. However, this increase is more moderate when the jewelry item, which is classified under consumption goods, is excluded.

The disinflation process continued, with consumer inflation falling to 48.58% in October 2024. After the ongoing decline in global commodity prices in August, the rise in non-energy commodity prices in September spread across all main groups in October. Following the mild increase in the currency basket in August, exchange rate-driven effects on inflation remained temporary. The global supply chain pressure index hovered close to its historical average, indicating that there were no significant pressures stemming from global supply conditions. Against this background, pressures driven by producer prices on consumer inflation continued to weaken. In this period, demand conditions converged to levels supportive of disinflation. Price increases in administered items and D-PPI-based automatic tax revisions had an upward impact on consumer inflation in July and August. Inflation expectations remained on a declining trend yet exceeded the forecasts presented in the previous Inflation Report. High services inflation persisted in the third quarter, led by rents and education groups with strong time-dependent price-setting and backward-indexation behavior and transport services with high sensitivity to fuel prices. The high course was mainly driven by rents, while services inflation excluding rents displayed a gradual, albeit limited slowdown. Core goods inflation remained low in this period. In the food group, the rise in fresh fruit and vegetable prices remained below its historical trend in the third quarter of the year, but this favorable picture was disrupted in October due in part to the field-to-greenhouse transition. Thus, the impact of food prices on consumer inflation became more visible in October. The underlying trend of inflation continued to decelerate in

October, as in the third quarter. The improvement observed in services inflation as of October is expected to extend into the last quarter.

Year-end inflation forecasts for 2024, 2025 and 2026 are revised as 44%, 21% and 12%, respectively. In the third quarter, energy prices and the lump sum tax revisions as well as price developments in administered items had a notable impact on consumer inflation. The October inflation realizations remained above the upper bound of the forecast range in the previous Inflation Report, resulting in a forecast deviation of 0.2 percentage points. In the upcoming period, the improvement in the underlying trend of inflation and expectations may remain limited when compared to the projections of the previous Report. Given the lagged effects of monetary tightening, the slowdown in demand is expected to continue and provide support for disinflationary path. The upward revision in the year-end inflation forecast for 2024 was primarily driven by the food price assumption as well as the revision in the underlying trend of inflation and the initial conditions. Regarding the revision to the year-end inflation forecast for 2025, the change in administered price assumptions due to the impact of the regulations on electricity pricing dynamics had a significant impact, in addition to the aforementioned effects.

Medium-term forecasts are based on an outlook in which the tight monetary policy stance would be maintained until the inflation outlook displays a significant and sustained decline, and the coordination among economic policies would be strengthened. The monetary transmission mechanism will be supported by additional macroprudential measures, and sterilization tools will continue to be used effectively. The supportive course of demand conditions to disinflation on the back of the maintenance of the tight monetary policy stance and the tightening of financial conditions with the lagged effects of the taken policy steps is anticipated to become more pronounced in the upcoming period. Forecasts rely on a monetary policy that will remain tight until a significant and sustained decline in the underlying trend of monthly inflation is observed, and inflation expectations converge to the projected forecast range. With the contribution of the forward guidance emphasizing the decisive tight stance in monetary policy, the convergence of inflation expectations to the Inflation Report forecasts in the short term and to the inflation target in the medium term is critical for ensuring permanent price stability. The decisive monetary policy stance is expected to support the downtrend in underlying inflation amid the moderation in domestic demand, the real appreciation in the Turkish lira and the improvement in inflation expectations.

1.1 Monetary Policy Decisions

The CBRT kept the policy rate constant at 50% in the August-October period. In July, the underlying trend of monthly inflation edged up month-on-month; however, there was no significant change in August. The underlying trend of inflation increased slightly in September, while a slowdown was recorded in October. Indicators for the third quarter suggest that domestic demand continues to slow down with a diminishing inflationary impact.

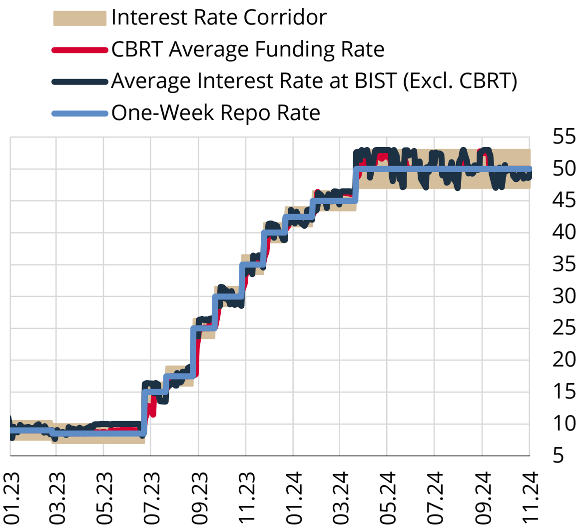
The CBRT has kept the policy rate constant and remains highly attentive to upside inflation risks. The CBRT maintained its view that the consistency of inflation expectations and pricing behavior with the projections continue to pose risks to disinflation process. At the October meeting of the Monetary Policy Committee, the CBRT stated that the uncertainty regarding the pace of improvement in inflation increased in light of incoming data. The CBRT stressed that the tight monetary stance will be maintained until a significant and sustained decline in the underlying trend of monthly inflation is observed, and inflation expectations converge to the projected forecast range. The CBRT stated that monetary policy tools will be used effectively in case a significant and persistent deterioration in inflation is foreseen. The decisiveness regarding the tight monetary stance will bring down the underlying trend of monthly inflation through moderation in domestic demand, real appreciation in the Turkish lira and improvement in inflation expectations. Consequently, the disinflation process will gain strength.

The CBRT has sustained the policies that support Turkish lira deposits to strengthen the monetary transmission mechanism. In its announcement of August 29, 2024, the CBRT increased the monthly growth target from 0.6 points to 0.8 points for banks with real person TL deposit shares between 45% and 50%. Additionally, the monthly growth target was abolished for banks with real person TL deposit shares exceeding 60%, and a condition of keeping this share above 60% was introduced. In line with the objective of gradual phasing out of KKM deposits, legal person KKM accounts started to be included in the calculation of the total target for KKM accounts' transition to TL and renewals. To support TL deposit rates by reducing the cost of reserve requirements for banks, the upper limit of the remuneration of required reserves for TL deposits, based on the rate of transition to TL was increased from 80% to 84% of the policy rate. Moreover, the ratio for TL required reserves to be maintained in blocked accounts was raised by 5 points to ease the impact of short-term volatilities in market liquidity on TL deposit rates. On September 21, 2024, the ratio for TL required reserves maintained for FX deposits was reduced from 8% to 5%, while the ratio for short-term TL deposits was raised from 12% to 15% and that for long-term TL deposits from 8% to 10%, which will also allow for withdrawal of some excess TL liquidity from the market. At the same time, for the remuneration of required reserves for TL deposits, the transition-to-TL target, which was causing volatility in deposit pricing amid the diminishing KKM balance, was abolished. As such, the cost of reserve requirements to banks was reduced as well. Meanwhile, the maximum commission rate of 5% applied based on the level of transition-to-TL rate was raised to 8%, to ensure that banks continue to meet the TL-transition target of 15%.

Maximum contractual interest rates for credit cards were differentiated based on the amount of term debt. With an amendment introduced on September 27, 2024, in credit card transactions excluding cash withdrawals or cash payments, the maximum contractual interest rates, formerly applied by adding 114 basis points to the reference rate, started to be determined, effective November 1, 2024, by adding: i) 39 basis points to the reference rate for personal credit cards with term debt less than TRY 25,000, ii) 114 basis points for personal credit cards with term debt between TRY 25,000 and 150,000 and iii) 164 basis points for personal credit cards with term debt exceeding TRY 150,000 and for corporate credit cards regardless of the term debt. Thus, the CBRT aimed to reduce credit card indebtedness and contribute to the rebalancing in domestic demand. Additionally, the maximum interest rate to be charged in restructuring of personal credit card debt was limited to the reference rate.

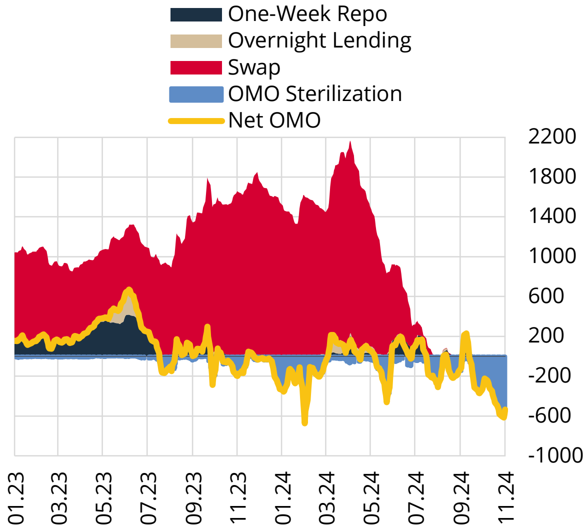
When there was excess liquidity in the system, it was sterilized mainly through overnight deposit buying auctions and overnight rates hovered close to the CBRT policy rate. In the current reporting period, overnight interest rates moved within the CBRT's interest rate corridor (Chart 1.1.1). In the reporting period, a decline was observed in the funding need of the system owing to the improvement in the CBRT's FX position and the public spending of the Ministry of Treasury and Finance. Although net OMO funding shifted to positive territory for a short while during the volatility episode in financial markets at the beginning of August, a liquidity surplus emerged in the market due to the improvement in the CBRT's FX position and increased public spending. With the tax collections at the end of August, the excess liquidity in the system was significantly reduced, and the continued increase in Treasury accounts in the following days led to a liquidity deficit in the system again. Between August 29-September 9, the CBRT changed its funding composition in response to the increased liquidity need and started to provide funding mainly via overnight lending. In this period, the CBRT's weighted average funding rate and overnight repo rates converged to the CBRT lending rate of 53%. In the rest of September, liquidity conditions were mainly affected by the CBRT's FX transactions, and the funding need of the system decreased. In September, in order to reduce short-term volatility in the liquidity and support monetary transmission, the CBRT raised the ratio for maintaining TL required reserves in blocked accounts by 5 points and changed the ratio for TL-denominated required reserves leading to a moderate decline in excess liquidity in the market. The amount of excess liquidity sterilized through the swap channel, which was TRY 6 billion as of August 2, 2024, increased and reached TRY 237 billion as of November 1, 2024. In this period, net OMO funding decreased from TRY -89 billion to TRY -428 billion (Chart 1.1.2). As of November, sell-side gold swap auctions started to be held, and the sterilization toolkit was diversified. Although the CBRT sterilizes excess liquidity in the market mainly through overnight deposit buying auctions, it also holds one-week FX swap auctions against the Turkish lira and deposit buying auctions. As of November 1, a total of TRY 670 billion has been sterilized, including TRY 422 billion through deposit buying auctions, TRY 237 billion through sell-side swap auctions and TRY 11 billion through the CBRT Interbank Money Market and Borsa Istanbul Committed Transactions Market transactions.

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.