Monitoring Turkey: All eyes remain on policy moves

The Central Bank of Turkey (CBT) delivered another strong hike in September and repeated the signal for further tightening. Deposit and lending rates will likely maintain their uptrend in the near term with quantitative and selective credit tightening moves set to reinforce the rate hikes and support the plan to unwind the FX-protected deposit scheme

Turkey: At a glance

- We raised our growth forecast for this year to 3.5% as the momentum is still strong despite some signals of moderation in economic activity. We see 2.5% for the next year given an expected slowdown in domestic demand with policy tightening, although the risks are on the upside given the latest MTP forecast at 4.0% and March elections.
- Given the deterioration in pricing behaviour, exchange-related effects, widespread increase in wages and tax adjustments, continuing strength in domestic demand and the upward reversal in global commodity prices (particularly oil prices), inflation will likely remain under pressure in the near term. We have already seen a significant jump since the elections. Accordingly, we expect annual inflation to be close to 70% this year and 40% in 2024.
- The CBT's focus has remained on anchoring inflation expectations and achieving disinflation. Following 12.5 percentage point hikes in the last two MPCs, we expect the policy rate to be

35% until the year-end, though risks are markedly on the upside. While it is a close call in our view whether we will see another 500bp hike or a decline in pace to 250bp moves, this would lead to a positive ex-ante real policy rate based on the 33% inflation forecast in the medium-term plan. Macro-prudential tightening should also help disinflation efforts. Given the policy signals, we expect the terminal rate to reach 40% in early 2024, and early signals of rate cuts should come forward in late 2024.

- In the January-July period of this year, domestic demand pushed imports significantly upwards and the deterioration gold trade balance weighed on the current account, despite the narrowing energy deficit with the supportive impact of a decline in energy and commodity prices and continued strength in tourism revenues. We see the whole year deficit-to-GDP ratio at 4.1% (US $43.6 billion) and we expect a gradual decline to 2.5% ($29 billion) next year.

Quarterly forecasts

	2Q23	3Q23	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F	1Q25F
Real GDP (%YoY)	3.8	3.3	3.0	2.5	2.0	2.4	2.9	2.9
CPI (eop, %YoY)	38.2	61.7	69.6	68.8	71.9	46.3	40.0	31.2
Central bank key rate (eop, %)	15.00	30.00	35.00	35.00	40.00	40.00	35.00	30.00
3m interest rate (eop, %)	21.22	40.16	42.70	42.29	44.32	41.28	35.85	30.63
10yr yield (eop, %)	16.79	27.15	26.65	29.36	29.63	28.28	26.90	24.99
USD/TRY exchange rate (eop)	26.05	27.37	30.00	32.48	34.14	35.25	36.00	37.86
EUR/TRY exchange rate (eop)	28.43	28.95	33.90	37.68	39.95	41.60	42.12	43.92

Source: Various sources, ING

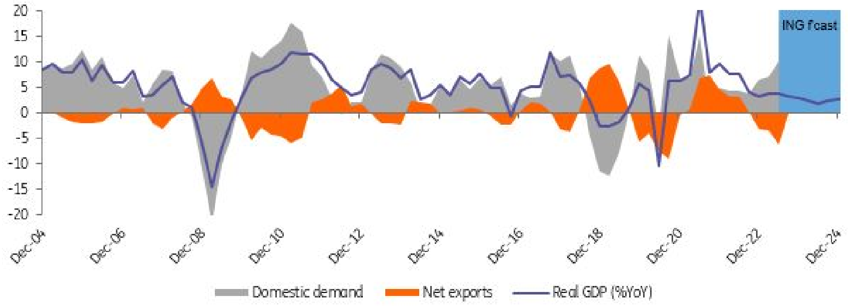
Moderate slowdown in the third quarter

Leading indicators that have been released so far point to a moderate slowdown in the third quarter:

1. Third-quarter PMI was below the 50-level threshold at 49.5, in comparison to the first and second-quarter averages of 50.37 and 51.5 respectively.
2. The third-quarter average of real estate sector confidence (on a seasonally adjusted basis) stood at 104.9, lower than the second-quarter average of 105.3. The same pattern also applies to the retail, construction and services confidence indices.
3. The seasonally adjusted consumer confidence index fell significantly to 73.2 on average in the third quarter, compared to 87.9 in the previous quarter. Capacity utilisation, on the other hand, was an exception with a slight increase seen in the quarterly average to 76.5% from 76.2%.

While data releases confirm expectations of a moderation in economic activity with policy tightening, a sluggish growth outlook in the eurozone – Turkey's key export market – signals weakness in external demand.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

No strong sign of deceleration in July IP

Industrial production in July posted a 7.45% YoY increase on calendar adjusted basis. In seasonally adjusted terms, it contracted by a mild 0.39% month-on-month. As a result, following more than a 0.5% quarter-on-quarter result in the first quarter despite earthquake effects and a strong 2.2% QoQ in the second, we saw a modest start to the third quarter in industrial production, without any strong signals of a loss of momentum.

While manufacturing production dropped on a sequential basis, mining, electricity and gas turned positive, supporting the industrial sector's performance. In the breakdown, capital goods dragged the headline the most with a -0.5ppt contribution, while nondurable consumer goods provided another -0.3ppt impact. On the flip side, energy recorded a 2.8% MoM growth, lifting the monthly industrial production by 0.4ppt and limiting the drop. Among sectors, volatile transport equipment (dominated by defence industry products) deducted 0.7ppt from manufacturing, followed by wearing apparel at 0.6%.

IP vs PMI

Source: ICI, TurkStat, ING

Retail sales suggest remaining strength in domestic demand

Retail sales volumes on a calendar-adjusted basis increased by 31% YoY, while the seasonally and calendar-adjusted index maintained an uptrend at 2.7% MoM. The data revealed that domestic demand growth, which was robust in the first half of this year, made a strong start to the third quarter as well. Among sub-groups, non-food (excluding automotive fuel) and food group sales increased by 41.8% and 19.1% YoY respectively, while automotive fuel rose by 17.0% YoY. The highest annual increase in non-food sales was observed in electrical appliances and furniture at 62.8% YoY.

The seasonally-adjusted unemployment rate inched down to 9.4% in July – the lowest rate since early 2014 – from 9.6% a month ago. Moving forward, labour market conditions will remain sensitive to economic activity and domestic demand outlook. Given the ongoing tightening of monetary, fiscal and macroprudential policies accompanied by the slowdown in credit growth, domestic demand will likely lose momentum. This implies that pressure on unemployment is likely to result in a return to double digits.

Retail sales vs consumer confidence

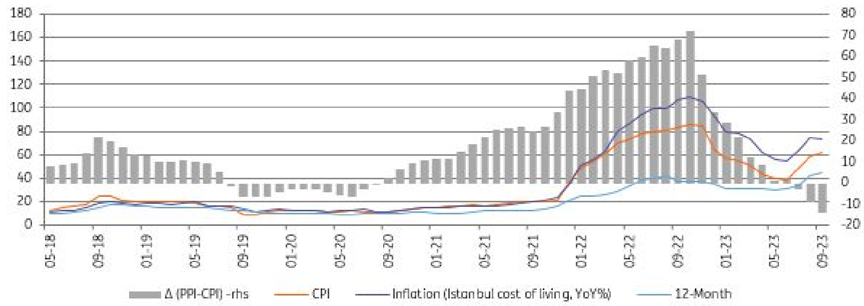
Source: TurkStat, ING

Annual inflation continued to rise in September

With monthly inflation at 4.75% (close to our call at 4.7% and market expectations of 4.9%), annual inflation maintained an uptrend and reached 61.9% in September versus the 65% envisaged for the whole year in the government's medium-term plan and 58% in the CBT's forecast released towards the end of July.

The data reflects a continuation of broad-based deterioration in price dynamics as both food and non-food prices (excluding the housing group) increased above those seen last September, while a rise in energy prices and ongoing pressure in services continue to attract attention. Core inflation (CPI-C) came in at 5.3% MoM, rising to 68.9% on an annual basis attributable to exchange rate developments, changes in administered prices and commodity prices. Accordingly, the underlying trend for the headline has further increased in September, although at a slower pace thanks to goods inflation. The services group has maintained the elevated trend given continued pressures in rent, catering and transportation services.

Inflation outlook (%)



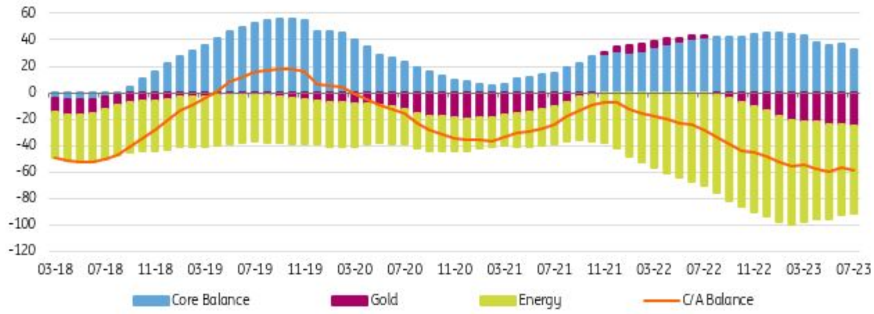
Source: ICC, TurkStat, ING

Spike in July current account deficit

After some relief in June with a surplus of $0.7 billion, the current account dove into deficit again in July with $-5.5 billion – much higher than the consensus and our call of $4.5 billion. Accordingly, the 12M rolling deficit widened to $-58.5 billion (around 5.8% of GDP). A quick glance at the data suggests that core trade and gold balance were the major drivers in the deterioration of the gold deficit, despite lower energy bills with a drop in oil prices.

The capital account, on the other hand, witnessed net identified inflows at $3.8 billion. Net errors and omissions stood at $4.4 billion and reached $12.6 billion in the two months following the elections, reversing the outflows seen two months prior. With the monthly current account deficit and large inflows via net errors and omissions, official reserves recorded a $2.8 billion increase. However, given the weakness in the flows, reserves financed more than half of the current account deficit in the first seven months of this year.

Current account (12M rolling, US$bn)



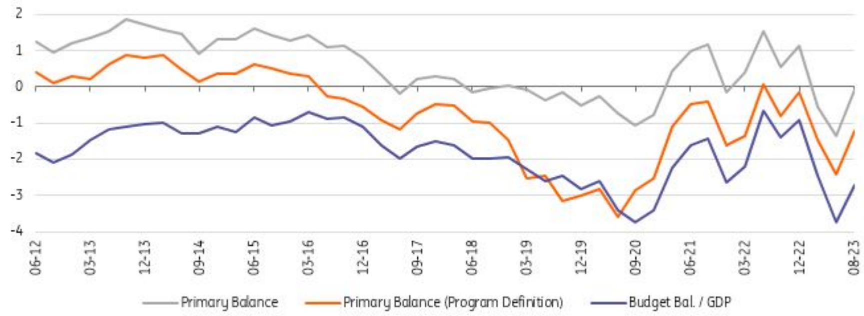
Source: CBT, ING

Improvements in August budget data

In August, the budget posted a surplus of TRY 51.3 billion – an improvement compared to the deficit of TRY 3.6 billion in the same month last year, while the deficit for the last 12 months narrowed to 2.5% of GDP. This is attributable to a significant increase in direct and indirect taxes, continuation of collections from the recent tax restructuring, and a modest increase in non-interest expenditures thanks to the slowdown in goods-services procurement expenditures.

However, the deficit of TRY 383.7 billion in the first eight months continued to point to a significant deterioration compared to the surplus of TRY 33.1 billion in the same period of the previous year. In the new Medium Term Plan (MTP), the budget deficit forecast for 2023 was revised to TRY 1.63 trillion (6.4% of GDP). This suggests a very large deficit for the remainder of this year. The MTP forecasts suggest that the budget deficit-driven monetary expansion will continue for the rest of the year and into next year, and that fiscal policy will not be supportive of the CBT in terms of disinflation.

Budget performance (% of GDP)



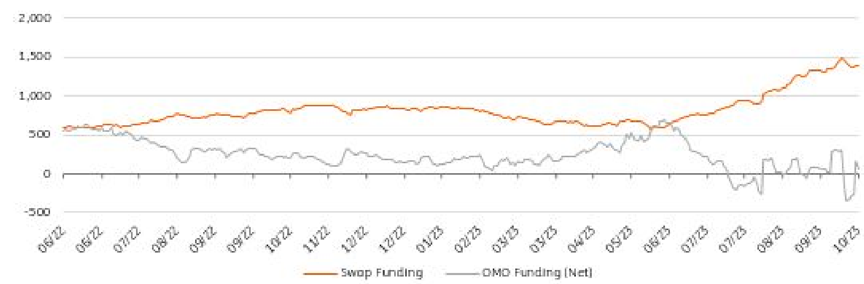
Source: Ministry of Treasury and Finance, ING

No surprise from the MPC in September

Following the lower-than-expected hikes in June (+650bp) and July (+250bp) and the upside surprise in August (750bp), the CBT has continued the tightening cycle with another 500bp hike and in line with the consensus, pulled the one-week repo rate to 30%. In the note explaining the rate decision, the CBT's focus has remained on anchoring inflation expectations and achieving disinflation. In this regard, the bank pointed again to strong domestic demand, stickiness in services prices, the increase in oil prices and the jump in inflation expectations as the factors posing additional upside risks to the inflation outlook.

However, on a positive note, the bank observed that "tax regulations and cost pressures stemming from wages and exchange rates have broadly passed through to prices" and that the underlying trend is likely to turn to a decline. The CBT stressed again the importance of FDI inflows and an improvement in the current account to contribute to price stability. This month, signalling a recovery in TRY outlook, the bank inserted a new phrase that "increasing domestic and foreign demand for Turkish lira-denominated assets" will also be supportive for the price stability objective.

Central bank funding



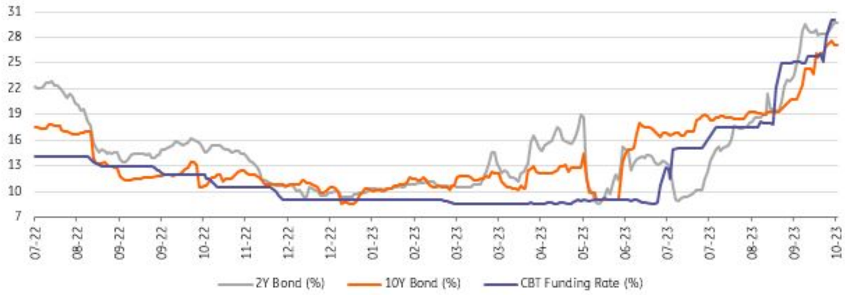
Source: CBT, ING

FX and rates outlook

While the CBT has kept its tightening bias, expectations for the final policy rate have also increased further, given another bout of an inflation uptrend with a broad-based deterioration in price dynamics lately. This tightening cycle, alongside a visible deceleration in growth, should lead to an improvement in the current account in the period ahead. However, the outlook has remained challenging as the decline in global leading activity indicators increases the risk of a slowdown in exports. On the capital account, an ongoing pivot to a more conventional policy stance will likely be critical for recovery in investor confidence and hence identified flows.

Since the elections, we have seen a significant adjustment in bond yields, with the 2Y rate hitting 30% and 10Y bond yields around 27%. This is quite close to all-time highs given the ongoing policy shift and an end to the CBT's intervention in the secondary market for fixed-rate bonds. However, the security maintenance framework that has been revised to unwind the FX-protected deposit scheme is largely in place and limits the extent of adjustment in bond yields. In this environment, there has been some non-resident investor interest lately, with more than $700 million in inflows to local debt (including repos). The CBT also acknowledges increasing domestic and foreign demand for Turkish lira-denominated assets.

10Y local bond vs FX basket



Source: Refinitiv, ING

Sovereign credit holds firm amid market volatility

While the recent market backdrop has been tough for hard currency sovereign bonds given the relentless move higher in UST yields, Turkey has held up fairly well in comparison to its similarly rated peers. Turkey's dollar sovereign bond spreads are on average 15-20bp wider over the past month, compared to over 100bp in many high-beta African single-Bs, even comparing well to higher-rated peers such as South Africa, Colombia, and the Dominican Republic.

In our view, this still leaves fairly limited upside for Turkey, with relative and absolute valuations near the 5-year tight while structural challenges remain and local elections early next year bring the potential for political headline noise over the coming months. However, the continued gradual shift towards orthodox policy and monetary tightening – along with strong technical factors from local demand – should help to keep spreads well anchored, even as markets anticipate potential new supply from the sovereign.

ICE US$ Bond Sub-Index Spreads vs USTs

Source: Refinitiv, ING

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