

## Turkey's monetary policy under focus

Officials from the Central Bank of Turkey have recently made statements to guide expectations on inflation and the rate-cutting cycle. The CBT will likely remain on hold for longer, while the timing will be determined by underlying inflationary trends and the alignment of inflation expectations



Turkey's Central Bank governor Fatih Karahan at a news conference earlier this year

### Turkey: At a glance

- Governor Fatih Karahan reiterated the guidance for a change in the monetary policy stance which is the evolution of the underlying inflationary trend and inflation expectations. Deputy Governor, Akçay, on the other hand, stated that while central banks naturally tend to err on the side of caution, what a central bank is cautious about depends on the situation. According to him, this could be the risk of reviving pricing pressures due to a premature interest rate cut, or a situation in which an excessive or unnecessarily prolonged tightening process leads to a hard landing. He thinks that since the current conditions pose a higher risk in the first case, a rate cut is not on the agenda now.
- Annual inflation has maintained its downtrend, accelerating in comparison to July, with a supportive base despite special consumption tax and administrative price adjustments and pressure in food prices.
- The downtrend will likely continue with another pronounced drop in August. The extent of the decline will be determined by administrative price adjustments, as we saw at the

beginning of this month with a 38% increase in natural prices, whose direct and indirect effect on the headline is expected to be less than 1ppt.

- The lagged effects of monetary tightening on credit and domestic demand and the continued real appreciation of the Turkish lira are likely factors keeping the underlying inflation trend on a downward path for the remainder of this year. While economic activity is on the way for a pronounced slowdown in 3Q with tight financial conditions, a deeper-than-expected impact may also be a factor in the timing of the cutting cycle.
- Moody's upgraded Turkey's long-term foreign and domestic-currency issuer ratings to B1 from B3 and the outlook has remained positive. After Moody's two-notch upgrade, the three major rating agencies are aligned at the same level, which is four notches below investment grade. As all still see the outlook as positive, we see the potential for the upgrade cycle to continue with the improvement in macro indicators, catching up with market pricing that currently assesses Turkey one notch higher at 'BB-'.

## Quarterly forecasts

	1Q24	2Q24	3Q24F	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F
Real GDP (%YoY)	5.7	3.5	1.9	0.9	1.2	2.9	4.3	5.0
CPI (eop, %YoY)	68.5	71.6	47.9	41.7	31.6	27.3	23.3	23.2
Central bank key rate (eop, %)	50.00	50.00	50.00	45.00	37.50	32.50	30.00	27.50
3m interest rate (eop, %)	50.58	49.79	47.25	41.71	38.17	33.92	30.58	29.08
10yr yield (eop, %)	26.82	28.28	26.79	22.91	19.45	18.86	17.76	16.84
USD/TRY exchange rate (eop)	32.35	32.65	34.10	37.00	39.17	41.03	42.63	44.00
EUR/TRY exchange rate (eop)	34.92	35.05	37.51	40.70	43.09	45.14	46.89	48.40

Source: Various sources, ING

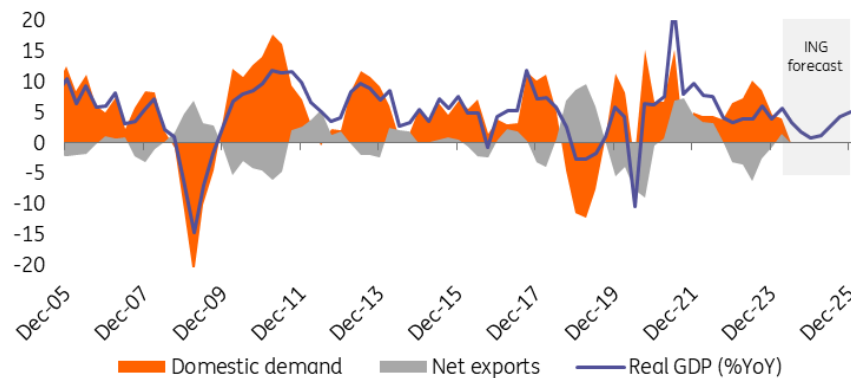
## GDP will likely lose significant momentum in 3Q

Economic activity displayed a strong momentum in the first quarter before the local elections, and despite some moderation, it was relatively robust. However, high-frequency data indicates that the slowdown in the economy continues. When we look at the July tendency surveys and sectoral confidence indices, they provide additional signals about the slowdown in the economy:

1. manufacturing industry capacity utilisation dropped by 0.3 points to 75.9% in seasonally adjusted terms.
2. a deterioration in manufacturing and sectoral PMIs driven by declining orders.
3. a drop in real sector confidence (seasonally adjusted) to below 100 for the first time since the pandemic.
4. signs of a slowdown in services with a plunge in PMI into contractionary territory.

Based on the July data, GDP growth will likely lose further momentum in the third quarter.

## Real GDP (%YoY) and contributions (ppt)



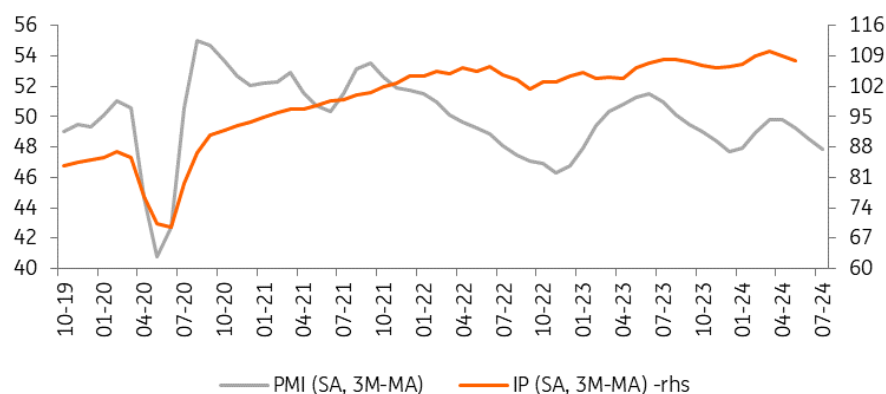
Source: TurkStat, ING

## Growing challenges in manufacturing

The manufacturing sector PMI, which returned to contractionary territory in April, continued its deteriorating trend and posted 47.2 in July. This is the lowest level since last November and hints at challenging market conditions as the second half of the year began. In the breakdown, further moderation in new orders is attributable to challenging demand conditions, leading to the scaling back of operations and adversely affecting employment decisions given lower workloads.

The data also shows that new business and new export orders slowed to a greater degree at the start of the third quarter. Findings in the sectoral PMIs, on the other hand, released by the Istanbul Chamber of Industry, are also in line with what the manufacturing PMI data suggested in July. Out of ten sectors, all but wearing apparel have PMIs below the 50 threshold.

## IP vs PMI



Source: ICI, TurkStat, ING

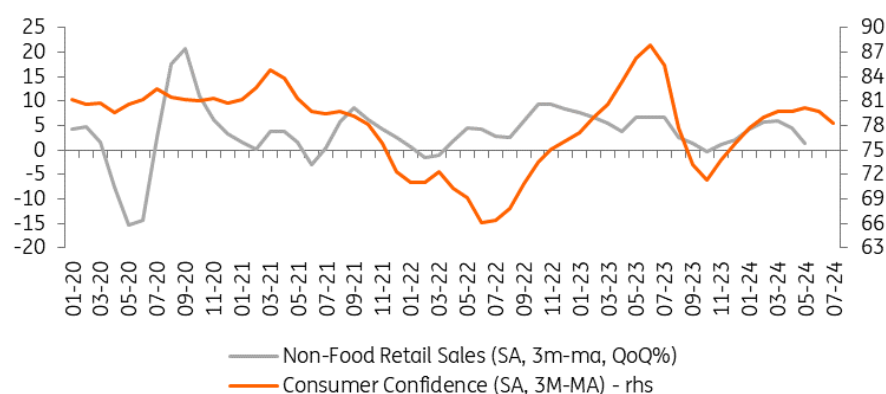
## Further moderation in May retail sales

Sequential growth in retail sales, which turned negative in March and April, remained so in May with 0.3% MoM driven by non-food (0.2% MoM) and fuel (-1.1% MoM), while food recorded a modest 0.1% MoM increase. The data show that after reaching historically high levels in 1Q, retail sales as an indicator of domestic demand are slowing down in the second quarter. Retail sales

volume on a calendar-adjusted basis, on the other hand, increased by 5.8% YoY, the first single-digit growth since mid-2022.

The momentum loss, though still limited in the 2Q as of May, is likely attributable to monetary tightening measures introduced by the CBT in recent months, while we will likely see further moderation in the upcoming data given recent signals related to a cooling down in domestic demand. That said, the (seasonally adjusted) unemployment rate stood at 8.4% in May, the lowest in more than a decade, with a slight decline from 8.5% a month ago. Labour force participation and employment rates are at historically high levels at 54.5% and 50%, respectively.

## Retail sales vs consumer confidence



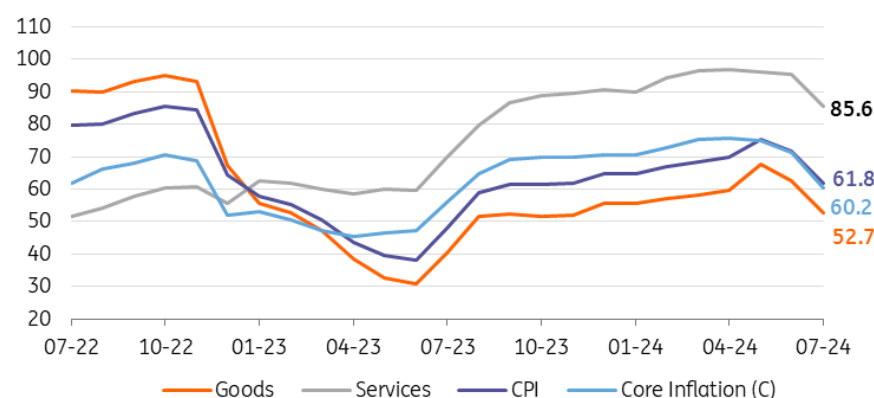
Source: TurkStat, ING

## Big drop in annual inflation on base effects

Following the warning from the CBT related to a temporary rise in July inflation due to "adjustments in administered prices and taxes as well as supply-side factors in unprocessed food prices", it came out at 3.23% vs the consensus at 3.45%. However, because of the large favourable base effect (as it was 9.49% in July 2023), annual inflation recorded a significant drop to 61.8% from 71.6% a month ago and maintained its downtrend. Cumulative inflation in the first seven months of this year reached 28.8% vs the 38% CBT forecast for this year. Core inflation (CPI-C) came in at 2.45% MoM, moving down to 60.2% on an annual basis, supported by the relatively slow-moving FX basket after the local elections. While cost-push pressures are easing, as evidenced by recent PPI data, pricing behaviour and inertia in services have been key factors, continuing to pressure inflation.

As for the underlying trend, the CBT foresees a decline in seasonally adjusted monthly inflation to around 2.5% on average in the third quarter, and slightly below 1.5% in the last quarter of the year. The July headline figure, on a seasonally adjusted basis, showed a month-on-month increase as expected, mainly driven by the goods group, while an increase in services and core trends remained relatively limited. However, the underlying trend in services is still elevated, confirming the challenges of disinflation.

## Inflation outlook (YoY%)



Source: TurkStat, ING

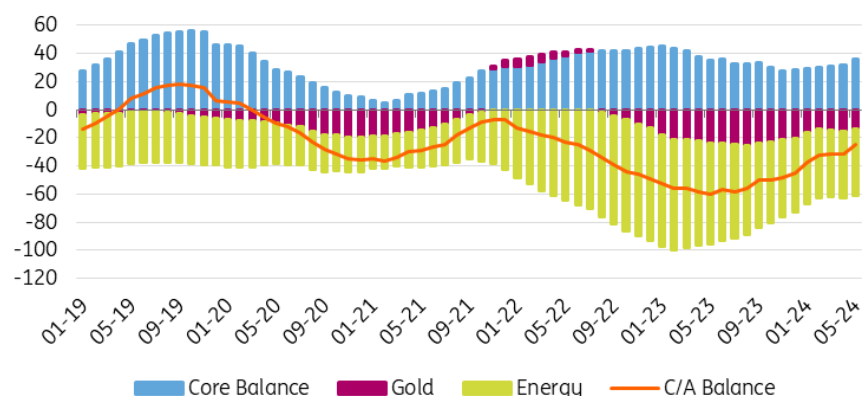
## Sharp drop in May current account deficit

May's current account posted a US\$1.2bn lower-than-expected deficit, which led to a marked drop in the 12M rolling deficit from US\$31.7bn a month ago to US\$25.2bn (translating into c.2.2% of GDP). Accordingly, the annual deficit, which is the lowest since mid-2022, returned to its improvement trend after a temporary pause in April. In the breakdown, compared with the same month of last year, we see:

- a lower gold deficit at US\$0.9bn vs US\$2.2bn last year. Gold imports, which dropped significantly in the first two months, strengthened in March and April around local elections but decelerated again in May and June
- an improving energy bill to US\$3.5bn from US\$3.9bn
- the turning of the core trade balance to a slight surplus at US\$0.3bn vs US\$3.9bn deficit a year ago
- higher services income (including tourism revenues) at US\$4.7bn.

On the capital account, net identified flows, which were weak in the first four months, showed an acceleration in May with US\$14.4bn. After one of the historic outflows ahead of March local elections, US\$9.9bn, and another negative reading in April at US\$0.3bn, net errors and omissions turned to a strong positive at US\$4.5bn. With the small monthly c/a deficit and large capital inflows, official reserves posted a record monthly increase at US\$17.6bn.

## Current account (12M rolling, US\$bn)



Source: CBT, ING

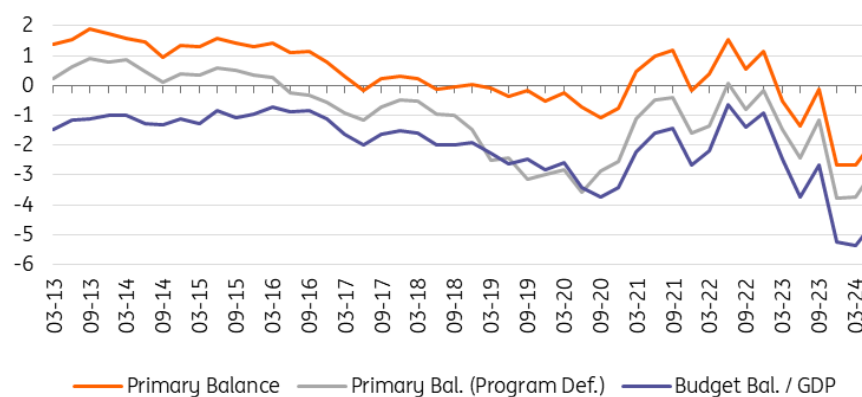
## Revenue growth remained strong in June

The June budget reflected a slight improvement in the primary balance compared to the same month of last year, though the bottom line deteriorated with a 25% increase in nominal terms. Accordingly, the budget posted a deficit of TRY275.3bn in June alone vs TRY219.6bn deficit in the same month of last year, while the deficit for the last 12 months widened to TRY1.64trln (4.6% of GDP), currently below of the government's revised target at 5%.

The June budget reflected:

1. rapidly growing interest expenses, up by 166% YoY (translating into a 55% real increase) likely due to an uneven distribution of the Treasury's repayment Schedule in a high-interest environment.
2. continuing strength in direct and indirect tax collections, with total revenues up by 120% (translating into 28% in real terms).
3. moderating primary expenditures, remaining flat in real terms thanks to a contraction in current expenditures, though the expansion in personnel expenditures has remained strong.

## Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

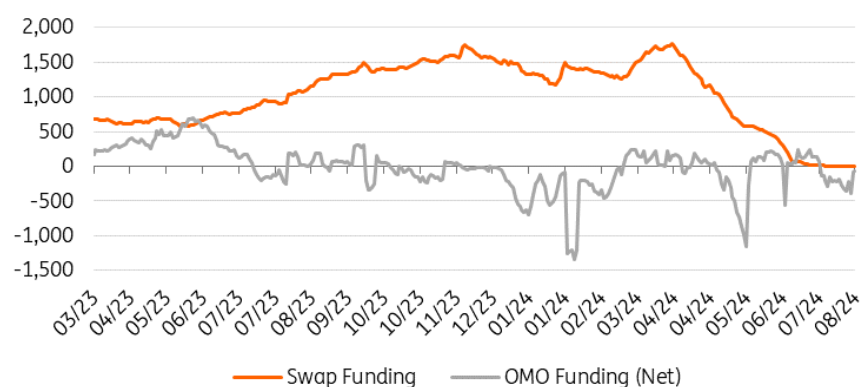
## The CBT remained mute in July, as expected

The Central Bank of Turkey kept the policy rate unchanged at 50% in July, in line with the consensus and our call, while the upper band and lower bands of the interest corridor (53% and 47%, respectively) have also remained flat. In the statement, the bank once again cited the lagged effects of monetary tightening for its rationale, while it maintained the forward guidance with:

- keeping the tightening bias, still leaving the door open for further hikes if required by the inflation outlook. The bank restated that the MPC remains highly attentive to inflation risks.
- pledging to keep rates higher for longer, until a significant and sustained decline in the underlying inflation trend and convergence of inflation expectations to the CBT's forecast range.

However, the market participants' year-end forecasts remain above the CBT's forecast range at 43%, while compared with the expectations at 25.4%, the difference is more significant for 2025.

### CBT funding (TRYbn)



Source: CBT, ING

## FX and rates outlook

The CBT's FX reserves continued to rise driven by sharp reverse currency substitution among residents and foreign inflows, while the bank eliminated its FX swaps with domestic banks. The bank also terminated the deposit transaction of US\$5bn carried out with the Saudi Fund for Development. Accordingly, external liabilities have recently improved by approximately US\$7bn through the reduction of deposit balances, though swaps with global CBs remain flat, currently at around US\$23bn.

Additionally, the FX-protected lira deposit accounts unwinding will likely accelerate in the coming weeks given:

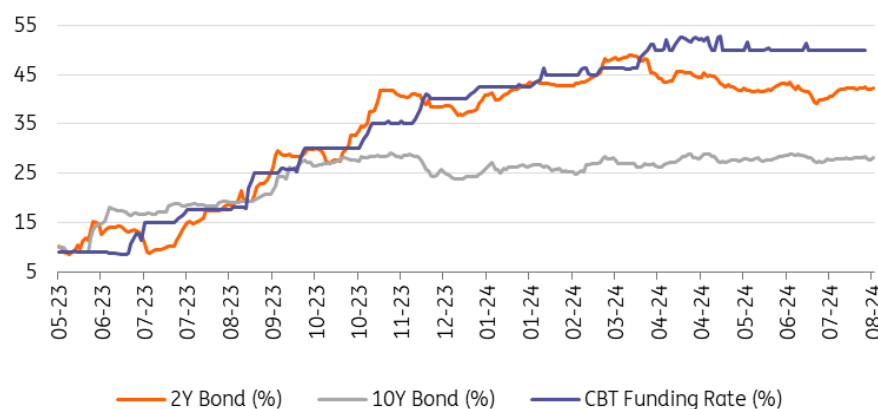
- a reduction in the maximum interest rate for these accounts from 40% to 35%.
- the removal of tax incentives on this product for corporates and individuals.

While these developments indicate a continuation of de-dollarisation in the economy, recent shifts in the global environment can lead to volatility in the near term. The inflation path and inflation expectations will remain the main focus, while the CBT is likely to continue with macroprudential measures if needed.

The CBT repeated its pledge to keep rates higher for longer and retained its tightening bias. On the fiscal side, there are signals of tightening with spending cuts and revenue-raising actions targeting wealthy individuals and corporates while the government signals a lower budget deficit target for this year (5.0% of GDP vs 6.4 in the medium-term plan). Based on July inflation at 68.5%, the ex-post real policy rate is still negative, while the ex-ante real policy rate is close to +20% (vs 12M inflation expectations at 30.0%).

After continuous inflows following the local elections until mid-June, foreign appetite showed some momentum loss in recent weeks. In fact, foreigners' bond purchases, which were at US\$11.3bn between the end of March and mid-June, dropped to US\$2.4bn in the last six weeks. While the recent volatility can weigh on local bonds, the impact can be limited as yields are close to peaks and the macro-financial outlook is improving.

### Local bond yields vs CBT funding rate



Source: Refinitiv, ING

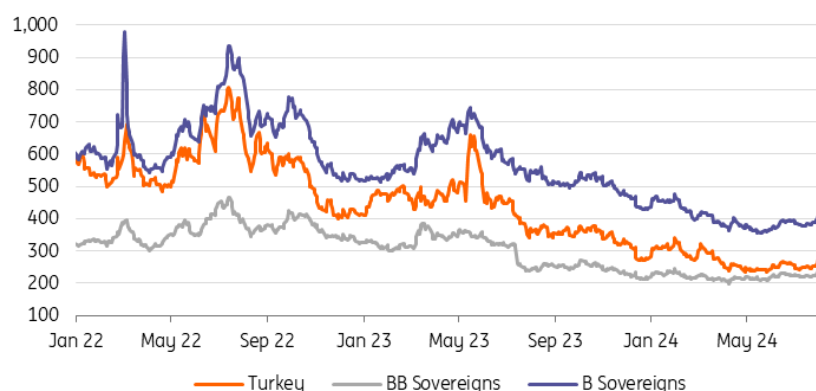
### Sovereign credit: Global-driven shakeup but limited damage for TURKEY

The recent global risk-off moves have seen Turkish sovereign credit spreads move wider from the tightest levels seen since early 2018, although all-in yields on USD paper have seen limited movement given the sharp fall in core rates. Valuations now look slightly more attractive versus the BB-rated peer group (offering around a 40bp pickup compared to 20bp a few weeks ago) but still are at the tight end of their longer-term range.

We see limited scope for further spread compression from here despite the generally positive fundamental momentum, given expectations for more supply to come from Turkey later in the year and lingering political risks.



## ICE US\$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

### Authors

#### Muhammet Mercan

Chief Economist, Turkey

[muhammet.mercan@ingbank.com.tr](mailto:muhammet.mercan@ingbank.com.tr)

#### James Wilson

EM Sovereign Strategist

[James.wilson@ing.com](mailto:James.wilson@ing.com)

### Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.