Monitoring Turkey: Focus on elections

As double elections on 14 May approach, the macro outlook will depend on whether the current policy mix, thus preference for low interest rates, continues, or if there will be a focus shift to disinflation with a significantly tighter monetary stance and easing of regulations

Skyline of Istanbul, Turkey

Turkey: At a glance

- While the early growth tracker has shown some recovery after initial weakness following recent earthquakes, the outlook ahead is uncertain given the weaker global backdrop and high inflation environment weighing on purchasing power.
- The drop in annual inflation continued in April as widely expected, due to strong base effects. Despite the likelihood of another fall in the near term, further disinflation would be quite challenging with a deterioration in pricing behaviour and higher trend inflation.
- While the current account deficit continued its widening path, capital flows have remained quite weak in the absence of strong unidentified inflows, leading to pressure on international reserves this year so far.
- In the first quarter of this year, a major fiscal expansion pulled the budget deficit to 2.4% of GDP given weakening tax collection performance and earthquake recovery-related expenditures
- While the Central Bank of Turkey remained mute in April, there are expectations of a

normalisation in the conduct of monetary policy in the period ahead given growing macro imbalances.

Quarterly forecasts

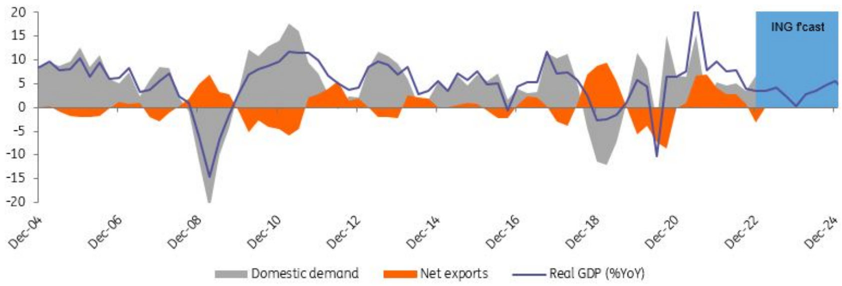
	4Q22	1Q23	2Q23F	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F
Real GDP (%YoY)	3.5	3.0	4.0	2.3	1.0	2.9	3.8	4.2
CPI (eop, %YoY)	64.3	50.5	40.7	43.5	47.0	38.4	34.8	29.4
Central bank key rate (eop, %)	9.00	8.50	8.50	8.50	8.50	8.50	8.50	8.50
3m interest rate (eop, %)	10.48	11.07	16.39	15.65	15.32	14.97	14.89	14.62
10yr yield (eop, %)	9.83	10.49	13.34	15.35	14.27	13.75	13.40	13.30
USD/TRY exchange rate (eop)	18.69	19.16	21.22	23.06	24.00	24.96	25.86	26.70
EUR/TRY exchange rate (eop)	20.00	20.79	23.34	25.83	27.60	28.70	30.51	31.51

Source: Various sources, ING

Signals of a rapid recovery in activity continue

While the data February indicators show earthquake-related weakness in economic activity, recent data releases signal a rapid recovery: i) Manufacturing PMI increased significantly reaching 51.5 in April from 50.1 in February, ii) after a decline in March, capacity utilisation rose to pre-earthquake levels in April and iii) real sector confidence maintained its recovery since the beginning of this year. However, according to sector PMIs in manufacturing, recovery rates in the beginning of the second quarter differed markedly. Some sectors, such as land and sea vehicles came to the forefront in growth driven by strong new orders. All in all, the recovery signal is likely attributable to the impact of reconstruction efforts and also in line with what the OECD weekly growth tracker shows with a close to 4.5% year-on-year GDP growth rates on a monthly average basis in the first half of April.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

Plunge in economic activity in February

Given the significant impact of earthquakes in southern Turkey on economic activity, industrial production in seasonal and calendar adjusted terms plunged by 6% month-on-month in February following a strong start to the year with a 2.0% MoM increase a month ago. Regarding broad economic categories, all subcategories recorded significant contractions with intermediate goods taking the lead with close to double digits at -9.3% MoM, followed by nondurable consumer goods at -5% MoM. In year-on-year terms, industrial production (calendar adjusted) printed a significant 8.2% contraction. IP on an average 3-month rolling basis turned negative with a sharp monthly decline. This points to a likely weakening in the growth performance in the first quarter compared with the previous quarter.

IP vs PMI

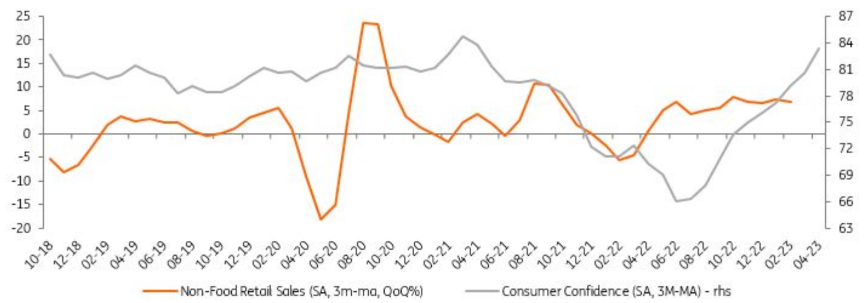
Source: Markit, TurkStat, ING

Earthquakes weighed on February retail sales

Retail sales that have been on a consistent growth path since May 2022 and made an even stronger start to this year with a 5.7% sequential growth in January. However, it dove into negative territory in February with a 6.5% MoM decline. Year-on-year performance on the other hand, remained high at 21.5%, though weakened in comparison to the growth rate recorded a month ago. The data along with turnover indices that plunged in all sectors except construction confirm the disrupting impact of the earthquakes on the economy.

The labour market, on the other hand, saw a slight increase in the seasonally adjusted unemployment rate to 10% in February from 9.8% in January. However, the actual rate is likely higher as TurkStat said that the Household Labour Force Survey could not be conducted in certain cities due to the earthquake disaster in Turkey.

Retail sales vs consumer confidence

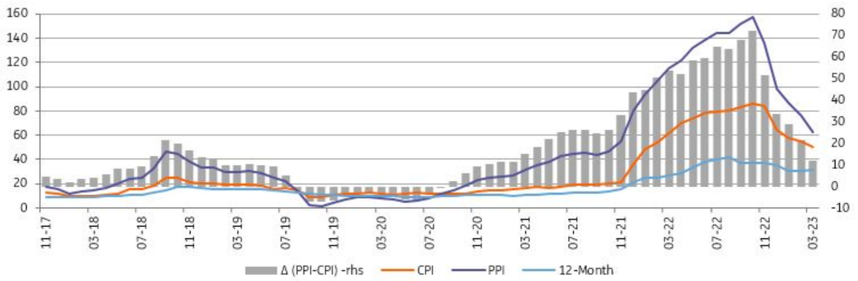


Source: TurkStat, ING

Inflation in Turkey continues to fall

The annual inflation maintained its downtrend in April to 43.4% from 50.5% a month ago thanks to a better-than-expected monthly reading at 2.4% (vs the consensus at 2.6%), though it was the second highest April print in the current inflation series started in 2003. Given this backdrop, the latest data show still high pricing pressures, however, the increases in all groups was lower than the last year and helped lead to a drop in the headline number. PPI inflation recorded another sharp drop to 52.1% YoY, the lowest reading since October 2021, implying still high but relatively improving cost-push pressures in comparison to previous months. While the monthly reading was at 0.8% with support from price drops in heavy-weight utilities, the base effects have remained the key determinant of the decline in the annual inflation.

Inflation Outlook (%)

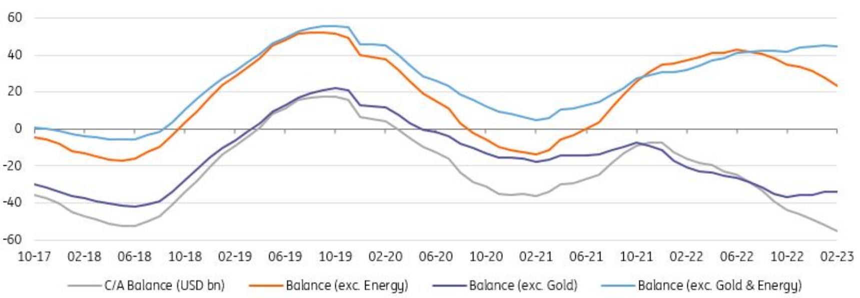


Source: TurkStat, ING

Capital flows remain weak in February

After the record monthly deficit in January, we saw a continuation of the widening in external imbalances with -US$8.8bn in February. Accordingly, the 12-month rolling deficit maintained its widening and reached US$55.4bn (translating into c.6.0% of GDP). The key drivers of the monthly reading over the same month of the previous year was a rapid increase in net gold trade, while core trade that was at a surplus last year turned to a deficit this year. Among other variables, the net energy deficit and services income showed some improvement. The capital account on the other hand has remained weak with a mere US$3.1bn net inflows. With the monthly current account deficit and small net errors & omissions at US$1bn, reserves recorded a US$4.7bn drop.

Current account (12M rolling, US$bn)

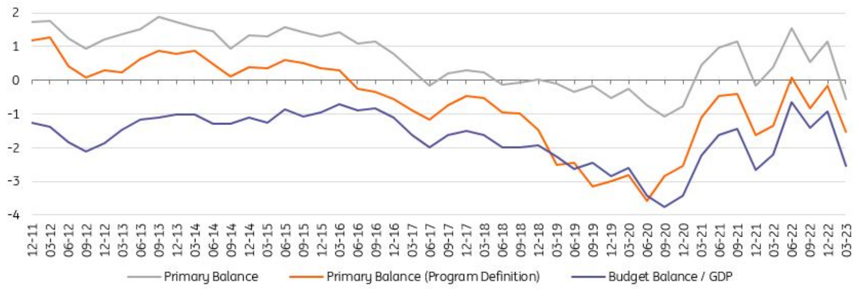


Source: CBT, ING

Budget deficit widening

In the first quarter of this year, we see a major fiscal expansion pulling the budget deficit to 2.4% of GDP. The real budget trend, which excludes one-off revenues, can be observed from the programme (IMF) defined primary balance realisation. In this budget setting, there was a deficit of around TRY31.9bn in March, bringing the primary balance for the last 12 months to a deficit of 1.5% of GDP. In addition, the 12-month budget balance excluding one-off revenues rose to a deficit of 3.5% of GDP. All in all, as we entered this year, the new loosening steps seemed to be on an upward trend. With the addition of the budget expenditures related to the earthquake, the risks to budget deficit forecasts continue to be significantly upward.

Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

The Central Bank of Turkey kept rates on hold in April, as expected

The CBT kept the policy rate at 8.5% in the last rate setting meeting ahead of the 14 May double elections. The CBT's assessment note this month was almost a carbon copy of the note shared after the March meeting. Accordingly, it kept the forward guidance unchanged, concluding that "the current monetary policy is adequate to support the necessary recovery in the aftermath of the earthquake", while pointing out that "the effects of the earthquake in the first half of 2023 will be closely monitored". Finally, while the bank restated the need to keep financial conditions supportive in response to the earthquakes it also repeated its emphasis on alternative policy instruments and alignment of all policy instruments with "Liraisation" targets.

Central Bank Funding

Source: CBT, ING

Elections key catalyst for the currency and rates

The key challenge for the CBT currently is to maintain stability of the exchange rate in the near term. In April, it asked banks to limit the amount of dollar purchases they make in the interbank market to ease pressure on the lira. Following the CBT move, the banks began widening spreads between their bid and ask prices for foreign currencies, while volatility in the currency market has increased to some extent. Given elevated inflation and ongoing upside risks, the real value of exchange rates is likely to remain under focus.

In the bond market, the CBT has maintained its purchases from the secondary market, raising its securities portfolio to 6% of the balance sheet size at the end of April. Despite these purchases and security maintenance requirements, bond yields are under upward pressure lately as market participants look ahead to the policy framework after the 14 May elections.

10Y Bond vs FX Basket

Source: Refinitiv, ING

External debt markets starting to price in policy shift

Spreads on Turkey's dollar sovereign bonds have remained relatively resilient amid recent pressure on the high-yielding, single-B section of the EM credit markets. Markets are now starting to price in some form of policy shift towards orthodoxy after elections, with current credit spreads over 150bp tight to the single-B peer group average. The upcoming elections and likely uncertainty should remain a source of volatility, although positioning among real-money foreign investors appears to remain fairly light overall and a strong bid from domestic investors will keep shorter-dated dollar bonds well anchored. We would see fairly limited potential for spread tightening in the medium term given the tough macro backdrop of weakening external balances and more focus on fiscal stimulus, with any policy changes likely to be somewhat politically unpopular.

ICE US$ Bond Sub-Index Spreads vs USTs

Source: Refinitiv, ING

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