Monitoring Turkey: Change of behaviour by the Central Bank of Turkey

The central bank seems to have slowed down the depreciation of the lira recently. It has done this not by selling FX to the market, but by slowing down the pace of FX purchases

The building of Turkey's central bank in Ankara

Turkey's economy: At a glance

- In the October rate decision, the Central Bank of Turkey (CBT) maintained its key messages, emphasising its vigilance regarding inflation risks and keeping its forward guidance unchanged. Once again, the Bank sounded confident that its tight monetary stance would lead to a) a decline in the underlying trend of monthly inflation by moderating domestic demand, b) a real appreciation in the Turkish lira, and c) an improvement in inflation expectations.
- The statement also adopted a cautious tone due to growing uncertainty about the pace of inflation improvements, and the CBT reiterated its expectation that the disinflation process would gain strength amid a drop in services inflation in the last quarter.
- Given this backdrop, the CBT has slowed down TRY depreciation (broadly flat in October outperforming all other major EM peers) by slowing down the pace of FX purchases. Accordingly, it purchased US$7.0bn in October vs US$11.9bn in September and an average of US$23.3bn of FX per month in the April-July period. If the CBT continues in this way,

inflation at the end of this year may be close to the upper limit of the CBT's forecast range at 42%.
- The normalisation of the policy framework has allowed the CBT to improve its net reserve position considerably while eliminating (buy-side) swaps with local banks in the summer months. Additionally, to mop up excess lira liquidity in the banking system, the CBT has also started to sell FX & gold and buy Turkish lira. The total stock as of early November exceeded US$7bn, while depo auctions for this purpose are on the decline. This implies that i) the CBT increasingly relies on swaps, this time to manage excess TRY liquidity, and ii) the recovery in the net reserve position (excluding swaps) is stronger in comparison to the rise in gross reserves.
- While annual inflation dropped further, the underlying trend remained elevated in October, albeit recording a drop in comparison to September thanks to a moderation in services inflation. In the latest inflation report of 2024, the CBT markedly revised its inflation forecast for next year to above 20%. While the new set of projections is now more attainable, the projected delay in the disinflation process is attracting attention.
- The trade data for September shows that the foreign trade deficit remained nearly unchanged, but it began to improve in October. This suggests that the recovery trend in the current account is likely to continue over these two months, as the CBT's actions to balance demand factors are supportive of the external outlook.

Quarterly forecasts

	2Q24	3Q24	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F	1Q26F
Real GDP (%YoY)	2.5	2.3	1.7	0.5	2.4	3.2	3.9	4.4
CPI (eop, %YoY)	71.6	49.4	44.0	33.9	30.0	25.2	24.6	22.7
Central bank key rate (eop, %)	50.00	50.00	47.50	40.00	32.50	30.00	27.50	25.00
3m interest rate (eop, %)	49.79	48.88	47.46	40.78	33.87	30.18	29.41	25.60
10yr yield (eop, %)	28.28	28.40	26.53	24.34	20.61	19.37	18.77	18.21
USD/TRY exchange rate (eop)	32.65	34.16	35.00	37.17	39.03	40.63	42.00	43.50
EUR/TRY exchange rate (eop)	35.05	38.00	36.75	38.66	40.60	42.26	42.84	43.94

Source: Various sources, ING

Significant revision to inflation projections

The Central Bank Governor Fatih Karahan held a meeting to introduce the last inflation report of the year and shared the latest inflation forecasts. With a significant revision to those presented in the previous report, the CBT raised the inflation forecast to 44% (from 38%), 21% (from 14%) and 12% (from 9%) for this year, 2025, and 2026, respectively.

The governor reiterated the policy guidance:

- pledging to keep rates higher for longer until there is a significant and sustained decline in the underlying trend of monthly inflation. Regarding the recent price developments, while acknowledging slower-than-expected disinflation so far, he added that underlying inflation continued to decelerate in October driven by lower core goods inflation in addition to a more pronounced deceleration in services excluding rent.
- signalling a convergence of inflation expectations to the CBT’s projected forecast range. Approaching the year-end, the forecast range corresponding to 2024 narrowed down mechanically to 42-46%, while the band for next year was 16-26%. Accordingly, market

participants' end-2025 inflation expectation, which was 25.6% in the latest survey, is now in the CBT's forecast range.

Governor Fatih Karahan sees inflation below 1.5% month-on-month in seasonally adjusted terms in 3Q25 (implying a significant delay as this level was previously the call for the last quarter of 2024), and it will decline further to slightly above 1% MoM in 4Q25. However, in the first quarter of next year, there may be temporary pressures according to Karahan, likely implying some impact from automatic revisions in the special consumption tax (SCT) on certain products in January, as well as uncertainty surrounding the minimum wage hike etc.

Overall, the shared forecasts that function as intermediate targets have been substantially revised upwards implying a significant delay in the disinflation process though they are now more realistic and closer to market expectations. While focusing on the structural challenges in food and rent inflation, a relatively positive CBT assessment of the October data and projected inflation path imply that if accompanied by a benign November release, a rate cut in December should not be fully ruled out, in our view. While economic activity is set to slow further due to significantly tight financial conditions, a deeper-than-expected impact could also influence the timing of the rate-cutting cycle.

The Treasury's borrowing plan for 2025

The Treasury and Finance Ministry announced the borrowing strategy for 2025. While expecting domestic debt rollover at 132%, below what was envisaged in the programme for this year, the Treasury plans to cut the ratio to 119.3% in 2025. The rise in debt redemptions next year - by c.0.4ppt of GDP - stems from both domestic and external debt.

Out of TRY2,385bn domestic debt redemptions in 2025, TRY2,229bn will be made via the market (with the remaining TRY156bn to public institutions via non-competitive sales). Assuming that domestic borrowing from public institutions will be completely rolled over (the usual Treasury assumption, while the Treasury must meet total demand from these institutions), TRY2,689bn of TRY2,846bn domestic borrowing might be via the market (corresponding to a market rollover ratio of c.120.7%).

The Treasury last year announced that it would borrow US$10bn in 2024 and it secured US$10.4bn, US$8.6bn of which is cash, while the rest is related to the early retirement of bonds maturing this year and next. According to the Treasury's own projections, it will repay US$5.1bn in the last quarter of 2024 and US$21.3bn (US$12.6bn of this amount is principal) in 2025. Despite the heavy schedule, it plans to raise issuance to US$11bn next year, while the CBT's strengthened reserve position should be a relief factor.

Despite higher external funding plans, domestic borrowing requirements seem to be high, despite a narrower budget deficit forecast. The rate outlook - given the CBT's commitment to maintain a tight stance even after the rate-cutting cycle starts - and the continuation of foreign investors' appetite will be key.

Details of the Programme

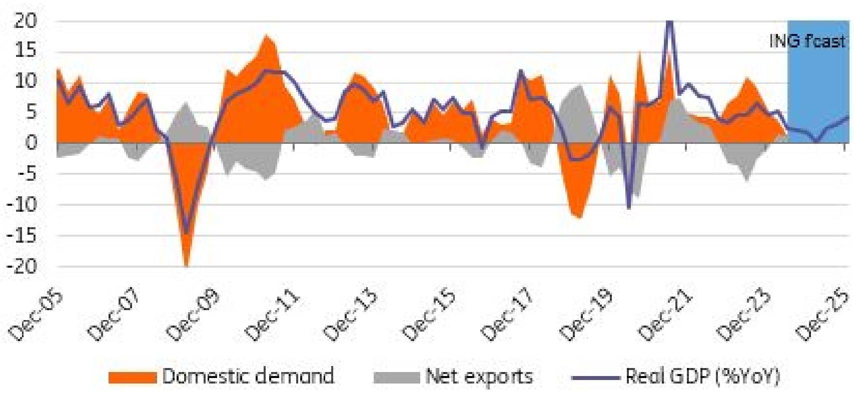
% of GDP	2024 (programme)	2024 (realization)	2025 (programme)	YOY Chg 2025P
I. Total debt service	**5.0%**	**5.1%**	**5.6%**	**43.9%**
Domestic debt service	3.6%	3.8%	4.1%	42.3%
Principal	1.8%	1.6%	1.4%	15.0%
Interest	1.8%	2.2%	2.7%	62.6%
External debt service	1.5%	1.3%	1.5%	48.6%
Principal	0.9%	0.8%	0.9%	54.2%
Interest	0.6%	0.5%	0.5%	39.5%
II. Financing	**5.0%**	**5.1%**	**5.6%**	**43.9%**
Total borrowing	5.7%	5.7%	5.7%	33.1%
External borrowing	0.8%	0.6%	0.8%	69.0%
Domestic borrowing	4.9%	5.0%	4.9%	28.6%
Other resources*	-0.6%	-0.5%	-0.1%	-72.8%
Domestic borrowing roll-over ratio (%)	**136.5%**	**132.0%**	**119.3%**	

Source: Ministry of Treasury and Finance, ING

Domestic demand loses momentum with a slower-than-expected pace

In August, the retail and trade sales volume indices increased on a monthly and quarterly basis. The underlying trend of industrial production remained weak in August. Accordingly, the gap between retail sales and industrial production started to widen again in the third quarter. In addition to these developments in retail sales and IP: i) the services production index decreased slightly in August, as it did in July ii) survey data for manufacturing firms indicates a quarterly decline in domestic orders in 3Q iii) the manufacturing industry capacity utilisation rate posted a decline in 3Q. Given this backdrop, the CBT slightly revised its assessment in the rate-setting statement and noted that domestic demand has approached disinflationary levels while the previous statement noted a diminishing impact of domestic demand on inflation.

Real GDP (%YoY) and contributions (ppt)

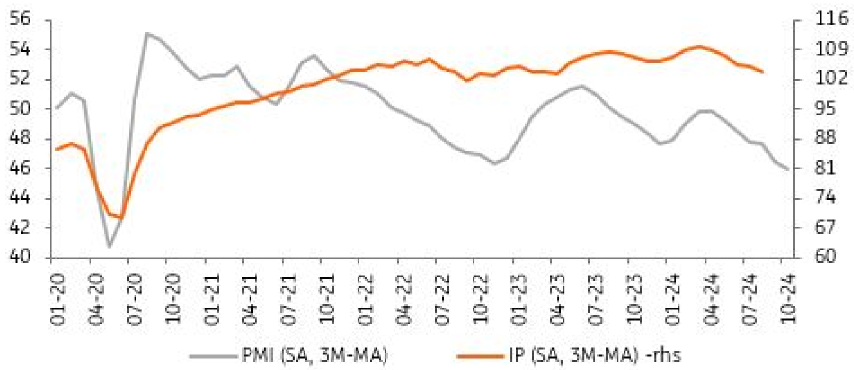


Source: TurkStat, ING

PMI remained in contractionary territory

After plunging to the lowest levels since early 2019 (if we exclude extraordinary conditions during the Covid pandemic in 2020), the manufacturing sector PMI showed a recovery in October to 45.8. Despite rates of moderation in key sub-variables of PMI like output, new orders, purchasing activity and employment softened in September, and the PMI itself has remained in contractionary territory since April, highlighting the challenging conditions that manufacturers currently face. Demand conditions have remained weak as implied by sluggish total new orders and exports. This backdrop has led to a scaling back of operations and adversely affected employment decisions and purchasing activity. On a positive note, both input costs and output prices increased at softer rates, implying easing inflationary pressures.

IP vs PMI

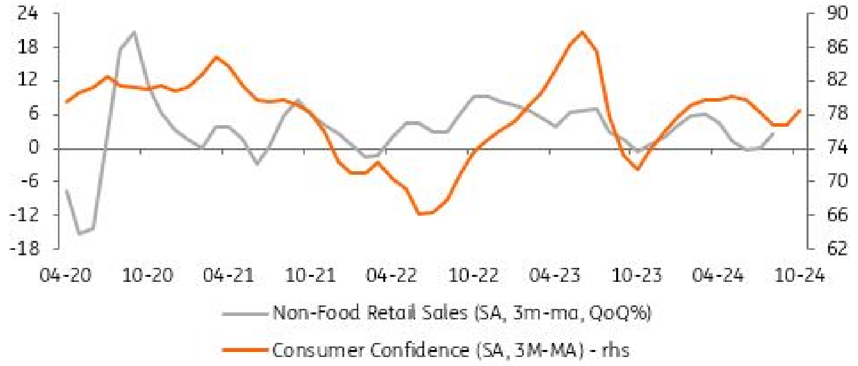


Source: ICI, TurkStat, ING

Survey indicators suggest a decline in employment

Sequential growth in retail sales, which turned positive in June and July, continued in August with a 2.2% month-on-month increase, driven by strength across all sub-items (both food and non-food up by 2.0% MoM and fuel 3.2% MoM). Retail sales volumes on a calendar-adjusted basis increased by 13.3% YoY, and returned to double-digit territory after single-digit growth rates in the previous three months. While other early indicators show a moderation in domestic demand with monetary tightening measures introduced by the CBT, retail sales have followed a recovery trend in the first two months of the third quarter. As an additional note, the (seasonally-adjusted) unemployment rate stood at 8.5% in August, the lowest in more than a decade, with a decline in the third quarter from 9.1% in June. However, survey indicators suggest a decline in manufacturing firms' future employment expectations.

Retail sales vs consumer confidence

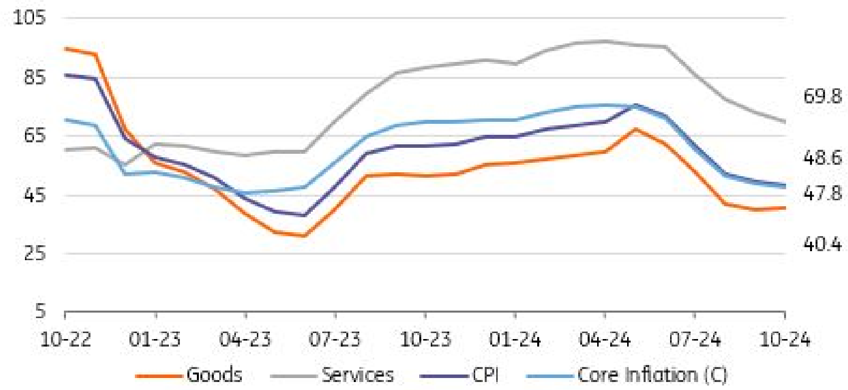


Source: TurkStat, ING

Improvement in the underlying services inflation trend

CPI inflation was 2.9% in October, higher than the market consensus of 2.5%. The annual figure, however, has maintained its declining trend and fell to 48.6% from 49.4% a month ago, given that favourable base effects (as it was 3.43% in October 2023) were more apparent in the second half of this year. Cumulative inflation in the first 10 months of the year reached 39.8%, exceeding the Central Bank of Turkey's 38% forecast for the year (with a forecast range of 34-42%). Regarding the underlying trend, the Turkish Statistical Institute will release seasonally adjusted headline CPI and core indicators tomorrow. According to our calculations, the October headline figure, on a seasonally adjusted basis, recorded a sequential decline, thanks to a marked slowdown in the services inflation underlying trend. However, the CBT expects a drop in seasonally-adjusted monthly inflation to below 1.5% in the last quarter of this year, and to attain this level, the monthly outcome should be less than 1% in November and December from the more than 2.5% level in October.

Inflation outlook (YoY%)



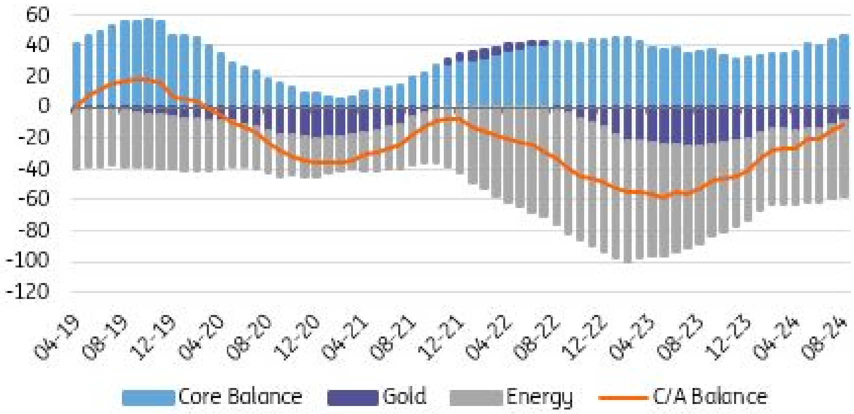
Source: TurkStat, ING

Current account continues to narrow

The current account balance in August recorded a US$4.3bn surplus, broadly in line with expectations and significantly better than the level seen in the same month of 2023. The 12-

month rolling deficit – which has narrowed to US$11.3bn (translating into around 0.9% of GDP) from US$15.1bn a month ago – marked the lowest reading since the end of 2021. It should also be noted that revisions in services incomes have also contributed to the better current account turnout. The deficit dropped by US$2.0bn for the first seven months, while the revision pulled the 2023 deficit to US$40.5bn from US$45bn. The capital account, on the other hand, posted outflows for the first time since January at US$3.2bn, while unidentified outflows stood at US$3.7bn. Despite the strong monthly c/a surplus, official reserves posted a US$2.5bn drop in August.

Current account (12M rolling, US$bn)

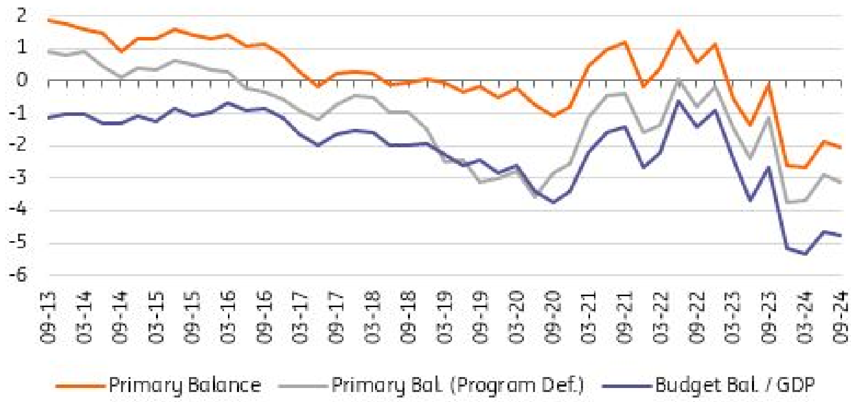


Source: CBT, ING

Budget deficit narrowed in September

The September budget witnessed a recovery due to the postponement of provisional corporate tax from August, leading to a more than 25% real increase in this month alone. However, real growth in primary spending continued (4.9% YoY) despite losing momentum (9.6% in the first nine months) and interest expenditures more than doubled in September, which attracted attention. Accordingly, the ratio of the budget deficit to GDP dropped to 4.8% (primary balance at 2.0% deficit), close to the medium-term plan target of 4.9%. On the flip side, budget data excluding one-off revenues and expenditures show the deficit at c.5.8% of GDP on a 12m rolling basis (vs primary deficit at 3.1%). The authorities aim to narrow the central government budget deficit to 3.1% in 2025. However, tax revenues are quite sensitive to the growth outlook, and the expected slowdown in the activity should dampen tax revenues.

Budget performance (% of GDP)

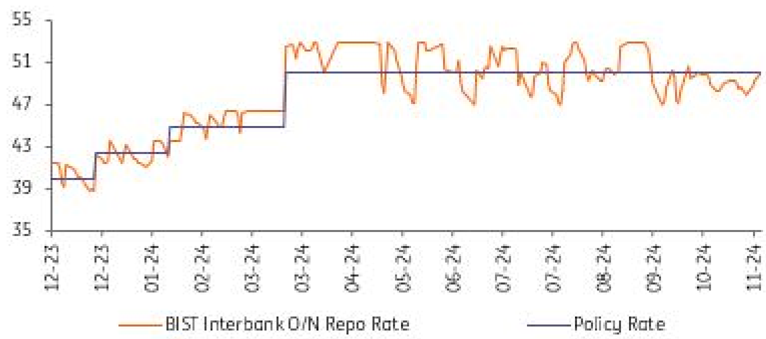


Source: Ministry of Treasury and Finance, ING

The CBT turned more cautious about the pace of disinflation

In line with the consensus, the CBT kept rates on hold at 50% at its October rate-setting meeting, while the interest rate corridor also remained unchanged, with the upper and lower bounds at 53% and 47%, respectively. In its assessment of the inflation outlook, the central bank acknowledged a slight increase in the underlying inflation trend. Given that goods inflation moved down to 40.3% year-on-year and the core goods inflation – a better indicator for the trend – inched down to 28.3% YoY (not only thanks to base effects but also exchange rate-related factors), the CBT added that core goods inflation remained low last month. Services inflation, which is less sensitive to currency movements but more heavily impacted by domestic demand and the minimum wage, stood at 72.9% YoY in September. The CBT has remained optimistic on this front, maintaining its expectation that an improvement will occur in the last quarter. However, the central bank has flagged rising uncertainty related to the pace of the improvement considering recent data releases.

The Policy Rate vs. Interbank O/N Rate



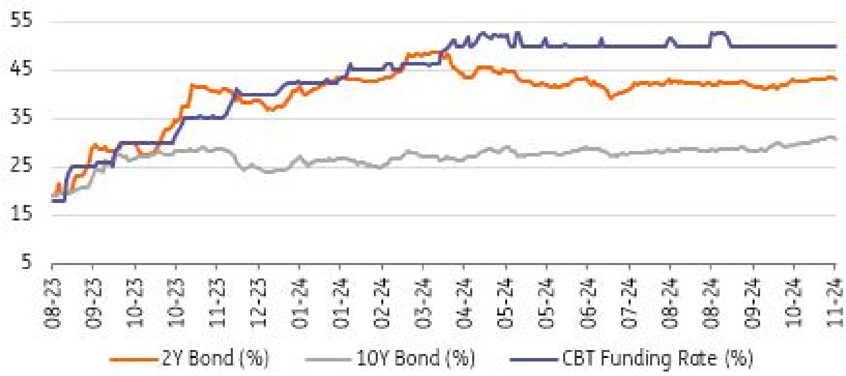
Source: CBT, Refinitiv, ING

FX and rates outlook

The CBT has slowed down real TRY appreciation, with USD/TRY almost unchanged in October, outperforming EM peers, by slowing down the pace of FX purchases. Accordingly, it purchased US$7.0bn in October vs US$11.9bn in September and an average of US$23.3 bn of FX per month in the April-July period. Given the slower-than-expected disinflation, markets are gaining confidence that the CBT will start the easing cycle later rather than sooner, while the central bank visibly wants FX to help keep disinflation on track. Thus, we believe the window for investors collecting carry in the TRY market will be open a bit longer. At the same time, the time for the first CBT rate cut is approaching regardless of whether it is in December or early next year. Thus, we prefer the spot market over the forward market which is repricing rate cuts, resulting in a flattening of the FX implied yield curve. The outcome of the US election is expected to have minimal impact on the TRY market. We believe this increases its appeal in an environment of heightened volatility in emerging markets. Overall, TRY remains our favourite carry currency within the CEEMEA space and we expect 35.00 USD/TRY for year-end.

Rates have not reacted much to the recent higher-than-expected inflation print and continue to slide down in front of the OIS curve. However, the expectation of a first rate cut in January remains in place though there is still a possibility for December. The exact timing of the start of the cutting cycle seems to be a matter of fine-tuning. However, rates have been moving in a downward direction for some time now, with a steepening bias. We remain more cautious in the bond space. Data shows a resurgence in foreign investor inflows in recent months. But TURKGBs appear more sensitive to upside inflation surprises. Yields at the short end of the curve are the highest since the first half of this year while the long end is the highest since late last year, also elevated by core rates. However, as we approach the first rate cut, we believe TURKGBs will attract increasing attention and the next CPI print or the December meeting could trigger a reversal, in our view.

Local bond yields vs CBT funding rate



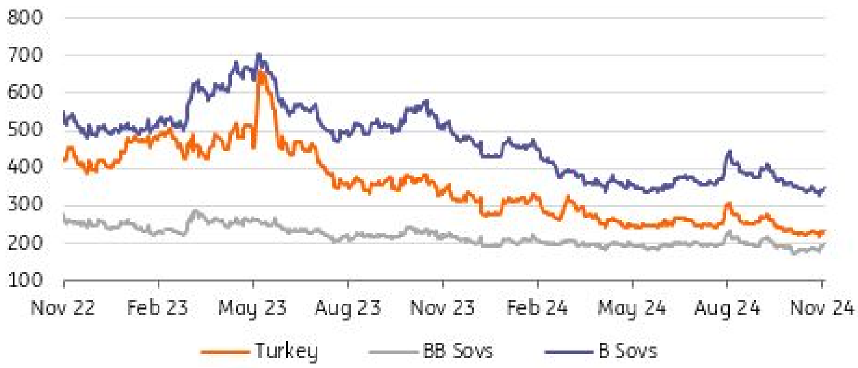
Source: CBT, Refinitiv, ING

Sovereign credit: Spreads grinding tighter

The performance of Turkish sovereign credit has remained robust against a backdrop of rates and geopolitical volatility, with spread levels compressing further towards the BB-rated sovereign average. At the same time, continued gradual improvement in fundamentals (narrowing current account deficit, FX reserve rebuild, and declining annual inflation rate) has been rewarded with more rating upgrades, with S&P following Fitch in moving to BB- at the start of this month. We should see more positive momentum in early 2025, with Moody's currently holding a positive outlook on their B1 rating, before a likely stabilisation at these levels.

With valuations squeezed fairly tight to the rating peer group, we see limited room for a further rally in spreads, while increased external issuance plans for next year could be a slight negative catalyst, in particular in an environment of higher US rates. One area of interest for investors is likely to be the steepness of the Turkish spread curve, with longer-dated maturities beyond 15 years offering an attractive pickup over the belly.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: Refinitiv, ING

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