Monitoring Turkey: A challenging picture for policymakers

Policymakers have implemented several measures in response to recent volatility in financial markets and a decline in reserves. Given this backdrop and elevated global policy uncertainty, the challenges for the remainder of 2025 are growing. However, lower commodity prices may provide some relief for Turkey

Turkey's economy at a glance

- In the absence of any further exchange rate shock, large wage adjustments, unexpected hikes in administered prices, or jumps in commodity prices in the remainder of this year, we continue to expect inflation below 30.0%.
- While the deterioration in the inflation expectations is relatively contained after the March volatility, the Central Bank of Turkey (CBT) has prioritised financial stability after large reserve depletion.
- The central bank has announced several measures including an across-the-board 200bp hike in FX reserve requirement ratios (withdrawing more than US$7bn from the banking system), increased surrender requirements for exporters from 25% to 35% temporarily until end-July (with an additional $2-2.5bn monthly support for the CBT reserves, and the

introduction of a higher monthly conversion target of 0.3 points for TRY deposit share of corporates for banks (having a share below 60%). These moves aim to encourage a switch from FX to TRY and to begin replenishing FX reserves. The trajectory of these reserves, along with inflation rates and the investment choices of residents, will be crucial in determining the attractiveness of Turkish assets.

- The CBT funds banks mainly from the upper band and keeps the ON rate close to 49%. A change in funding composition towards one-week repo auctions and the consequent fall in the effective funding rate towards the policy rate will provide evidence related to the timing of rate cuts that will be conditional on the market stability and return of reserve accumulation.
- The CBT will release its inflation report on 22 May before the 19 June MPC meeting. While the report will offer further insights into the CBT's outlook and hint at future policy directions, we might see a slight upward revision in its inflation forecasts due to recent developments since the first report.
- The current account deficit continued its gradual widening in February, mainly driven by developments in foreign trade. Early indicators for March and April hint at further year-on-year widening in the current account. Looking ahead, several factors – including increasing uncertainty due to the US-China trade war, declining energy prices, and the impact of recent domestic political developments leading to tighter financial conditions – are expected to shape the future trajectory of the external balances.

Quarterly forecasts

	4Q24	1Q25	2Q25F	3Q25F	4Q25F	1Q26F	2Q26F	3Q26F
Real GDP (%YoY)	3.0	2.1	2.6	3.0	3.4	4.1	3.8	3.4
CPI (eop, %YoY)	44.4	38.1	36.0	30.5	29.0	24.6	20.7	19.7
Central bank key rate (eop, %)	47.50	42.50	43.50	38.50	33.50	29.50	26.50	23.50
3m interest rate (eop, %)	46.19	47.98	44.05	38.02	33.97	29.48	26.17	23.76
10yr yield (eop, %)	29.31	32.80	31.09	28.15	24.24	23.04	20.55	20.35
USD/TRY exchange rate (eop)	35.34	37.94	39.44	41.09	43.00	45.17	47.03	48.63
EUR/TRY exchange rate (eop)	36.59	41.04	44.57	45.61	48.59	50.59	53.62	55.44

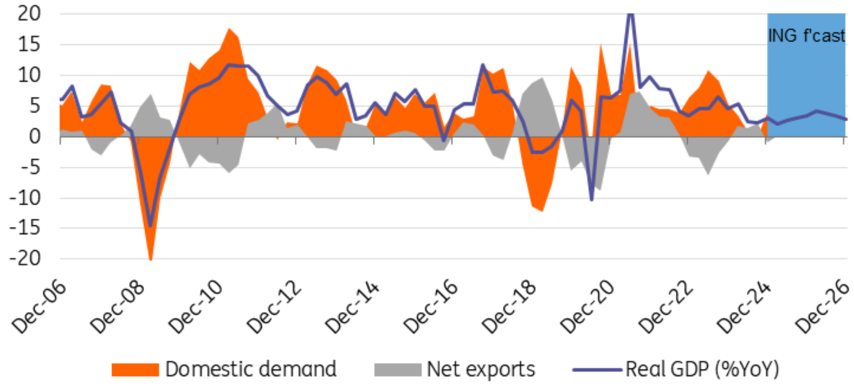
Source: Various sources, ING

Downward pressures for domestic demand

Political developments, coupled with global economic uncertainties stemming from Trump's policies, have negatively impacted consumer confidence. Accordingly, the consumer confidence index, which generally followed an uptrend from mid-2024 onwards, changed course in April and declined from 85.9 to 83.9. This was due to a worsening outlook for the general economic situation and expectations of rising inflation.

On the consumption side, data suggests that strong demand continues, with an increase in both turnover and credit card expenditures, though the latter adjusted for inflation shows signals of reaching an inflection point. The challenging outlook for domestic demand is evident not only for consumption, but also for investment given the higher for longer interest rate environment following recent CBT actions.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

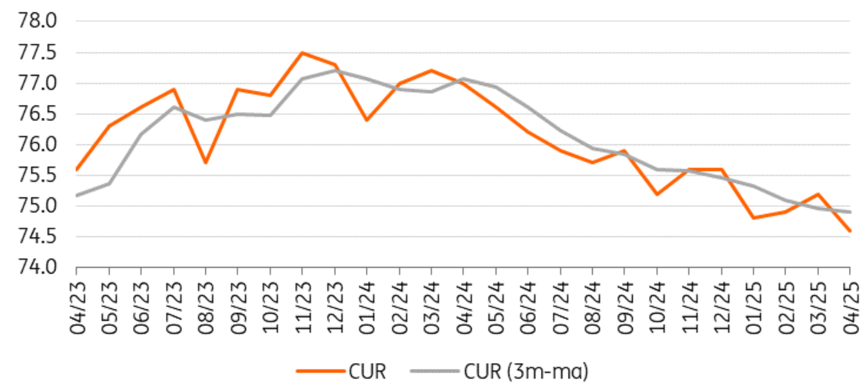
Activity is likely to slow

After contracting in February, industrial production increased in March on both an annual and monthly basis, while services production is moving up moderately. The capacity utilisation rate in April declined to 74.6%, the lowest level observed since March 2023. Meanwhile, the seasonally adjusted real sector confidence index dropped to 100.8, marking its lowest level in the past seven months.

For the second quarter, the manufacturing PMI remained unchanged in April at 47.3, indicating ongoing difficulties with further declines in new orders, output, and exports. For sector PMIs, apart from the food sector which saw increases in output, new orders, and employment, the other nine major manufacturing sectors experienced widespread slowdowns in new orders at the beginning of the second quarter. The survey shows that most sectors also scaled back production and employment, while cost pressures generally strengthened.

All in all, the CBT's recent tightening measures, along with weaker external demand, increase the downside risks for the growth outlook this year.

Capacity utilisation rate (%)



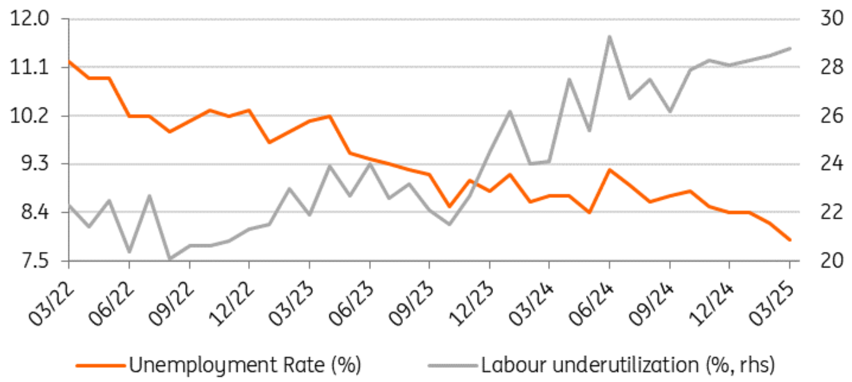
Source: CBT, ING

Headline unemployment rate below 8% in March

In March, seasonally adjusted employment stood at 32.6m people and recorded a 1.2% MoM increase. The labour force participation rate also rose by 0.4 ppt to 53.4%, while the unemployment rate dropped to the lowest level since 2005, the start of the current series, at 7.9%. On the other hand, the seasonally adjusted average weekly actual working hours increased by 0.3 hours compared to the previous month, reaching 43.7 hours.

One of the broader unemployment indicators, the underutilisation rate – which combines time-related underemployment, potential labour force, and the unemployed – has maintained an uptrend in recent months to reach 28.8%. This rate, which peaked at 29.4% in May 2021, has fluctuated within the 20-25% range in subsequent years but recently showed an increasing pace. Survey indicators suggest that the future employment expectations of manufacturing industry firms in recent months have remained below the historical average.

Labour market outlook



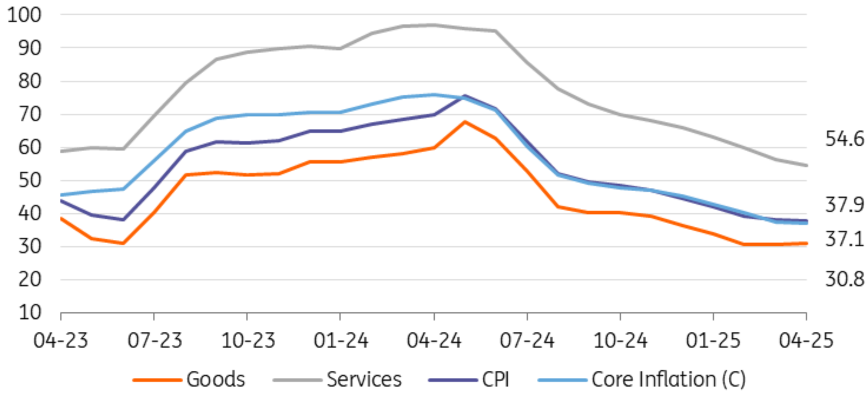
Source: TurkStat, ING

Softer-than-expected inflation in April

April inflation was 3.0% MoM, coming in below the consensus of 3.1% (and our call at 3.2%) thanks to relatively benign unprocessed food prices. As a result, annual inflation, which has been on a downtrend over the past year, showed a minuscule change to 37.9% (from 38.1% a month ago).

PPI turned out 2.8% MoM driven mainly by food products, textiles and metals, while showing a drop in annual change to 22.5% YoY vs a month ago. The 6.5% MoM and 3.9% MoM increases in the currency basket (50:50 EUR:USD) in March and April, respectively, showed an acceleration compared to previous months and signalled that the pass-through from exchange rates to prices will be more pronounced lately. However, the year-on-year lira increase remains relatively muted at less than 23% and hints at cost pressures being contained.

Inflation outlook (YoY%)



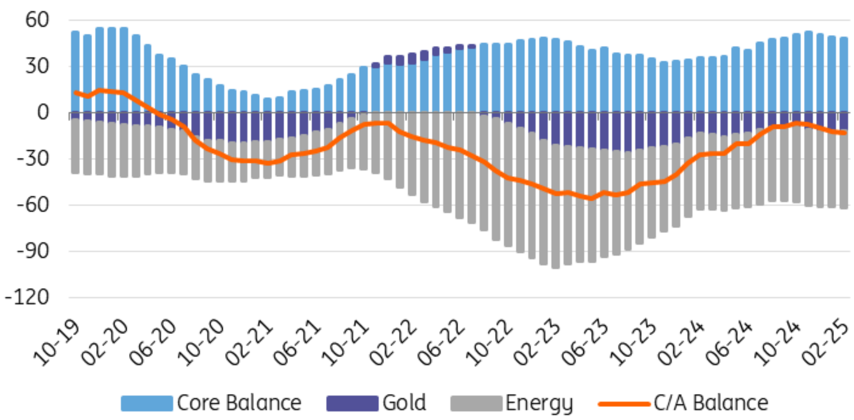
Source: TurkStat, ING

Current account deficit widened in February

The current account for February showed a deficit of US$4.4bn, slightly exceeding the market expectation. A closer look at the monthly data reveals that the larger deficit, compared to the same month last year, was driven by two main factors: a widening trade deficit and a larger deficit in the primary income balance. As a result, the 12-month rolling current account deficit, which began increasing in November of the previous year, expanded further to $12.8bn.

On the capital account side, inflows amounted to $2.6bn, showing a significant slowdown from $11.9bn recorded in January. With net errors and omissions outflows at $1.1bn and an increasing current account deficit, official reserves shrank by $2.9bn in February.

Current account (12M rolling, US$bn)



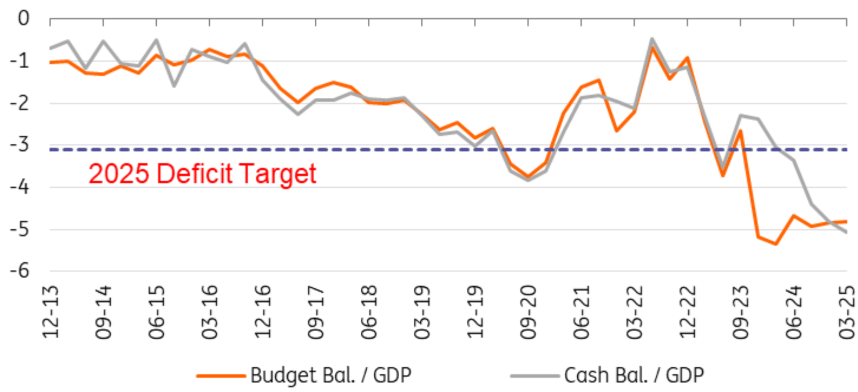
Source: CBT, ING

Budget deficit remained high

According to the March budget results, non-interest expenditures remained relatively stable with an annual increase of 40.2% YoY. The key factor contributing to this stability was the elimination of transfers to state-owned enterprises and public banks. Tax collection accelerated, registering an increase of 53.4% YoY. Direct taxes saw significant growth, with income tax collection reaching double the amount recorded last year.

Meanwhile, the increase in value-added tax collections also gained momentum. On the other hand, interest expenditures more than doubled in nominal terms, driving the budget deficit to TRY261.5 bn that surpassed the TRY209.0bn deficit recorded in the same month last year. As a result, the total deficit over the last 12 months rose to the equivalent of 4.9% of GDP. The latest Medium-Term Programme (OVP) had projected a budget deficit at 3.1% of GDP.

Budget performance



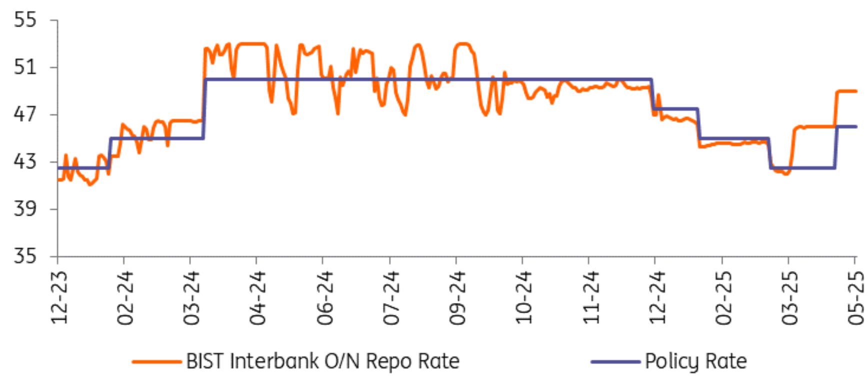
Source: Ministry of Treasury and Finance, ING

The CBT hiked against the consensus for no change

In its April rate-setting meeting, the CBT gave a hawkish surprise and hiked the policy rate (1-week repo rate) by 350bp, bringing it to the current effective funding rate at 46%. It also kept an asymmetrical interest rate corridor with the overnight lending rate now at 49% and overnight borrowing rate at 44.5%, though the corridor is slightly narrower at 450bp vs 500bp before the decision.

Continuing reserve losses since late March seem to be the determining factor in the CBT decision. The forward guidance remained largely unchanged, indicating that policy tightness will be determined by considering both realised and expected inflation, as well as the underlying trend. The bank also reiterated its meeting-by-meeting decision approach. However, the tone turned more hawkish as we see signals of direct tightening in case of “a significant and persistent deterioration in inflation outlook”, while the message previously referred to an effective usage of monetary policy tools.

The policy rate vs. interbank O/N rate



Source: CBT, Refinitiv, ING

FX and rates outlook

USD/TRY has reverted to its earlier stable uptrend with some acceleration, similar to the months before the March spike, following a period of stability from mid-March to mid-April. The central bank has made it clear through its actions and communication in recent weeks that it will not allow any further additional inflationary pressures coming from FX, and the situation seems to be fully under central bank control again. Still, on paper, the FX picture remains similar to before.

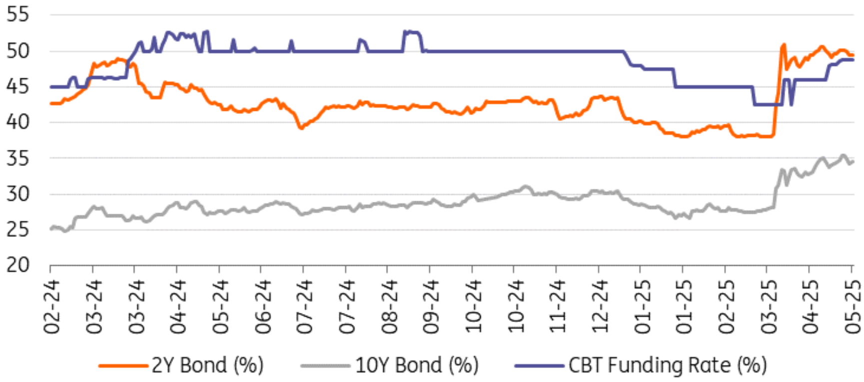
The TRY offers a fat carry that has been further bolstered by CBT rate hikes, and hawkish communication suggests the central bank will be cautious with rate cuts. Even though we may see some cuts in the coming months, it will not materially affect TRY's attractiveness. Therefore, we believe the markets will remain interested in long positions, but on the other hand, we cannot expect the same level of positioning as we have seen before. Having said that, we still prefer the spot market over the forward market since liquidity may be tight again in case of some volatility. For the end of the first half of the year, we expect USD/TRY at 39.44 and 43.00 in our year-end forecast.

Turkish government bonds (TURKGBs) saw a strong sell-off in March following the move in FX, especially at the short end of the curve, resulting in a strong flattening of the curve, and the market has not changed much since. Similar to the FX forward implied yield, we believe it will take longer before we see some normalisation and rally again here.

Despite April inflation surprising to the downside and so far not showing a materially different inflation picture, TURKGBs weekly data still shows outflows from foreign holders. Although bond yields moved up, especially in late March, the peak in outflows was not visible until about mid-April and is still continuing. Therefore, we believe the market needs more time here than in the FX market to see some inflows. Although the valuation outright and vs OIS curve clearly show attractive levels, we believe the market will want to see more inflationary numbers confirming the continuation of disinflation and a reversal in the hawkish CBT communication.

On the supply side, MinFin has covered about 37% of the planned TURKGBs issuance in our forecast, indicating an orderly situation. Although the budget execution suggests some fiscal slippage risk, we believe the government will meet the fiscal target this year for now. The issuance calendar suggests that MinFin's focus is mainly on shorter maturities, likely to avoid locking in higher debt service costs in longer maturities. On the other hand, if we do see some foreign inflows, it should be more at the front of the curve as positioning to lower inflation and possible rate cuts, which higher issuance in this bucket may deter potential demand.

Local bond yields vs CBT funding rate

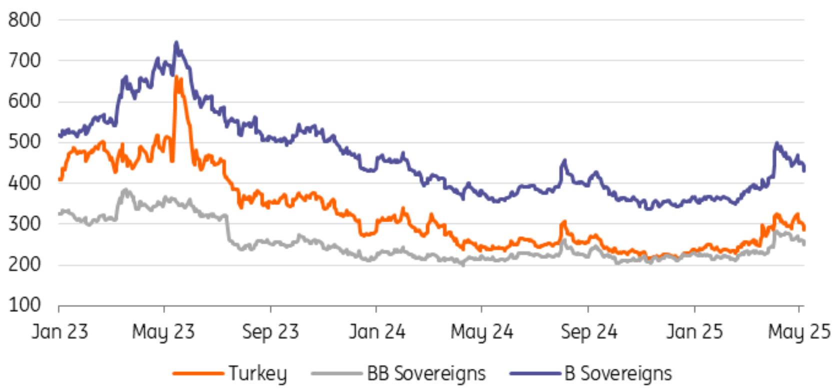


Source: CBT, Refinitiv, ING

Sovereign credit views: looking for stabilisation

With the central bank showing a willingness to act in the face of market volatility, investor concerns about prospects for maintaining the policy shift to orthodoxy have been somewhat calmed over recent weeks. While the steady improvement in credit fundamentals and subsequent rating upgrades now appears to be on pause, we remain confident that volatility should gradually ease, with much of the focus on stabilisation in the FX reserve picture after the recent drop. Investors will have an eye on the potential for sovereign issuance in the international market if sentiment stabilises further, while a scheduled rating review for Moody's in July will also be watched with interest, given the positive outlook and current rating one notch lower than peers at B1.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: Refinitiv, ING

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

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