Monitoring Turkey: Focus shifts to economy

While municipal election results showed a better performance by the opposition than pre-election polls had envisaged, the focus now shifts to the economy. President Erdogan has signalled policy continuity. On the macro side, key indicators suggest the outlook has turned slightly less favourable since January

Source: iStock

Turkey: At a glance

- The Central Bank of Turkey responded to inflationary pressures with a strong and unexpected rate hike in March, a large set of macro-prudential measures and liquidity tightening. These moves will likely further ease concerns about the Bank's priority to bring down inflation, contribute to supporting both local and foreign investors' confidence in TRY assets and help anchor inflation expectations.
- The Bank seems confident that the tight monetary stance will lead to i) a decline in the underlying trend of monthly inflation by moderating domestic demand, ii) real appreciation in the Turkish lira, and iii) improved inflation expectations. Accordingly, the Bank expects that "disinflation will be established in the second half of 2024". A disinflation path in line

with the CBT projections will increase the chances of a rate-cutting cycle towards end-2024. We now expect 250bp in cuts towards year-end.
- The CBT's macro prudential moves are expected to lead to a sharp slowdown in credit growth. This could also create problems for the real economy. Given this backdrop, once it achieves market stability and control over inflation expectations, the CBT will also decide the timing to unwind credit restrictions, likely by synchronising with rate cuts.
- Inflation was lower than the consensus in March but despite some improvement in the underlying trend, the data showed continuing pricing pressures in non-food groups and confirmed challenges to the disinflation process.
- GDP growth in the first quarter will likely remain robust on the back of base effects from last year, continuing support from the fiscal side and still solid private consumption. However, given the extent of monetary policy tightness currently, the slowdown in the economy will become more pronounced after the local elections and 2024 growth could turn out to be below the 3% level, in our view.
- The downward trend in the current account deficit, which started after hitting a peak in July last year, has continued. According to the provisional customs data released by the Ministry of Trade, the foreign trade deficit dropped by more than 40% to US$7.0bn in February. The data implies a continuation of the recovery in February's current account. Additionally, the positive impact of recent CBT actions on the balancing of demand factors is likely to be observed with a lag and support the trend in the current account.

Quarterly forecasts

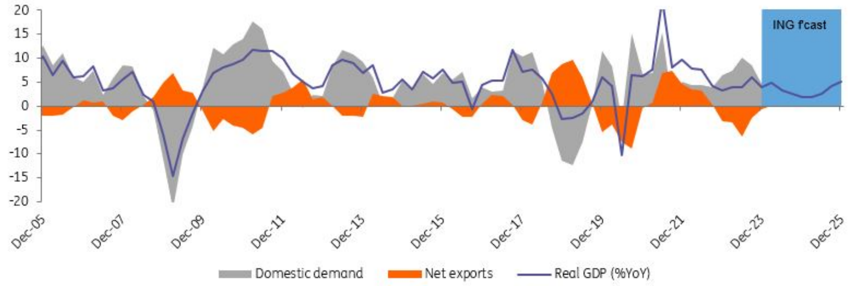
	4Q23	1Q24	2Q24F	3Q24F	4Q24F	1Q25F	2Q25F	3Q25F
Real GDP (%YoY)	4.0	4.8	3.2	2.5	1.8	1.9	2.6	4.2
CPI (eop, %YoY)	64.8	70.1	74.0	47.2	43.2	31.8	27.5	25.9
Central bank key rate (eop, %)	42.50	50.00	50.00	50.00	47.50	40.00	35.00	32.50
3m interest rate (eop, %)	38.61	50.58	48.50	48.35	45.59	41.43	35.46	33.62
10yr yield (eop, %)	25.06	26.82	28.71	26.67	23.87	20.58	19.98	19.04
USD/TRY exchange rate (eop)	29.48	32.35	35.23	38.12	41.00	43.79	46.19	48.24
EUR/TRY exchange rate (eop)	32.54	34.92	38.75	42.69	46.74	50.36	52.65	54.51

Source: Various sources, ING

Downside risks to GDP growth

Fourth quarter GDP data shows an acceleration in private spending despite an increasingly restrictive policy stance with the CBT rate hikes. And leading indicators point to a further recovery in GDP growth in the first quarter of this year as evidenced by the higher PMI, the increase in sectoral confidence indicators and consumer confidence etc. This implies that there is still a long way to go to rebalance the economy. However, we expect weaker private consumption and gross fixed investments, especially after the first quarter given the additional monetary policy tightening delivered by the central bank in recent weeks. Accordingly, the slowdown in the economy will become more pronounced after the local elections and 2024 growth should fall below 3%. In the CBT’s March expectations survey, the growth forecasts of the markets for 2024 remained flat at around 3.3%, though we will likely see downward revisions in April.

Real GDP (%YoY) and contributions (ppt)

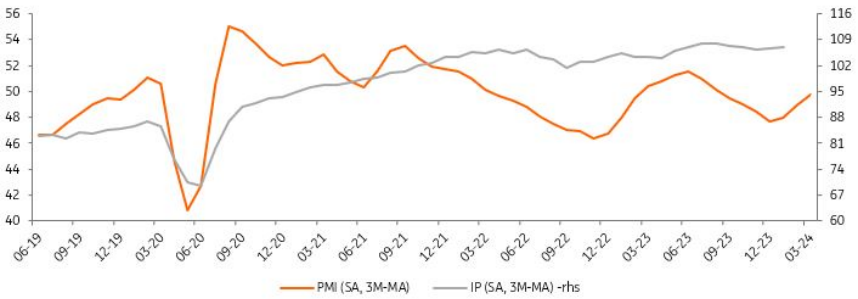


Source: TurkStat, ING

Limited improvement in industrial production

In January, calendar-adjusted industrial production (IP) recorded a 1.1% year-on-year increase, while the seasonally and calendar-adjusted index remained practically unchanged near all-time highs. The data shows a limited improvement in activity, led by strong consumption. In the breakdown, despite the contraction in the production of intermediate (-0.3% month-on-month) and capital goods (-3.2% MoM), consumption goods production prevented any further deterioration. The deterioration in the manufacturing sector (-0.6% MoM), on the other hand, is not broad-based as only some sectors (14 out of 24) contributed negatively. Among the laggards, computer, electronic and optical products had the highest negative contributions, at -0.7ppt, followed by machinery and equipment. On the flip side, food products provided the highest positive impact and lifted the manufacturing sector by 0.7ppt. All in all, there was a slight recovery in January, though this increase is likely to be temporary given the expected impact of the tightening measures taken in March.

IP vs PMI

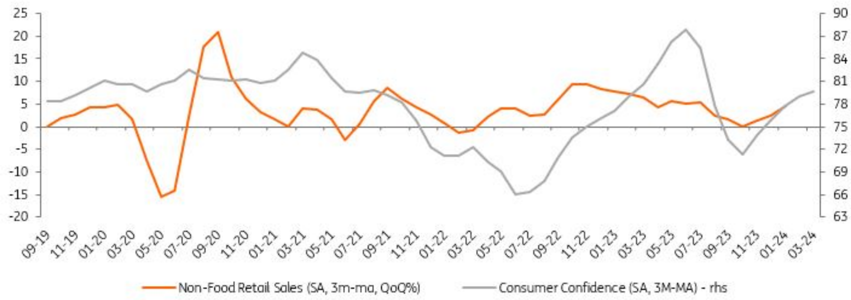


Source: ICI, TurkStat, ING

Continuing strength in retail sales

Retail sales volume on a calendar-adjusted basis increased by 13.3% YoY in January. The seasonally and calendar-adjusted index, on the other hand, recorded the highest sequential growth since July at 2.6% MoM. Retail sales, along with surging consumption goods imports in February, suggest continuing strength in domestic demand conditions and a need for tightening in financial conditions. The CBT moves in response are impactful on this front. Among subgroups, non-food and food sales increased by 2.9% MoM and 2.6% MoM, respectively, while automotive fuel sales recorded a relatively mild increase of 1.1% MoM. The highest annual increase in non-food sales was observed in electrical household appliances and furniture. On the other hand, the (seasonally-adjusted) unemployment rate inched up to 9.1% in January. This figure has been floating around 9% since last August. The composite measure of labour underutilisation, which is the sum of time-related underemployment, unemployment, and potential labour force, increased by 1.7ppt in January on a sequential basis to 26.5%. This indicator has been on the rise in the last three months from 21.4%, now standing at the highest since mid-2021.

Retail sales vs consumer confidence

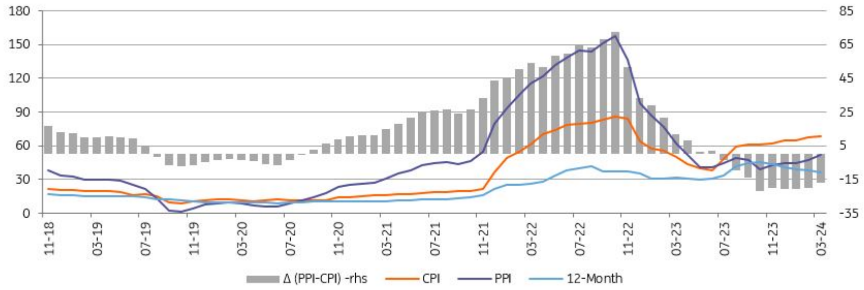


Source: TurkStat, ING

Better than expected March inflation

Monthly inflation at 3.16% MoM was lower than the consensus (3.6%) and our call (4.1%), but pushed annual inflation up to 68.5% YoY, from 67.1% a month ago mainly due to the impact of non-food prices. While there was an increase of 2.3% in March 2023, the average of March months in the 2003-based index has been 1.1%, indicating that the base effect was favourable for this year. However, the outcome was the second-highest March reading in the current series. Accordingly, cumulative inflation in the first quarter stood at 15.1% vs the 36% CBT forecast for this year. Core inflation (CPI-C) came in at 3.5% MoM, moving up to 75.2% on an annual basis on the back of pricing behaviour, the implications of recent exchange rate developments, inertia in services, still resilient domestic demand, and the ongoing deterioration in pricing behaviour. On a seasonally-adjusted basis, after the spike in January, core inflation has remained elevated owing to second-round effects from wage hikes and administered price hikes. However, as pointed out by the central bank in the MPC minutes, the underlying headline trend showed an improvement thanks to the goods group, while services have maintained the uptrend, confirming the challenges for disinflation. As a result, monthly headline inflation (seasonally adjusted) dropped to the 3-3.5% range but remained elevated. The CBT sees seasonally-adjusted monthly inflation hovering below 4% on average in the first half of this year (around 3% except for January). This implies that disinflation should be more pronounced in the coming months for the forecast to hold.

Inflation outlook (%)

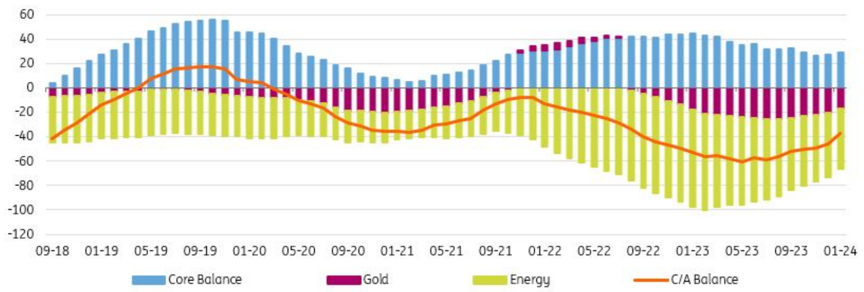


Source: TurkStat, CBT, ING

Sharp drop in January c/a deficit

The current account in the first month of this year posted a deficit of US$2.6bn, better than the market consensus at US$2.8bn. In the breakdown, compared with the same month of last year, we see: i) a sharp drop in the gold trade deficit from US$4.5bn to US$0.6bn ii) an improvement in the net energy trade with a fall in the deficit to US$5.1bn from US$7.7bn and turn in the core trade balance to a surplus of US$1.6bn from a slight deficit. While these items turned out to be the major drivers of the recovery in the current account balance, flat services income and a drop in primary income limited the extent of the recovery. Accordingly, the 12-month rolling deficit recorded a sharp decline to US$37.5bn (translating into c.3.4% of GDP) from US$45.4bn a month ago given the large base in January 2023. On the capital account, net identified flows turned mildly negative at US$1.8bn. Errors and omissions outflows that came back since September were at US$1.8bn in January. With the monthly c/a deficit and capital outflows, official reserves recorded the first decline since the May 2023 elections at US$6.2bn.

Current account (12M rolling, US$bn)

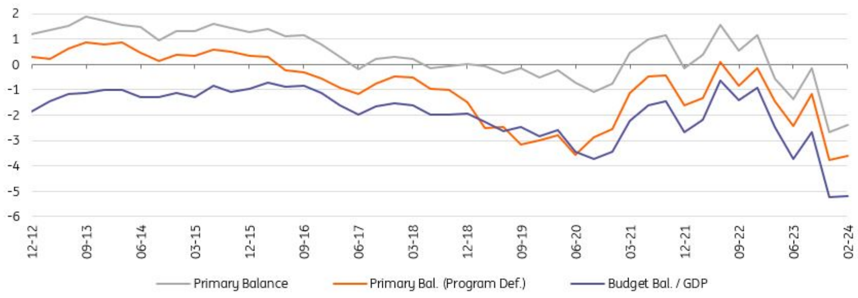


Source: CBT, ING

US$5.2bn Eurobond issuance in 2024 so far

Budget data for January and February indicate continuing pressure especially due to interest payments. Given this backdrop, the recent acceleration in the budget deficit points to additional challenges for the disinflation process. While the current outlook implies expenditure-cutting and revenue-raising measures that will not create inflationary pressure, FinMin's Mehmet Simsek recently stated that the government does not plan across-the-board tax increases in income tax, corporation tax or value-added tax but will focus on spending cuts to improve the fiscal outlook. Simsek's signal of increased support from fiscal policy for disinflation should be positive. Finally, within the framework of the 2024 external financing programme, the Treasury issued a euro-denominated bond and borrowed EUR2bn. With this issuance, a total of approximately USD 5.2bn worth of financing has been obtained from international capital markets this year so far with US$10bn planned for the whole year.

Budget performance (% of GDP)

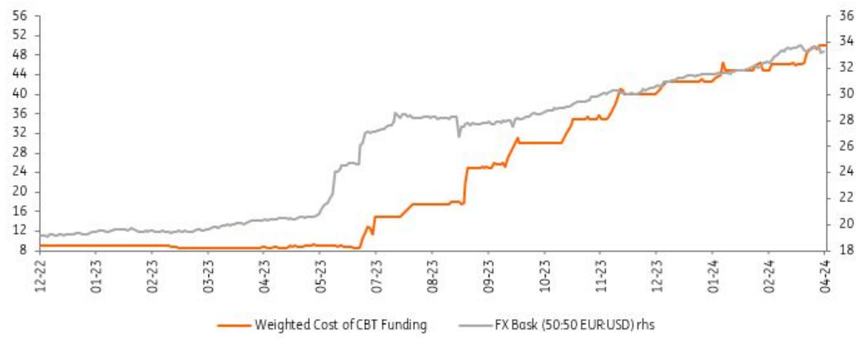


Source: Ministry of Treasury and Finance, ING

A surprise hike from the central bank

Despite the strong non-rate reaction which tightened financial conditions in March, the CBT delivered a 500bp hike "in response to the deterioration in the inflation outlook". While the market call was for no move in March, it was mainly based on the view that the bank would prefer to see the impact of the additional quantitative and macro-prudential tightening steps introduced since the February MPC as a response to the increased pressures on inflation and FX. Additionally, the CBT widened the interest corridor from 300bp to 600bp (by setting ON borrowing and lending rates 300 basis points below and above the policy rate). This change will provide further room to increase the effective cost of funding to the upper band by delivering additional liquidity tightening if needed. In its assessment, the CBT acknowledged i) the higher-than-expected underlying monthly inflation trend ii) resilient domestic demand, and reiterated inertia in services inflation, geopolitical risks and food prices as the key drivers of inflation.

CBT funding rate (%) vs FX basket



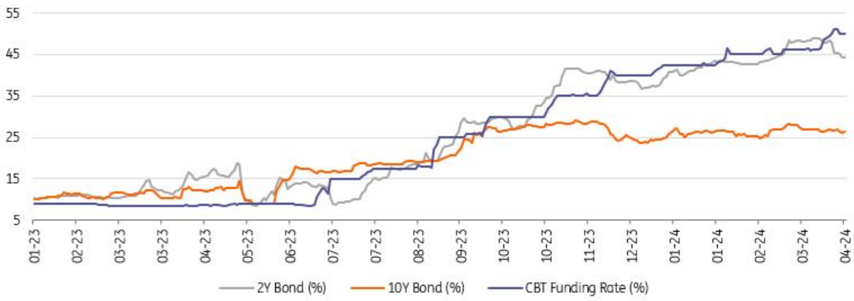
Source: Refinitiv, ING

FX and rates outlook

Between the February and March MPCs, the lira fell close to 5%, likely reflecting onshore demand for hard currency driven by expectations of post-election exchange rate volatility, a high seasonal current account deficit in the absence of large tourism revenues and weaker foreign inflows compared to 4Q23. Accordingly, net foreign exchange reserves, which increased rapidly in November and December, have seen a downward trend since the beginning of this year. Given this backdrop, the CBT bank has responded with a number of tightening actions including another 500bp hike and widening the rates corridor now +/-3% around the policy rate at 50%. The bank has maintained its hawkish stance with a determination to keep rates high and monetary conditions tight.

Following the MPC meeting and in the aftermath of local elections, pressure on the exchange rate subsided while local bond yields moved downwards, though the rising inflation path in the near term is still a concern adversely impacting real returns.

Local bond yields vs CBT funding rate

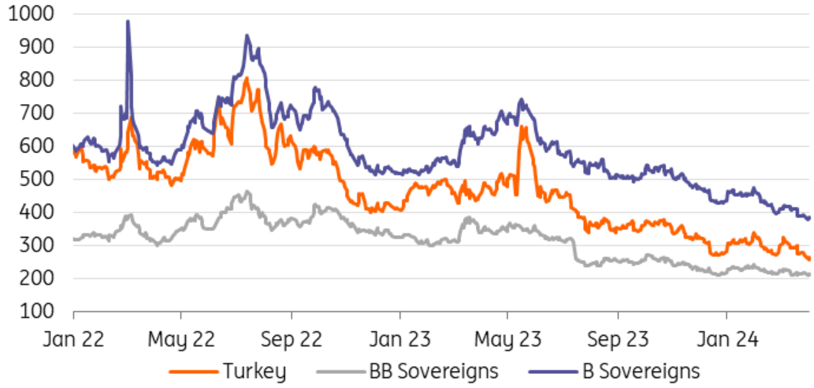


Source: Refinitiv, ING

Sovereign credit: Renewed confidence in policy shift

Turkey's surprise rate hike ahead of local elections should shore up investor confidence that policymakers will stick to their orthodox shift until there are clearer signs of disinflation later in the year. At the same time, with a perceived risk event out of the way due to the smooth passage of local elections, investors will be looking for more concrete signs of improvement in underlying fundamentals, including a further adjustment in the current account and a rebuilding of FX reserves. In this context, spread levels for Turkish sovereign credit look fair, having compressed towards the BB-rated sovereign average, while slightly lagging the rally seen in many higher-beta single-B sovereigns year-to-date. We would keep an eye out for further new supply as a potential negative catalyst, while the next scheduled rating review by S&P on 3 May could see some further positive momentum (currently B with a positive outlook).

ICE US$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

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