Monitoring Turkey: Geopolitical shock increases risks

The geopolitical shock from the Middle East conflict has increased near-term risks to the macro outlook with effects on the risk premium, inflation, monetary policy and the current account balance. The economic impact of these developments will depend on both the scale and duration of the disruption

Geopolitical conflict heightens macro risks for Turkey

Turkey's economy at a glance

In response to the outbreak of the US-Iran conflict, the Central Bank of Turkey (CBT) has taken several actions, including:

1. Providing FX supply to the system by actively utilising its FX reserves and the start of lira-settled FX forward sales (NDF). Accordingly, the bank is estimated to sell more than US$11bn, while NDF stock stood at US$0.5bn as of 5 March.
2. Reducing TRY supply that could go to FX. While FX sales have been reducing TRY liquidity in the system, it has also started issuing liquidity bills (at TRY58.1bn as of 5 March).
3. Supporting demand for TRY. The bank suspended one-week repo auctions and allowed the ON rate to move higher to the upper band of the corridor. The effective cost of funding also moved up to 40%.

- In its 2026 policy paper, the CBT announced that it aimed to increase the OMO portfolio to a nominal TRY450 bn in 2026, from TRY262 bn, up 72%. With the geopolitical developments, the CBT has also increased the size of daily securities purchases with a total TRY73.2bn in March so far vs TRY78.2bn in the first two months, which supports bond yields.
- February inflation, which was particularly impacted by food, led to a temporary increase in the annual figure, though the downtrend will likely resume in March. We expect 25% inflation this year due to elevated February inflation, leading to a higher path and ongoing pressure on energy prices. The uncertainty surrounding oil prices increases risks to the inflation outlook. Therefore, to absorb the impact of oil prices, the government introduced a tax regulation which basically says that if refinery prices go up because of higher global oil prices or a weaker exchange rate, the government can cut the special consumption tax on these products by up to 75% of that increase.
- We think the CBT will not change the policy rate in March, keeping it at 37%, then resume cautious cuts, pulling it to 30% at the end of this year, though risks are on the upside.
- According to a CBT study, a US$10 increase in Brent crude oil prices would result in a US$4-5bn rise in the current account deficit. Accordingly, we revised our current account deficit forecast for 2026 to US$32bn, assuming no meaningful impact on tourism. On the capital account side, risk aversion may weigh on portfolio flows, though the reaction so far has remained measured.

Quarterly forecasts

	4Q25	1Q26F	2Q26F	3Q26F	4Q26F	1Q27F	2Q27F	3Q27F
Real GDP (%YoY)	3.4	3.6	3.9	4.1	4.4	4.6	5.0	4.4
CPI (eop, %YoY)	30.9	30.2	28.0	25.7	25.0	21.8	20.8	19.0
Central bank key rate (eop, %)	38.00	37.00	35.00	33.00	30.00	28.00	26.00	25.00
3m interest rate (eop, %)	40.10	37.57	35.16	32.65	30.13	27.82	26.05	24.28
10yr yield (eop, %)	28.89	30.46	29.15	27.99	26.29	24.18	23.25	21.23
USD/TRY exchange rate (eop)	42.94	44.51	46.42	48.58	51.00	53.05	55.06	57.05
EUR/TRY exchange rate (eop)	50.45	51.63	54.78	58.29	62.22	64.72	67.17	69.60

Source: Various sources, ING

FX and rates outlook

The central bank reacted quickly to the US-Iran conflict with the above measures, and was visibly well-prepared for the potential risk and record-high long TRY positioning. USD/TRY has remained admirably stable since the start of the conflict and the central bank even slowed the daily rate of appreciation of the pair to maintain market attractiveness. At the same time, we could see significant activity in the forward market, pushing implied yields steeply upwards.

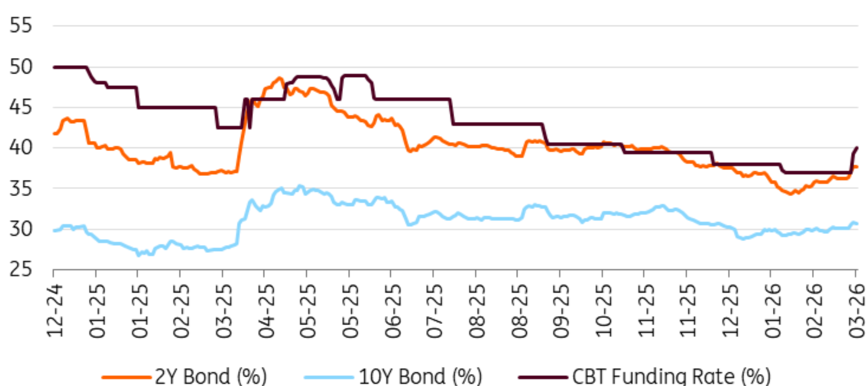
The Middle East conflict comes at a challenging time for the CBT, as domestic inflation is already showing signs of stalling in its disinflation trend. At the same time, higher oil prices could place significant additional pressure on the Turkish economy, one of the countries most exposed to such shocks.

Part of the yield movement reflects a simple reassessment of market expectations for further CBT rate cuts. The remaining part stems from increased central bank activity in the market, undertaken to offset the outflow of TRY long positions. The T/N yield has thus climbed to 39%, which should contribute to market stability here, and we do not expect any significant fluctuations in the USD/TRY trajectory compared to previous expectations due to the US-Iran conflict at this time,

unless we see a significant escalation. The CBT has entered a stressful period with record-high FX reserves (US$210bn as of 27 Feb) and record-high long TRY market positioning (around US$40bn according to the governor), while we estimate that outflows led to a reduction of less than half.

Rates see a similar story as FX forward implied yields, with CBT rate cut expectations repricing due to the local slowdown in disinflation and the additional inflation impact from higher energy prices. The market has moved year-end expectations for the CBT rate from somewhere around 30% to the current 32.3%, well above our forecast. At the same time, the entire curve has seen the expected bear flattening. Given the reduced central bank protection in the rates market, it can be expected that the market will take longer to find equilibrium and a possible recovery, depending on the development of the US-Iran conflict and energy prices.

Local bond yields vs CBT funding rate



Source: CBT, Bloomberg, ING

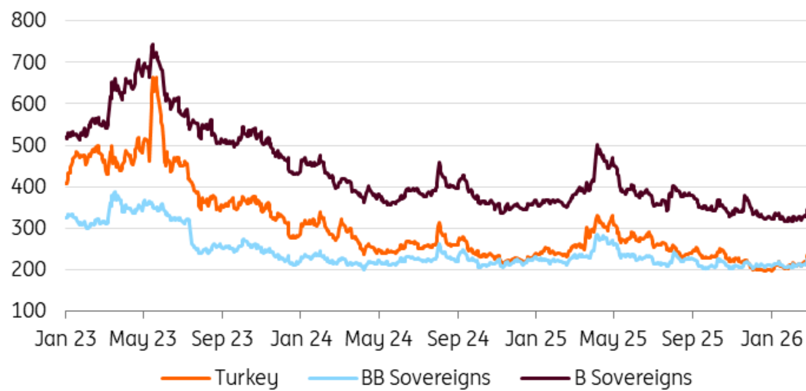
Sovereign credit views

Increased geopolitical risk from the Middle East comes at a tough point for Turkey, with the combination of higher energy prices, risk-off sentiment and geographical proximity meaning the impact is a clear net negative for the country.

While the central bank has reacted well to the expected outflows from heavy local currency carry positioning in order to avoid a sharp TRY selloff, in the hard currency space, the latest developments also come after a strong run, with relative spread levels at their tightest in about a decade at the start of February.

While there has been a modest widening in Turkey's USD sovereign bond spreads (around 15bp over the past week, and 30bp YTD on average) so far, the risk seems skewed towards further potential widening if the conflict and energy disruption continue. Some positive factors remain, with the improvement in fundamentals and build-up of buffers over the past few years key to avoiding a less orderly selloff, while the fast start to the year in terms of Eurobond issuance ($3.5bn in USD and €2bn in EUR) means immediate external financing needs are low.

US$ Bond Sub-Index Spreads vs USTs



Source: Refinitiv, ING

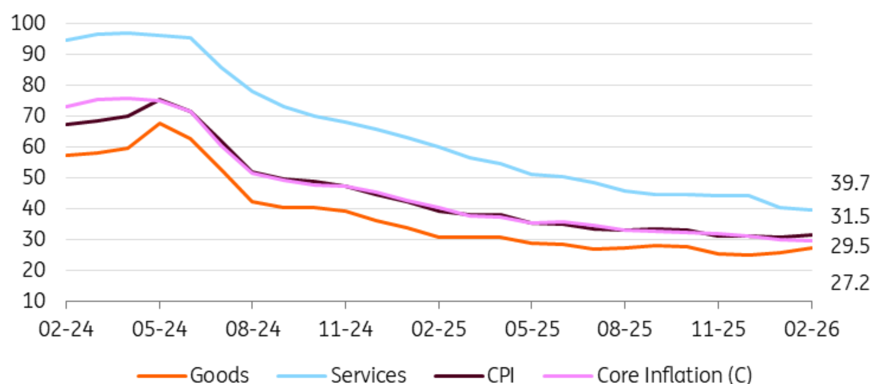
February brings another sharp inflation rise

February inflation at 2.96% month-on-month was close to the consensus, while annual inflation temporarily changed direction and rose to 31.5% from 30.7% in January. While the food group was again the key driver of pricing pressures, some non-food groups like transportation and catering services also contributed to the strong increase last month.

Core inflation (CPI-C) rose by 1.53% MoM, bringing the annual rate down to 29.5% for the first time since late-2021, thanks to modest nominal TRY depreciation in recent months as well as the slow pace of increase in the PPI that keeps costs for producers under control. In February, PPI stood at 2.4% MoM, moving up to 27.6% YoY vs January.

PPI inflation on an annual basis has remained close to 27% over the past six months, implying no meaningful deterioration in cost pressures, which is also attributable to supportive currency developments, while global commodity prices and particularly oil prices in the current geopolitical backdrop will likely remain the key risk factors to the PPI trend in the near term.

Inflation outlook (YoY%)



Source: TurkStat, ING

CBT raises 2026 annual inflation forecast to 18%

In the first inflation report of this year, the CBT kept inflation targets unchanged for this year and

next at 16% and 9%, respectively, while introducing 8% for 2028. However, the CBT hiked the forecast range for this year to 15-21% (with a mid-point of 18%) from 13-19% previously. For next year, the forecast range is 6-12% (9% mid-point). The forecasts are now closer to, but still quite optimistic versus those of market participants.

According to the report, the key factor behind this adjustment was the increase in the weight of the services group within the consumer price index basket, following recent methodological changes to the CPI calculation. The CBT estimated approximately 1ppt to the annual inflation projection. In addition, despite lower assumptions for oil and energy prices (oil down to US$60.9 from US$62.4 vs ING's forecast of US$56.5), the upward revision to TRY denominated import price assumptions driven by rising non energy commodity prices has contributed to higher inflation estimates. A limited adjustment to the food price assumption (from 18% to 19%, which is quite optimistic given the current level at 31.7% as of January) has also exerted upward pressure on the forecast. Moreover, the output gap remaining at higher-than-anticipated levels has also played a role in the updated forecasts.

Regarding the outlook, the governor struck a notably positive tone, highlighting significant improvement in rent inflation (projected to decline to 30–36% this year from 56.6% in January), the supportive impact of education due to recent regulations aimed at reducing backward indexation, a moderate rise in core goods inflation consistent with the current pace of the exchange rate, and a more pronounced decline in inflation expectations – particularly among corporates – which is helping to strengthen pricing behaviour.

Governor Karahan sees underlying inflation in March and April converging to levels realised in November and December, implying an improvement despite growing concerns in the market for the 2026 inflation outlook.

Details of the inflation report

	2026	2027
IR 2026-I Year End Interim Target (%)	**16.0**	**9.0**
Forecast Range (%)	15.0-21.0	6.0-12.0
Mid-point of the Forecast Range (%)	18.0	9.0
IR 2025-IV Year End Interim Target (%)	**16.0**	**9.0**
Forecast Range (%)	13.0-19.0	6.0-12.0
Mid-point of the Forecast Range (%)	16.0	9.0
Forecast Revision (in Mid-point) as Compared to Previous Report (% Point)	2.0	0.0
Revisions in Assumptions*		
Export-Weighted Global Growth Index (Annual Average % Change)	2.3 (2.2)	2.2 (-)
Oil Prices (Average, USD)	60.9 (62.4)	56.0 (-)
Import Prices (USD, Annual Average % Change)	2.0 (-0.6)	-0.9 (-)
Food Price Inflation (Year-End % Change)	19.0 (18.0)	11.0 (-)

* Figures in parentheses denote values presented in the previous Inflation Report.

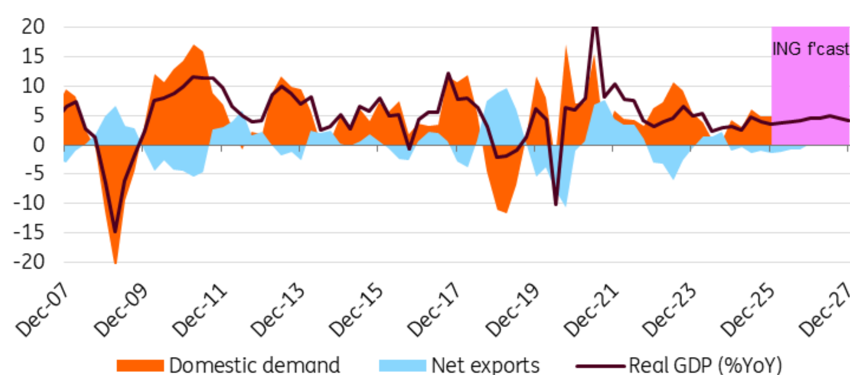
Source: CBT, ING

Growth slows in 4Q; domestic demand still the main engine

Turkey's GDP expanded by 3.4% YoY in the final quarter of 2025, falling short of both the market consensus of 3.8% and our own projection of 3.9%. The figure marks a deceleration from the previous quarter, which had been revised up to 3.8% year-on-year by TurkStat. Growth during the period was mainly supported by private consumption and, to some extent, by investment, while weaker external demand and government consumption, as well as inventory depletion weighed on the overall outcome. For the full year, GDP rose by 3.6% vs 3.3% in 2024.

After seasonal adjustment, fourth quarter GDP corresponds to a QoQ increase of 0.4%, indicating a gradual slowdown compared with the preceding two quarters. The sequential performance was driven primarily by private consumption, which contributed 2.8ppt to growth. All other expenditure components pulled the growth rate lower: net exports had the largest negative impact at -1.8 points, followed by inventory depletion (-0.3 points), government consumption (-0.2 points) and capital formation (-0.1 points).

Real GDP (%YoY) and contributions (ppt)



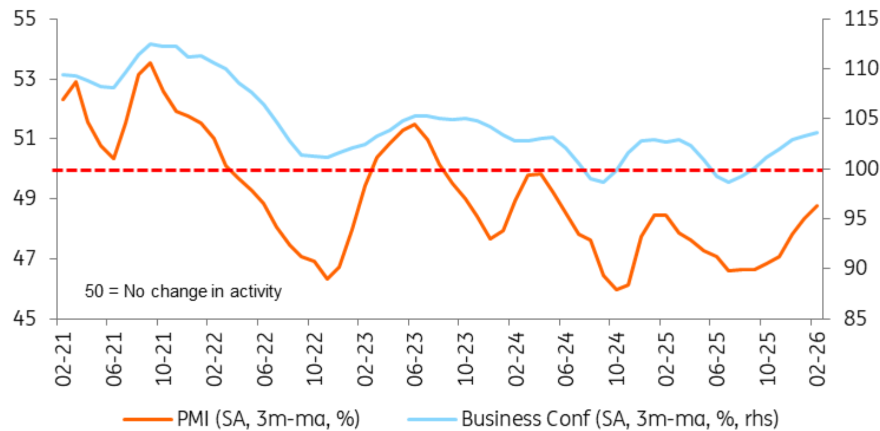
Source: TurkStat, ING

Moderating business conditions in manufacturing

The manufacturing sector PMI increased to 49.3 in February from 48.1 in January (on a seasonally adjusted basis), reaching the highest level since early 2024, suggesting the sector was nearing stabilisation. The figure, which is still in contractionary territory, signals continuing but less pronounced challenges in business conditions for the manufacturing sector. In the breakdown, the data shows further signals of improvement in demand, with new orders easing to the least extent in almost two years, while output, employment and inventories all moderating in comparison to January. Pricing pressures signalled further strengthening, as evidenced by inflation data so far this year.

While the manufacturing PMI portrays a generally optimistic picture, findings in the sectoral PMIs, on the other hand, released by the Istanbul Chamber of Industry, showed that only three of 10 sectors recorded an increase in their PMIs in comparison to January, while two of them positioned above the 50 level. However, compared with the 4Q average, the average of PMIs in the first two months of this year shows some positivity with moderately less challenging business conditions, in line with the developments in the manufacturing sector.

PMI & Business Confidence



Source: ICI, CBT, ING

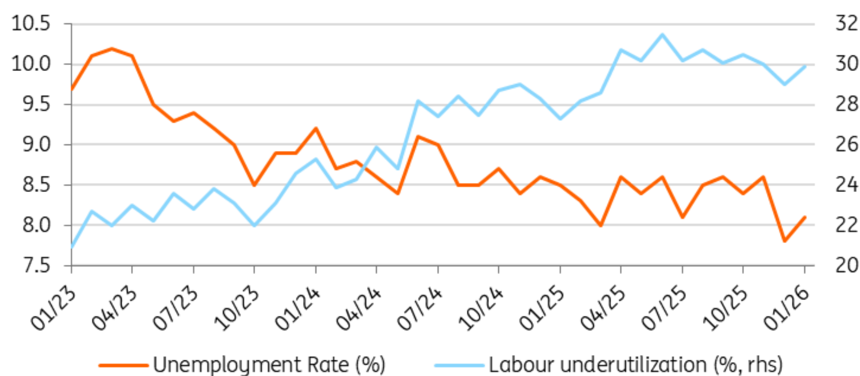
Unemployment rate rises from all-time low

According to the seasonally adjusted labour market data, the headline unemployment rate that plunged to 7.8% in December, its lowest level in the current series starting in 2005, rose to 8.1% in January, though it remained below the 2025 average. This is attributable to the employment decline being larger than the decline in labour force participation and the rise in unemployment.

Accordingly, compared to the previous month, the number of unemployed rose by 73K, standing at 2.82m. The number of employed people, on the other hand, also fell by 516K people compared to the previous month. This implies weak employment generation and employees leaving the workforce as the labour force participation rate fell, standing at 52.1% vs 52.9% in January, while the drop in the last two months reached 1.3%, showing ongoing strains in the labour market.

Broadly defined unemployment indicators also look under pressure compared to the previous month. One of the broader unemployment indicators, the underutilisation rate – which combines time-related underemployment, potential labour force, and the unemployed – increased by 0.9 ppt MoM to 29.9%.

Labour market outlook



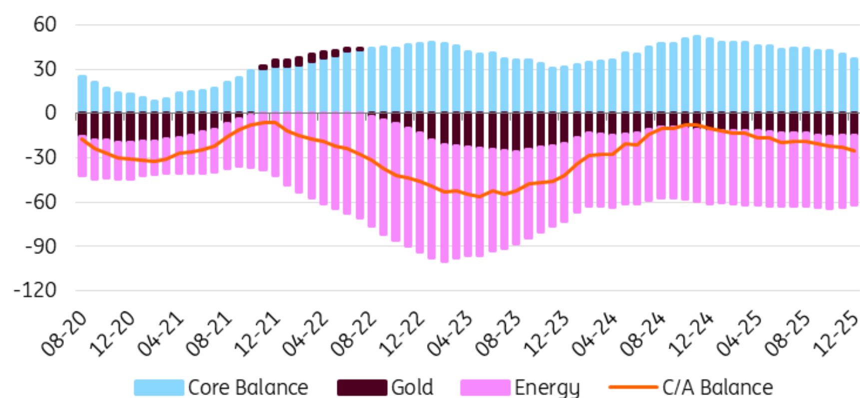
Source: TurkStat, ING

Current account deficit remains on a widening track

The current account posted a deficit of US$7.3bn, higher than the market forecast (US$5.3bn) and our call (US$5.5bn). As a result, the 12-month rolling current account deficit maintained the uptrend and reached US$25.2bn, or approximately 1.8% of GDP, from US$22.7bn a month ago.

In 2025, resident outflows rose to US$44.2bn from US$35.4bn a year ago. Foreign inflows, on the other hand, recorded an increase, coming in at US$64.2bn, compared to US$57.8bn in 2024. As a result, the capital account has remained in positive territory with US$19.8bn, compared to US$22.3bn. In addition, outflows via net errors and omissions remained elevated, totalling US$-16.6bn vs US$-11.3bn in 2024. Taken together with the widening current account deficit, which grew from US$-10.4bn to US$-25.2bn, official reserves were depleted by US$22.0bn vs a slight US$0.6bn increase recorded a year earlier.

Current account (12M rolling, US$bn)



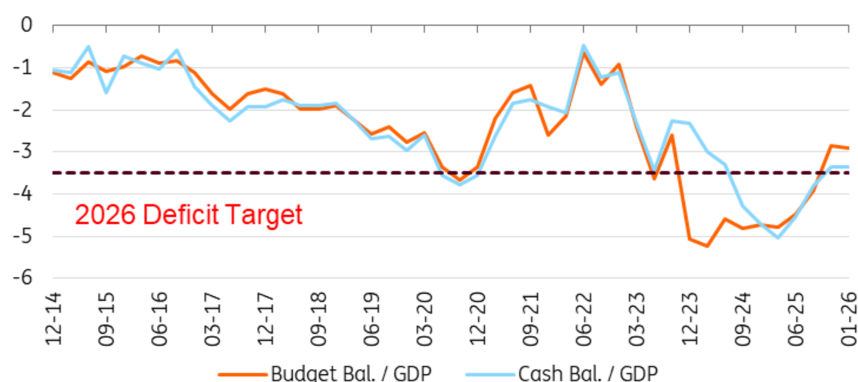
Source: CBT, ING

Strong primary surplus in January

January's budget results showed a deterioration in the budget balance compared with the same month last year, driven largely by the sharp annual increase of 180% in interest expenditures. Accordingly, the total budget deficit reached TRY214.5bn, exceeding the TRY139.3bn deficit recorded in the same month of the previous year. With these figures, the cumulative budget deficit for the last 12 months amounted to TRY1.87tr, corresponding to 3.0% of GDP. In the latest Medium-Term Program, the budget deficit forecast for 2026 was set at TRY2.71tr (3.5% of GDP).

The positive development in January, on the other hand, was the primary surplus standing at a strong 0.7% of GDP. On the revenue side, tax collections increased by 49.0% YoY, supported by strong growth in income and corporate tax revenues and an acceleration in value-added tax receipts, which were one of the factors that supported the primary surplus, in addition to high non-tax income up by 92.9% YoY driven by 5G licence sales. On the expenditure side, the slowdown in current transfers helped contain primary spending. Primary expenditures rose by a moderate 32.0% YoY, largely due to the deceleration in current transfers, whose growth rate eased to 27.1% YoY.

Budget performance



Source: Ministry of Treasury and Finance, ING

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