

Monitoring Turkey: Growing interest

Turkish assets have been supported by expectations of an orthodox policy framework along with a gradual return of capital flows. In this environment, the central bank has maintained a tightening bias, while announcing several non-rate measures following the recent developments in credit growth and deposits and to mop up excess liquidity



Skyline of Istanbul, Turkey

Turkey: At a glance

- Inflation is expected to come down in the period ahead with large base effects. Whether i) the stability in the exchange rate is to continue, ii) the subsidies provided to consumers in electricity and natural gas prices to remain in place and the government to avoid inflationary tax adjustments will be key determinants for the pace of disinflation, while the deterioration in pricing behaviour and the rigidity in services inflation are challenges in the period ahead.
- The Central Bank of Turkey (CBT) will closely watch the inflation path and inflation expectations. It will maintain a tight stance with the policy rate at 50%, while keeping the funding cost and ON repo rate high via liquidity policy, in our view.
- Improved expectations and high interest rates lead to a rapid increase in the CBT net FX position as it has purchased around US\$66bn in the two-month period after the elections. Gross reserves have recorded a relatively modest increase at US\$19.1bn, while net reserves (excluding swaps) improved by a significant US\$60.4bn.
- The recovery trend in the current account deficit that started after the peak last July has lost momentum in March. While we likely see a temporary increase in April, the provisional customs data imply the return of improvement in May. Going forward, the impact of the CBT tightening on the balancing of demand factors is likely to be supportive for the external outlook, while the ongoing recovery in global economic activity is expected to have a favourable impact on Turkey's exports and thus on the current account balance.
- Banking sector data show that these actions led to a slowdown in credit growth including a sharp decline in consumer credit card spending, while we will likely see further deceleration with the recently imposed cap on FX loans expansion. Given this backdrop, while early indicators for the second quarter point to some weakening in activity, which is still moderate so far, growth is expected to lose significant momentum in the remainder of this year with tightening financial conditions, slowing real wage growth and a likely increase in the unemployment rate.

Quarterly forecasts

	1Q24	2Q24F	3Q24F	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F
Real GDP (%YoY)	5.7	3.1	1.9	0.8	0.9	3.1	4.4	5.2
CPI (eop, %YoY)	68.5	72.2	46.1	41.8	31.8	27.2	25.1	23.8
Central bank key rate (eop, %)	50.00	50.00	50.00	45.00	37.50	32.50	30.00	27.50
3m interest rate (eop, %)	50.58	48.50	47.32	42.19	38.58	34.11	30.94	28.60
10yr yield (eop, %)	26.82	27.94	25.70	22.17	20.41	19.75	18.45	17.15
USD/TRY exchange rate (eop)	32.35	32.55	34.06	37.00	39.17	41.03	42.63	44.00
EUR/TRY exchange rate (eop)	34.92	35.15	37.46	40.70	43.09	45.14	46.89	48.40

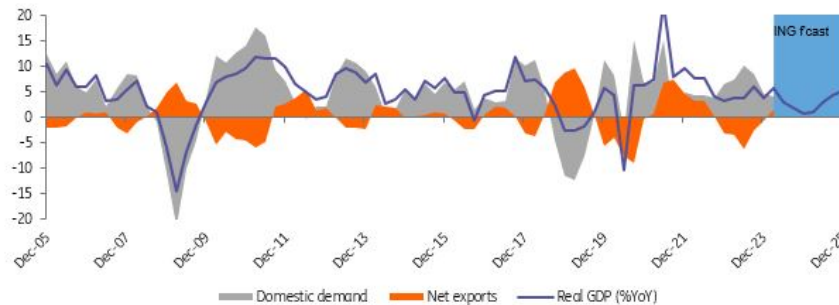
Source: Various sources, ING

Domestic demand strength in the first quarter

GDP growth in the first quarter turned out to be 5.7% on a year-on-year basis, aligned with market consensus and our call, on the back of still strong domestic demand and positive contribution from net exports. First quarter GDP translates into a quarter-on-quarter growth rate at 2.4% after seasonal adjustments, showing a momentum gain in comparison to a relatively modest fourth quarter 2023 reading at 1.0%. Accelerating sequential performance is attributable to investments and government spending turning positive after a negative reading a quarter ago and supportive

impact of net exports despite the contractionary effect of inventory build-up and moderation in private consumption. Early indicators so far, on the other hand, point to some weakening in activity, though the pace is relatively slow at this stage.

Real GDP (%YoY) and contributions (ppt)

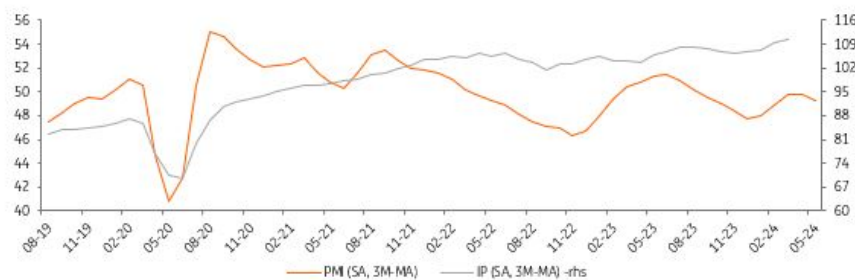


Source: TurkStat, ING

PMI dove further into contractionary territory in May

The manufacturing sector PMI, which returned to contractionary territory in April at 49.3 fell further in May to 48.4, the lowest reading in 2024 so far. The data imply increasing pressures for the manufacturing sector with the significant policy tightening in recent months. In fact, the key driver of the PMI turned out to be a moderation in new orders attributable to challenging demand conditions leading to a scaling back of operations and adversely affecting employment decisions given lower workloads. On a positive note, inflationary pressures seem to abate in May with a decline in the rate of input cost inflation likely attributable to recent strength in the currency. Findings in the sectoral PMIs on the other hand, released by the Istanbul Chamber of Industry, are in line with the manufacturing PMI.

IP vs PMI



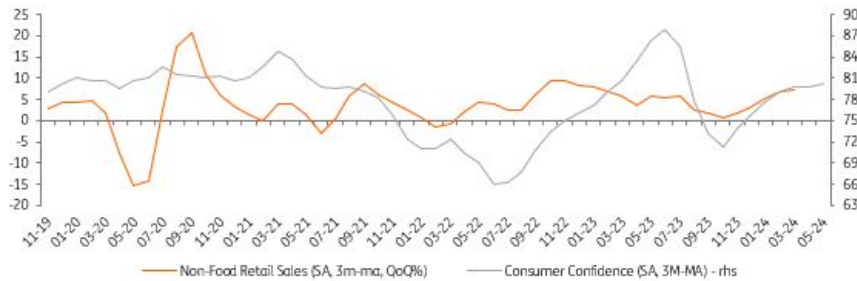
Source: ICI, TurkStat, ING

Signs of weakening in retail sales

Sequential growth in retail sales, after recording a continuous growth rate since last September remained flat in March with across-the-board weakness in food (0.2% MoM), non-food (0.3% MoM) and fuel (-1.8% MoM). This is likely attributable to monetary tightening measures introduced in March while we will likely see further moderation in the upcoming data given recent signals related to a cooling in domestic demand as we have seen a deceleration in credit spending since mid-March. Retail sales volume on a calendar-adjusted basis increased by 19.4% YoY. On the other

hand, the (seasonally adjusted) unemployment rate stood at 8.6% in March, the lowest since 2012, with a slight decline from 8.7% in the previous month. Given that the activity will lose further steam in the rest of 2024, unemployment is also expected to rise from these levels.

Retail sales vs consumer confidence

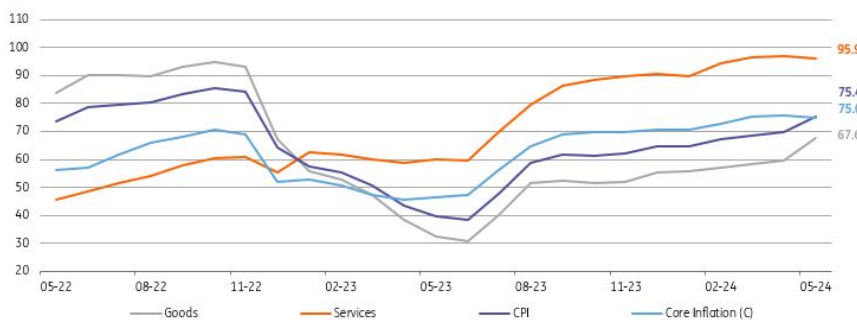


Source: TurkStat, ING

No major surprise in May inflation

May CPI inflation turned out 3.37% MoM with across-the-board price increases in both food and non-food groups, pulling the annual figure to 75.4% YoY, which was in line with what the CBT envisaged in the latest inflation report. While it was flat in May 2023 due to the 1-year government subsidy in natural gas, the average for the month of May on the 2003-based index was 0.9%, indicating that the base effect was significantly unfavourable for this year. Core inflation (CPI-C) came in at 3.8% MoM, moving down to 75.0% on an annual basis. It was supported by the relatively flat USD/TRY after the local elections, though pricing behaviour and inertia in services have been the factors, continuing to pressure inflation. In the remainder of this year, annual inflation is expected to drop rapidly with the large base effects and is likely to be in the CBT's forecast range (34-42%) at end-2024, close to the upper band, in our view.

Inflation outlook (YoY%)



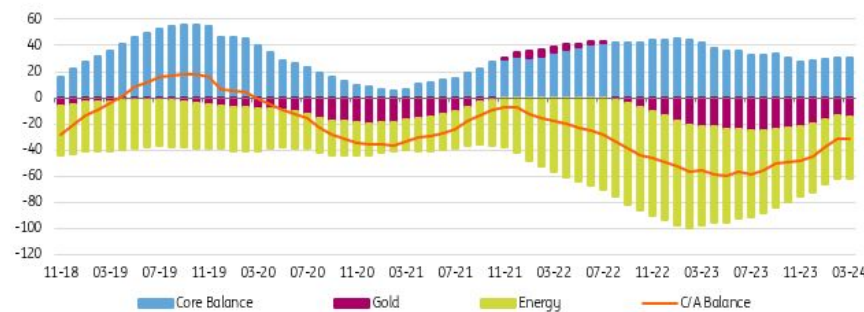
Source: TurkStat, ING

Improvement in current account deficit lost momentum in March

The current account posted a deficit at US\$4.5bn in March, while the improvement in the 12M rolling deficit that followed a faster pace in the first two months of the year lost momentum with a modest decline to US\$31.2bn (translating into c.2.8% of GDP) from US\$31.9bn in the previous month. On the capital account, net identified flows has remained weak with a mere

US\$3.8bn inflows, falling short of the current account deficit again following mild outflows in the previous month. Errors and omissions outflows recorded one of the historical outflows ahead of the March local elections with US\$9.6bn, similar to the outflows we saw during the financial volatility in December 2021 (US\$10.6bn) and before the May 2023 presidential elections (US\$9.6bn). With the monthly current account deficit and weak flow outlook, official reserves recorded a US\$10.3bn decline. Flows were relatively weak in the first quarter, though the recent data show a re-acceleration in inflows due to increasing appetite of foreign investors to Turkish assets on the back of the clear messages by the CBT and the government regarding the continuation of a tight policy framework.

Current account (12M rolling, US\$bn)

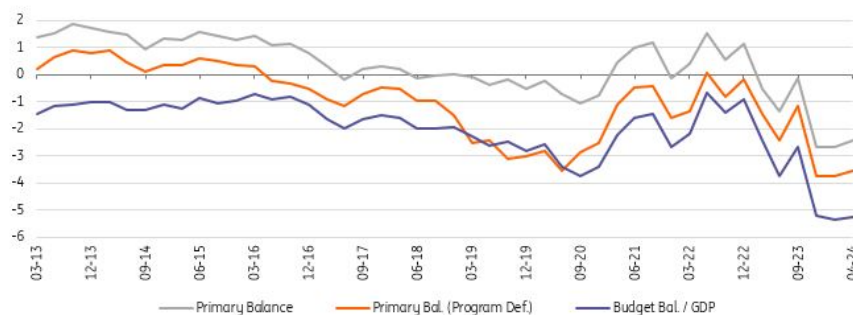


Source: CBT, ING

Budget deficit widened in April

Despite continued strength in direct and indirect tax collections, the April budget reflected a worsening in the deficit compared to April 2023 due to the acceleration in non-interest expenditures driven by personnel expenditures and current transfers. Accordingly, the budget posted a deficit of TRY177.8bn in April alone vs a TRY132.5bn deficit in the same month of last year, while the deficit for the last 12 months rose to TRY1,684bn (5.3% of GDP). Minister of Treasury and Finance, Mehmet Şimşek, recently announced a package of measures, which include cutting purchases of goods and services and investment spending to control the widening in the budget deficit and help disinflation while he signalled additional actions in the period ahead. Accordingly, the government targets a budget deficit-to-GDP ratio this year close to the level realised in 2023 (5.2%) or lower.

Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

Additional liquidity and macro-prudential tightening

In the May meeting, the CBT kept the policy rate flat at 50%, in line with the consensus and our call. In the statement, the bank cited the lagged effects of the monetary tightening, though dropped the reference to “a significant tightening in financial conditions” for its rationale. It also maintained the tightening bias, still leaving the door open for further hikes if required by the inflation outlook and restated that the Monetary Policy Committee (MPC) remains highly attentive to inflation risks. The forward guidance was unchanged, as the CBT, in addition to the continuing tightening bias, pledged to keep the current level of policy interest rate as long as needed. The bank also announced macroprudential and liquidity tightening moves following the recent developments in credit growth and deposits and to mop up excess liquidity in the system.

CBT funding (TRYbn)



Source: CBT, ING

FX and rates outlook

Given the clear CBT message, still leaving the door open for further hikes if required by the inflation outlook in addition to the recent rate and non-rate tightening, foreign interest in the lira is on the rise since the local elections. Accordingly, the inflation path and inflation expectations is the main focus, while the bank will continue to keep the funding cost and ON repo rate high via liquidity policy, in our view. With the breakdown of the exchange rate depreciation expectations, the downward trend in the FX deposits (including FX protected deposits), has resumed, while gold imports are also falling. These developments indicate a return of the de-dollarisation in the economy. The currency will likely remain supported in the period ahead.

In the MPC statement, while the CBT also reiterated that services inflation is sticky and the domestic economy remains resilient, it has remained sensitive to the inflation outlook. Based on the May inflation at 68.5%, ex-post real policy rate remains negative, while ex-ante real policy rate is close to 15% (vs 12M inflation expectations at 35.2%). Despite the improvement in the macro-financial outlook, Treasury borrowing rates remain quite high given the monetary tightening and the easing of bank obligations to purchase government securities. However, it seems borrowing rates have reached a peak recently.

Local bond yields vs CBT funding rate



Source: Refinitiv, ING

Sovereign credit: Spreads stabilise as curve shape normalises

The last month has seen relative stability in Turkish dollar bond spreads, with much of the positive economic news from consistent orthodox policy now priced in. Spread levels have compressed down to now offer only a modest pickup of around 30bp over the BB-rated sovereign average. While a potential further rating upgrade by Moody's at their next review, scheduled for 19 July, could be a positive catalyst, we expect the momentum for further spread tightening is softening, with most foreign investors shifting their attention to the local market for more interesting prospects. At the same time, the impact from tight monetary policy in driving de-dollarisation may be supportive for the currency but can also be seen in weaker demand from local investors for Turkish dollar bonds. In turn, this has driven a flattening of the Turkish Eurobond spread curve, with shorter-dated paper cheapening for the first time in a while after previously seeing persistent demand from local players.

ICE US\$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

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