Monitoring Turkey: More rate hikes needed to tame inflation

The Central Bank of Turkey's latest rate hike was significant and raises expectations for an even higher final policy rate. The Bank also announced a new strategy to unwind the FX-protected deposit scheme. These actions should lead banks to hike deposit rates. The risk of FX demand from locals in this process will be closely watched

The Central Bank of Turkey in Istanbul

Turkey at a glance

- Given the need for rebalancing to control inflation and reduce external imbalances, the CBT's recent move to raise interest rates to 25%, which is likely to impact deposit and loan rates, is an important step towards tightening financial conditions and controlling domestic demand.
- In addition to monetary policy tightening, policymakers also rely on macro-prudential tools to restrict domestic demand, and we have seen limitations on loan growth and adjustments to the risk weights of retail loans.
- With the deterioration in pricing behaviour, currency weakness, the widespread increase in wages and tax adjustments and markedly negative real policy rate, inflation will likely remain under pressure in the near term.

- The improvement in the current account deficit in June was mainly attributable to the foreign trade deficit, which was significantly below last year's level with the help of a lower energy bill.
- The CBT's FX reserves have significantly increased over June and July. While there has been a slowdown in the reserve build-up since the second half of July, the latest data after the August hike shows a relatively strong rise again.

Quarterly forecasts

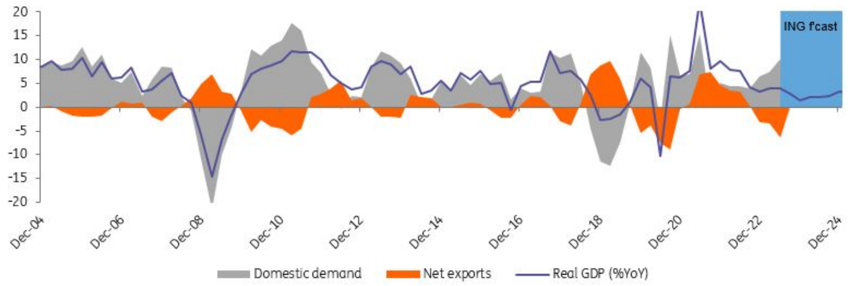
	2Q23	3Q23F	4Q23F	1Q24F	2Q24F	3Q24F	4Q24F	1Q25F
Real GDP (%YoY)	3.8	2.8	1.5	2.0	2.2	2.4	3.2	2.9
CPI (eop, %YoY)	38.2	59.9	66.2	61.2	63.8	42.6	40.0	35.7
Central bank key rate (eop, %)	15.00	27.50	35.00	35.00	35.00	35.00	35.00	30.00
3m interest rate (eop, %)	21.22	33.50	38.66	37.83	37.48	35.75	35.42	31.59
10yr yield (eop, %)	16.79	20.51	26.08	27.44	27.72	27.70	27.00	25.23
USD/TRY exchange rate (eop)	26.05	27.00	30.00	31.19	32.56	34.16	36.00	37.24
EUR/TRY exchange rate (eop)	28.43	29.70	33.90	36.18	38.10	40.30	42.12	43.20

Source: Various sources, ING

Strong economic activity in 2Q

GDP growth in the second quarter of 2023 (at 3.8% on an annual basis) came in stronger than the consensus. This was due to buoyant consumption and robust investment, as domestic demand rapidly recovered after February's earthquakes thanks to the supportive policy stance ahead of May's elections. Government spending has remained strong, reflected in the continuing expansion of primary expenditures. Net exports, on the other hand, have continued to be a drag, while the inventory drawdown, which includes statistical errors, detracted 2.5ppt. Second quarter GDP translates into a quarter-on-quarter growth rate of 3.5% after seasonal adjustments, showing a significant gain in momentum in comparison to the 0.1% drop (revised from 0.3%) seen in the first quarter. Leading indicators for the third quarter signal that the economy is on a rebalancing path with ongoing tightening in monetary policy and credit conditions, though the risks to our 2023 growth forecast at 3% are on the upside as evidenced by strong momentum in the second quarter.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

IP acceleration in June

Industrial production in June posted a 0.64% year-on-year increase on a calendar-adjusted basis, while in seasonally-adjusted terms, it rose by 1.55% month-on-month, pulling the index up to another peak. Accordingly, the performance in the second quarter has strengthened to 2.3% quarter-on-quarter, showing strong activity thanks to the support provided to the quake regions and robust domestic demand from loose policies. In the breakdown, intermediate goods provided the strongest contribution to the headline rate, at 0.9ppt, a 2.2% sequential increase. This was followed by nondurable consumer goods, which pulled the headline rate up by another 0.5ppt. On the negative side, durable goods dragged the rate down by 0.1ppt. In terms of sectors, computer products, basic metals, non-metallic minerals and food were the major supportive items for the monthly performance. Early indicators for the third quarter point to a gradual slowdown as: i) August economic confidence plunged to the lowest level since mid-2022, due in particular to the plunge in consumer confidence ii) the PMI has remained below the 50 threshold in the third quarter, and iii) the capacity utilisation rate moderated in August.

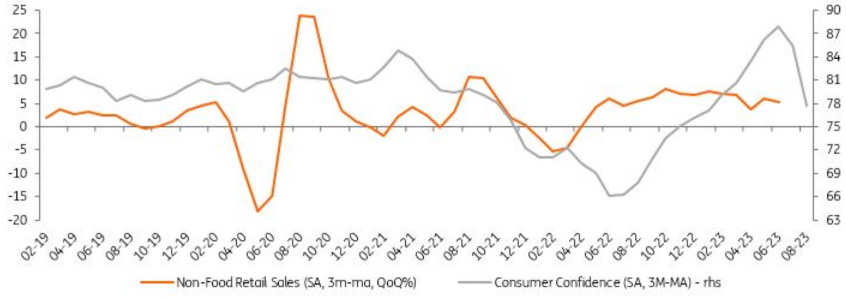
IP vs PMI

Source: Markit, TurkStat, ING

Retail sales point to strong consumption demand

According to the June data, retail sales volumes on a calendar-adjusted basis increased by 28.5% YoY, while the seasonally- and calendar-adjusted index dropped by a mere 0.1% MoM. However, growth in 2Q has remained strong with a 5.2% QoQ increase (vs 6.9% in 1Q). This implies strong private consumption as confirmed by the 2Q GDP release on the back of higher lending, real TRY appreciation and elevated inflation expectations. In the breakdown, non-food sales (excluding automotive fuel) fell 1.3% MoM, which was the major driver of a sequential decline in June retail trade despite a healthy 2.3% MoM growth in the food group. Automotive fuel sales fell by 0.1% MoM. On the other hand, the (seasonally-adjusted) unemployment rate inched up to 9.6% in June from 9.5% a month ago, which was the lowest rate since early 2014. Supplementary indicators for the labour force have deteriorated, with the composite measure of labour underutilisation at the highest point in the last two years. Strains are likely ahead with the expected rebalancing and slowdown in activity.

Retail sales vs consumer confidence

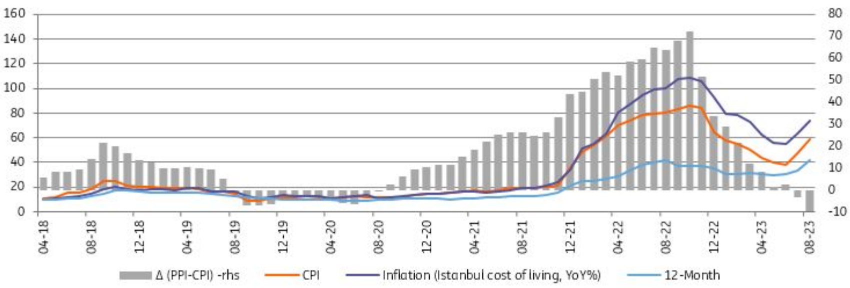


Source: TurkStat, ING

Inflation surges in August

Inflation came in at 9.1% MoM in August, higher than the consensus (7.0% MoM) and the highest August figure in the current inflation series. The jump in inflation was driven by both food and non-food prices, despite a supportive base, as the average August inflation rate in the 2003-based index is 0.5% and 2022 August inflation was at 1.5%. Core inflation (CPI-C) came in at 8.9% MoM, rising to 64.8% on an annual basis, attributable to exchange rate developments, administered price hikes and a rise in commodity prices. Durable goods prices rose by 7.8% MoM, while core goods inflation increased to 52.0% YoY. The underlying trend (as measured by the three-month moving average, annualised percentage change, based on seasonally adjusted series) for all inflation indicators, which markedly increased in July, accelerated further in August. After a sharp increase in June and July, the PPI has also remained on a rapid upswing with a monthly reading of 5.9%, reflecting a significant jump in the Turkish lira equivalent of import prices due to commodity and exchange rate increases. The data implies that cost pressures have gained strength again.

Inflation outlook (%)

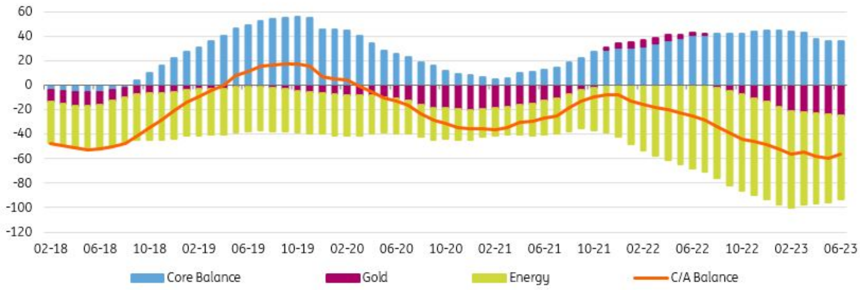


Source: TurkStat, ING

Drop in annual current account deficit

After a long and increasing trend in the 12M rolling deficit, we saw a recovery in June to US$56.5bn (translating into 5.8% of GDP) from US$59.7bn a month ago. This is attributable to the monthly deficit last year turning to surplus this year at US$0.7bn. This is slightly better than the consensus. A quick glance at the June data points to a similar performance in core trade, services and primary income with respect to the same month of 2022. The lower energy bill, thanks to a drop in oil prices, has driven the improvement in the current account despite a higher gold deficit. The capital account, meanwhile, witnessed net inflows at US$5.0bn. With the monthly current account deficit and large inflows via net errors and omissions at US$5.5bn, official reserves recorded a jump of US$11.2bn. However, given the weakness in the flows, reserves financed three-quarters of the current account deficit in the first half of this year.

Current account (12M rolling, US$bn)

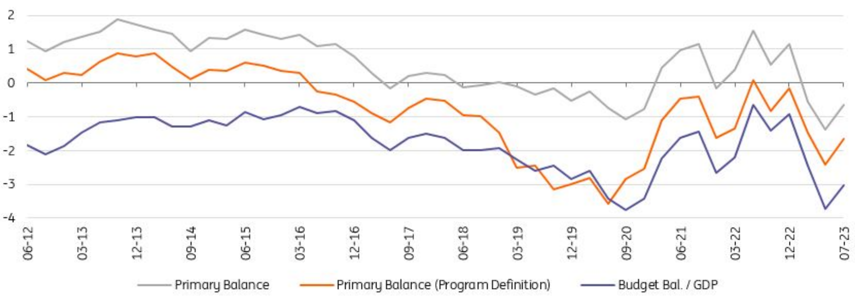


Source: CBT, ING

Improvement in July budget data

In July, the budget posted a surplus of TRY48.6bn, up from a TRY64.0bn deficit in the same month of last year, while the deficit for the last 12 months stood at TRY603.3bn (3.0% of GDP). According to the primary balance realisation (as defined by the IMF) which excludes one-off revenues, the 12-month rolling primary deficit was at 2.4% of GDP (4.8% if interest expenses are included). The July budget results reflected an improvement compared to the same month of last year due to the significant increase in direct and indirect taxes, large collections from the recent tax restructuring, and limited increase in non-interest expenditures due to the slowdown in current transfers and transfers to SEEs. After the supplementary budget passed in parliament after the May elections, revenues and expenditures increased to TRY4.93tn and TRY5.59tn, respectively, while the budget deficit forecast remained unchanged.

Budget performance (% of GDP)

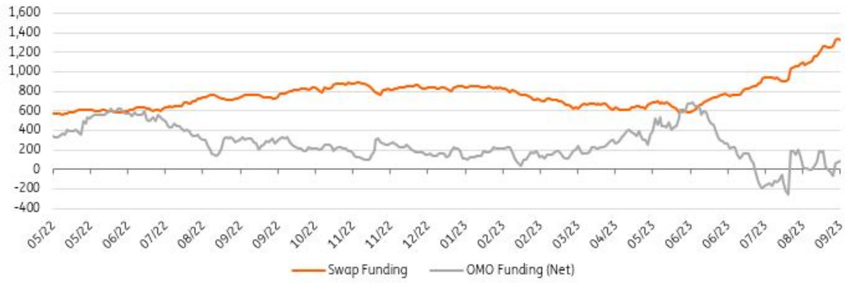


Source: Ministry of Treasury and Finance, ING

CBT surprised in August rate setting meeting

Turkey's central bank hiked interest rates by more than expected in August to 25%, up from 17.5% previously. The forward guidance related to monetary policy tightening remains unchanged. This suggests that the hike is attributable to the recent appointment of three new Monetary Policy Committee members. In the note explaining the rate decision, the CBT acknowledged the inflationary pressures by pointing out that the increase in the underlying trend was attributable to "the strong course of domestic demand, cost pressures stemming from wages and exchange rates, stickiness of services inflation and tax regulations". The bank foresees that inflation can reach the upper band of its end-of-year inflation forecast in 2023 of 62%, not only because of the above mentioned factors but also due to the recent rise in oil prices, significant deterioration in inflation expectations and pricing behaviour. Therefore, a further deterioration in the inflation outlook was the key reason for the CBT to respond forcefully.

Central bank funding



Source: CBT, ING

Details of Medium Term Plan (2024-2026)

The newly-released Medium Term Plan (MTP) for 2024-2026 targeted a stable growth environment and reduced inflation via a tight monetary stance, fiscal discipline and structural transformation. Having more realistic figures, the plan revised growth forecasts down from 5-5.5% last year to the 4-4.5% range, implying a slower rebalancing path, while the budget deficit remained significantly wide (at 6.4% of GDP this year and next) due to earthquake spending. On the external front, imbalances are assumed to improve gradually with a slow decline in the current account deficit to 3.1% next year and 2.6% in 2025 from 4.0% this year. This signals significant external financing needs through the programme's horizon. Accordingly, the programme envisages higher nominal exchange rate projections, which are at 23.9 in 2023 and at 36.8 in 2024, implying a 54% annual increase in the average USD/TRY. Despite the elevated currency, the MTP sees a significant improvement in inflation, falling to 33% next year from 65% at end-2023. This is higher than the upper band of the CBT's forecast range in the latest inflation report and will require a continuation of the tight monetary stance. We expect the policy rate to be 35% at the end of this year and to remain flat next year, though the risks to the rates profile are on the upside.

MTP Projections

		NEW MTP		
MACRO ASSUMPTIONS	2023E	2024F	2025F	2026F
GDP growth (%)	4.4	4.0	4.5	5.0
Unemployment Rate (%)	10.1	10.3	9.9	9.3
Inflation (%)	65.0	33.0	15.2	8.5
C/A Balance (US$ bn)	-42.5	-34.7	-31.7	-30.0
C/A Balance (% GDP)	-4.0	-3.1	-2.6	-2.3
Cent Adm Budget Balance (% of GDP)	-6.4	-6.4	-3.4	-2.9
Cent Adm Primary Balance (% of GDP)	-3.9	-3.4	0.0	0.7
EU Defined Public Debt Stock	33.3	35.2	34.6	33.2

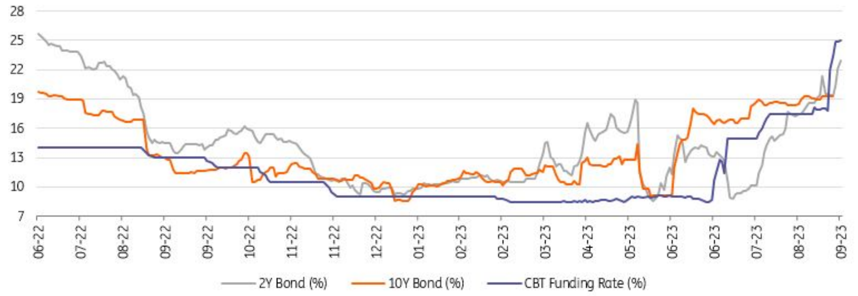
Source: Various sources, ING

FX and rates outlook

While the surprise hike from the CBT last month has supported the TRY in recent days, it is not enough given the inflation outlook, with a broad-based deterioration in price dynamics. On the balance of payments side, the expectation is that the 12M rolling deficit will likely narrow given that TRY weakness after the elections, a gradual tightening in monetary and fiscal policies, and measures to limit the growth rate of retail loans may all reduce domestic demand and lead to a slowdown in import growth. However, the outlook has remained challenging given the ongoing slowdown in Europe and the rest of the world.

In its August rate-setting statement, the CBT signalled again that it will continue with rate hikes and quantitative tightening steps. The bank also revised security maintenance requirements with a new objective of phasing out the FX-protected deposit scheme which has supported bond yields lately, even though buying auctions have ceased (the share of government securities on the balance sheet is on the decline). Going forward, rising inflation challenges and the gradualist stance of the CBT imply the real policy rate will remain deeply negative.

10Y local bond vs FX basket



Source: Refinitiv, ING

Further supply could halt the eurobond rally

Further positive news on the policy direction in Turkey recently has driven a steady grind tighter in USD bond spreads. The surprise rate hike in August, along with recent comments from President Erdogan about the need for tight monetary policy added to investor optimism - as usual aided by strong technical drivers from light real-money positioning.

However, in this context, the average spread on Turkey's sovereign dollar bonds at around 350bp is hovering near its five-year minimum, also seeing significant outperformance versus most BB and single B-rated peers. With the primary market reopening for EM issuers (including already seeing two deals for Turkish banks this week) and expectations of further supply from Turkey, including the sovereign itself, the march lower in credit spreads could pause in the coming weeks.

ICE US$ Bond Sub-Index Spreads vs USTs

Source: Refinitiv, ING

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