Monitoring Turkey: Prudent and data-dependent central bank

Due to a favourable inflation outlook, increasing signs of an economic slowdown, and early indications of an easing cycle, the Central Bank of Turkey reduced the policy rate in December. It stressed that future rate cuts would be data-dependent, cautious, and not continuous

Turkey's economy: at a glance

- In December, it was announced that a 30% increase in the minimum wage, lower than expected, would take effect from 1 January 2025. This is projected to add a measured 1ppt to headline inflation. Additionally, the number of planned MPC meetings for 2025 has been reduced from 12 to eight, suggesting larger rate cuts per meeting. This contributed to a significant 250bp cut last month. We anticipate the Central Bank of Turkey (CBT) will continue with another 250bp cut this month.

- The food group was the reason for lower-than-expected inflation in December after a strong contribution in the previous two months, while the downtrend in annual inflation has remained in place. The underlying inflation trend may show a temporary increase in the coming few months despite measured adjustments in the minimum wage and the special consumption tax on fuel supportive of the current disinflation trend. However, disinflation will likely continue this year, given the CBT's signal that it will maintain its tight stance despite the start of interest rate cuts, the ongoing real TRY appreciation and improvement in services inflation.

- Balance of payments dynamics improved significantly last year thanks to resilient exports despite significant real TRY appreciation and contracting imports driven by lower gold and energy deficit, although the impact of monetary policy tightening on consumption goods imports has remained limited so far. The current account deficit likely remained below US$10bn at the end of 2024, while the impact of the CBT actions on the balancing of demand factors will continue to be supportive for the current account this year.

- The Banking Regulation and Supervision Agency (BRSA) abolished the implementation of 200% risk weights on commercial credits, which will have a positive impact on the capital adequacy ratio (CAR) and support the commercial credit supply of banks by relaxing the Risk Weighted Asset amounts. The BRSA also decided that the exchange rate to be used in CAR calculation is revised, likely with a negative impact on the ratio. But it is hard to see an acceleration in lending, given the monthly growth restrictions. This is a move to support normalisation in the regulations and provide support to CARs.

- The CBT also revised monthly growth caps by raising the limit on SME lending to 2.5% (from 2%) and cutting limits on FX lending to 1% (from 1.5%) and other TRY commercial loans to 1.5% (from 2%). While differentiating SME loans (having 21.4% in TRY loans) from other TRY commercial loans (with 54.7% share) will provide relief to SMEs in accessing financing from the banking sector, other tightening adjustments target loan growth and composition to be in line with the disinflation path envisaged for 2025.

- To support the reduction in the KKM balance, the CBT has implemented measures to make KKM less attractive, thereby accelerating its decline. The CBT appears confident in the stability of the Turkish lira despite the beginning of the easing cycle this month and is prepared to use some reserves if necessary, as it has not been focusing on reserve accumulation recently.

Quarterly forecasts

	3Q24	4Q24	1Q25F	2Q25F	3Q25F	4Q25F	1Q26F	2Q26F
Real GDP (%YoY)	2.1	1.9	0.4	2.3	3.6	3.7	4.5	4.3
CPI (eop, %YoY)	49.4	44.4	35.4	31.2	26.3	25.4	22.8	20.7
Central bank key rate (eop, %)	50.00	47.50	42.50	37.50	32.50	27.50	25.50	23.50
3m interest rate (eop, %)	48.88	46.19	42.37	38.17	32.92	28.94	25.93	25.04
10yr yield (eop, %)	28.40	29.31	28.36	25.23	22.26	21.20	19.12	18.91
USD/TRY exchange rate (eop)	34.16	35.34	36.85	38.61	40.65	43.00	45.17	47.03
EUR/TRY exchange rate (eop)	38.00	36.59	38.33	40.16	42.27	43.86	45.62	47.98

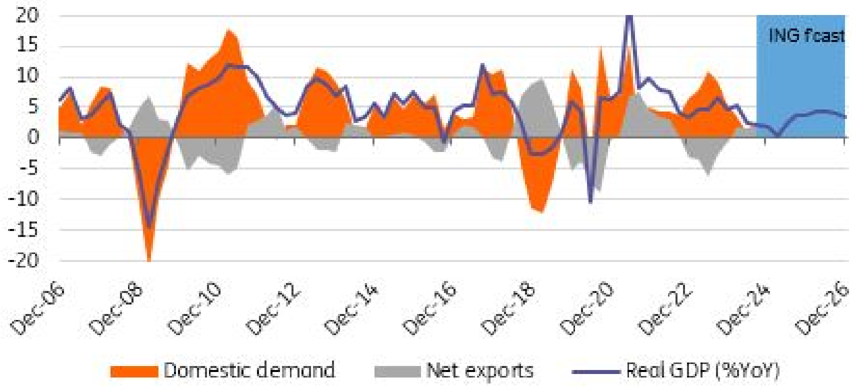
Source: Various sources, ING

Signals of recovery in the fourth quarter of 2024

The Turkish economy lost momentum in the third quarter pushing it into a technical recession. Given this backdrop and looking at the output gap indicators, the CBT thinks that demand will continue to slow, reaching disinflationary levels. The rebalancing in domestic demand, driven by tight monetary policy, and the output gap that will remain negative will be important components of the disinflation process.

On the flip side, recent leading indicators for the fourth quarter of last year point to some recovery compared to the third quarter. Consumer confidence posted a significant increase, averaging 80.5 in the fourth quarter, compared to 76.8 in 3Q, while all fourth quarter sectoral confidence indices' averages stand above their 3Q averages. The CBT's survey data for manufacturing firms also indicate an increase in domestic market orders in the fourth quarter.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

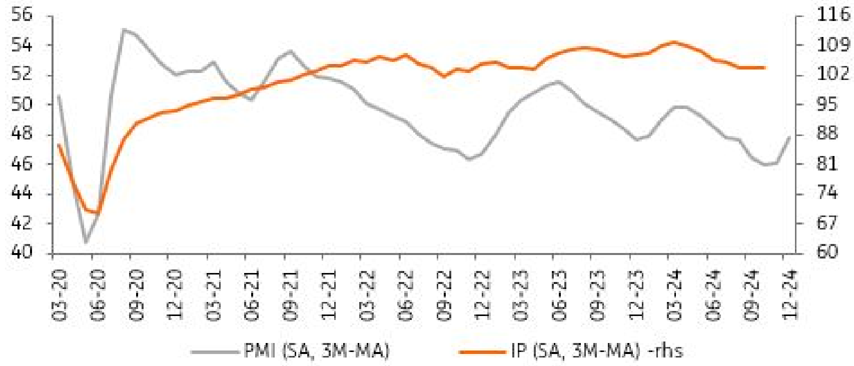
PMI rose further in December

The manufacturing PMI index increased to 49.1 in December from 48.3 in the previous month, though remaining below the threshold value for the last nine months. In the PMI, values below 50 indicate a contraction in manufacturing production compared to its potential, while values above 50 indicate growth.

The December data showed that the pace of slowdown in the manufacturing sector was the lowest in the last eight months and very moderate. The third quarter average was 46.4, the weakest quarter of 2024. The final quarter's average, on the other hand, was 47.7, indicating a recovery compared to the previous quarter.

A continuation of this can lead the sector to growth in 2025. The monthly improvement is attributable to output, new orders, purchasing, and inventories moderating to much lesser extents than in November, though employment was scaled back after a rise.

IP vs PMI



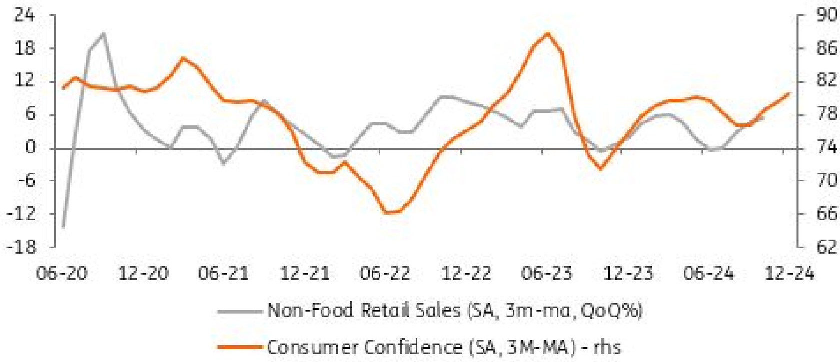
Source: ICI, TurkStat, ING

Moderate increase in October retail sales

October retail sales volume recorded a moderate 0.2% sequential increase after above 2% growth rates in the previous two months. It recorded a slight month-on-month decline when food was excluded. On the flip side, the services production index posted a limited increase of 0.2% MoM in October, showing a moderation in comparison to September driven by real estate activities and the information and communication sector.

In the labour market, the seasonally adjusted unemployment rate stood at 8.8% up from 8.7% a month previous. Labour force participation and employment rates are at historically high levels of 54.7% and 49.9%, respectively. The composite measure of labour underutilisation, which is the sum of time-related underemployment, unemployment, and potential labour force, jumped by 1.9ppt and turned out at 27.6% vs an all-time high level of 29.2% in June 2024.

Retail sales vs consumer confidence



Source: TurkStat, ING

Disinflation continues with benign food prices

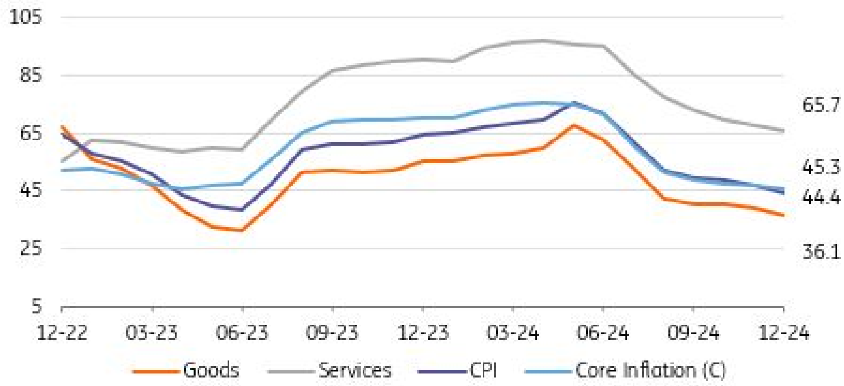
With monthly inflation at 1.0% MoM which was below consensus (at 1.6%) and our call (at 1.4%), annual inflation in 2024 turned out to be 44.4% YoY (vs the CBT forecast in the latest inflation report at 44%) with a drop from 47.1% the previous month.

Although there was a 2.9% increase in December 2023, the average increase for December over the past 10 years, based on the 2003 index, was 1.0%. This indicates a favourable base effect for this year.

Core inflation (CPI-C) came in at 1.1% MoM, the lowest monthly reading since the second half of 2021, moving down to 45.3% on an annual basis, supported by the relatively slow-moving FX basket and increasingly benign PPI outlook.

Going forward, pricing behaviour and inertia in services have remained key risk factors for the pace of the current disinflation process. The underlying trend, which the CBT monitors closely, seems to have improved significantly in December for the headline and core inflation.

Inflation outlook (YoY%)



Source: TurkStat, ING

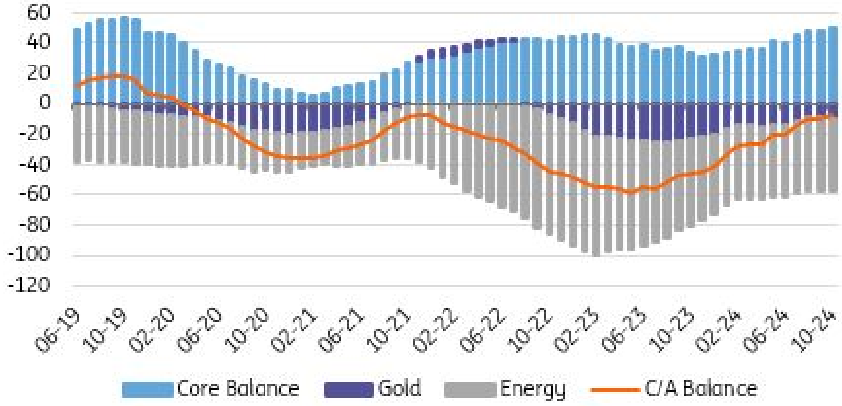
Continuing improvement in external imbalances

The October current account balance posted a US$1.9bn surplus, higher than the market consensus (at $1.3bn) and our call ($1bn). Given that it was well above the level realised in the same month of 2023, a 12M rolling deficit that has maintained a narrowing trend to $7.7bn (translating into c. 0.6% of GDP), from $9.5bn a month ago was the lowest reading since mid-2020.

The capital account, which turned positive in September after outflows in August, continued to show inflows of $3.2bn. With a strong monthly current account surplus, a positive capital account, and minor outflows in net errors and omissions amounting to $-0.2bn, official reserves expanded by $4.9bn in October.

In the breakdown of monthly data, residents' movements including outward FDI, financial assets held abroad and so on posted $8.2bn outflows. Non-resident flows, on the other hand, strengthened further with $11.4bn.

Current account (12M rolling, US$bn)



Source: CBT, ING

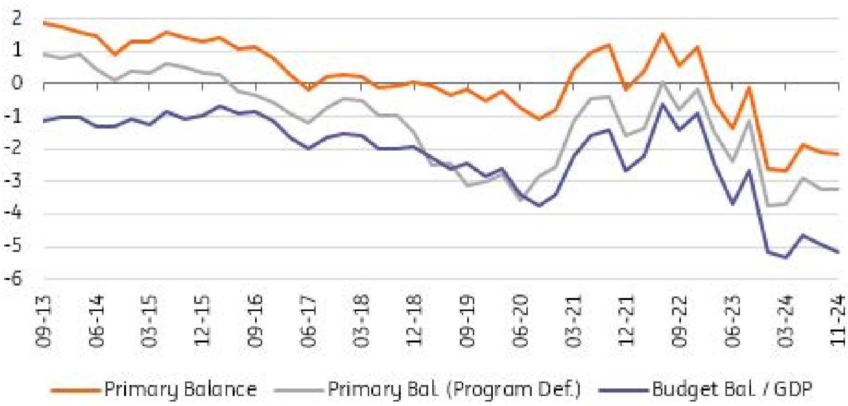
Budget deficit widened in November

The November budget turned to a deficit from a large surplus last year. The deterioration is attributable to sluggish revenue collection as tax collections slowed down significantly, driven by a significant weakening in corporate tax, one of the direct taxes, and a limited increase in special consumption tax, among indirect taxes. Plus a continuing strong real growth in interest expenses.

Accordingly, the ratio of budget deficit to GDP on a 12M rolling basis stood at 5.2% (primary balance at 2.1% deficit). But excluding one-offs, the primary balance is at a 3.2% deficit (and the total deficit at -6.2%).

The Government recently announced a few actions including an increase in withholding tax collected from dividends, the introduction of a tax for e-commerce transactions, and a more than 40% adjustment in some administrative fines. These suggest the government is taking steps towards achieving a 3% budget deficit target for 2025.

Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

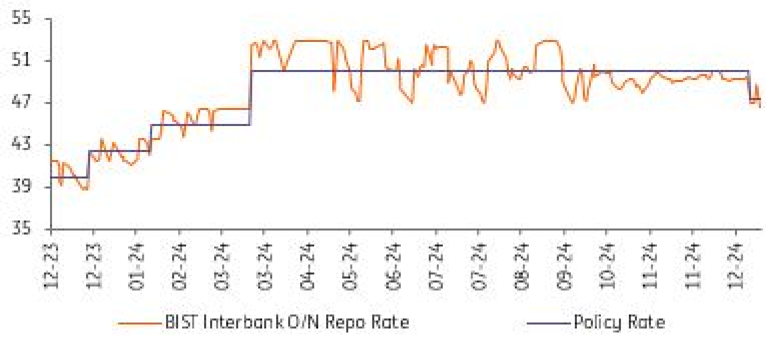
CBT cut the policy rate and narrowed the corridor in December

At the final MPC meeting of the year, the Central Bank of Turkey initiated an easing cycle as expected and cut the policy rate by 250bp to 57.5%, though expectations related to the size of the cut varied between 100bp and 250bp. Additionally, the CBT narrowed the interest corridor from 600bp to 300bp (by setting ON borrowing and lending rates 150bp below and above the policy rate), returning to the width before the March 2024 meeting.

Given excess liquidity in the system, creating downward pressure in ON rates being sterilised by the CBT through net open market operations (OMO), and sell-side TL currency/gold swap auctions (reverse swap), the narrower corridor will reduce the volatility in ON rates and push closer to the policy rate.

The CBT also released a relatively hawkish message and stated that it would take its decisions “prudently on a meeting-by-meeting basis with a focus on the inflation outlook”. While implying a continuation of interest rate cuts in the period ahead, the addition to forward guidance shows that the cuts will depend on the data, but not be aggressive and uninterrupted.

The Policy Rate vs. Interbank O/N Rate



Source: CBT, Refinitiv, ING

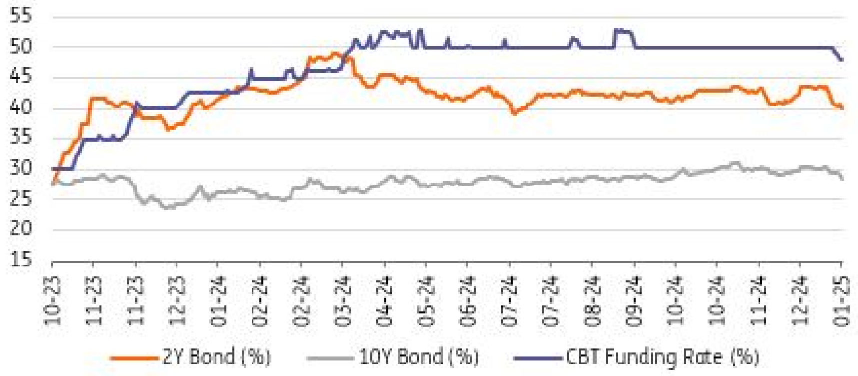
FX and rates outlook

The start of the cutting cycle in December did bring higher USD/TRY volatility but mainly to the downside with the CBT’s hawkish messages and narrower rate corridor. Since the beginning of the year, TRY has resumed its trend of nominal depreciation. However, the USD/TRY exchange rate has remained stable below the 35.400 level. Despite the onset of gradual FX carry deterioration, TRY continues to outperform other emerging market currencies.

Moreover, the central bank seems to be confidently in control of the situation with the credibility of the disinflationary process improving. Overall, we believe that TRY should remain the main carry trade in the EM space this year. We expect 36.85 USD/TRY for the end of the first quarter and 43.00 for the year-end.

Given the larger-than-consensus rate cut at the start of the CBT cutting cycle in December, it is not surprising that the market reacted by steepening the curve at a decent pace. At the same time, the measured minimum wage hike and fewer meetings suggest that CBT can afford to continue with a 250bp pace in January. Thus, we believe the market is still underestimating the cutting cycle, especially at the front of the OIS curve. At the same time, more attractive carry and falling inflation will increase the attractiveness of TURKGBs this year, in our view.

Local bond yields vs CBT funding rate



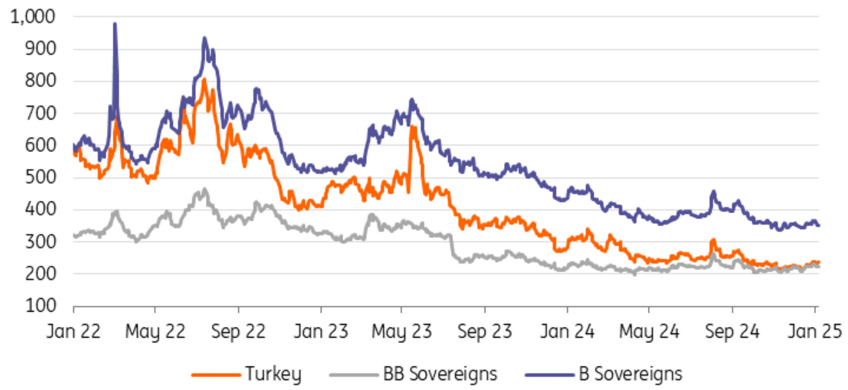
Source: CBT, Refinitiv, ING

Sovereign credit views

An improved BoP position and a strengthened external balance sheet are key positives for Turkey over the past year, offsetting modest fiscal pressures and driving fundamental improvement. We expect new sovereign supply is likely in the international market in the near term, with $11bn budgeted for the full year, leaving spread levels, in general, looking fairly tight at around the BB-sovereign average.

At the same time, we continue to see the most value in longer-dated sovereign paper, given the steepening in the dollar curve seen over the back end of last year. Geopolitics remains an area of uncertainty amid the recent developments in Syria and the Middle East.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

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