Monitoring Turkey: Inflation forecasts rise as cuts are set to continue

The Central Bank of Turkey has raised its inflation forecasts for 2025, citing factors beyond the control of monetary policy and bringing market inflation expectations back within its forecast range. CBT Governor Fatih Karahan has emphasised a cautious approach to rate cuts but is yet to indicate a move towards a slower pace of easing

Istanbul, Turkey

Turkey's economy at a glance

- In its first inflation report of this year, the CBT raised its inflation forecast again from 21% to 24%, while keeping its 2026 forecast unchanged at 12%. The revision for this year is attributable to a) an increase in the weight for services (0.8ppt), b) a revision in the projections for food inflation (to 24.5% from 22.5%, lifting the forecast by 0.5ppt) and c) administered price hikes (1.7ppt).
- During the Q&A session, CBT Governor Fatih Karahan stated that the bank sees some room for rate cuts due to the decline in inflation and inflation expectations. However, it will maintain a data-dependent approach, evaluating the underlying inflation trend, domestic demand indicators, and inflation expectations on a meeting-by-meeting basis.
- Regarding reserves that have shown significant increase since March last year, the governor

added that the CBT will continue to accumulate reserves depending on the market conditions and the disinflation path, though the pace of reserve accumulation will likely be slower.
- CPI recorded a strong monthly increase in January, mainly due to adjustments in services and administered prices, though it was broadly in line with the CBT expectations. Following the data and expected further impact of administrative price hikes in February's data, we now see year-end inflation at 27.0%.
- Given rising inflationary pressures in the near term, the CBT will likely maintain its strong focus on the exchange rate path and credit growth restrictions. Based on its communication, we expect another 250bp cut in March, and envisage the year-end inflation policy rate at 29%.
- Despite deterioration in the headline deficit in November, balance of payments (BoP) dynamics improved significantly last year as the non-energy c/a balance rose to a surplus of US$43.6bn, while core c/a balance (excluding energy and gold) reflecting the underlying trend recorded a US$54.4bn surplus. The 12-month rolling c/a deficit will likely be close to US$10bn at the end of 2024, while impact of the CBT's actions on the balancing of demand factors will remain supportive for the current account this year.
- In early February, the CBT raised the reserve requirement ratios from 8% to 12% for: a) funds from repo transactions originating abroad, b) loans obtained from abroad, and c) deposits/participation funds from foreign banks. This decision seems to absorb a relatively small portion of the excess liquidity in the system while the aim is likely to encourage banks to extend the tenor of external financing with a cost increase in the short term.

Quarterly forecasts

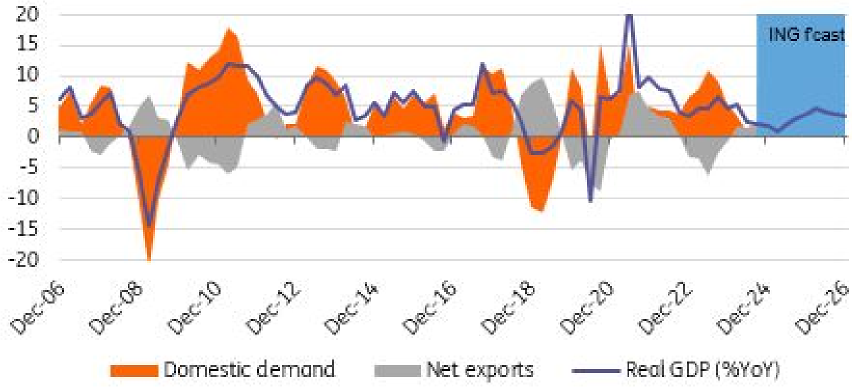
	3Q24	4Q24	1Q25F	2Q25F	3Q25F	4Q25F	1Q26F	2Q26F
Real GDP (%YoY)	2.1	2.0	0.9	2.2	3.1	3.8	4.7	4.2
CPI (eop, %YoY)	49.4	44.4	39.3	34.4	28.6	27.0	21.6	19.9
Central bank key rate (eop, %)	50.00	47.50	42.50	37.50	33.00	29.00	25.50	23.50
3m interest rate (eop, %)	48.88	46.19	42.51	37.44	32.49	29.49	26.16	23.76
10yr yield (eop, %)	28.40	29.31	28.17	24.42	22.31	21.17	19.58	18.48
USD/TRY exchange rate (eop)	34.16	35.34	36.53	38.10	40.20	43.00	45.17	47.03
EUR/TRY exchange rate (eop)	38.00	36.59	37.26	38.10	40.20	43.86	46.08	47.98

Source: Various sources, ING

Growth to remain sluggish in 2025

While sequential growth rates were negative in both the second and third quarters, leading to a technical recession, the weakness seen in the third was attributable to private consumption and government spending despite an unexpected recovery in investments and relatively healthy growth in exports. However, early indicators related to the last quarter of 2024 – including sentiment indicators, retail sales, etc. – imply sequential growth returning to positive territory. Still, January data, including capacity utilisation, real sector confidence, and consumer confidence, shows that the recovery will not last long. We expect the growth rate at 2.9% in 2024, potentially moderating further to 2.6% should a continuation of tight financial conditions weigh on private consumption.

Real GDP (%YoY) and contributions (ppt)



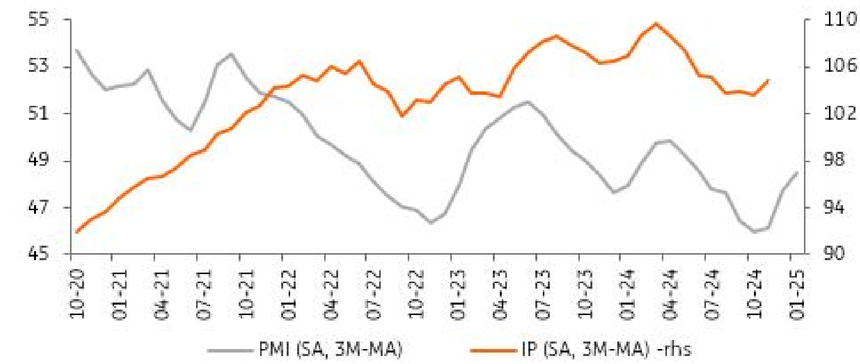
Source: TurkStat, ING

PMI recovery ceased in January

Turkey's manufacturing PMI index dropped to 48 in January despite picking up from 44.3 in September to 49.1 in December, and therefore remains in the contractionary territory it has been in for the last 10 months. In the breakdown, new orders, including total new business and new export orders, moderated. This implies that demand conditions have remained subdued.

While manufacturing production and employment were scaled back last month, inflationary pressures also strengthened, with an acceleration in both input and output costs. Findings in sector PMIs released by the Istanbul Chamber of Industry are also aligned with what the manufacturing PMI data suggests. Out of 10 sectors, all except food recorded PMI readings below the 50 threshold, implying continuing weakness in economic activity. New orders moderated across the board in January and inflationary pressures intensified, despite signs of easing in previous months.

IP vs PMI



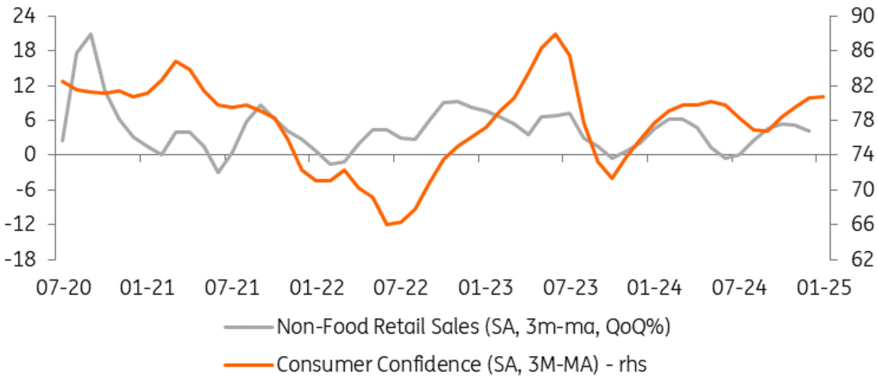
Source: ICI, TurkStat, ING

Retail sales are still strong

After a strong 1.9% month-on-month reading in November, December retail sales volume recorded another positive figure with 0.4% MoM. This indicates a strong 4.2% of growth in the fourth quarter compared to the third-quarter average, driven mainly by the non-food group, followed by food.

Retail sales volume on a calendar adjusted basis, on the other hand, rose by 13.5% YoY, and remained in double-digit territory. The data shows that retail sales as an indicator of domestic demand have remained elevated and reached historically high levels. However, according to the central bank, the overall trajectory of the retail sales volume index has been influenced by developments in the retail sales of watches and jewellery sub-sector, where the majority of turnover is driven by gold and gold products. The Bank has found that excluding this item helps better understand underlying consumption trends, which indicate that retail sales have remained flat since mid-2024.

Retail sales vs consumer confidence

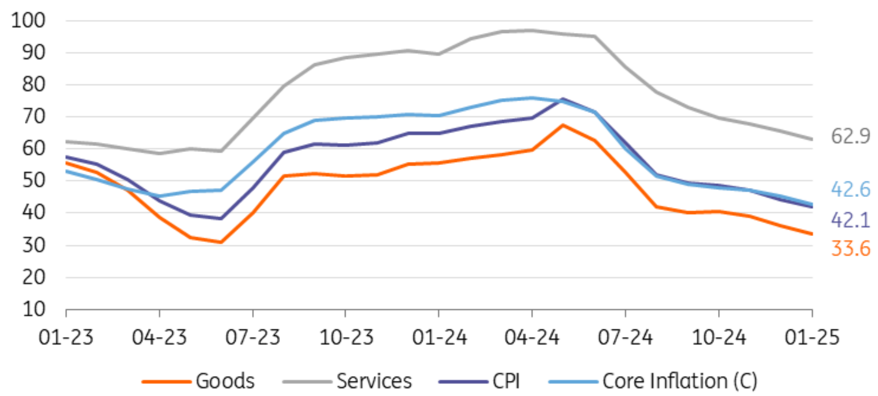


Source: TurkStat, ING

Services continue to weigh on headline inflation

In January, monthly inflation came in at 5%, significantly exceeding market expectations on the back of services prices – particularly health, rent, and education prices – despite recent MPC statements highlighting expectations of stronger coordination with fiscal policy. Energy and core inflation also recorded significant monthly increases. While there was a 6.7% rise in January 2024, the average for this calendar month (according to the 2003-based index for the last 10 years) was 3.5%, indicating that the base effect was favourable for this year. Accordingly, annual inflation maintained its downtrend, to 42.1% from 44.4% a month ago. It should also be noted that January inflation was largely in line with CBT projections released in the last inflation report of 2024, and in line with the MPC guidance that highlighted a rise in the underlying inflation trend.

Inflation outlook (YoY%)

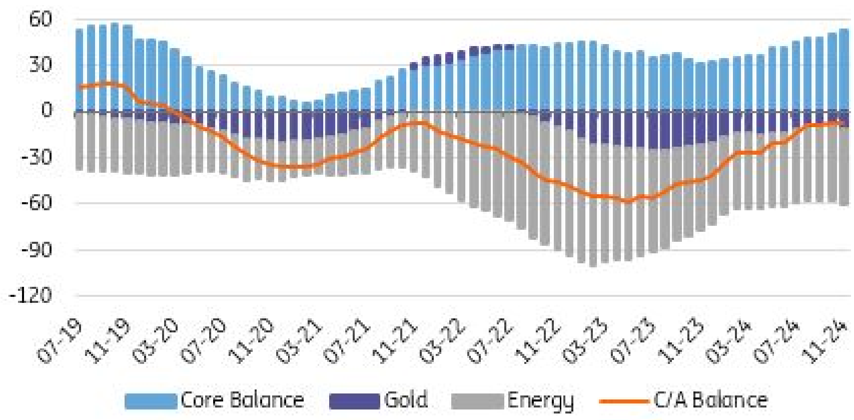


Source: TurkStat, ING

Annual c/a deficit slightly widened in November

Turkey's current account (c/a) balance – which had posted a better deficit figure than market consensus at US$2.9bn in November –showed a deterioration compared to the level realised in the same month of 2023 driven by foreign trade. Accordingly, the 12-month rolling deficit widened to US$7.4bn (translating into c. 0.6% of GDP) from US$7.1bn a month ago, which was the lowest reading since mid-2020. After a long improvement trend since mid-2023, the annual deficit is likely close to cyclical trough, in our view. The capital account, which was positive in September and October following outflows in August remained so with US$5.7bn inflows. With a positive capital account more than offsetting monthly current account deficit and outflows in net errors and omissions with US$-1.5bn, official reserves posted a US$1.3bn expansion in November.

Current account (12M rolling, US$bn)

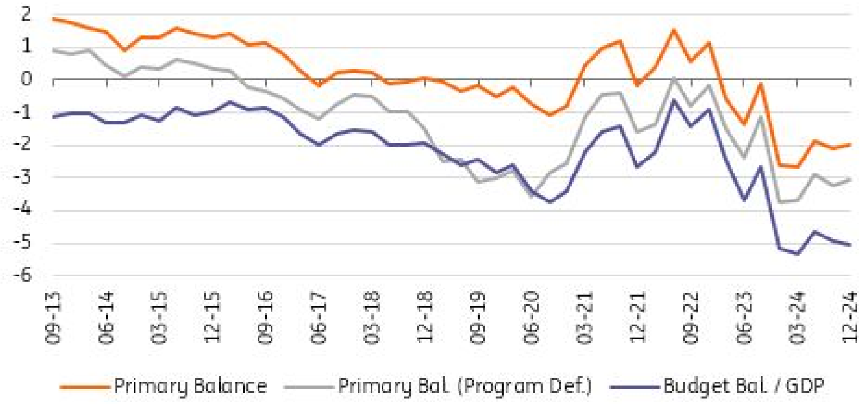


Source: CBT, ING

Budget deficit was high in 2024

In Turkey's 2024 budget, the real increase in revenues is favourable from a fiscal discipline perspective. In the breakdown, we see a strong contribution from domestic activity, related indirectly to tax incomes. This is thanks to a real increase in VAT and oil and natural gas-related SCT, a significant impact from income tax and healthy non-tax revenues. Strong real growth in primary expenditures is attributable to earthquake spending, to some extent. Details of primary spending reveal marked real increases in personnel and social security expenditures. Finally, interest expenditures are skyrocketing in the current environment. Accordingly, the budget deficit to GDP ratio (excl. earthquake expenditures) deteriorated to 2.9% in 2024 (below 5% in the headline rate) from 1.8% in 2023. The headline primary balance was also on the deficit at roughly 2% of GDP.

Budget performance (% of GDP)

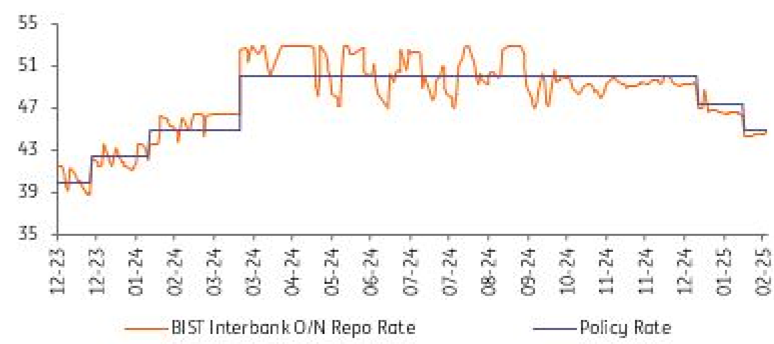


Source: Ministry of Treasury and Finance, ING

CBT delivers expected 250bp rate cut in January

At its first MPC meeting of the year, the CBT – after initiating its easing cycle in December – continued with another rate cut by 250bp, pulling the policy rate to 45% as expected. The statement noted the decline in the underlying trend in December, though highlighted a temporary rise in January. After negative surprises between September and November, the underlying trend, which the CBT monitors closely, seems to have improved significantly in December for both headline and core inflation in a downside surprise. Inflation expectations also improved markedly in January as: a) 12 and 24-month inflation expectations declined by 1.7ppt and 0.8ppt to 25.4% and 17.7% respectively, b) the end-2025 inflation forecast remained broadly unchanged at 27.07% vs the CBT's upper forecast band at 26%, c) 12-month inflation expectations for households and firms have been on a downward path since the second half of 2024, though well above the CBT's forecast range of 63.1% and 47.6%. This backdrop contributed to the rate cut decision last month.

The Policy Rate vs. Interbank O/N Rate



Source: CBT, Refinitiv, ING

FX and rates outlook

As expected, the Turkish lira has returned to its usual pace of nominal depreciation after some volatility before the end of the year. TRY long positioning remains severely overcrowded. While the forward market can boost a shrinking carry in some cases, given the market uncertainty we see the spot market as a safer place with the possibility of a smooth exit should any problems arise.

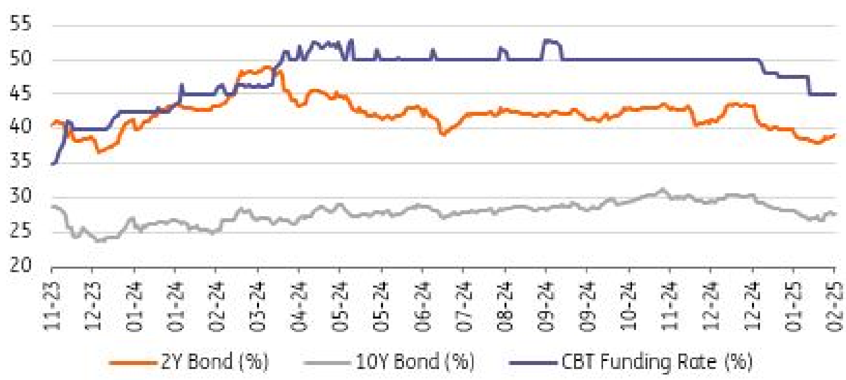
Despite the onset of gradual FX carry deterioration, TRY continues to outperform other emerging market currencies. We believe that, at least in the coming months, FX should behave well given some upside in recent inflation prints. This should push the central bank towards a more cautious stance, maintaining its usual trajectory of nominal appreciation. For the end of this year's first quarter, we expect USD/TRY at 36.53, and 43.00 at the end of this year.

TURKGBs saw strong inflows from abroad in the second and third quarters of 2024, with the share reaching 10% as of the end of last year. At the same time, we believe technicals should support further inflows into the bond market. The weight of TURKGBs in GBI-EM has been gradually increasing from 0.91% at the beginning of last year to 1.69% after the addition of Sep-29 in January. We believe Turkey's weight in the index will continue to grow, and on paper should head somewhere towards 5% based on the volume of eligible bonds for the index. This is likely to take a few years but should provide steady foreign inflows in the months ahead.

On the supply side, the Ministry of Finance covered year-to-date about 12% of this year's TURKGBs issuance, according to our calculations, and was met with decent demand in primary auctions, indicating a good start to the year. Still, February and March should see lower supply compared to January and we should only see higher supply in April.

On the valuations side, the January inflation print sparked a wave of profit-taking after the January rally. As expected, Friday's inflation report brought some tone adjustment on the hawkish side, deepening some outflows from the market. We think this brings us to the point where valuations are becoming attractive again with the long-end of the TURKGBs curve approaching the key rate level in our forecast for the end of this year. At the same time, the OIS ASW is coming into attractive ranges. We therefore believe that TURGBs will offer value again once the market stabilises after the current sell-off and the market gains more confidence in the disinflation process.

Local bond yields vs CBT funding rate

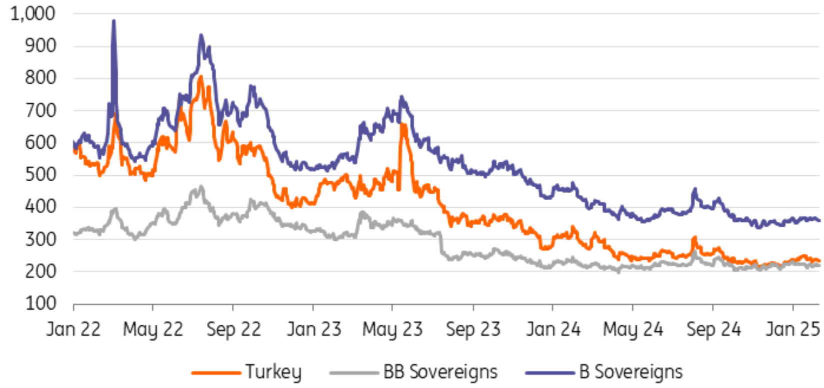


Source: CBT, Refinitiv, ING

Sovereign credit views

After some volatility over January, spread levels have generally squeezed tight towards the BB-sovereign average again for Turkey, leaving us with fairly limited room for a further rally in our view. In terms of fundamentals, the external sector improvement has continued, with net FX reserves comfortably in positive territory and the current account near balance. However, the inflation rate remains elevated and growth momentum sluggish. On the ratings side, we see the potential for more improvement, with Moody's likely catching up with Fitch and S&P in July at BB-/Ba3 (Moody's currently at B1, Positive), before stabilisation for now at the BB- level.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

Looking forward, the investor focus will be on fiscal consolidation and maintaining a cautious monetary policy stance, which should in turn support the disinflation process. Current spread levels seem fair given the improvement in fundamentals over the past year or so, while the flattening of the spread curve since the back end of last year means longer-dated maturities now look less attractive compared to the five-year bucket in particular. In terms of issuance, last week's $2.5bn deal made a decent start to the sovereign's $11bn Eurobond funding plan, but we expect more to come from both the sovereign and corporates in the country in the coming months.

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