Monitoring Turkey: Stronger fiscal policies will help the disinflation process

In the recently released medium-term plan (MTP), Turkey's Vice President Cevdet Yilmaz acknowledged a short-term trade-off between inflation and growth, and reiterated disinflation as the main policy focus

Antalya, Turkey

Turkey's economy: At a glance

- Vice President Yilmaz has pledged to continue coordinating monetary, fiscal and income policies to reduce inflation to single digits.
- The summer's current account surplus has led companies to seasonally boost their FX deposit accounts. Additionally, the accelerated exit from the FX-protected deposit scheme, driven by recent policy measures, has contributed to a rise in FX deposits. In response, the CBT has implemented a series of policy adjustments, aligning with its guidance to apply further tightening if necessary.
- These actions will likely push TRY deposit rates higher, limit conversion from FX-protected deposits to FX deposits and help sterilise excess liquidity in the system. Accordingly, we can see a supported TRY after depreciation at a faster pace in August.
- Economic activity has slowed, primarily due to domestic demand. However, private consumption, which has been the main growth driver in recent quarters, continued to grow

sequentially, reaching a new historical high.

- There have been signals of additional weakness in domestic demand since the end of the second quarter. Tightening financial conditions, slowing real wage growth and the likely increase in the unemployment rate point to a further slowdown in economic activity in the period ahead. We see 2.5% GDP growth in 2024 and 3% in 2025.
- Annual inflation has maintained a downtrend with an acceleration in the last two months with a supportive base despite administrative price adjustments and no respite from services.
- The downtrend will likely continue as the lagged effects of the monetary tightening on credit and domestic demand and the continued real appreciation of the Turkish lira are likely factors that will keep the underlying inflation trend on a downward path for the remainder of this year.
- There has been a series of upgrades in recent months. Fitch recently upgraded to BB- (three notches below the investment grade), though the outlook now is stable which likely signals further improvement in the macro outlook is required for additional upgrades.

Quarterly forecasts

	2Q24	3Q24F	4Q24F	1Q25F	2Q25F	3Q25F	4Q25F	1Q26F
Real GDP (%YoY)	2.5	2.1	0.6	0.3	2.9	3.8	4.4	4.6
CPI (eop, %YoY)	71.6	47.9	41.8	31.6	27.3	23.2	23.0	21.2
Central bank key rate (eop, %)	50.00	50.00	45.00	37.50	32.50	30.00	27.50	25.00
3m interest rate (eop, %)	49.79	46.64	40.89	37.47	33.31	31.07	28.73	25.46
10yr yield (eop, %)	28.28	27.25	23.38	20.49	18.91	18.02	17.12	16.73
USD/TRY exchange rate (eop)	32.65	34.58	37.00	39.17	41.03	42.63	44.00	45.50
EUR/TRY exchange rate (eop)	35.05	38.73	40.70	43.09	45.14	46.89	48.40	50.05

Source: Various sources, ING

The Government continues to prioritise disinflation

VP Yilmaz held a conference with the participation of Finance Minister Mehmet Simsek, Central Bank of Turkey (CBT) Governor Fatih Karahan, and relevant members of the Cabinet and presented details of the Medium Term Plan (MTP) for 2025-27, which includes the government's macroeconomic projections and outlines the main set of policies and reforms.

Yilmaz emphasised that disinflation remains the main policy focus while pledging continuing coordination between monetary, fiscal and income policies to reduce inflation to single digits over time.

According to the MTP, GDP growth forecasts were revised down for 2024-26, by 0.5pp each year. However, it should also be noted that the government sees growth accelerating between 2025 and 2027, from 4.0% in 2025 to 4.5% in 2026 and 5% in 2027, which is the same path in comparison to the previous MTP's forecast horizon (between 2024 and 2026).

The authorities' growth projection of 3.5% for this year looks more optimistic than the consensus (3.4%). We see economic activity further slowing from 3.8% in the first half of the year given the implications of a tighter macro policy mix and will be around 2.5% this year. We also believe that the official forecast path beyond 2024, which is more ambitious than the consensus view, will be challenging to achieve.

On the inflation side, the MTP sees that inflation, expected to be 41.5% at the end of this year (up from 33% in the previous plan) would be above the CBT's forecast of 38%, though remains in its 34-42% forecast range. The MTP also revised 2025 inflation to 17.5% (from 15.2%), while the central bank sees 14% in the latest inflation report with a forecast range of 7-21%. This revision likely increases the possibility of a similar upward revision in the CBT's forecast for end-25 with the release of this year's last inflation report in November.

In the fiscal sphere, the new programme forecasts the 2024 central government budget deficit at 4.9% of GDP (from 6.4% in the previous plan), which is broadly in line with Simsek's earlier guidance that they target a budget deficit-to-GDP ratio this year close to the level realised in 2023 (5.2%) or lower.

The MTP envisions 3.1% in 2025 and looks for a steady improvement thereafter with the deficit narrowing to 2.5% of GDP by the end of 2027. The government has signalled fiscal prudence as it plans to achieve budget targets for next year via spending cuts of as much as 1.5% of GDP and expanding tax income by 0.9% of GDP.

Simsek explicitly pointed out that fiscal policy would provide very strong support to disinflation, implying less reliance on inflationary administered price hikes and tax hikes. It should also be noted that the combination of subdued public investment (capital expenditures and capital transfers to decline by 0.7% and 1.15% of GDP respectively) and relatively strong current spending (up by 0.3%) in 2025 according to the MTP is not particularly desirable for the long-term growth outlook.

Finally, regarding USD/TRY assumptions derived from the MTP figures, Yilmaz highlighted that the USD/TRY assumptions in the MTP are based on the market participants' expectations for this year, while they relied on inflation differentials for the following years to assuming no real change in the value of the currency.

MTP projections

	NEW MTP				PREVIOUS MTP		
	2024E	2025F	2026F	2027F	2024F	2025F	2026F
GDP growth (%)	3.5	4.0	4.5	5.0	4.0	4.5	5.0
Unemployment Rate (%)	9.3	9.6	9.2	8.8	10.3	9.9	9.3
Inflation (%)	41.5	17.5	9.7	7.0	33.0	15.2	8.5
C/A Balance (US$ bn)	-22.0	-28.6	-25.6	-22.6	-34.7	-31.7	-30.0
C/A Balance (% GDP)	-1.7	-2.0	-1.6	-1.3	-3.1	-2.6	-2.3
Cent Adm Budget Balance (% of GDP)	-4.9	-3.1	-2.8	-2.5	-6.4	-3.4	-2.9
Cent Adm Primary Balance (% of GDP)	-1.9	0.0	0.3	0.6	-3.4	0.0	0.7
EU Defined Public Debt Stock	25.6	25.3	25.1	24.8	35.2	34.6	33.2
USD/TRY (avg) (implied)	33.2	42.0	44.4	46.9	42.6	44.6	45.7

Source: Presidency of Strategy and Budget

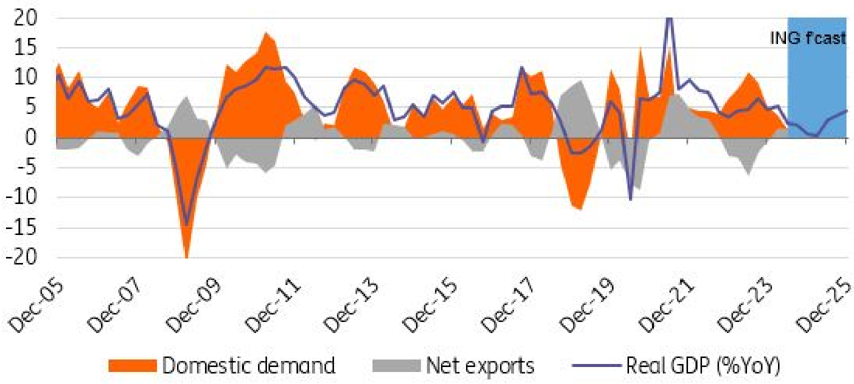
GDP growth loses momentum in the second quarter

Second-quarter GDP growth in Turkey was 2.5% on a year-on-year basis, well below the market consensus (3.2%) and our call (3.5%), largely driven by domestic demand.

The Turkish Statistical Institute also revised first-quarter GDP expansion to 5.3% from 5.7% and 2023 growth up to 5.1% from 4.5%. Accordingly, GDP growth in the first half of the year stood at 3.8% with downward forces in the second half of the year at play.

The second-quarter performance translates into a barely positive quarter-on-quarter growth rate of 0.1% after seasonal adjustments. This shows a significant momentum loss compared to a relatively modest reading in the first quarter of 1.4%. The decelerating sequential performance is attributable to the turning of investments and net exports to negative and the declining supportive impact of government spending.

Real GDP (%YoY) and contributions (ppt)



Source: TurkStat, ING

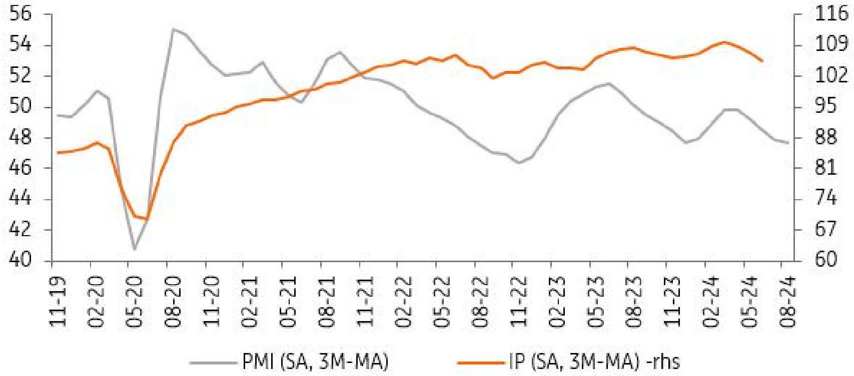
PMI remained below 50 in August

While the second-quarter GDP indicated a rebalancing with moderated domestic demand and a positive contribution from net exports, third-quarter indicators suggest a further decline in economic activity.

Accordingly, the manufacturing sector PMI that returned to contractionary territory in April posted another weak reading of 47.8 in August. This signals a continuation of subdued demand conditions with a further softening of new orders, though external demand was more positive as new export orders returned to growth for the first time since June 2023.

The challenging demand conditions led to the scaling back of operations and adversely affected employment decisions and purchasing activity. Findings in the sectoral PMIs on the other hand, released by the Istanbul Chamber of Industry, are also in line with what the manufacturing PMI data suggest. Out of 10 sectors, all have a PMI below the 50 threshold, implying increasing weakness in economic activity.

IP vs PMI



Source: ICI, TurkStat, ING

Unemployment rate jumped in June

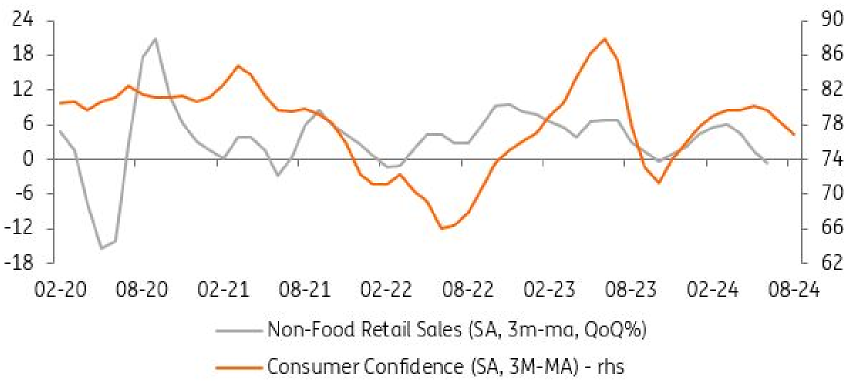
Sequential growth in retail sales, which turned negative after February, recorded a 1.7% month-over-month increase. Meanwhile, retail sales volume, adjusted for the calendar, rose by 8.6% year-over-year, though it has moderated in recent months.

The data show that after reaching historically high levels in the first quarter, retail sales as an indicator of domestic demand are stagnating. This is likely attributable to monetary tightening measures introduced by the CBT in recent months while we will likely see declines in the upcoming data given recent signals related to the cooling down in domestic demand.

Based on the seasonally adjusted results, the decline in employment in June was higher than the decline in labour force participation and pushed the headline unemployment rate significantly upwards, while the rise in broadly defined unemployment rates was even more pronounced.

The number of unemployed individuals aged 15 and over rose by 234,000 in June compared to the previous month, reaching 3.3 million. The unemployment rate increased by 0.7 percentage points to 9.2%, whereas May recorded the lowest rate since September 2012.

Retail sales vs consumer confidence



Source: TurkStat, ING

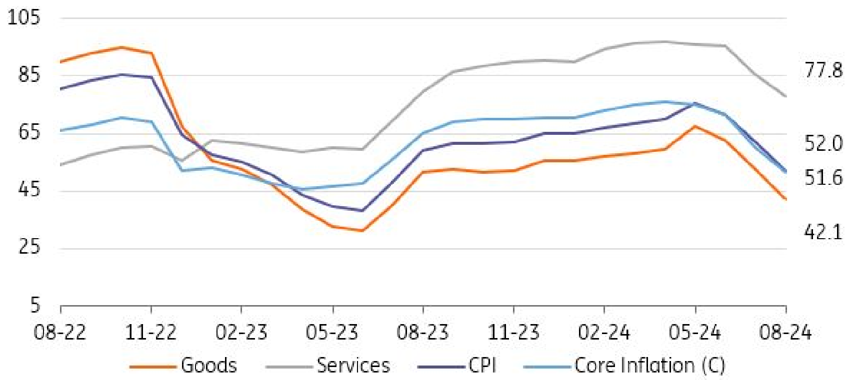
Inflation slows, but services remains an issue

With slightly better-than-expected August inflation at 2.47%, the annual figure continues to fall, to 52% from 61.8% in July. The significant drop in the headline figure is attributable to the large favourable base effect (as it was 9.09% in August 2023) associated with food and transportation despite adjustments in administered prices.

Cumulative inflation in the first eight months of this year, on the other hand, reached 31.8% vs the 38% CBT forecast for this year. Regarding the underlying trend, the Turkish central bank foresees a decline in seasonally adjusted monthly inflation to around 2.5% on average in the third quarter, and slightly below 1.5% in the last quarter of the year.

The August headline figure, on a seasonally adjusted basis, showed a month-on-month decline, mainly driven by the goods group (despite higher core goods), while services have remained elevated, showing no meaningful signs of improvement yet and confirming the challenges for the disinflation process.

Inflation outlook (YoY%)



Source: TurkStat, ING

Current account as expected in June

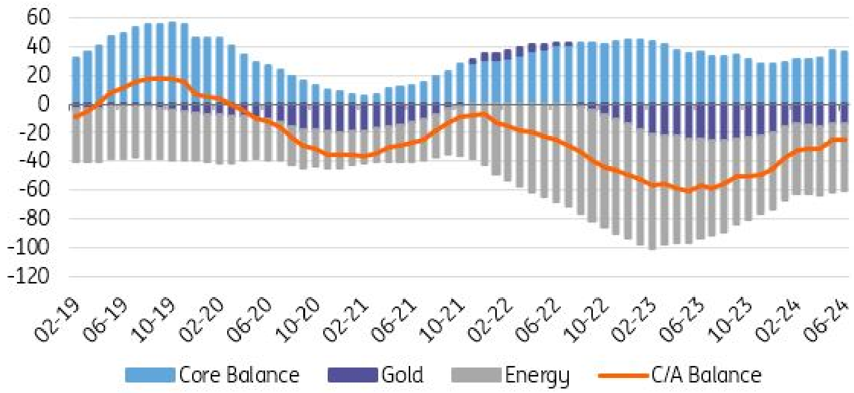
The current account balance in June was a US$0.4bn surplus, in line with expectations, though it was lower than the level realised in the same months of 2023. Accordingly, the 12M rolling deficit slightly deteriorated to $24.8bn (about 2.1% of GDP) from $24.5bn a month ago.

In the breakdown, compared with the same month of last year, we can see:

- A lower gold deficit of $0.5bn vs $1.1bn last year. Gold imports are on the decline after the local elections while the 12M rolling gold trade (net) has improved to the lowest level since end-2022 at $27.2bn.
- A flat energy bill at $3.2bn.
- The turning of core trade to the balance vs a $1.1bn surplus a year ago.
- Higher services income (including tourism revenues) at $5.6bn.
- A slight deterioration in primary and secondary income. The capital account that posted strong $14.4bn inflows in May recorded just $0.1bn of inflows in June, while unidentified flows stood at $0.8bn. With the monthly c/a surplus, official reserves posted a $1.2bn increase. In the breakdown of monthly data, residents' movements almost offset

non-resident inflows.

Current account (12M rolling, US$bn)



Source: TurkStat, CBT, ING

The budget deficit widened in July

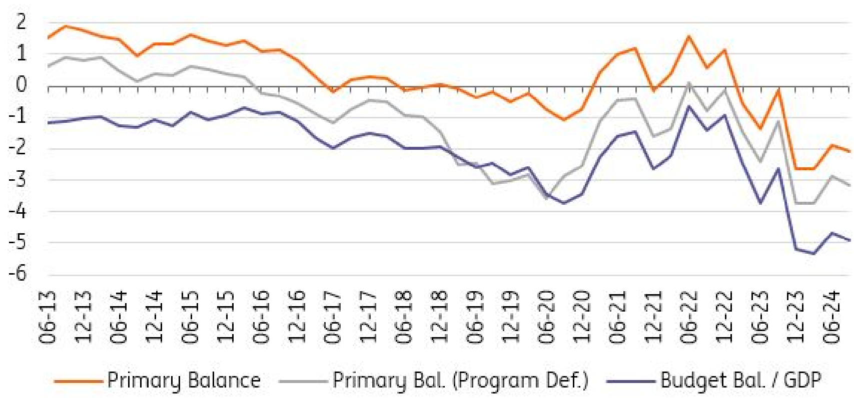
In July, tax collection performance pointed to a significant slowdown with an annual increase of 35.8%, while corporate tax among direct taxes, and VAT among indirect taxes recorded a year-on-year decline in nominal terms.

Special Consumption Tax (SCT) growth, on the other hand, showed a slowdown with moderation in domestic demand.

Non-interest expenditures saw accelerated growth driven by the increased purchases of goods and services, investment expenditures, and transfers to SEEs. Consequently, total revenues rose by 44.9%, while total expenditures surged by 81.6%.

As of July, the budget deficit-to-GDP ratio for the past 12 months increased to 5.1%, compared to a 4.0% growth forecast in the MTP. The primary balance recorded a deficit of 2.2%. The government aims to achieve a budget deficit-to-GDP ratio this year close to or lower than the 2023 level of 5.2%.

Budget performance (% of GDP)



Source: Ministry of Treasury and Finance, ING

CBT keeps rates unchanged at 50%

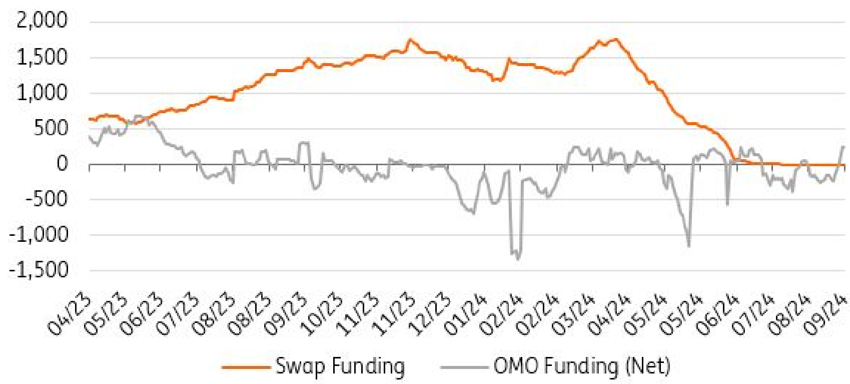
At the August rate-setting meeting, the CBT kept the policy rate flat at 50%, in line with the consensus and our call, while the interest rate corridor was also unchanged with the upper and lower at 53% and 47%, respectively.

The bank reiterated a continued tightening bias to manage expectations for future rates and inflation, nad pledged to keep rates higher for longer until a significant and sustained decline in the underlying trend of monthly inflation and the convergence of inflation expectations to the CBT's projected forecast range.

According to the bank, “the alignment of inflation expectations and pricing behaviour with projections has gained relative importance for the disinflation process”. This implies that it remains sensitive to the credibility gap. While market participants' expectations for this year and end-2025 have been sticky in recent months, standing at 43.3% (34-42% forecast band of the CBT) and 25.6% (14-21%Y forecast band), respectively, HHs and corporates see inflation at around 72% and 55%, respectively in the next 12 months.

Given this backdrop, as well as risks related to the inflation outlook and foreigners' and locals' portfolio preferences, the CBT has maintained its cautious approach as recently signalled by CBT officials with a preference to "err on the side of caution".

CBT funding (TRYbn)



Source: CBT, ING

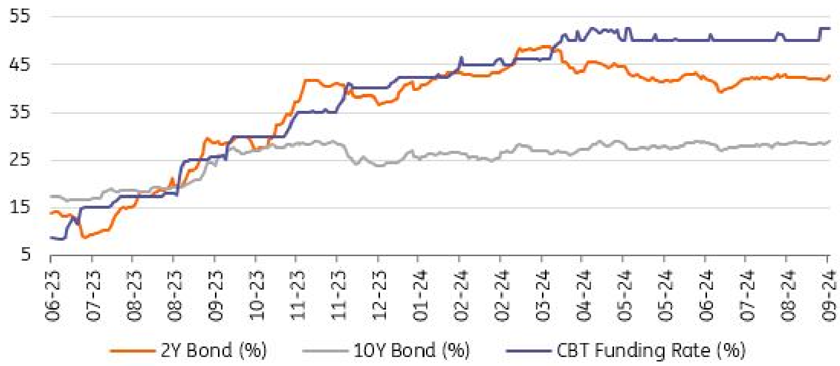
FX and rates outlook

The CBT allowed more weakness in August and eased some pressure on TRY after more stable previous months. This makes TRY levels attractive for buyers chasing high carry once again. In particular, should the current fragile global developments bring some spike in USD/TRY, we believe the market would take advantage of the attractive entry point.

The market is currently anticipating approximately 700 basis points of rate cuts by the end of this year in both FX forwards and OIS. However, we view this as overly dovish compared to our forecast of 500bp rate cuts starting in November. Additionally, a scenario with no rate cuts this year would not surprise us, given the still significantly unanchored inflation expectations that are crucial to the CBT.

TURKBGs have seen strong summer inflows after a rather muted June reaching foreign holdings to new highs of 8.7%. The weight of TURKGBs also continues to gradually increase within the GBI-EM index, which should ensure steady inflows from abroad in the months ahead regardless of market conditions. While the front end of the OIS curve is being pushed down by dovish market expectations, the TURKGBs curve has moved to the upside with the long end reaching the highest yields this year.

Local bond yields vs CBT funding rate



Source: Refinitiv, ING

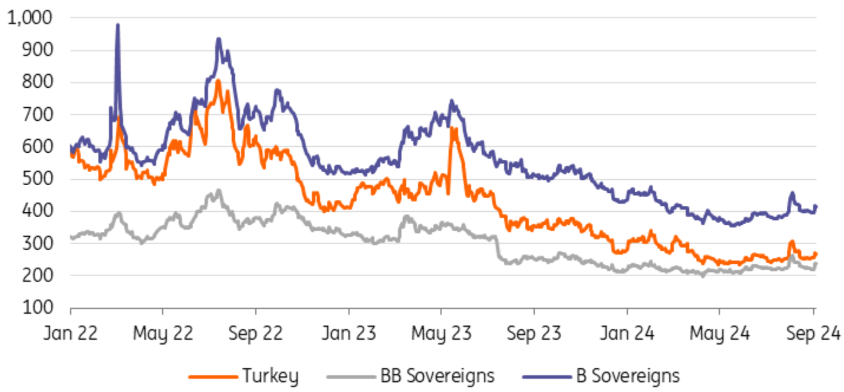
Sovereign credit: Holding steady

Turkey's latest economic plan should reinforce investor confidence that the shift to orthodox policy seen since last year's elections is set to continue, with the authorities maintaining further disinflation as a policy priority.

While some of the government's forecasts may prove somewhat optimistic, the plans for significant fiscal consolidation for 2025 and beyond are a clear positive. Spreads in the hard currency sovereign space remain fairly tight versus BB-rated peers, with the pickup for Turkey having moved in a narrow range of around 20-40bp since May.

Investors will now be looking towards the potential for further upgrades into BB-territory (currently positive outlooks at all three main rating agencies) for more upside, while expected issuance from the sovereign on the back of the recent bank and corporate deals present a slight risk.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: ICE, Refinitiv, ING

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