Monitoring Turkey: Disinflation on track

Turkey's macro policy is currently at its most restrictive level since the launch of the current programme. Accordingly, gradual reserve accumulation has resumed, while underlying inflation improved notably in May, suggesting that the volatility experienced in March had a limited lasting effect

Turkey's GDP growth was 2.0% year-on-year in the first quarter of 2025, falling short of the market consensus of 2.3%

Turkey's economy at a glance

- In the second inflation report, the shared forecasts that function as intermediate targets have remained unchanged as the Central Bank of Turkey (CBT) aims to signal that the inflation outlook has not significantly changed and will remain in its target range at the end of this year. A strong base effect and broad declines in pricing pressures have driven annual inflation downward in May, reinforcing an improving trend. In the absence of any further exchange rate shock, large wage adjustments, unexpected hikes in administered prices and a jump in commodity prices for the remainder of this year, we continue to expect inflation below 30.0%.
- Currently, the CBT employs macroprudential measures and relies on policy rate and credit caps at the same time to control both the price and volume of credit. In its latest inflation report, Deputy Governor Cevdet Akcay stated that the bank has two options: lowering rates if conditions permit, while maintaining macroprudential measures, or keeping the policy

rate high while gradually removing volume restrictions. The choice between these strategies is unclear at this stage, but the CBT is unlikely to adjust the policy rate at its MPC meeting scheduled for 19 June.

- The CBT mainly funds lenders at the upper band, keeping the overnight rate close to 49%. May's inflation data, combined with stabilising market conditions and the resumption of reserve accumulation, may enable the CBT to shift its funding toward one-week repo auctions, potentially leading to a lower effective funding rate that aligns with the policy rate.
- The growth outlook for the remainder of 2025 appears more cautious following the volatility experienced in March. Additionally, global economic challenges – especially those arising from US tariffs – could negatively affect Turkey's export performance. Given these factors, we expect growth to decelerate from 3.2% in 2024 to 2.8% in 2025. However, the possibility of further economic weakness should not be overlooked.
- As the tightening in financial conditions adds to challenges for companies, policymakers decided to launch a new support package under the Credit Guarantee Fund, worth TRY30m for manufacturing SMEs to benefit from, and the guarantee limit will be TRY25bn. The size is small given total SME loans are TRY3.8tr (less than 1% of the total), while Minister of Treasury and Finance Mehmet Simsek declared that lending growth restrictions will remain in place for some time.
- The CBT differentiated the reserve requirement ratio across maturities. The ratio, which was 12% for maturities up to one year for TL-denominated funds from repo transactions, was raised to 18% for maturities up to one month, and 14% for maturities up to three months. The move implies caution for extremely short-term foreign flows.

Quarterly forecasts

	1Q25	2Q25F	3Q25F	4Q25F	1Q26F	2Q26F	3Q26F	4Q26F
Real GDP (%YoY)	2.0	2.9	3.0	3.3	4.0	3.7	3.3	3.0
CPI (eop, %YoY)	38.1	35.3	30.3	29.0	24.7	21.0	19.5	18.1
Central bank key rate (eop, %)	42.50	46.00	40.00	35.00	30.00	26.00	23.00	20.50
3m interest rate (eop, %)	47.98	47.41	41.29	36.49	29.88	25.79	23.26	20.96
10yr yield (eop, %)	32.80	32.21	26.93	23.38	21.31	18.25	17.99	16.63
USD/TRY exchange rate (eop)	37.94	39.67	41.21	43.00	45.17	47.03	48.63	50.00
EUR/TRY exchange rate (eop)	41.04	44.83	45.75	48.59	50.59	53.62	55.44	57.50

Source: Various sources, ING

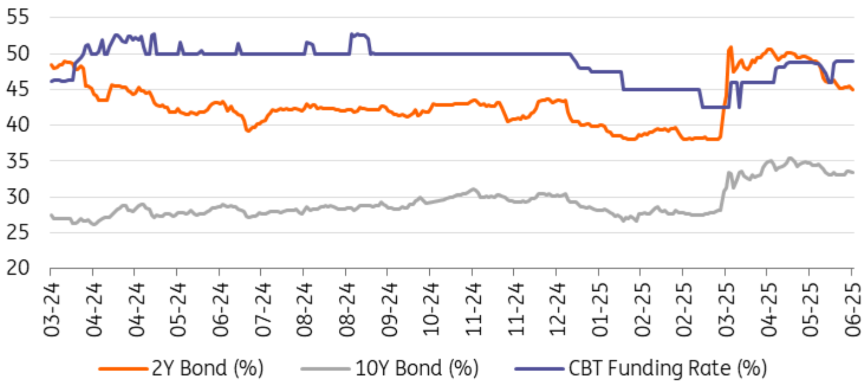
FX and rates outlook

The Turkish lira continued its gradual depreciation against the dollar in May at a steady pace, and there is not much of a new story here. Still, the fat carry leaves the market biased, sustaining demand. We do not see a change in the current direction in the coming months, especially if the central bank wants to return to rate cuts. Therefore, TRY remains our favourite carry currency in the EM space. The central bank has made it clear through its actions and communication in recent weeks that it will not allow any further additional inflationary pressures coming from FX, and the situation seems to be fully under central bank control again. Having said that, we still prefer the spot market over the forward market since liquidity may be tight again in case of some volatility. For the end of the first half of the year, we expect USD/TRY at 39.67 and 43.00 in our year-end forecast.

Turkish government bond (TURKGBs) yields remain at elevated levels following the March sell-off, and lower-than-expected May inflation has not changed the situation despite some steepening of the curve in recent weeks. As we discussed in the previous Monitoring Turkey, the market, in our view, needs more evidence of continued disinflation after a stronger May number.

On the supply side, MinFin has covered almost 50% of the planned issuance of TURKGBs according to our calculations, and there does not seem to be a big problem here. OIS market expectations for this year are close to our CBT rate forecast. However, the market is still trading TURKGBs at a significant premium over the OIS market, and the short end of the curve looks cheap in the context of our inflation expectations and CBT path.

Local bond yields vs CBT funding rate



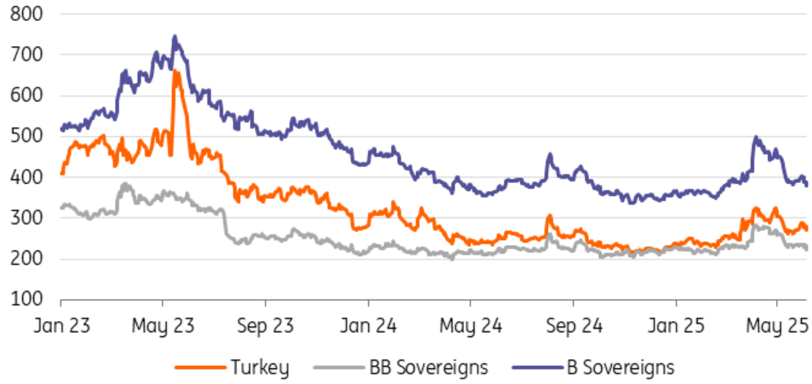
Source: CBT, Refinitiv, ING

Sovereign credit views

With markets stabilising in May, the Turkish sovereign returned to international markets with a $2bn, 7-year deal, bringing YTD funding to $4.5bn. While more issuance is expected, likely in the second half of the year, there are also potential positive catalysts to come with Moody's (and Fitch's) rating review scheduled for late July – Moody's currently has a positive outlook and is one notch lower than S&P and Fitch at B1.

We remain fairly optimistic about the prospects for Turkey's dollar bonds, with the orthodox economic policy setup seemingly staying in place despite some political noise, while spread levels have held around 50bp wide of the BB sovereign average.

ICE US$ Bond Sub-Index Spreads vs USTs



Source: Refinitiv, ING

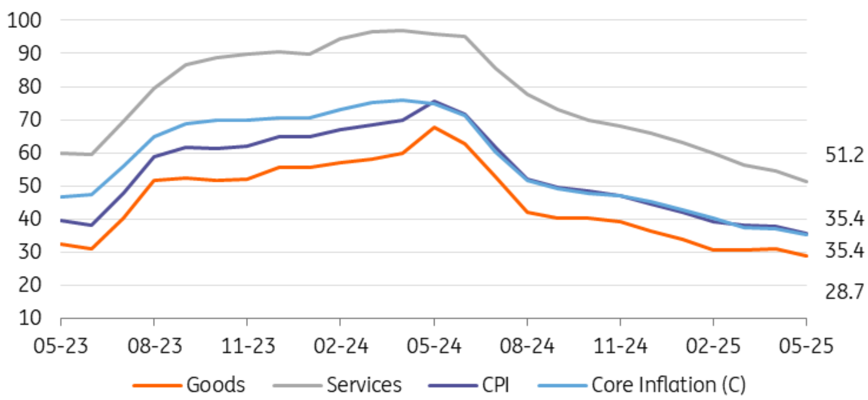
Inflation drops sharply in May

CPI inflation stood at 1.53% MoM in May, coming in lower than the consensus. This was largely due to moderate price increases across both food and non-food categories. As a result, annual inflation, which has been on a downward trend for the past year, saw a sharp drop to 35.4%, down from 37.0% in the previous month. PPI increased by 2.5% MoM, driven mainly by food products and utilities. Annual producer inflation reached 23.1% YoY, marking the first monthly increase in a year.

This indicates that despite a slower pace of currency depreciation at 1.9% MoM in May, the sharp currency basket (50:50 EUR:USD) increases of 6.5% MoM in March and 3.9% MoM in April led to a stronger pass-through effect. However, cost pressures remain under control due to the CBT's continuing grip on the exchange rate, with the FX basket rising by around 25% YoY as of May. Core inflation (CPI-C) rose by 2.4% MoM, bringing the annual rate down to 35.4%.

May inflation data indicate an improvement in underlying trends. The surge seen in March and April has reversed, showing widespread progress, particularly in goods.

Inflation outlook (YoY%)



Source: TurkStat, ING

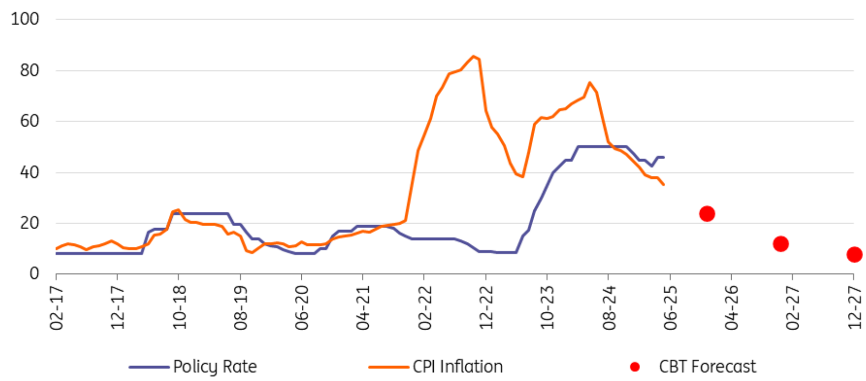
Central bank keeps inflation projections flat

In May, central bank Governor Fatih Karahan held a meeting to introduce the second inflation report of the year and shared the latest inflation forecasts after the volatility in late March. Without any meaningful revision to those presented in the previous report, the CBT kept the inflation forecast unchanged at 24%, 12% and 8% for this year, 2026, and 2027, respectively. Approaching the year-end, though the forecast range corresponding to 2025 should have narrowed down mechanically, the bank kept it between 19% and 29%, citing “the recent rise in uncertainties”. The bank does not perceive inflation as being rigid, and expects seasonally adjusted monthly inflation to ease to just above 1% by year-end (down from the current level of over 2.5%). However, the balance of risks remains tilted to the upside.

According to the report, this year’s inflation outlook reflects several upward pressures: a 0.5ppt impact from higher food inflation assumptions, a 0.3ppt upward revision in the output gap, a slightly stronger underlying inflation trend (+0.1 ppt), and a 0.1ppt increase from exchange rate effects on TRY-denominated import prices – despite lower USD import price assumptions. These were largely offset by a 1ppt downward revision in administered prices, driven by February’s reduction in health examination co-payments.

Given this background, the CBT's governor pointed out that the central bank's policies have prevented a serious deterioration in the inflation outlook. He added that the bank would maintain a tight and prudent stance, determine the policy rate in a way to ensure the tightness required by the projected disinflation path, and maintain a meeting-by-meeting approach in adjustment of the policy rate with a data-driven approach. This stance would support the disinflation process via moderation in domestic demand, the real appreciation in the Turkish lira and the improvement in inflation expectations.

CBT forecast vs inflation (%)



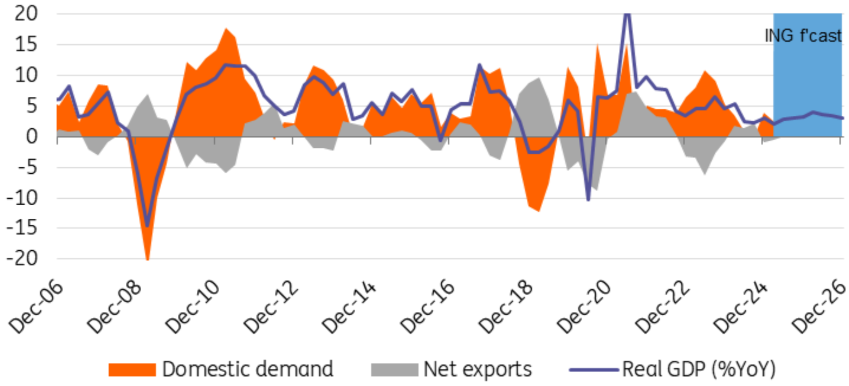
Source: CBT, TurkStat, ING

Domestic demand drives economic growth in the first quarter

In the first quarter of 2025, Turkey's GDP growth was 2.0% year-on-year, falling short of the market consensus of 2.3% (and our call of 2.1%). Despite showing a moderation compared to previous quarters, this performance was mainly driven by both private consumption and investments. In the sectoral breakdown, construction emerged as the biggest contributor, followed by services. Industry, on the other hand, was weak with a negative contribution as evidenced by early indicators such as capacity utilisation and PMI.

First quarter GDP translates into a quarter-on-quarter (QoQ) growth rate of 1.0% after seasonal adjustments, showing a momentum loss in comparison to the last quarter of 2024. However, it still marks a healthy reading given the technical recession last year with QoQ contractions in 2Q24 and 3Q24. The sequential performance is attributed to the turn of contributions from net exports and inventory build-up to positive, as well as increasing support from government consumption despite a drag from both private consumption and investments.

Real GDP (%YoY) and contributions (ppt)



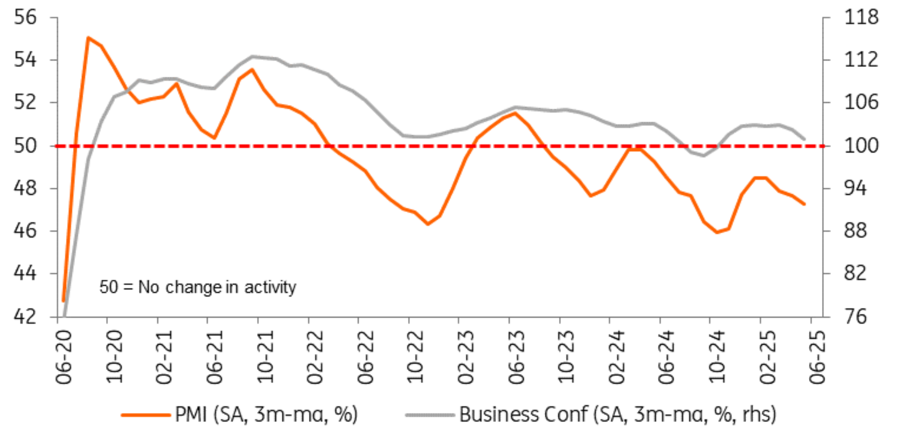
Source: TurkStat, ING

Activity is likely to lose further momentum in the second quarter

Early indicators for the second quarter point to emerging signs of weakness. On the production side, we see a decline in manufacturing capacity with the average CUR in April-May remaining below the average in 1Q25, and PMI remaining in contraction territory as weak demand and inflationary pressures contributed to a further easing.

Consumption indicators, on the other hand, confirm the ongoing slowdown following recent tightening in financial conditions, leading to a significant increase in both lending and deposit rates despite a continuing decline in annual inflation. The anticipated slowdown in economic growth across Europe and the US may create additional headwinds for exports. Given this backdrop, quarterly growth will likely witness a significant slowdown in 2Q25.

PMI & Business Confidence



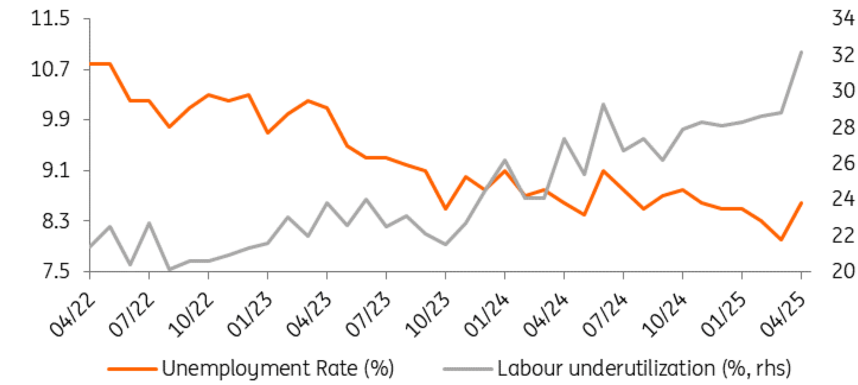
Source: ICI, CBT, ING

Growing strains in the labour market

In April, seasonally adjusted employment was 32.4m people and recorded a 1.0% MoM decline. The labour force participation rate also fell by 0.2ppt to 53.4%, while the unemployment rate moved up to 8.6% from the lowest level since 2005, the start of the current series, at 8.0%.

On the other hand, the seasonally adjusted average weekly actual working hours dropped by 1.2 hours compared to the previous month, standing at 42.2 hours, the lowest in the last four years. One of the broader unemployment indicators, the underutilisation rate – which combines time-related underemployment, potential labour force, and the unemployed – maintained an uptrend in recent months and reached 32.2%, the historical peak. The data indicates growing strains in the labour market, despite headline unemployment remaining quite low.

Labour market outlook



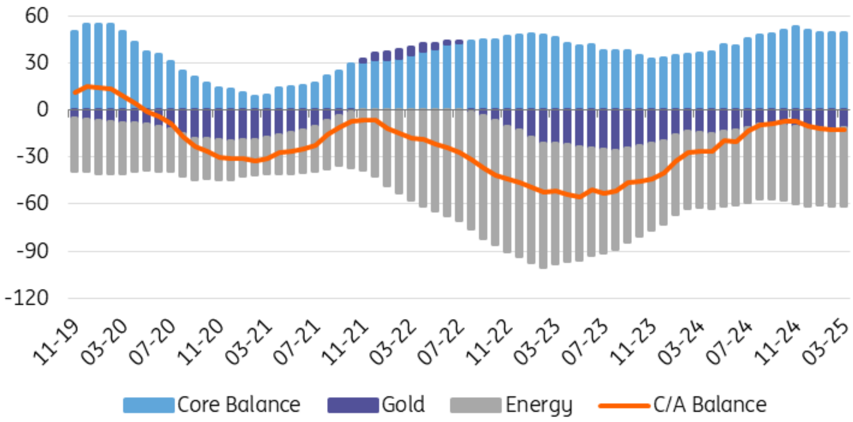
Source: TurkStat, ING

Capital account saw significant outflows in March

The current account for March showed a deficit of US$4.1bn, slightly exceeding the market expectation of $3.95bn (but better than our call of $4.2bn). A closer look at the monthly data reveals that the deficit remained unchanged compared to the same month last year, as a wider energy deficit and lower primary income were offset by a slightly better core trade balance, narrower gold trade deficit and improving secondary income.

As a result, the 12-month rolling current account deficit, which began increasing in November of the previous year, remained flat at around $12.6bn (about 1% of GDP). On the capital account side, following continuous inflows since October 2024, we saw outflows as expected with the political developments in March at $7.1bn, the highest since the August 2018 financial volatility. With large net errors and omissions outflows of $3.9bn, and the current account deficit, official reserves shrank by $15.1bn, the largest since the presidential elections in May 2023.

Current account (12M rolling, US$bn)



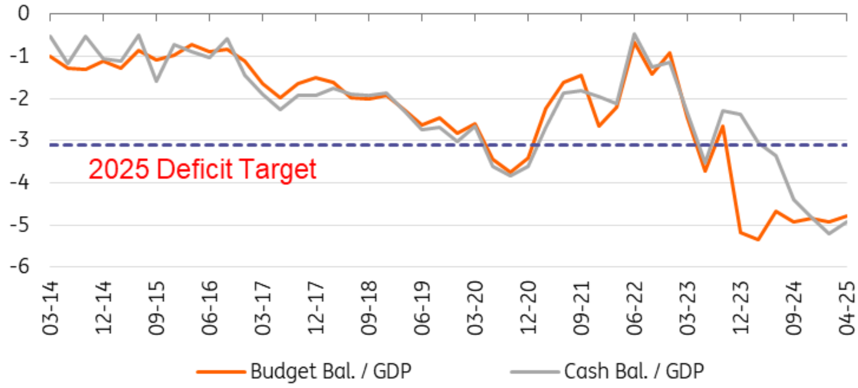
Source: CBT, ING

In April, the budget deficit remained stable vs last year

The budget results for April indicated a slight improvement in the budget balance compared to the same month last year, driven by a strong increase in tax revenues and a decline in current transfers. Tax collection accelerated, rising by 61.4% annually (with a real increase of 17.1%), while direct taxes more than doubled from the previous year (with a real growth rate of 46.7%). Non-interest expenditures were pulled down by a significant slowdown in current transfers, resulting in an annual growth rate of 32%, which remained below inflation (real -4.2%). Meanwhile, interest expenses surged by 128.6% compared to the previous year (real increase of 65.8%).

As a result, based on the April data, the ratio of the 12-month cumulative budget deficit to GDP stood at 4.7%, exceeding the 3.1% deficit estimate in the Medium-Term Programme, while the primary balance recorded a deficit of 1.4%.

Budget performance



Source: Ministry of Treasury and Finance, ING

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