Trip Notes

Türkiye October 2024

View from Istanbul

Aktia

Türkiye: Back to Basics

- In early October, we were In Istanbul to get the latest on-the-ground insights about current state and direction of the Turkish economy. During the two days we with policymakers, local banks, other financial institutions, economists, and academicians.
- The meetings affirmed our constructive view as the shift towards orthodox economic policies have addressed the macro imbalances, though still a lot of work needs to be done. The question is how patient the political leadership is, as the rebalancing most likely means below-average growth and higher unemployment rates.
- The risk for policy U-turn or bias moving towards growth supporting measures over containing inflation was seen low at least until the end of 2025. However, going into 2026 the risk will start to increase as the elections are nearing.

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All eyes on inflation

The shift towards orthodox economic policies since mid-2023 has increased investor confidence in Türkiye. Overall, there seems to be a consensus that economic rebalancing, focusing on inflation and external balance, is on track at the moment. Especially, the current account has shown a meaningful correction. The disinflationary process, on the other hand, is still in an early phase. Despite annual inflation having peaked from above 70% levels, it is still high at close to 50%, with monthly prints remaining relatively elevated, and household inflation expectations especially remaining uncomfortably high.

The key component for the disinflationary story is domestic demand. The dominant narrative is that the central bank's aggressive monetary policy tightening is cooling down private consumption, which, in turn, will drag inflation lower. While many seem to share the view that a slowdown in growth has taken place after Q1 and will continue, some highlight the risk that private consumption may be more resilient than the central bank expects. Some noted that the contraction in manufacturing PMI does not reflect the overall pulse of the economy. Growth is anticipated to be around 3% in 2024-2025, which is less than the Medium-term Economic Programme (MTP) envisages at 3.5% and 4.0%, and clearly less than the average growth during the past ten years (~5%), and below the estimated potential (~4.5%).

Many seem to think the inflation forecasts by the authorities are optimistic, with below 20% figures seen as difficult to achieve, at least not before the end of 2025 or beyond. In September, inflation decreased to slightly below 50%, while the central bank's latest CPI report sees inflation at 38% at the end of the current year, and 14% at the end of 2025. The MTP foresees inflation at 41.5% at the end of 2024 and 17.5% at the end of 2025. Indeed, price pressures have started to ease, but the monetary policy authorities are far from out of the woods yet. Especially, the minimum wage negotiations at the end of this year are a major uncertainty factor. As a significant amount of the labor force in the manufacturing and service sectors earn the minimum wage, it has straightforward implications for private consumption, and thus for the inflation outlook. Moreover, the minimum wage hike usually serves as a benchmark for other wage negotiations. Many seem to expect the minimum wage hike to land in the 25-30% range, which would still be in line with a moderating inflation view. Increases above 30% would be a major headwind.

The minimum wage negotiations at the end of this year are a major uncertainty factor for inflation outlook

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The last minimum wage negotiations, which came into effect in early 2024, were an inflation shock with the hike being close to 50%. That said, negative surprises can be found in recent history, but based on the meetings, we think that this time risks are more contained as no elections are scheduled until 2028. Also, economic rebalancing (despite its short-term social cost), if achieved, could support the current political leadership going into the next elections.

Building Credibility

Turkey is notoriously well-known for its poor track record of credible monetary policy, and from time to time, the central bank has had room to really fulfil its inflation-targeting mandate. Now is that time again. More importantly, the overall economic policy setting, as laid out in the MTP, is tilted towards containing inflation.

Overall, the central bank's monetary policy reaction is seen as credible, with the policy rate hiked from 8.5% to 50%. Rates have been on hold for six consecutive MPC meetings. During the past year or so, the central bank has enforced the monetary policy transmission mechanism, with the key element being the FX channel, which is especially important for goods inflation and for anchoring inflation expectations. Under this approach, the Lira is tightly managed by the central bank, showing gradual depreciation on a nominal basis against the USD, but strengthening in real terms (i.e. nominal depreciation is less than inflation). Inflation has responded to the tightening of fiscal conditions and macroprudential measures, but admittedly, it is still very high, with most MoM changes still above +2.5% during the year. The lower headline inflation is driven by goods (40% YoY); however, service inflation has remained sticky (73% YoY). The central bank expects service inflation to start showing clearer downward pressure in the coming months as some components, such as rents, react with a several-month lag. Rent inflation is still clearly above the historical trend, around 120% YoY, due to the removal of the cap on rent hikes.

Another issue from the central bank's point of view is household inflation expectations, which are far from the central bank's target. In our view, while the central bank admits that this is a problem, it also downplays the importance of household inflation expectations, especially as the price-setting side (corporates) and financial markets' inflation expectations have reacted meaningfully to monetary policy tightening. Some pointed out that businesses would like to pass the higher costs to prices but are unable to do so due to softening domestic demand.

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Central bank at a crossroads, approaching to rate cuts

Many expect the central bank to start normalizing rates at the end of this year as the communication has lately turned less hawkish. In the meetings, many expected the first cut to materialize either in October or December but given the September inflation print (published after the bulk of the meetings) surprised to the upside, the start of easing is likely tilted toward December or early 2025. For the central bank, the October CPI print is highly important as administrative prices will not add noise as during the previous months.

The central bank is expected to launch the easing cycle with a 250-bps cut. An initial cut of 500 bps should be seen as a red flag, indicating that the central bank is more growth-minded than serious about bringing inflation lower. Overall, the central bank is anticipated to move gradually and keep real rates in positive territory to support deposits in the lira. The central bank emphasized that during the past quarters, a lot of work has been done to build credibility and improve the inflation outlook, and it wouldn't make sense to throw that away by doing too much too early.

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The central bank is likely to keep the managed Lira regime and macroprudential measures in place until it has increased confidence that conditions support lower inflation and that lower rates won’t cause backlashes. Some pointed out that it would make sense for the central bank to start the monetary policy normalization process by easing macroprudential tools first, rather than cutting rates, to test how the economy and market react. The choice of the sequence could have a political motivation behind it, as globally, central banks are now cutting rates. Credit growth caps are expected to stay even beyond 2025 to prevent excessive credit growth triggered by lower interest rate costs. However, during the past few months, the caps haven't been binding, but still, the central bank wants to mitigate the risk of credit fueling excessive domestic demand.

The collapse of local sentiment is one of the main concerns for the central bank, meaning a sharp and quick increase in USD demand and a reversal of de-dollarization, which would induce pressure on the Lira. So far, there has been encouraging development regarding de-dollarization, with the share of local investors' FX/gold deposits down to 45% in September (the lowest since mid-2018) as domestic rates are attractive and TRY volatility has calmed down after the 2023 elections. Some noted that the progress is not due to locals’ stronger confidence in institutions such as the central bank, but rather because the compensation for holding TRY deposits makes economic sense. Put differently, lower rates are a risk going forward, and the central bank’s communication and expectation management is of very high importance. On the positive side, the central bank has been able to accumulate FX reserves (net reserves USD 20 billion, the highest since 2019), with plenty of ammunition at its disposal if needed. In August, when FX volatility picked up, the central bank sold around USD 0.5 billion to support the Lira, i.e., the monetary policy authorities are vigilant when it comes to pressure on the currency. The central bank is still looking to add reserves, which have been supported by foreign portfolio inflows, locals' de-dollarization, and more favorable current account dynamics.

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External balance in check

The external imbalances have shown a meaningful correction in the current account deficit, thanks to improvements in the trade balance (lower energy and gold imports), as well as strong performance in tourism (revenues reached an all-time high in 2023 at USD 56 billion, with further strength expected this year). The current account deficit is expected to be 1.5% of GDP this year and to widen slightly to ~2% next year. As a reminder, Türkiye's current account deficit was over 4% in 2023, over 5% in 2022, and it has been above 3% on average during the past ten years.

Türkiye has a structural current account deficit due to energy dependence, meaning renewed upside pressure in oil prices is a risk for the external balance. Some also see a risk of tourism flows moderating due to loss of competitiveness on the back of TRY appreciation in real terms. However, in our view, the short-term risks regarding external financing are now likely contained if the policy approach remains intact, thanks to strong financial inflows and the compressed current account deficit. So far, FDI inflows have been relatively muted.

Due to the progress in addressing macro imbalances and the increased credibility of policymaking, all three major credit rating agencies have upgraded their ratings for Türkiye this year. The market is expecting further rating improvements, with Türkiye’s hard currency sovereign bonds trading in line with BB-rated bonds, while two out of three raters still have a B rating for Türkiye.

Fiscal stance becoming more aligned with the monetary policy

Unsurprisingly, the fiscal policy outlook is currently less of a hot topic than inflation. The main narrative is that the fiscal stance will tighten in 2025, which is highly welcome from an inflation point of view, as both monetary and fiscal policies are tilted towards containing domestic demand.

This year, the fiscal stance has been accommodative, with the cash-based budget deficit rising to around 4.2% of GDP in the first eight months of the year, versus 2.3% at the end of 2023. Earthquake-related spending and interest expenditures explain the bulk of the increase. The MTP sees the general government budget deficit narrowing to 3.1% from the 4.9% expected this year. The main tools for lowering the deficit are expenditure cuts (e.g., earthquake-related spending drops in 2025), withdrawal of tax exemptions, and broadening the tax base with a focus on the informal economy, which has a very high share in Türkiye. No major tax increase announcements are expected over the next year.

Looks goods, but how long?

The policymakers have taken the right steps, but obviously the main question is whether there will be a U-turn in policies at some point. Based on the meetings we had, we think that over 2025 the probability is relatively low, but the risks start to increase going into 2026 as politicians gear up for the 2028 general elections. An early election would be a risk and could reverse the policy framework, meaning there would be less focus on inflation and a bias toward supporting growth. In addition, many seem to believe that there is no real will to do what needs to be done to get inflation below 20% or even into single digits, as it would sacrifice too much growth.

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Based on the meetings, the political leadership is likely to tolerate the economic pain required to bring the economy into better footing, as the last round of unorthodox experiments (unsurprisingly) failed. So, higher unemployment and bankruptcies are accepted. Some note that a 1-2%-point rise in unemployment is not alarming for the political leadership. For the time being, unemployment has not shown a meaningful uptick from the historically low level of 8.8%, but unemployment is a lagging indicator, and a rise is expected over the coming quarters – this tolerance will be put to the test. On the labor demand side, especially SMEs are feeling the pressure of financial conditions, and bankruptcies are starting to increase, but the general expectation is that the rise in unemployment will be contained due to subsidies for businesses.

Our view and positioning

The Turkish market is largely driven by idiosyncratic factors, less so by global risk sentiment, at least for the time being, as addressing macro imbalances and the outlook for economic policies are taking the driver's seat. The policymakers have taken positive steps towards a conventional economic framework, which is highly welcome. However, In our view, the relevant question is *when* the policy bias turns more growth supporting measures (with unorthodox measures) at the cost of inflation, rather than *if* they are introduced. However, we do not see signs that this is happening very soon. We anticipate the policy setting to last over 2025, with risks starting to increase going into 2026. In addition, the risk of a policy U-turn may increase if disinflation proves to be clearly more gradual than the policymakers expect, testing their patience, and/or the economy faces a hard landing, though this was not seen as the baseline in the meetings.

We think the carry in the Turkish market is sufficient to compensate for the risks, with the very short end of the curve above 40% and bonds around 30%. Ex-ante real yields are positive, and we expect the FX to continue being managed by the central bank, i.e., the current nominal depreciation path is expected (trend -19% p.a. versus USD since June). We have decided to invest in TRY assets (no investment since early 2021) via FX forwards, and we are ready to add duration if we see further progress in disinflation and if we have increased confidence that the central bank is taking a cautious approach in normalizing rates. The outcome of the minimum wage negotiations is also an important data point for us when considering adding duration.

Türkiye is designated as red in the country selection model, meaning we don't finance the government, but exposure can be taken via FX forwards and/or AAA-rated bonds issued by Development Finance Institutions. While we think the economy is now moving in the right direction, we want to see further evidence of the continuation of orthodox policy before Türkiye can be upgraded to yellow, which would open the possibility of investing in government bonds.

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