Turkey: Disinflation without sacrificing growth in 2024

KEY MESSAGES

The CBRT's recent front-loaded rate hikes match CPI expectations, encouraging deposit-holders to stay in TRY and foreign investors to increase their exposure to local assets.

We expect the CBRT to hike the policy rate in two steps to 45% in January and then leave it unchanged until July before starting to cut.

We forecast 35% CPI, a 30% policy rate and 3.5% GDP growth for end-2024. The CBRT's front-loaded tightening stimulates inversion of the government bond yield curve and slows down the credit impulse.

Monetary tightening inevitably weighs on economic growth, but we expect ample market liquidity and fiscal expansion to generate reasonable growth next year.

Our base case implies that CPI slows and the slight negative output gap continues in 2024. Upside CPI risks could come from FX shocks. However, we expect 2024 will see the underlying dynamics governing FX volatility weaken.

Turkey's central bank (CBRT) has re-embraced orthodox monetary policy this year, increasing its policy rate from 8.5% in May to 40% in November. At its last meeting the CBRT signalled that it is nearing the end of the hiking cycle. We think it will hike the policy rate in two stages to 45% next month and then keep it stable until July before starting to cut.

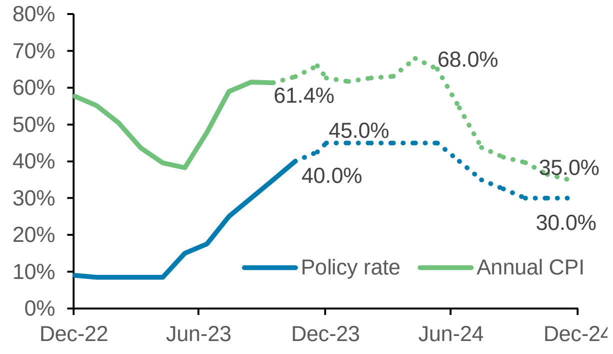
We target 35% CPI at year-end 2024. We expect annual inflation to fall sharply in the second half of 2024 and target 35% CPI inflation by year end. We therefore think the policy rate will decline to 30% by the end of 2024 while keeping ex-ante real policy rates above their historical averages (see Figures 1 and 2).

We also welcome the CBRT's efforts to deregulate the banking sector and support an efficient functioning of the monetary transmission mechanism. Both monetary tightening and a deregulated banking sector will persuade deposit-holders to save in local currency and thereby reduce inflation, we argue.

This note set outs our rationale for these forecasts and our views on Turkey's economy for 2024.

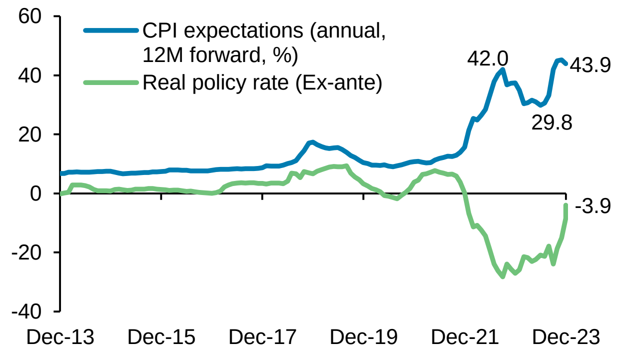
Our optimism about 2024 disinflation is threefold. i) Real TRY appreciation; ii) A decline in currency volatility; and iii) Weakening credit impulse. The first two factors will help reduce cost pressures and the third will weaken domestic demand. The bear steepening of the yield curve (Figure 3) and front-loaded CBRT rate hikes suggest these factors will help disinflation in 2024.

Fig. 1: Annual CPI and policy rate



Sources: TEB, BNP Paribas, TSA

Fig. 2: CPI expectations and real policy rate (%)



Sources: TEB, BNP Paribas, CBRT

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Yield curve inversion + tight monetary conditions benefit TRY

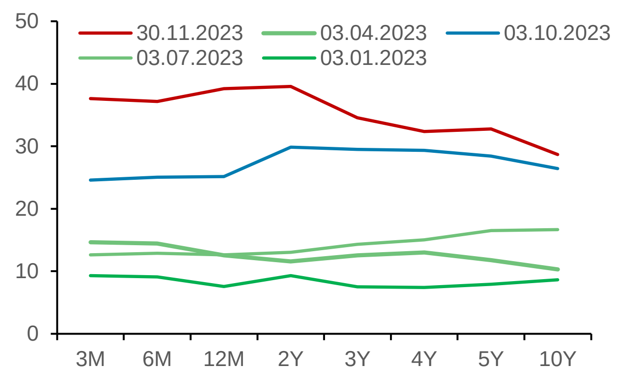
Real exchange rate set to appreciate, in our view. The TRY has appreciated by 15% in real terms since July, a trend we expect to continue. In other words, we believe nominal currency depreciation will stay slightly below consumer price inflation in 2024 (Figure 4).

Three key reasons support our view: (i) Our exchange market pressure index (Figure 5), which comprises FX depreciation and 2y USD denominated government bond yields, shows signs of reversing from extreme market conditions. (ii) The monetary conditions index, which measures monetary policy tightness by looking at the real exchange rate gap and real policy rate gap, implies that capital inflows will accumulate (Figure 6). (iii) A significant increase in the CBRT's gross reserves (USD36bn since end May) and positive ex-ante deposit rates encourage TRY savings and a stronger TRY.

In fact, a sharp fall in the dollarization rate from 68% in August to 59.6% in November implies less foreign exchange pressure from locals going forward (Figure 7).

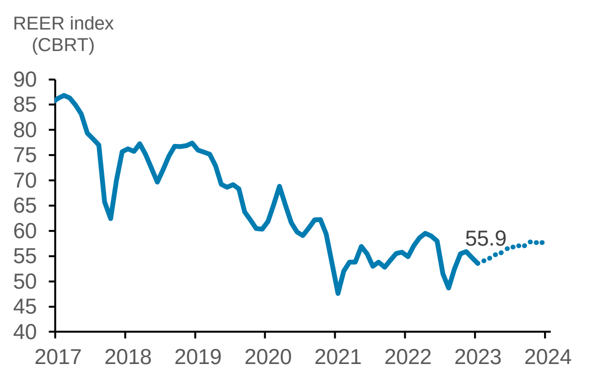
Current account improvement will help real TRY to appreciate. A lower current account deficit in 2024 due to fewer gold imports and weak domestic demand supported by mediocre loan growth will help ease TRY exchange rate pressure. We forecast the current account deficit will fall from 4.3% of GDP (USD43.5bn) in 2023 to 2.7% of GDP (USD30.5bn) in 2024. Given a historical average deficit of 4% of GDP, this could be considered a significant improvement in current account dynamics. Such a moderate current account deficit could be financed comfortably, we argue.

Fig. 3: TURKGBs yield curve evolution (%)



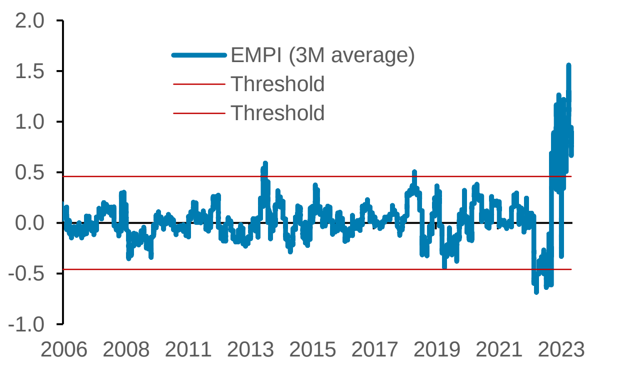
Sources: TEB, BNP Paribas, CBRT

Fig. 4: TRY REER and forecast path



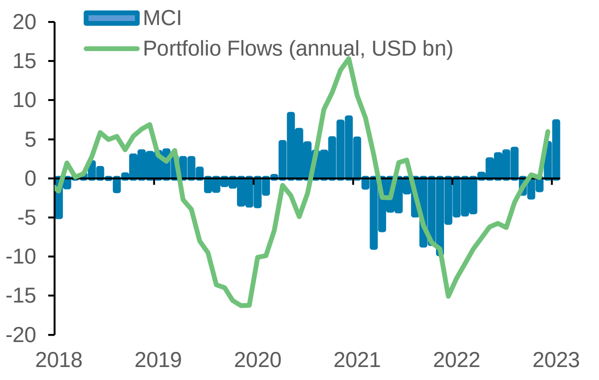
Sources: TEB, BNP Paribas, CBRT

Fig. 5: Exchange Market Presure index (EMPI)



EMPI derived from FX depreciation and 2y USD denominated bond yields
Sources: TEB, BNP Paribas

Fig. 6: Monetary conditions index and portfolio flows



MCI derived from real exchange rate and real policy rate gap
Sources: TEB, BNP Paribas

Dollarization and FX volatility to decline

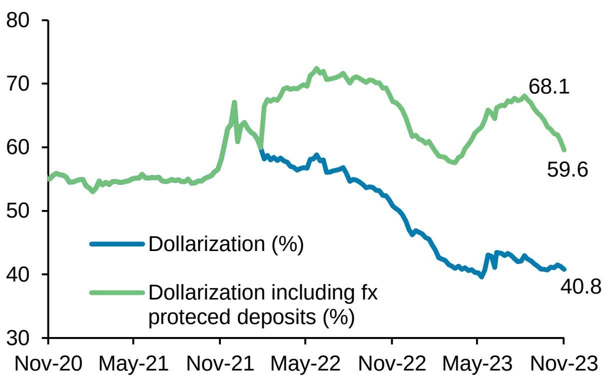
Decline in CDS premiums and FX volatility should be supported by offshore swap market deregulation. Since July we have seen currency volatility stabilize and CDS premiums decline. As the CBRT continues to front-load tightening, we expect CDS rates and volatility to fall further in 2024. Lower currency volatility would also help disinflation which, in turn, would reduce FX forward rates and make Turkish assets more attractive.

We see growing interest in Turkish bonds although inflows so far remain weak. However, Turkey's economy minister recently commented that restrictions on offshore swaps could be eased in 2024. That would encourage more capital inflows as the cost of hedging TRY exposure would come down. Assuming a functioning offshore swaps market, we could see significant inflows into Turkey's bond markets (Figures 8-10).

Domestic demand might lose momentum. As growth momentum continues to slow in 2024, showing the lagged affects of monetary tightening, we expect domestic demand to stabilize. Loan restrictive coefficients, a significant increase in TRY reserve requirements to sterilize TRY liquidity, an inverted yield curve and higher loan rates will continue to drive the decline in the credit impulse, in our view (Figures 11-12).

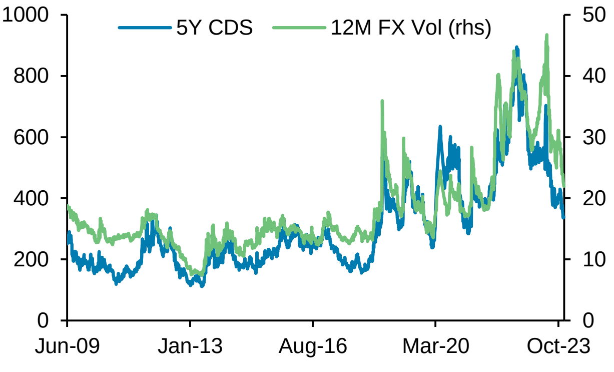
Selective loan policies support growth-current account mix: Policy-makers encourage investment and export credits to change Turkey's growth structure. We are seeing the impact of this growth model in loans. While momentum has picked up recently in commercial loans, particularly for private-sector banks, the loss of momentum in consumer loans loss has continued. This will help reduce the current account deficit while GDP growth remains solid (Figures 13-14).

Fig. 7: Dollarization (%)



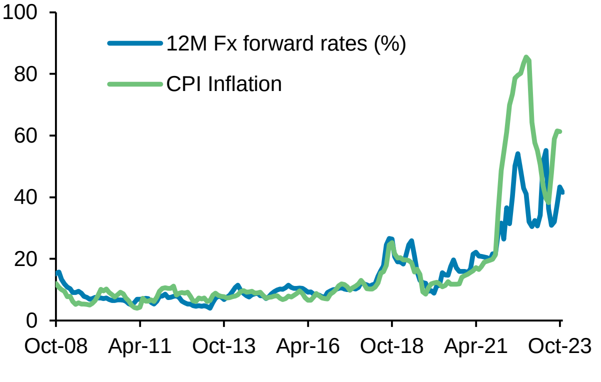
Sources: TEB, BNP Paribas, BRSA

Fig. 8: CDS premium (bp) and FX implied vol (%)



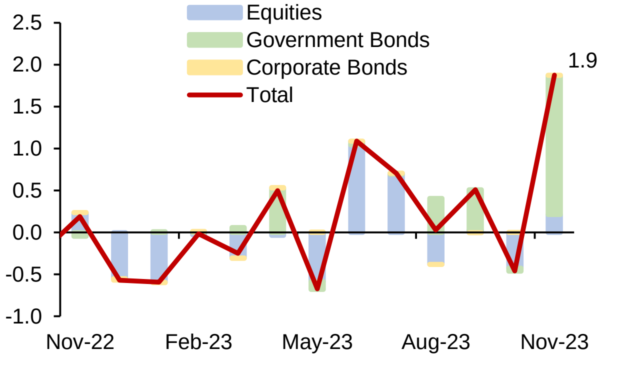
Sources: TEB, BN Paribas, Bloomberg

Fig. 9: FX implied rates (CCY swap) and CPI (%)



Sources: TEB, BNP Paribas

Fig. 10: Monthly portfolio flows (USDbn)



Sources: TEB, BNP Paribas

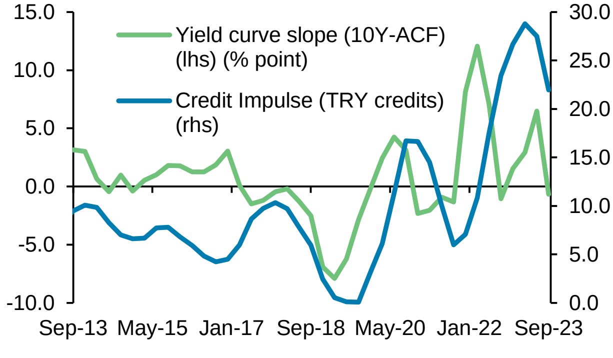
Liquidity and fiscal expansion offset slowdown in credit impulse

Turkey can still generate solid, 3.5% growth in 2024. We expect real exchange rate appreciation, coupled with selective loan policies (i.e. limiting consumer loans while supporting commercial loans), will support economic activity. Turkey recorded solid growth during episodes of real appreciation in the past. Our 3.5% growth forecast for end-2024 is also supported by ample TRY liquidity in local markets. The source of abundant liquidity could be the CBRT's FX purchases from exporters, its swap transactions with banks or its rediscount credits to exporters.

Revaluation payments to FX protected accounts by the CBRT have also improved TRY liquidity in the market. Despite the central bank's sterilization efforts, though, CBRT funding remains negative, implying ample liquidity. Conversely, these high TRY liquidity conditions could be a concern in terms of tackling inflation. We think this could imply more sterilization by the CBRT (Figures 15 and 16).

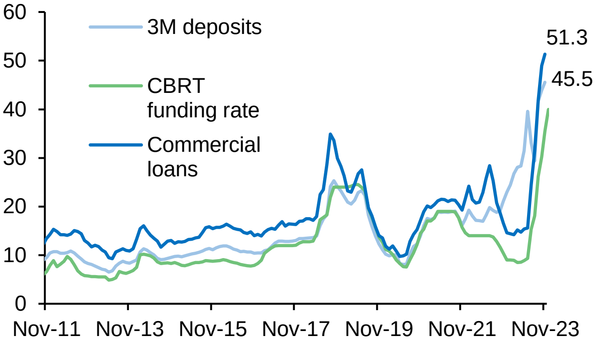
Budget deficit to GDP to reach 5.3% in 2024. Turkey's large budget deficit is a further reason for our 3.5% GDP growth forecast for end 2024. Although the treasury's 2024 borrowing programme forecasts a budget deficit to GDP of 2.8%, we believe earthquake expenditure could increase the deficit (medium-term economic programme puts the figure at 6.4%). A higher-than-expected budget deficit would be financed by more external borrowing given lower CDS rates, strong Treasury cash buffers, efficient tax collection and potential tax hikes (Figure 17). On a positive note, some of the earthquake expenditure could be postponed until 2025 to create a sound fiscal balance in 2024.

Fig. 11: TURKGB yield curve and credit impulse (%)



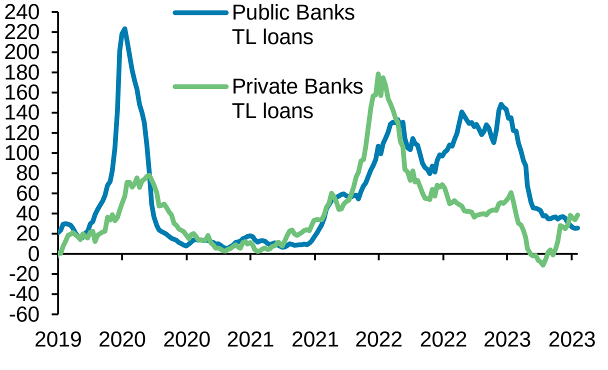
Sources: TEB, BNP Paribas, Bloomberg, TSA

Fig. 12: Banking system interest rates (%)



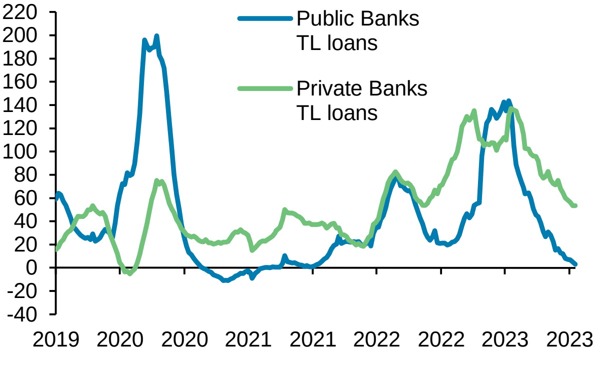
Sources TEB, BNP Paribas, CBRT

Fig. 13: Commercial loan growth (13w FX adjusted ann.%)



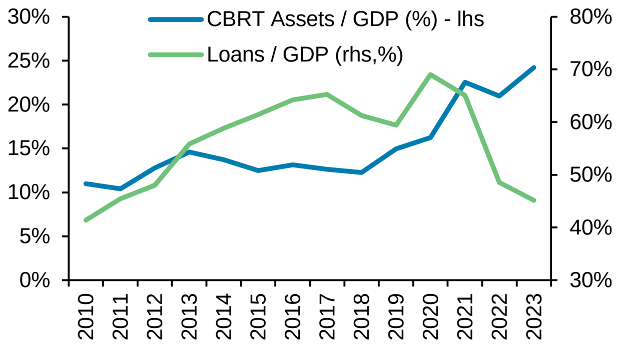
Sources: TEB, BNP Paribas, BRSA

Fig. 14: Consumer loan growth (13w FX adjusted ann. %)



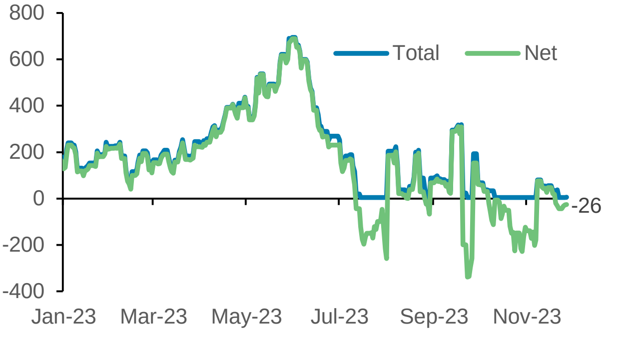
Sources: TEB, BNP Paribas, BRSA

Fig. 15: CBRT assets and loans / GDP (%)



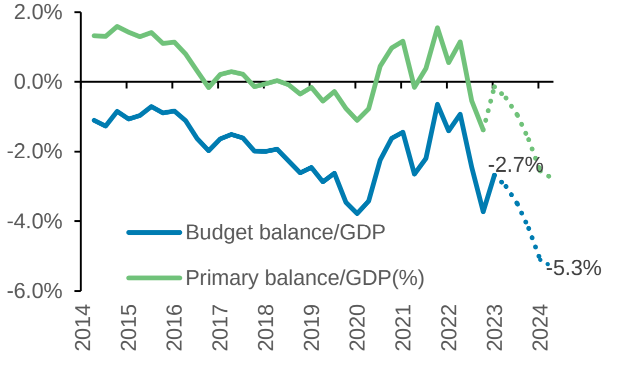
Sources: TEB, BNP Paribas, Bloomberg, TSA

Fig. 16: CBRT funding by open market operations (USDbn)



Sources: TEB, BNP Paribas, CBRT

Fig. 17: Budget balance / GDP



Sources TEB, BNP Paribas, BRSA

Our macroeconomic forecasts

Our 35% CPI forecast for year-end 2024 aligns with TRY/USD at 36.1: Our model output for our base case shows that 3.5% GDP growth and 35% CPI inflation in 2024 are attainable assuming currency stability and real exchange rate appreciation (5% real appreciation on average by using a currency basket).

Domestic demand's contribution to GDP, however, declines to 3.9 percentage points in 2024 from an estimated 9 percentage points in 2023. Although net exports' contribution stays negative, it improves compared to 2023. Net exports' contribution in 2024 is higher despite currency appreciation due to lower imports.

Our bear case, however, which puts year-end USD/TRY at 44, generates 52% year-end inflation and 2% GDP growth. While domestic demand's contribution to GDP remains very limited in this scenario, net exports' contribution increases to 1.4 percentage points due to real depreciation (6.3% real depreciation on average) by sacrificing economic growth too much in 2024. The current account deficit falls sharply given weak domestic demand and currency depreciation (Figures 18 and 19).

The model outputs suggest that the CBRT would keep domestic currency strong in real terms in 2024 to reduce inflation to its forecast in order to maintain policy credibility, which is needed to bring down inflation to the CBRT's 14% forecast for year-end 2025 .

Overall, the policies implemented so far are encouraging, in our view. They make us optimistic that the CBRT will achieve its 2024 inflation forecast (36%) and give us confidence in our own CPI projection (35%). We assume the CBRT maintains its tight stance at least until the end of H1 2024 to achieve its inflation targets.

Fig. 18: Our base case macroeconomic forecasts

	TRY/USD	GDP growth (%)	Inflation (%)	CAD (USD bn)
2022	18.7	5.5	64.3	-49.1
2023	30.9	4.0	66.0	-43.5
2024	36.1	3.5	35.0	-30.5
2023 % change	65.4			
2024 % change	17.1			

	Domestic demand (pp)	Net exports (pp)	GDP growth (%)
2022	4.8	0.7	5.5
2023	6.9	-2.9	4.0
2024	3.9	-0.4	3.5

Sourcs: TEB, BNP Paribas (estimates for 2023 and 2024)

Fig. 19: Our bear case macroeconomic forecasts

	TRY/USD	GDP growth (%)	Inflation (%)	CAD (USD bn)
2022	18.7	5.5	64.3	-49.1
2023	30.9	4.0	67.6	-42.6
2024	44.0	2.0	52.0	-4.0
2023 % change	65.4			
2024 % change	42.7			

	Domestic demand (pp)	Net exports (pp)	GDP growth (%)
2022	4.8	0.7	5.5
2023	6.9	-2.9	4.0
2024	0.6	1.4	2.0

Sources: TEB, BNP Paribas (estimates for 2023 and 2024), BRSA

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