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TURKEY

Monitoring Turkey: Further easing likely in fourth quarter

The CBT has lowered the effective funding rate from 40% to 37%, citing easing inflation risks, weaker domestic demand, and improving monetary transmission. Growth is slowing, inflation should fall below 30% this year, reserves have markedly recovered, and the CBT has resumed asset purchases while markets increasingly anticipate future rate cuts

- Turkey's Medium-Term Plan for 2027-2029, which projects above-consensus growth led mainly by domestic demand, also envisages higher inflation, increased primary spending, and a wider current account deficit than the previous plan for the next year.
- At the inflation report release meeting, Central Bank of Turkey Governor Fatih Karahan's key message was that normalising liquidity easing, which would reduce the effective funding rate from 40% to 37%, is on the agenda. According to the Governor, the worst appears to be behind us in the US-Iran conflict, and no extremely adverse developments are expected under current conditions. As for the factors shaping the inflation outlook, the economic slowdown has become much clearer, particularly in domestic demand indicators. The CBT also views low core goods inflation and easing inertia in services inflation as evidence that the demand channel and monetary transmission mechanism are working. Therefore, while the deterioration in inflation expectations has remained limited recently, upside risks to the outlook are fading. In turn, in the second half of

August, the CBT started weekly repo auctions, reducing the effective cost of funding and TLREF directly to the level of the policy rate.

- Elevated borrowing costs and the recent tightening of macroprudential measures appear to be translating into a more pronounced slowdown in 2Q26 GDP growth. Despite a clear loss of momentum and the lowest contribution since 2024, domestic demand, particularly private consumption, remained the main driver of economic activity in the previous quarter. At the same time, the contribution from net exports has shifted back into positive territory. We expect the economy to maintain a moderate growth performance in the second half of the year, increasing the risks surrounding our full-year GDP growth forecast of 3.0%. A potential resolution of the Gulf conflict could ease current downside pressures on the economic outlook and provide some support to growth prospects, while any further escalation would add to downside risks.
- Slightly lower-than-expected August CPI data helped maintain a downtrend in the annual figure, though the pace of disinflation is quite slow. Uncertainty surrounding oil prices – along with their spillover effects on other commodity prices – continues to pose risks to the inflation outlook. The resumption of the Iran-US peace process, on the other hand, would abate geopolitical tensions and help oil prices return to prewar levels, which in turn would be supportive for the inflation outlook. We expect annual inflation at 29.2% at the end of 2026. The weaker-than-expected 2Q data is also likely to reinforce expectations of policy rate cuts by the CBT. While the bank is likely to remain on hold at the September MPC given the limited time that has elapsed since its liquidity move, we see the policy rate at 35% by the end of 2026 with two 100bp cuts in the last quarter.
- Foreign investor positioning has recovered from the US-Iran conflict shock, with FX swaps exceeding pre-war levels and reaching highs. However, bond inflows have remained modest on a year-to-date basis. Meanwhile, TL deposit inflows continued, while the sector's dollarisation ratio fell from 39.9% in May to 38.5% by late August. Gross reserves reached US$188.2bn.
- In its 2026 strategy, CBT planned to increase its Open Market Operations portfolio to TRY450bn this year. The bank had already purchased TRY220bn until 3 April, bringing the portfolio up to target. However, the size has declined recently due to maturities, and the CBT decided to replenish that amount. Additionally, given developments over the course of the year, the balance sheet size has been running somewhat above the level the bank had initially projected and determined as the target size for the portfolio. Accordingly, the CBT started purchase auctions on 20 August and has purchased TRY29.5bn (nominal) as of 4 September.

Quarterly forecasts

	2Q26	3Q26F	4Q26F	1Q27F	2Q27F	3Q27F	4Q27F	1Q28F
Real GDP (%YoY)	2.3	3.2	3.6	3.4	3.8	4.1	4.6	4.7
CPI (eop, %YoY)	32.1	29.8	29.2	26.4	23.7	22.4	22.0	21.2
Central bank key rate (eop, %)	37.00	37.00	35.00	32.00	30.00	28.00	26.00	25.00
3m interest rate (eop, %)	42.98	40.55	35.16	32.04	29.75	27.68	25.31	24.53
10yr yield (eop, %)	33.21	32.75	30.67	29.01	26.49	25.45	24.32	23.00
USD/TRY exchange rate (eop)	46.64	49.03	52.00	55.07	57.92	60.56	63.00	65.75
EUR/TRY exchange rate (eop)	53.30	56.38	60.32	63.88	68.34	72.06	75.60	80.22

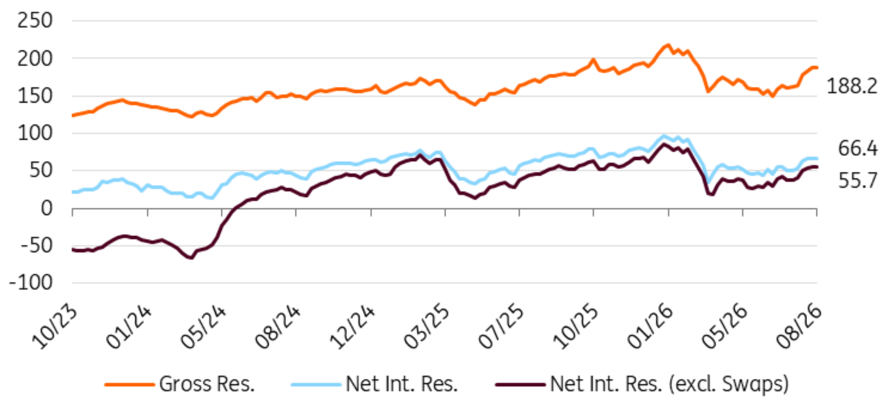
Source: Various sources, ING

FX and rates outlook

Following the normalisation of liquidity conditions, the decline in the effective funding rate from 40% to 37%, and the easing of upside inflation risks, market pricing has gradually turned more dovish and moved closer to our forecast for this year. The CBT rate is now priced at 34.50% for year-end. However, the market remains sceptical that the central bank can sustain easing next year, pricing in only around 100bp of cuts. We see scope for further repricing if disinflation continues in this part of the curve. Meanwhile, foreign inflows into TurkGBs remain limited, and the Ministry of Finance has completed about two-thirds of this year's issuance. A meaningful improvement in duration would probably require a significant de-escalation in the US-Iran conflict.

In FX, the outlook is broadly unchanged. As sentiment improves, the lira is typically the first market segment to attract returning investors. Long TRY positioning has already recovered to levels seen before the US-Iran conflict, despite the CBT's unexpectedly dovish stance in August and the prospect of an imminent restart of the easing cycle. Meanwhile, the continued recovery in central bank FX reserves should help sustain investor interest in the TRY carry trade. We forecast USD/TRY at 52 by year-end and 63 by the end of next year.

CBT reserves (US$ bn)



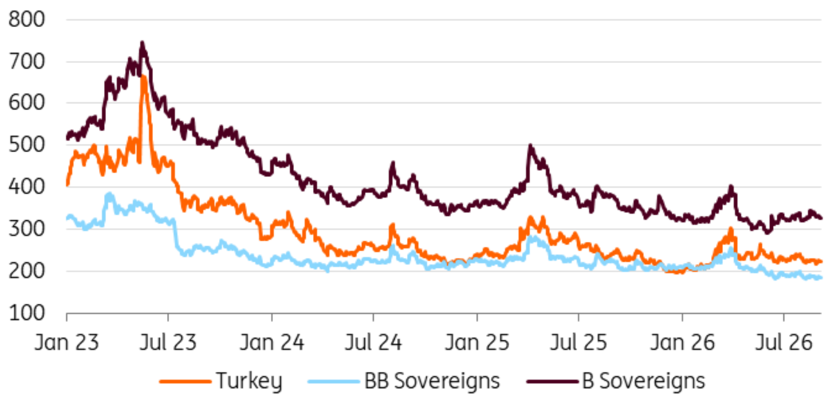
Source: CBT, ING

Sovereign credit views

Despite some decent global macro volatility, relative valuations for Turkey's dollar bonds have remained fairly steady – the pickup over the BB sovereign average has held at around 40bp, with five-year CDS spreads at near 220bp. While the latest Medium-Term Plan has seen a worsening in the outlook for inflation and the current account deficit, there were few surprises relative to market expectations and the normalisation in monetary policy points to some comfort over spillover effects from the Middle East.

In this context, the focus for investors will be on avoiding a more aggressive dovish shift in monetary policy expectations, while any easing in Middle East tensions and energy prices could offer a more positive catalyst. Valuations should remain relatively attractive for EM investors given the pickup over BB peers, along with stabilisation in the FX reserve picture and positive fiscal performance.

US$ Bond Sub-Index Spreads vs USTs



Source: Refinitiv, ING

The Turkish government projects less ambitious disinflation in 2027

At the weekend, Vice President Cevdet Yılmaz, Finance Minister Mehmet Şimşek, and Central Bank Governor Fatih Karahan unveiled the Medium-Term Plan (MTP) for 2027-2029, setting out the government's macroeconomic forecasts and key policy and reform priorities. Vice President Yılmaz emphasised that the programme seeks to reinforce macroeconomic stability, expand high value-added production, improve productivity, and enhance competitiveness through price stability, fiscal discipline, and financial stability.

While reaffirming its commitment to disinflation, the government projects year-end inflation of 28.4% in 2026. This forecast is above the 16% projection in the previous plan, close to the central bank's 28% forecast, and slightly lower than the 29.4% expectation in the latest Market Participants Survey. During the presentation of the August Inflation Report release last month, Governor Karahan had stated that the Bank maintained its 2027 forecast in light of geopolitical risks and ongoing MTP preparations that could affect the macroeconomic framework. Accordingly, the MTP substantially revised its 2027 inflation forecast upward to 21%, compared with 9% in the previous plan. The new projection is broadly in line with the 21.9% consensus in the Market Participants Survey.

In the meeting at the weekend, Karahan noted that the upward revision to the 2027 forecast was driven partly by the carry-over impact of higher-than-expected inflation this year on the following year’s starting point, and partly by the global economic backdrop. According to CBT calculations, the impact of the US-Iran war and related global developments on 2026 inflation is estimated at around 7ppt. After eliminating war-related factors, inflation would be below 25%. With this estimate, the Governor implies that next year's figure is easily reachable.

The programme also lowered the 2026 GDP growth forecast by 0.5ppt to 3.3%. Growth is then expected to accelerate to 4.2% in 2027 (close to the previous plan forecast at 4.3%), reaching 5.0% by 2029. Official projections for 2026 and 2027 remain somewhat higher than the corresponding expectations in the Market Participants Survey. Additionally, relative to the previous plan, the MTP envisages a growth composition driven more by private consumption and less by private investment, while the public sector is expected to follow the opposite pattern.

On the fiscal side, the MTP projects a central government budget deficit of 3.1% of GDP in 2026 (down from 3.5% previously), rising to 3.5% in 2027 before gradually declining to 2.8% by 2029. Despite reconstruction and recovery spending in the earthquake-affected region having been largely completed this year, spending is expected to increase significantly, rising to 24.5% of GDP from 23%, mainly due to higher current transfers, reserve allocations, and interest payments. This increase is expected to be partially offset by stronger revenue collection, equivalent to around 1% of GDP. Policymakers also stressed that fiscal policy would support disinflation, implying reduced reliance on inflationary tools such as administered price increases.

On the external front, the government forecasts a current account deficit of 2.6% of GDP in 2026, followed by a gradual improvement in subsequent years. While the new projections are higher than those in the previous plan, the elevated and gradually increasing growth path outlined in the MTP raises questions about how achievable this external adjustment is.

Regarding exchange rate assumptions, the MTP’s implicit USD/TRY projections are broadly consistent with market expectations for this year. For the following years, the programme assumes average annual increases largely in line with inflation forecasts, implying little or no change in the currency’s real value.

The MTP for 2027-2029 vs the MTP for 2026-2028

	MEDIUM TERM PLAN (MTP)				PREVIOUS PROGRAM		
MACRO ASSUMPTIONS	**2026E**	**2027F**	**2028F**	**2029F**	**2026F**	**2027F**	**2028F**
GDP (TRY bn)	85,346	111,207	133,184	153,141	77,257	89,406	101,397
GDP (USD bn)	1,821	1,984	2,091	2,225	1,658	1,763	1,886
GDP growth (%)	3.3	4.2	4.6	5.0	3.8	4.3	5.0
Unemployment Rate (%)	8.1	8.0	7.8	7.6	8.4	8.2	7.8
Employment Rate (%)	48.6	49.2	49.8	50.6	49.8	50.5	51.6
Labor Force Participation Rate (%)	52.9	53.4	54.0	54.7	54.4	55.1	56.0
Inflation (%)	28.4	21.0	13.5	9.0	16.0	9.0	8.0
C/A Balance (USD bn)	-47.5	-38.5	-37.0	-35.5	-22.3	-20.5	-18.5
C/A Balance (% GDP)	-2.6	-1.9	-1.8	-1.6	-1.3	-1.2	-1.0
Foreign Trade Balance (USD bn)	-105.0	-105.0	-108.5	-110.0	-96.0	-99.0	-102.0
Exports (USD bn)	282.0	292.0	302.5	316.0	282.0	294.0	308.5
Exports / Imports (%)	72.9	73.6	73.6	74.2	74.6	74.8	75.2
USD/TRY (implied, avg)	**46.9**	**56.1**	**63.7**	**68.8**	**21.5**	**24.6**	**25.8**
FISCAL TARGETS % GDP							
Central Administration Balance	-3.1	-3.5	-3.1	-2.8	-3.5	-3.1	-2.8
Revenues	20.0	21.0	21.0	21.0	21.0	21.0	21.0
Expenditures	23.0	24.5	24.1	23.8	24.5	24.0	23.8
Central Administration Primary Balance	0.2	0.1	0.4	0.6	0.0	0.3	0.5
Public Sector General Balance	-2.7	-3.3	-3.1	-2.7	-3.1	-2.7	-2.6
Public Sector General Balance (IMF def.)	-0.2	-0.6	-0.3	0.2	-0.2	0.2	0.3
EU Defined Public Debt Stock	21.8	21.7	22.8	23.9	24.7	24.7	24.2

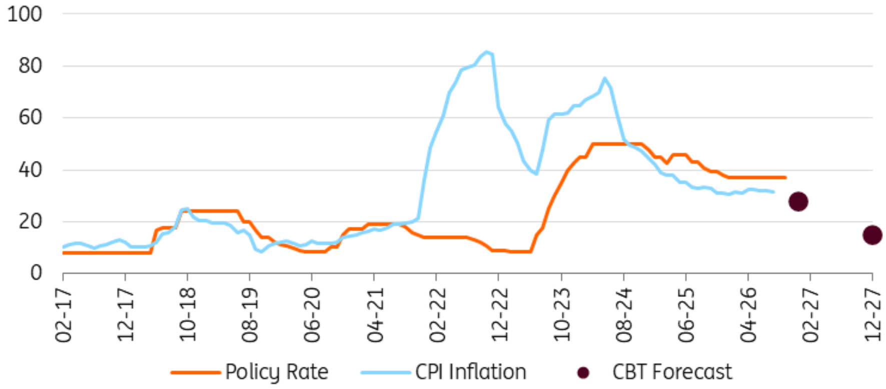
Source: Presidency of Strategy and Budget, ING

CPI inflation falls further in August

Monthly inflation in August came in at 1.84% vs the market consensus of 1.95%, while annual inflation maintained a downtrend with a slight decline to 31.5% (vs the CBT's target of 24% and forecast of 28% in the latest inflation report) from 31.8% a month ago. Despite energy and education pushing inflation higher, the positive surprise was attributable to the food group last month. Core inflation (CPI-C) rose by 1.8% month-on-month, slightly above the level recorded last year, leading to an increase in the annual rate to 30.1%. The managed currency by the central bank, with modest nominal TRY depreciation – by 1.6% in August on average and 16.9% year-on-year, significantly below inflation in the same period – limited the increase. This indicates that the CBT maintains its exchange rate policy, which continues to support the disinflation objective through the cost channel.

A breakdown of the data shows that the transportation group made the largest contribution to the headline (0.82ppt), driven by diesel prices in addition to the contribution from transportation services. This has occurred despite the newly introduced scheme that reduces special consumption tax (SCT) on diesel to TRY 0 per litre in the second half of August. The housing group followed, attributable to rent and energy-related items, with a monthly impact on the headline of 0.27ppt. The food group reading turned out relatively benign, with a mere 0.06ppt impact, thanks to a 2.0% MoM drop in unprocessed food prices vs a 2.0% increase last year and a slower increase in processed food. Accordingly, annual inflation fell to 33.8% (vs the CBT's assumption for this item at 28.5% for this year) from 37.5% a month ago.

Inflation expectations and CBT forecast (12m- ahead, YoY%)



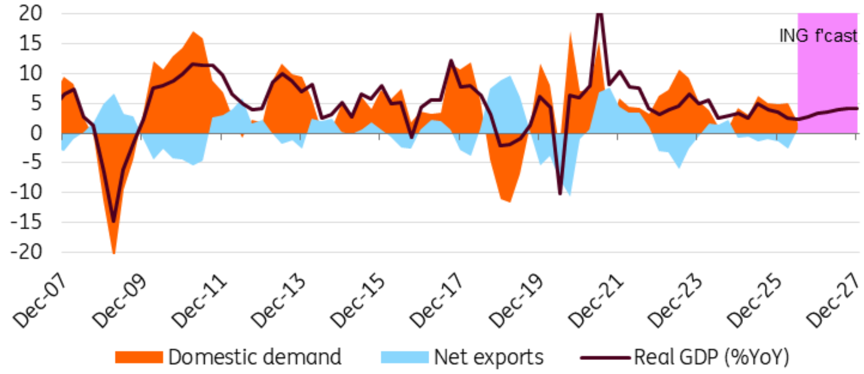
Source: CBT, Bloomberg, ING

2Q GDP growth restrained by softer domestic demand

In the second quarter of 2026, Turkey's GDP growth came in at 2.3% YoY, bringing growth in the first half of the year to 2.5% YoY. The latest figures point to a further moderation in economic activity compared with previous quarters. Despite a clear loss of momentum, domestic demand was the main driver of economic activity, while net exports turning positive also added to the headline rate.

On a seasonally adjusted basis, GDP expanded by 1.1% quarter-on-quarter in the second quarter, rebounding from the weak 0.3% growth recorded in the previous quarter. This recovery was driven mainly by net exports, which contributed 1.5ppt to the headline figure. Capital formation remained broadly unchanged after contracting in the first quarter of 2026, while inventory accumulation also made a positive contribution of 0.8ppt – although at a slower pace than in the previous quarter. By contrast, household consumption weakened further, reducing headline growth by 0.9ppt, while government consumption also turned negative and weighed on sequential growth performance during the quarter.

Real GDP (%YoY) and contributions (ppt)



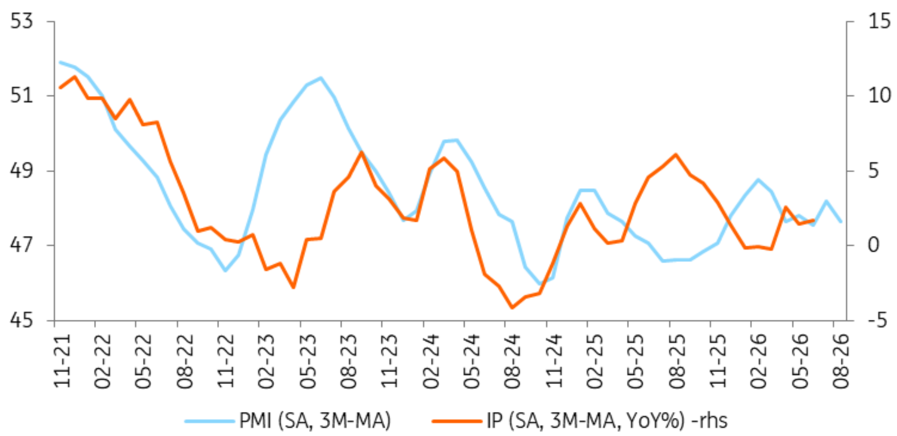
Source: TurkStat, ING

August PMI moved up further in contractionary territory

The manufacturing sector (seasonally adjusted basis) PMI moved slightly up in August to 48.1, the highest in the last three months. However, it has remained in contractionary territory. This has been the case for more than two years, confirming long-lasting challenges for manufacturers. In the breakdown, the rate of inflation in input prices moved up further with higher costs for fuel and oil, plus rising raw material prices, while selling prices were impacted by higher energy costs. Additionally, demand has remained soft with ongoing geopolitical risks, leading to weakness in total new orders and new export business.

Findings in sectoral PMIs, on the other hand, confirmed some fears surrounding the impact of war in the Middle East on economic activity; all 10 sectors are now positioned below the 50 level. Compared to a month ago, seven of these sectors recorded PMI declines on the back of higher inflationary pressures alongside weaker production and employment.

PMI & Industrial Production



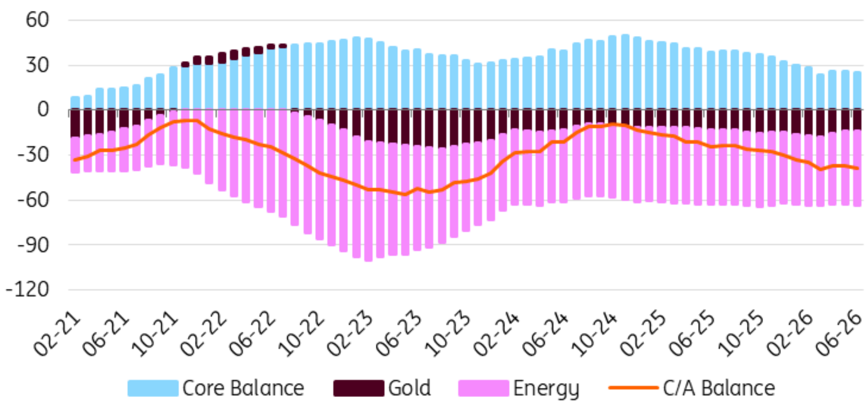
Source: ICI, TurkStat, ING

Large revisions to net errors & omissions

Following the pandemic, significant volatility has been observed in the Net Errors and Omissions (NEO) item of the balance of payments. Such fluctuations may be considered relatively normal over the short term. However, in 2021 and 2022, the NEO balance recorded exceptionally large positive inflows, while since 2023 it has posted a substantial cumulative negative balance of around US$58bn. Three separate revisions were introduced to address this issue, with the adjustments relating largely to items recorded under the financial account. These included: a) a more accurate measurement of bank deposits held abroad by residents; b) improvements in the classification and recording of financial derivatives; and c) the decomposition of domestically driven foreign banknote movements from external transactions. As a result of these revisions, the cumulative negative balance in the NEO account declined significantly, falling to US$23bn.

In the current account, standing at US$4.2bn, the deficit was narrower than the consensus in June. Compared with the same period last year, the June data shows a wider goods deficit, a larger services surplus and a higher secondary income deficit. Accordingly, the 12-month rolling deficit reached US$38.9bn, or approximately 2.5% of GDP, from US$37.0bn a month ago. On the other hand, the capital account saw a relative improvement from the previous month, with net inflows of US$5.2bn. With almost-flat net errors and omissions, and considering the current account deficit, official reserves recorded a US$1.0bn increase in June.

Current account (12M rolling, US$bn)



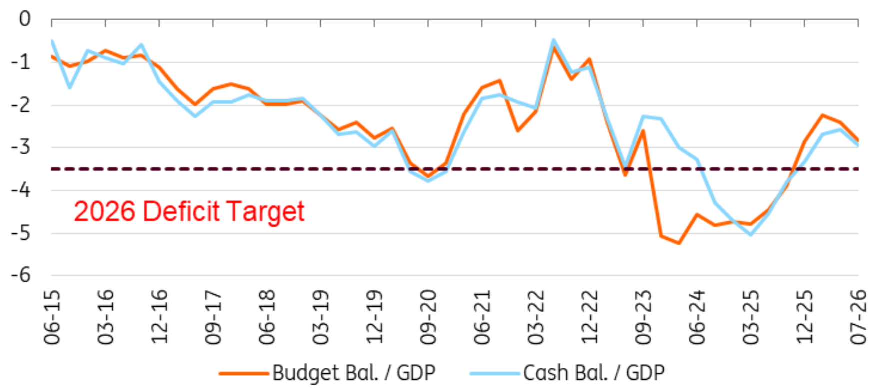
Source: CBT, ING

12M rolling budget deficit remains below the target

On the fiscal side, the Central Administration budget balance showed a relative deterioration in July, following the strength in June. This is attributable to a rapid expansion in spending, with a) interest expenditures more than doubling, translating into 84.3% real growth, likely due to uneven distribution of this item in the year, and b) a 12.7% real rise in primary spending contributed by all major sub-items except for capital expenditures. Accordingly, the 12-month rolling accrual-based government budget deficit widened to 2.7% of GDP in July, from 2.4% in June. The primary surplus narrowed to 0.6% of GDP in July, from 0.9% in June. Interest expenditures increased to TRY326.8bn in July 2026 by a high TRY192.2bn over the same period. The 12-month rolling budget deficit remains below the government's target of 3.5% of GDP.

The Ministry of Finance revisited the scheme reduced that reducing the special consumption tax (SCT) on diesel to TRY 0 per litre in the second half of August. After August, it will be increased by TRY 3 per litre each month through the end of 2026, ultimately reaching TRY 13.90 per litre as of January 2027. The new system should alleviate some of the near-term pressure on diesel pump prices, while the fiscal drag from energy subsidies is expected to persist.

Budget performance



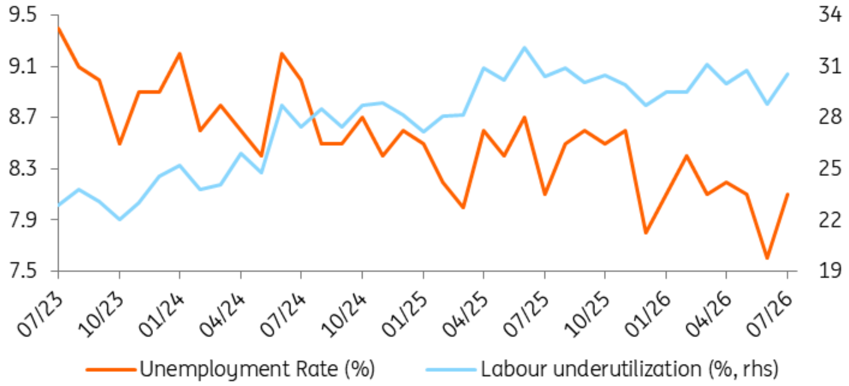
Source: Ministry of Treasury and Finance, ING

Unemployment rate rebounds from the lowest since 2005

According to the seasonally adjusted data, the number of unemployed people fell by 150K in July from the previous month, reaching 2.86m. The unemployment rate inched up by 0.5ppt on a monthly basis to 8.1%, rebounding from the lowest level in the data series published since 2005, at 7.6%. Meanwhile, the labour force participation rate stood at 52.5%, recording a drop vs June. The data showed that the rise in the headline unemployment rate was attributable to the drop in employment outpacing the fall in the labour force.

Broader measures of unemployment also pointed to a deterioration compared with the previous month. Among these, the inactive labour force rate – which comprises time-related underemployment, the potential labour force, and unemployed persons – jumped by 1.8ppt to 30.6% in June. Although this indicator typically exhibits a volatile pattern, it has been on an upward trend in recent years.

Labour market outlook



Source: TurkStat, ING

The CBT's 2026 inflation forecast at 28%

In comparison to the previous report, the bank has kept inflation targets flat at 24%, 15%, and 9% for this year and the next two years. On the other hand, the CBT hiked its forecast for 2026 to 28% from 26% earlier, now closer to that of market participants, standing at 29.4% in the latest survey. For next year and 2028, the forecasts are unchanged, and remain aligned with the targets.

The forecast hike for this year reflects a combination of changing assumptions related to several key drivers: a) a slight downward revision for external demand; b) a cut in oil prices (from US$89.4 to US$87.8); c) higher import prices on the back of diesel refinery margins, natural gas and commodity prices excluding energy; and d) an upward adjustment in food inflation to 28.5% from 26.3% due to recent data and the outlook for agricultural commodity prices.

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