TURKEY

GROWTH AND INFLATION ON THE MENU

Turkey is enjoying strong economic growth in 2021, following the credit-driven stimulus implemented in 2020. The cumulative performance over 2020 and 2021 has allowed the country to close the growth gap that resulted from the series of shocks between 2018 and 2020. Investment and the industrial sector have thus regained their previous size. Foreign currency reserves have recovered from the low levels they reached in 2020. Nevertheless, this has come at a price: inflation is running well ahead of levels seen in other emerging economies. As well as common factors (rising prices for oil and other commodities), there are specific country drivers (depreciation of the lira, untimely monetary policy decisions). There may also be an impact on bank balance sheets as measures relaxing the classification of non-performing loans come to an end - this will need to be monitored. In addition to an expansionist credit policy, reforms that benefit corporates and a substantial infrastructure investment programme are also growth drivers.

A RELATIVE NORMALISATION

Turkey has seen a recovery in activity, particularly in industry, that has exceeded all expectations. Economic growth is likely to hit 9.7% in 2021, following a year of positive growth, at 1.8%, in 2020.

The cumulative performance in 2020 and 2021 will have made up for the losses of preceding years when growth followed a boom-bust pattern. Investment, particularly in machinery and equipment, has been the main driver of growth. It contracted following the currency and interest rate shocks of 2018, which hit companies' ability to invest. Growth in investment since the 2nd quarter of 2020 has pushed it above its previous record level reached at the end of 2017.

As a result, industry has returned to the GDP share (24%) that it enjoyed before the mid-2018 crisis, thanks in particular to strong growth in manufactured goods exports since the 3rd quarter of 2020.

Foreign currency reserves have been partially rebuilt. They have returned to their pre-Covid levels, although remaining below these in relative terms (at 3.4 months of imports, from 4.2 months before Covid). Tourist flows have recovered, and are the main driver for improvements in the current account balance. The IMF's allocation of SDRs (USD 6 billion) and new bilateral currency swap agreements with other central banks have done the rest.

FORECASTS

	2019	2020	2021e	2022e
Real GDP growth (%)	0.9	1.8	9.7	3.5
Inflation (CPI, year average, %)	15.2	12.1	17.2	14.0
Gen. Gov. balance / GDP (%)	-3.5	-4.8	-1.3	-2.7
Gen. Gov. debt / GDP (%)	32.7	39.8	38.9	39.6
Current account balance / GDP (%)	0.9	-5.2	-2.8	-3.7
External debt / GDP (%)	57.1	61.0	55.6	48.2
Forex reserves (EUR bn)	79.0	50.0	77.0	69.0
Forex reserves, in months of imports	4.2	2.6	3.4	2.6

TABLE 1

e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

INFLATION RATE (%)

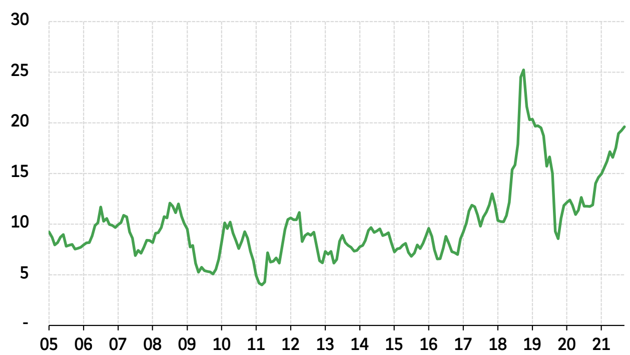

CHART 1

SOURCE: CEIC

INFLATION HAS EMERGED AS THE N°1 PROBLEM

The rebound in Turkey's growth has been driven by a rapid expansion in credit, notably in response to several monetary easing decisions. Although this expansion came mainly in the 2nd and 3rd quarters of 2020, its consequences are still being felt. The investment recovery that it has financed is continuing to drive growth. However, this accommodative monetary policy contributed to a depreciation of the lira in 2020 (combined with the high current account deficit), which is now feeding through to inflation.

A TRY depreciation of 10% adds 1.9 points to inflation after two months, and has a cumulative impact of nearly 3 points after 12 months (*Eco-Conjoncture*, January 2021).

Turkish inflation has also been exacerbated by higher prices for oil, food and most industrial commodities (particularly metals and plastics). In September 2021 the year-on-year increases in producer prices and consumer prices were 44% and 19.6% respectively.

The transmission of higher imported prices to domestic prices is even greater than in other economies, including emerging economies. This shows that corporates have a tendency to price their goods in foreign currency or with reference to a foreign currency equivalent, a characteristic of high-inflation countries where monetary policy is not considered credible enough by markets and companies.

The 100 bp cut in the policy rate announced on 23 September 2021 by the Central Bank is an illustration of this. It followed a reduction in the current account deficit and an increase in foreign currency reserves, which gave the central bank more room to manoeuvre. However, this move seems to lean against the wind as inflation pressures did not abate and other central banks are embarking on a tightening mood. This gap should become more critical as we move towards a tightening of monetary policy in the US. With high inflation and a structural external deficit, Turkey is one of the countries vulnerable to such a move, as seen in 2013 and 2018. In addition, there is an issue for all economic actors whose incomes are not indexed to prices.

HIGHER DEBT IN ABSOLUTE TERMS, BUT UNDER CONTROL IN RELATIVE TERMS

Strong nominal GDP growth should help stabilise the government debt-to-GDP ratio earlier than expected at below 40%, whilst the fiscal deficit should come down to 1.3% of GDP.

Similarly, corporates' turnover growth has also been very strong (72% in the first half of 2021, relative to the first half of 2019 in both industry and trade sectors). As a result, aggregate corporate debt ratios have stabilised despite credit growth in 2020 (35%).

This increase in credit has not so far resulted in an increase in lending risk for banks, due to flexibility in the classification of non-performing loans (extension of the late payment from 90 days to above 180 days to be considered non-performing). However, this measure came to an end in September. The non-performing loan ratio is likely to deteriorate (it was 3.7% of total loans in July 2021), with a potential increase of 1.8 points (corresponding to loans in arrears of between 90 and 180 days).

Credit expansion has helped keep afloat companies despite bumpy economic conditions. It has come along with government guarantees on the borrowings of these companies and a law that allows for the restructuring of debt. Nearly TRY 56 billion in loans had been restructured by end-May 2021, and the scheme has been extended until mid-2023. Meanwhile, the increase in the number of companies in liquidation has remained under control: 15,300 over the 12 months to end-August 2021, compared to 13,800 before the restructuring law came into force.

Moreover, having slowed since the beginning of the year, credit is now growing again, albeit less rapidly than in 2020: TRY 7 billion of new loans per week were issued in Turkisk lira over the last three months (figures to mid-September), compared to an average of TRY 20 billion per week in the 2nd quarter of 2020. Before the policy rate cut on 23 September, the central bank reduced all reserve requirement ratios on TRY deposits by 200 bp at the beginning of July.

INCREASED POTENTIAL GROWTH?

Turkey has generated growth with a lower current account deficit than prior to 2017 (excepting 2020, which was highly unusual). This rebalancing between domestic savings and investment flows suggests less reliance on capital flows.

However, the rebalancing came during a period of weak growth in 2018 and 2019. The reduction in investment weighed on potential growth. The rebound of investment since mid-2020 grounds to hope for an improvement in this potential.

Reforms have also helped. The number of procedures required to set up a company has been reduced since 2018. New business creations have hence increased rapidly, growing by as much as 20% in 2020 relative to 2019. This trend has come alongside the growing digitalisation of the economy, most visible in the 21% average annual increase in on-line bank accounts over the past three years, taking the total to 71 million in June 2021.

NEW LOANS IN LOCAL CURRENCY (TRY BN, 3-MONTHS MOVING AVERAGE)

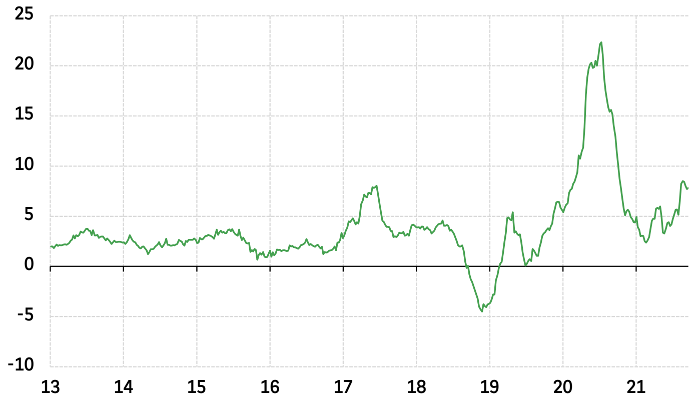

CHART 2 SOURCE: CENTRAL BANK OF TURKEY, BNP PARIBAS

At the same time, new loans have financed a number of companies involved in public-private partnerships, which have been worth a cumulative total of USD 134 billion over the last 20 years. These partnerships are used to develop the government's priority infrastructure (Istanbul Airport, the new canal providing an alternative route to the Black Sea Straits, the TurkStream gas pipeline). Infrastructure is a necessary condition for a lasting increase in potential growth, but is not in itself sufficient. Other types of investment, particularly in human capital, must follow to enable an increase in productivity, something that has not been largely observed over the past decade.

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