TÜRKIYE

STRONGER FUNDAMENTALS TO FACE A HIGH-RISK 2025

Since July, the three main rating agencies have upgraded the Turkish government's medium-term and long-term debt ratings. Macroeconomic fundamentals have really improved over the past twelve months, despite the tightening of monetary policy and the resulting slowdown in growth due to positive real interest rates for households and businesses. The slippage in the core budget deficit is still under control and the debt ratio is at an all-time low. The current account deficit has fallen sharply and the recovery in portfolio investment has helped with rebuilding official foreign exchange reserves. Finally, the de-dollarisation of bank deposits has continued and bank credit risks are generally under control. However, the economy's resilience will be put to the test in 2025, as fiscal policy will become restrictive, prevalent inflation could delay monetary easing and the external environment will be more challenging, with the economic slump in Germany, competition from China on the European market and the threat of increased protectionism.

Following the annual review of sovereign ratings, the three main rating agencies (S&P, Moody's and Fitch) revised upwards the rating of the Turkish Treasury's medium-term and long-term currency-denominated debt: by one notch for Fitch and S&P from B+ to BB- (on 06/09 and 01/11, respectively) and by two notches for Moody's from B3 to B1 (on 19/07). These improvements have not been awarded by positive developments neither in the domestic bond market nor in the foreign-exchange and equity markets. The 5-year CDS risk premium has widened very slightly since Moody's decision. At around 250 basis points at the end of October, it remains at an all-time low level but is still slightly higher than the new ratings would suggest. At the same time, the lira has continued to depreciate (-4% against the dollar since Moody's decision, -14% since the start of the year). The yield on lira-denominated Treasury bonds rose from 26% in mid-July to almost 29% at the end of October. Finally, the main index on the Istanbul stock exchange lost 20% in local currency terms, wiping out the gains made during the first part of the year.

Recent developments in financial variables illustrates the jitters being felt by investors and market operators, which may be due to Türkiye's sluggish economic situation. However, macroeconomic stability has improved significantly since mid-2023.

FORECASTS

	2021	2022	2023	2024e	2025e
Real GDP growth, %	11.4	5.5	5.1	3.0	3.0
Inflation, CPI, year average, %	19.6	72.3	53.9	58.3	30.2
Central gov. balance / GDP, %	-2.8	-1.0	-5.2	-4.6	-3.0
Gen. Gov. debt / GDP, % (EU standards)	40.4	30.8	29.3	27.6	26.8
Current account balance / GDP, %	-0.8	-5.1	-3.6	-1.0	-1.3
External debt / GDP, %	53.1	50.3	44.6	41.7	40.2
Forex reserves, USD bn	72.5	82.9	92.8	98.0	103.0
Forex reserves, in months of imports	3.1	2.6	2.9	3.3	3.4

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

ANOTHER TEST OF THE ECONOMY'S RESILIENCE IN 2025

In Q2 2024, real GDP stagnated compared with the previous quarter (+0.1%), meaning that year-on-year growth was only 2.5%, compared with an average of 5.1% over the Q1 2023-Q1 2024 period. In Q2 2024, household consumption and current public spending slowed sharply, while investment and exports contracted. The supply indicators (industrial production, services activity index) available for July-August suggest, at best, a new stagnation. By contrast, domestic demand indicators (retail sales and capital goods imports) are pointing to a rebound. Exports (measured in dollars) rose sharply in July-August before decreasing in September-October. To sum up, GDP growth in Q3 2024 is likely to be modest at best. The positive aspect of this economic outlook is that the household and business confidence indices both strengthened in September and October.

As a matter of fact, the severe tightening of monetary policy since May 2023 has not pushed the economy into recession. However, disinflation is slower than hoped; in September and October, the monthly rise in the all-items consumer price index was still 3%, meaning that, measured over a year, the inflation rate was still 49% in October, compared with the government's forecast of 41.5% at the end of the year. The central bank (CBRT) has left its key rate unchanged at 50%, and

TÜRKIYE: FX RESERVES REPLENISHMENT

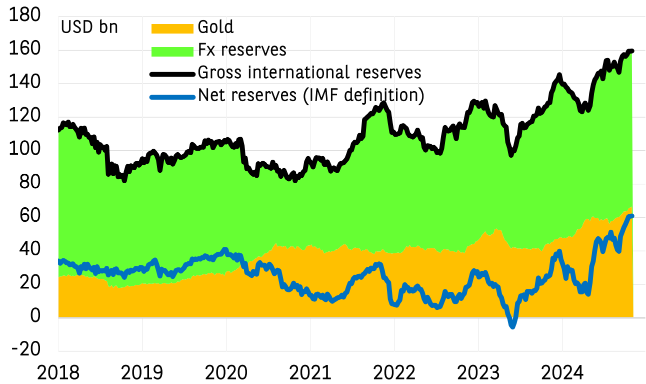

CHART 1 SOURCE: CBRT, BNP PARIBAS

lending rates to individuals and businesses have returned to positive territory in real terms. Domestic credit has slowed very sharply, from +80% year-on-year in mid-May 2023 to +30% in mid-October 2024, making a major contribution to the slowdown and landing of growth as a result.

The resilience of the economy to the monetary shock since 2023 is due to i) the support of fiscal policy, with a fiscal impact (fiscal impulse, i.e. the annual change in the primary budget balance) estimated by the IMF at +1.2 points of GDP in 2024, following +0.7 points in 2023, ii) the very strong wage catch-up due to the indexation of hourly wages to the minimum wage, which has increased by around 50% in real terms since the end of 2022, iii) the rise in employment (around +4.5% since the end of 2022), iv) sustained exports over the year as a whole (+1.4% over Jan-Oct compared with the 2023 average) and rising tourism revenues.

The resilience of the Turkish economy will be really put to the test in 2025; on the one hand, fiscal policy is likely to become restrictive (the fiscal impulse would be negative by 0.8 pp), and on the other hand, the stronger than expected tightening of the external environment would continue to adversely affect exports and investment. Maintaining growth will therefore depend on the success of disinflation, which should enable the CBRT to loosen its grip. The consolidation of purchasing power gains and lower interest rates would then enable consumption and investment to pick up again. However, if disinflation is to continue and become more pronounced, the tightening of fiscal policy alone will not be enough. An additional dose of real exchange rate appreciation is needed. The difficulty for the fiscal and monetary authorities will be striking a delicate balance between stimulating domestic demand and preserving the external balance at a time when the economic slump in Germany is likely to persist, competition from China is set to intensify and Trump's second term in office is raising fears of widespread rekindled protectionism. Against this backdrop, our scenario of growth remaining at 3% and inflation falling to 26% y/y by the end of 2025 is an optimistic one.

GREATER MACROECONOMIC STABILITY

Although prevalent inflation remains a serious problem for the lower and middle classes of the population, macroeconomic stability has improved over the last two years.

The current account deficit measured cumulatively over 12 months has narrowed considerably, from USD 55 bn in May 2023 to USD 11 bn in October 2024. The reduction in the oil bill accounts for just over half of this. However, excluding energy and net gold imports, the current account remains in substantial surplus thanks to the resilience of exports and, above all, tourism revenues, which reached an all-time high of USD 52.5 bn (still in cumulative terms over 12 months in October). The reduction in the current account deficit, coupled with the resurgence of portfolio investment (USD +22 bn) and the ability of banks and corporations to renew their medium-term and long-term debt on a large scale (USD +10.5 bn), have enabled official foreign exchange reserves to rise sharply since April, by USD 36 bn (including gold stocks) and USD 24 bn (excluding gold stocks). At the beginning of November, foreign exchange reserves as defined by the IMF exceeded USD 60 bn, whereas they were slightly negative at the end of May/beginning of June 2023.

Better still, net of the CBRT's off-balance sheet positions (which mainly consist of foreign exchange swaps with commercial banks), the CBRT's foreign exchange position, which had been monitored by the markets during previous periods of stress, was once again positive at USD 45 bn, whereas it was still largely negative until April 2024[1]. The de-dollarisation of deposits has led commercial banks to reduce their off-balance sheet foreign exchange credit position vis-à-vis the central bank.

The improvement in macroeconomic stability is also due to a slippage in the budget deficit (excluding exceptional spending linked to the earthquake in February 2023) remaining under control and the spectacular reduction in the debt ratio despite the depreciation of the lira (59% of central government debt is denominated or indexed on the exchange rate and 6% indexed on inflation). As a result, the Treasury's 'cash basis' deficit widened from 2.4% in 2023 to 4.4% in September 2024[2], but central government debt accounted for only 22% of GDP in September[3]. The interest burden has increased with the rise in interest rates (from 2.1% to 2.6% of GDP) but is largely sustainable.

Finally, the improvement in macroeconomic stability is due to the control of credit risk in the banks (at the end of September, the overall non performing loan ratio was still very low at 1.7%) and the improved solvency of corporations as a whole.

STRONG EXPOSURE TO COMPETITION FROM CHINA ON THE EUROPEAN MARKET

The Turkish economy is structurally vulnerable to external shocks, including financial shocks, of course, as external financing requirements remain very high (even though they have fallen), and a sudden outflow of portfolio investment, which has picked up over the last 12 months, would affect the lira and interest rates almost as severely as in the past.

The Turkish economy is also vulnerable through its foreign trade, particularly in the current circumstances. Exports will suffer both from the slump in Germany (the biggest trading partner of the EU and the UK, accounting for 8% of Turkish exports) and from increased competition from China. On the one hand, Chinese products imported into Türkiye account for 17% of total imports excluding energy and gold. Up until now, these imports have been mainly consumer products with low added value, but Chinese goods' penetration is growing and its Chinese corporations are moving upmarket. On the export side, the Chinese market is marginal for Türkiye (just 1.3% of exports). On the other hand, Chinese corporations are very serious competitors on the European market. For finished or semi-finished manufactured products, if we combine the share of Chinese exports in total imports from the Eurozone and the importance of the Eurozone for a given country, Türkiye's exposure to competition from China is only slightly lower than the exposure of the Central European countries, which are by far the most exposed.

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1 The negative position peaked at USD -61 bn at the end of March 2024. The return to a positive position is due to the accumulation of reserves recorded in the balance of payments, but, above all, to the non-renewal of foreign exchange swaps with commercial banks, which had enabled commercial banks to comply with the regulatory limit on their own general foreign exchange position (i.e. including the off-balance sheet position).
2 The Treasury's budget balance on a 'cash basis' (which is not usually the benchmark) is a better indicator for monitoring budget performance since December 2023, unlike the central government's balance on a accrual basis or commitment basis (the usual benchmark). This is because the latter includes spending commitments for the earthquake, whether any of this spending has been disbursed or not. As those commitments for 2023 were booked in December, the central government deficit rose from 2.7% of GDP in September 2023 to 5.2% in December. Conversely, between December 2023 and September 2024, the commitment-based balance fell (to 4.9% of GDP in September 2024) while the cash-based balance increased. Temporarily, the cash-based balance more accurately reflects the current stance of fiscal policy.
3 The figures for September 2024 are calculated on the basis of the deficit and debt figures published by the Ministry of Finance on that date and an assumption of 58% growth in GDP in value terms compared with Q3 2023. The ratio is expected to rise temporarily in December as earthquake-related expenditure is included in the deficit. The debt ratio is slightly higher by European standards, at 3.5 pp of GDP.