A CLEAR STRATEGY

The normalisation of economic policy (tightening of monetary policy and a dose of fiscal restraint) has restored confidence among investors and rating agencies. Official foreign exchange reserves consolidated over the summer, the lira is much more stable and risk premiums have eased. Economic growth remains resilient despite the slowdown in domestic credit, and the budget deficit is much lower than expected given pre-election promises. However, inflation has accelerated once again and the current account deficit has just about stabilised. The rebalancing of growth and de-dollarization have not yet been achieved, but it is more likely now that these will be seen in 2024.

Over the summer, confidence grew among foreign investors in the willingness and ability of the new team leading the Ministry of Finance and Treasury and the Central Bank (CbT) to convince President Erdogan to make a radical change in economic policy. The monetary turnaround started after their appointment and continued, with two further increases in the CbT base rate (750 bps and 500 bps), taking the policy rate to 30%. In August and September, non-residents' investments in domestic government securities returned, although flows remained limited (USD 400 million on average per month). The lira is more stable against the dollar and risk premiums on 5-year CDS are shrinking (Chart 1).

CLEAR ECONOMIC POLICY STRATEGY

Only yields on government bonds tightened following the rise in the policy rate, which enabled normalisation of the yield curve. Normalisation is the key word in economic policy. According to Cevdet Akçay, the aim is to break the dependence of economic agents (State, households, companies) on negative real interest rates, inverted yield curve despite very high inflation, and nominal depreciation of the exchange rate above inflation (in order to maintain an artificially undervalued real exchange rate). The dependence of companies, but above all households, on real interest rates, has fuelled a credit bubble, and the real depreciation of foreign exchange has led companies to maintain their market share without any effort in terms of productivity and innovation.

But this normalisation will take time and, to quote Mehmet Simsek, requires "patience" from investors. Fitch and S&P also confined themselves to revising the outlook for the Government rating from negative to stable. Normalisation will take time for at least two reasons. Firstly, the return to real interest rates presupposes i/ a slowdown in inflation that has still to come, ii/ further re-appreciation of the real exchange rate in order to firmly anchor inflation expectations and stimulate companies' non-price competitiveness. Secondly, normalisation involves the dismantling of the tangle of regulations facing banks, which had been created by the previous government with the aim of supporting growth through credit, while trying to limit pressures on external liquidity. And lastly, tightening of monetary policy may be accompanied by a slowdown in growth (which will have an effect on the population), and by an increase in credit risks, although these should remain limited.

GROWTH REMAINS UNBALANCED

So far, the Turkish economy has been more than resilient, despite the acceleration in inflation (+7.8% on average per month in Q3, 61.5% y/y in September), a consequence of the depreciation of the lira in Q2. In Q2, growth rebounded by 3.5% q/q after stagnation in Q1. Over the year, GDP growth was still at 3.8%. Growth remained unbalanced, with a negative contribution from net external trade of -1.6% q/q (-6.3% y/y).

In Q3, CbT confidence indicators of companies and households fell, on average, over the quarter as a whole, but recovered in September (except in the services sector). The rise in interest rates on both consumer credit (48%) and commercial credit (43%) led to a slowdown in domestic credit. Over the year, growth in bank lending in TRL remained very strong (+67% y/y in mid-September) but the momentum, measured over 3 months at an annualised rate, fell sharply (+33% compared to above 100% Q2). However, households continued to make extensive use of credit cards to fund their purchases.

Unemployment also continued to fall, reaching 9.4%, i.e. below its average since 2015 (10.5%), and real wage losses incurred from the end of 2021 to mid-2022 were largely wiped out. In total, household consumption is still expected to have contributed significantly to

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	1.9	11.4	5.5	4.0	3.5
Inflation, CPI, year average, %	12.3	19.6	72.3	54.2	49.5
Gen. Gov. balance / GDP, %	-3.5	-2.8	-0.9	-4.2	-5.4
Gen. Gov. debt / GDP, %	35.9	37.9	26.9	29.9	24.3
Current account balance / GDP, %	-4.4	-0.9	-5.4	-5.0	-3.4
External debt / GDP, %	59.5	53.3	50.6	50.4	48.2
Forex reserves, USD bn	50.0	72.5	83.0	84.0	89.0
Forex reserves, in months of imports	2.6	3.1	2.6	2.6	2.6

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TURKEY: FINANCIAL INDICATORS

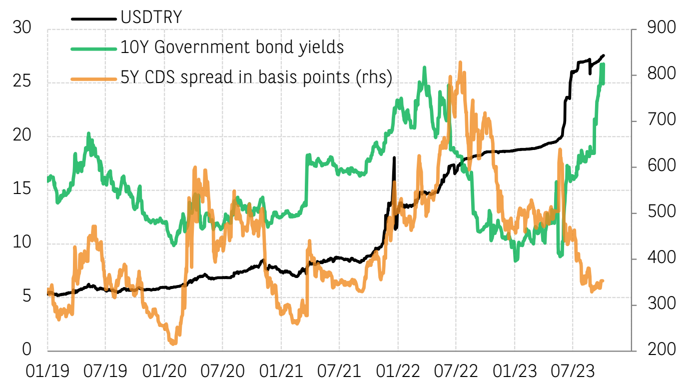

CHART 1 SOURCE: MACROBOND, REFINITIV, BNP PARIBAS

growth in Q3 2023. At the same time, imports of capital goods remained very strong. Private domestic demand is therefore expected to have supported growth in Q3. However, the contribution of external trade will remain firmly negative; in July and August, total non-oil imports (measured in dollars) increased by 5.9% compared to Q2, against 4.9% for exports. Despite the slowdown in domestic credit, the necessary rebalancing of growth has not been achieved. This is expected to be the case in 2024 if the new policy strategy is successful.

LIMITED DETERIORATION IN BUDGET DEFICIT

Prior to the election, the expected deterioration of the twin deficits against a background of tensions on foreign exchange reserves, was a real cause for concern. Developments over the summer are slightly more reassuring.

In August and over a period of 12 consecutive months, the primary deficit of the central government came out at just -0.1% of GDP, compared to a surplus of 1.1% in 2022. A downturn was broadly expected due to i/ expenditure associated with the earthquakes last February, with an estimated cost to the budget of 3% of GDP in 2023 and 2024, and ii/ pre-election promises. In the medium-term economic programme presented at the beginning of September, the primary deficit is expected to reach reach 3.9%, which means a very sharp increase in expenditure over the last part of the year. The low deficit so far can be explained by the reduced use of the earthquake envelope or delays in disbursements, and by a sharp increase in tax revenues linked to growth in revenues and the measures decided on by Mehmet Simsek in early July. The interest burden is contained at 2.5% of GDP, thanks to an effective interest rate on domestic debt in 2023 which is still limited to 18%, and a debt reduced to 30.3% of GDP in June.

For 2024, the MTEP forecasts a primary deficit of 3.4% and an interest burden up slightly to 3% of GDP, as a result of the rise in bond yields in H2 2023. The central government's external debt service for 2024 stands at nearly USD 17 billion (10.5 in principal and 6.5 in interest). If investors' appetite is confirmed, the Treasury should be able to issue as many international bonds as in 2023 (USD 7.5 billion so far) and at a lower cost (US benchmark bond yields have in theory reached their maximum and the spread of the last issue on 13/04/2023 was almost 600 basis points, which is significantly higher than currently). In addition, the liquidity buffer of the public sector (mainly the central government) with the CbT stood at USD 18 billion at the beginning of September.

DIFFICULT REDUCTION IN CURRENT ACCOUNT DEFICIT AND CHALLENGE OF DE-DOLLARIZATION

Regarding external accounts, the current account deficit (USD 58.5 billion over a period of 12 months ending in in July) has just about stabilised over the last three known months, despite significant tourism revenues (USD 45.2 billion). The oil bill was reduced by around USD 14 billion, thanks to the drop in oil prices between mid-2022 and mid-2023. However, net imports of gold, an asset that traditionally serves as a safe haven against inflation, reached USD 30 billion, whereas this item was balanced at the end of 2022. Excluding oil and gold, the trade balance, still at an equilibrium at the end of 2022, posted a deficit of USD 25 billion in August (over a period of 12 months).

The structure of the funding of the current account deficit improved slightly compared to 2022, but it remains fragile. Net direct investments did not accelerate (USD 6.2 billion), but portfolio investments are starting to return and residents' deposits remained sustained (USD37.2bn). Above all, the "errors and omissions" item is contributing much less to the balance of payments than was the case in 2022.

TURKEY: CENTRAL BANK INTERNATIONAL RESERVES

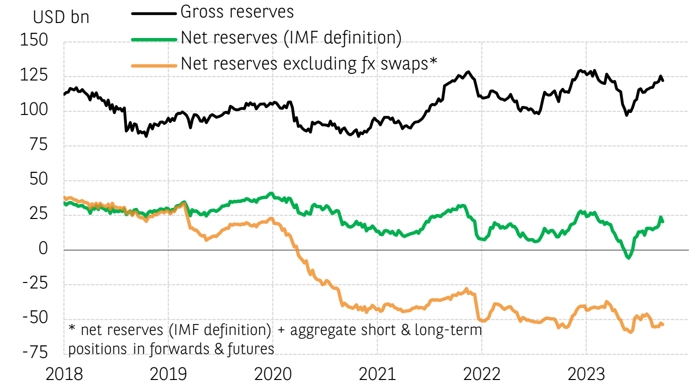

CHART 2 SOURCE: CENTRAL BANK, BNP PARIBAS

Overall, international reserves consolidated, reaching USD 122.2 billion at the end of September (including USD 74 billion in foreign exchange reserves), compared to USD 97 billion at the end of May.

Net international reserves, in IMF definition, are only USD 20 billion. If we consider the CbT's off-balance sheet foreign exchange positions (primarily foreign exchange swaps with commercial banks), net reserves are negative, to the tune of USD 54 billion. The media focus on these net reserves more than on gross reserves, which is very questionable. Firstly, because the CbT swap lines with the other central banks (i.e., the equivalent of USD 23.1 billion) are, a priori, stable resources (such as the deposits of Gulf States with the CbT). Secondly, the counterparties of the CbT's debtor foreign exchange position are local commercial banks (USD 126 billion when banks' foreign currency deposits and foreign exchange swaps are added together). In the past, the banking sector balanced its foreign exchange on-balance sheet position – by nature, a debtor position – with foreign investors. The vulnerability of the banking system (CbT + commercial banks) to the currency shock was therefore greater at the time.

De-dollarization is required for financial stability. Up until now, the State had been prompting households and companies to transfer their foreign currency and lira deposits to accounts in lira, which would guarantee them protection against depreciation of the exchange rate (the fx-protection deposit scheme known under the Turkish acronym KKM). KKM deposits currently represent the equivalent of USD 123 billion, which results in an "official" rate of dollarization of deposits of 41% (but 65% when these KKM deposits are included). This system represents a potentially significant cost for the State, valued at 3 points of GDP at the current exchange rate. The objective for the authorities is to encourage KKM account holders to close them, in order to transfer them to traditional accounts in lira. Rising interest rates on deposits should support this transfer. Even if the State has a financial interest, in theory, in making transfers quickly, the risk is redollarization of deposits and therefore, pressures on foreign exchange reserves if inflation remains high and the exchange rate continues to depreciate. Here again, success relies on the disinflation strategy with support from banks.

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