TÜRKIYE

THE REED

After picking up again in fall 2024 and winter 2025, the Turkish economy is expected to bend. This is due to financial tensions since mid-March, the impact of US tariff increases on exports, and a more restrictive fiscal policy. But it will not break. Our scenario remains one of continued gradual disinflation, which would allow the monetary easing cycle to resume. The government's solvency should continue to strengthen, but external vulnerability, due to volatile portfolio investment, is likely to increase. However, with moderate twin deficits, historically low public debt and a solid banking sector, financial stability is not at risk.

DIFFICULT REBALANCING OF GROWTH

After a slowdown in Q2 2024 and Q3 2024, growth picked up again in Q4. Real GDP grew by 2.7% cumulatively in Q4 2024 and Q1 2025. Growth was driven by domestic demand, with foreign trade making a negative contribution on average over the last two quarters. The rebalancing between these two components in the spring and summer of last year was short-lived. Private consumption remained the main driver, while exports were broadly stable. The gap between retail sales on the one hand and exports and industrial production on the other continues to widen. As regards investment, only construction investment is growing, with activity in this sector rebounding strongly (+9% cumulatively in Q4 2024 and Q1 2025).

The only indicators available for Q2 2025 are business and household surveys (up to May). Household confidence remains steady despite perceived inflation of 60% and high underemployment (nearly 30%), which puts the decline in the unemployment rate to a historically low level (8.6% in April)[1] in perspective. On the other hand, business confidence has deteriorated compared to Q1 in industry and services, with the trade sector spared for the time being.

TOWARDS GRADUAL DISINFLATION

At the same time, disinflation slowed. Admittedly, measured over one year, consumer price inflation fell sharply from +75.6% in June 2024 to +35.4% in May 2025. But this trend is misleading. The peak in mid-2024 reflects two episodes of monthly acceleration above 5% (in summer 2023 and then in January and February 2024). These were due to two episodes of financial stress that led to a sharp depreciation of the exchange rate. In fact, monthly core inflation remains high (+2.4% on average over the last three months available). Beyond the impact of the exchange rate on the price index (the pass through is 0.3 on average), inflation is being driven by both demand and costs: by demand, as consumption remains buoyant, even though households have been using credit cards less since the start of the year; by costs, because until Q4 2024, nominal wages grew much faster than inflation (70% year-on-year compared with 50%).

As productivity virtually stagnated in 2024, unit labor costs across the economy rose at the same pace as wage costs. Inflation expectations (published for May but collected in April) over a 12-month horizon among financial market professionals are, unsurprisingly, almost identical to the Central Bank's forecast for the end of the year (25%), but well below the expectations of non-financial business leaders (41%). Our forecast (30% at the end of 2025) lies between the Central Bank's forecast and the expectations of business leaders.

FORECASTS

	2022	2023	2024	2025e	2026e
Real GDP growth, %	5.5	5.1	3.2	2.5	3.5
Inflation, CPI, year average, %	72.3	53.9	58.5	34.8	24.8
Central gov. balance / GDP, %	-1.0	-5.2	-4.9	-3.3	-2.4
Gen. Gov. debt / GDP, % (EU standards)	30.8	29.3	25.6	24.3	24.0
Current account balance / GDP, %	-5.1	-3.6	-0.8	-0.9	-1.1
External debt / GDP, %	50.2	44.7	38.7	34.8	33.5
Forex reserves, USD bn	82.9	92.8	90.7	80.0	90.0
Forex reserves, in months of imports	2.6	2.9	3.0	2.6	2.7

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TÜRKIYE: UNBALANCED GROWTH

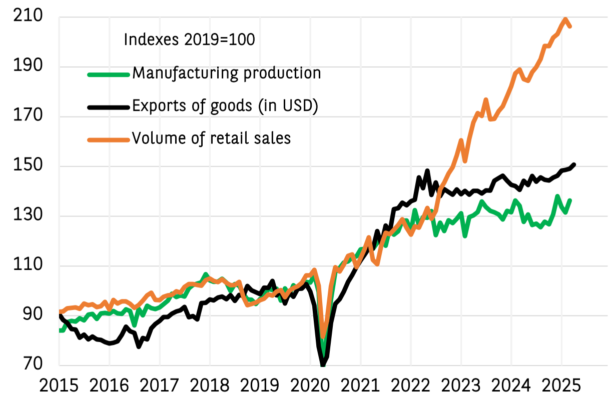

CHART 1 SOURCE: TUIK

TEMPORARY MONETARY TIGHTENING AND MORE RESTRICTIVE FISCAL POLICY

The Central Bank made another U-turn in April, raising its key policy rate from 42.5% to 46%. It cited the impact of financial tensions and tariff increases on inflation. Its statement also highlighted stronger-than-expected demand.

1 According to the Turkish Statistical Institute (TUIK) series, we have to go back to 2006-2007 to find a comparable unemployment rate (i.e., between 8.5% and 9%).

The key rate hike was accompanied by an increase in the reserve requirement ratio on short-term financing in Turkish lira obtained by banks on the offshore market. The monetary authorities' main objective is to avoid fueling carry trade operations. As compensation, and on the instructions of President Erdogan, Economy Minister Mehmet Simsek announced a new credit facility for SMEs at the end of May. This facility is currently very limited (TRY 30 billion, or around USD 800 million) but could be increased tenfold, as was the case in 2017. Overall, monetary tightening is likely to be limited and temporary. We expect disinflation to continue at a slow pace, which would nevertheless allow the central bank to resume its easing cycle in the second half of the year.

Fiscal policy is likely to be more significantly and sustainably restrictive. The central government budget deficit is expected to fall from 4.9% of GDP in 2024 to 3.3% this year thanks to a 1.5-point improvement in the primary balance (i.e. excluding interest payments). The budget would be virtually balanced (-0.2% of GDP), with the interest burden remaining broadly stable (3.1% of GDP compared with 2.9% in 2024). The decline in the primary balance would be the result of lower one-off expenditures related to the February 2023 earthquake (expenditures that are expected to be spread out until 2026) and an increase in the tax burden.

In this context i/ of a more restrictive fiscal policy than in 2024, ii/ bond yields rising since mid-March (from 26% to 33% in early June), and therefore tougher borrowing conditions for businesses and households, iii/ higher customs duties (see below), activity is expected to stagnate in the spring and pick up very gradually in H2 2025. Despite growth of 2.2% in Q1 2025, growth is expected to slow to 2.5% in 2025, compared with 3.2% in 2024. The assumption of a rebound in 2026 is based on a recovery in the Eurozone, a more conciliatory trade policy from the US, and a continued slowdown in inflation, allowing the Central Bank to ease its monetary policy again.

CURRENT ACCOUNT DEFICIT CONTAINED BUT GREATER EXTERNAL VULNERABILITY

Political tensions in March led to a decline in the Central Bank's international reserves, but not to a bleeding . Although they fell by USD 18 billion between mid-March and the end of May 2025, they remain high in absolute terms (USD 153 billion, including USD 69 billion in foreign exchange reserves) and satisfactory in terms of imports. They have even recovered since mid-May.

In Q1 2025, the current account deficit nevertheless widened (USD 4.5 billion per month on average, compared with 3.2 in Q1 2024), mainly due to net energy imports. Excluding energy and gold[2], the trade balance and current account balance remained in surplus. Cumulatively over 12 months, the current account deficit is only USD 12.6 billion, thanks in particular to a travel surplus, which remains above USD 50 billion. Before March 2025, the current account deficit was covered by portfolio investment and a large rollover debt ratio for companies and banks.

Non-resident portfolio investment in sovereign debt and equities reached USD 70 billion in mid-March, double the level at the beginning of 2024. It began to withdraw from March 19, explaining both the decline in foreign exchange reserves and the depreciation of the pound. This hot money still amounted to USD 50 billion on May 25. The exchange rate is also vulnerable to changes in the position of offshore investors' currency swaps with domestic banks (USD 30 billion), even if they do not result in an inflow of hard currency[3].

The increase in US customs duties on Turkey is substantial, with the effective rate rising from 3.3% to 15.7% (weighted average by exports). However, exports to the US account for only 8% of total exports, or 1.3% of GDP. Even assuming that the price elasticity of exports to the US is higher than that of total exports (-1 versus between -0.5 and -0.8[4]), the impact would only be -0.15 percentage points of GDP. Admittedly, Turkey is a major exporter of crude steel and steel products, on which tariffs have been raised from 25% to 50%. However, the US market accounts for only 7.5% of exports of these products. The threat is mainly indirect, as Turkish products compete with Chinese products, particularly on the European market, which accounts for 41% of the country's total merchandise exports. On this market, Turkish exporters have not lost any market share so far (with the exception of textiles). However, the sharp appreciation of the real exchange rate (+20% from early 2024 to April 2025), a major instrument of disinflation, risks causing them to lose market share this year.

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2 Net gold imports are structurally high in Turkey.
3 Currency swaps between the offshore sector and banks allow the latter to balance their net foreign currency positions between the structural net foreign currency liabilities on their balance sheets and their cash position in swaps. In doing so, they obtain Turkish lira financing to fund domestic lending, mainly in local currency. More specifically, banks exchange their dollars for Turkish lira with the offshore sector which obtains the lira on the spot market. The offshore sector is therefore engaged in a carry trade (borrowing a low-interest currency and investing it in a high-interest currency).
4 Gül and Kazdal "Time-varying relationship between exports and real exchange rate in Turkey: a recent analysis at sectoral level" - CBRT Working Paper 21/38 - December 2021.