TURKEY

ON THE RAZOR'S EDGE

The economic situation in Turkey offers striking contrasts between (i) sustained growth until Q1 2022 and stubbornly huge inflation, (ii) much greater confidence among companies than among households, (iii) a primary budget surplus and a deteriorating current account deficit due to the surge in the price of energy, and (iv) domestic borrowing conditions for the State at an unprecedented negative real rate despite massive outflows from portfolio investments. Economic policy still combines a deliberately accommodative monetary policy and a competitive exchange rate to stimulate investment, exports and import substitution. The government will now use fiscal leverage to mitigate the economic cost of inflation and is multiplying ad hoc measures to stabilise, unsuccessfully so far, foreign exchange reserves.

The Turkish economy has so far shown remarkable resilience to the multiple external shocks (commodity price boom, a slowdown in the eurozone, monetary tightening in the United States and war in Ukraine) and to the inflation and financial pressures that companies and households are facing. The former are adapting quite well to this difficult context. However, the latter are suffering more and more. Monetary authorities maintain a very accommodative monetary policy despite the acceleration of inflation and are multiplying ad hoc measures to stabilise external liquidity, which continues to dwindle. At the same time, the government will use fiscal firepower to compensate the population's loss of purchasing power before the presidential and parliamentary elections planned for June 2023, at the latest.

A VERY MIXED ECONOMIC SITUATION

Between Q4 2021 and Q1 2022, which covers the financial shock of autumn 2021 and the external shocks of winter 2022, economic growth held up well, with real GDP up 3.2% compared to the previous six months. In Q1 2022, GDP growth (+1.2% Q/Q) was even more balanced, supported by investment and a positive contribution from net external trade. By contrast, household consumption contracted and general government current expenditure was stable. This illustrates the contrast between the economic situation being perceived and experienced by companies compared to households.

For corporates, the confidence surveys by the Central Bank (CBRT) have shown deterioration since February, but the level of confidence remained high until June. In particular, opinion on export order books remained very significantly above the historical average (2020–2021 excluded). Until the start of this year, corporates had indicated a strengthening of their competitive position on external markets, particularly in Europe. More strikingly, opinion on investment and employment intentions continued to improve until June. Regarding investment, confidence is even at an all-time high. At the same time, commercial credit has accelerated very strongly since Q3 2021, reflecting the likely increase in working capital requirements linked to the rise in commodity prices and inventory financing as well as investment dynamics.

Conversely, consumer confidence has been deteriorating continuously since October 2021, reaching a record low in April/May. Yet the labour market situation has improved. Employment was 7% higher than it was at the end of 2019 and the unemployment rate has fallen to 11.3% in April compared with 13.4% at the end of 2019 (without a drop in the working population). The main reason was households' loss of purchasing power due to the acceleration of inflation (+5.1% per month on average between February and June 2022 after 12% on average in December-January, bringing the year-on-year rise in consumer prices to 78.6% in June). On average between Q4 2021 and Q1 2022, real wages were down 6% compared to their average level between Q2 2021 and Q3 2021, despite the 50% hike in the minimum wage on 1st January. The increase in household credit (+36% year-on-year at the end of June) is almost half that of commercial credit (+70%). However, credit card debt and general purpose loans, which are generally used to deal with unforeseen expenses, or even to make it through to the end of a difficult month, have picked up again sharply since April. In short, inflation is exacerbating household budgetary constraints.

FORECASTS

	2019	2020	2021	2022e	2023e
Real GDP growth, %	0.9	1.8	11.0	3.5	3.0
Inflation, CPI, year average, %	15.2	12.1	19.6	71.0	40.0
Gen. Gov. balance / GDP, %	-2.9	-3.5	-2.7	-3.9	-3.6
Gen. Gov. debt / GDP, %	30.8	35.9	38.1	40.0	39.5
Current account balance / GDP, %	0.7	-5.0	-1.7	-5.5	-3.0
External debt / GDP, %	54.6	60.1	54.0	59.0	51.0
Forex reserves, USD bn	77.1	49.0	72.5	55.0	65.0
Forex reserves, in months of imports	4.1	2.6	3.0	2.2	2.4

TABLE 1

e: ESTIMATE & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TURKEY: BUSINESS & CONSUMER CONFIDENCE

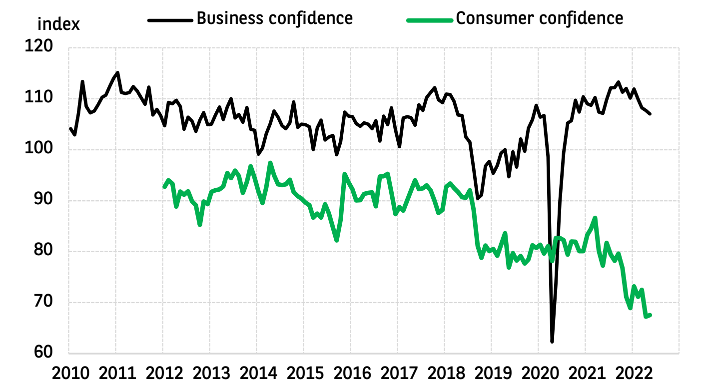

CHART 1

SOURCE: CENTRAL BANK, TURKSTAT

BUDGET SUPPORT

The inflation burden suffered by the population has pushed the government to introduce an additional budget of TRL 880 billion for extra expenditure, i.e. USD 50 billion (around 6.5% of 2021 GDP). Most of the extra expenditure is on staff expenses, social transfers and subsidies for coal and gas importers in order to limit the rise in energy prices. The revised budget nevertheless foresees an unchanged deficit of around TRL 280 billion, or just 2.5% of GDP forecast for 2022 thanks to an upward revision of tax revenues. In fact, over the first 5 months of the year, tax income increased by 25% in real terms. On average since the beginning of the year, the budget deficit has thus reduced to 2% of GDP with a primary surplus of 0.6% of GDP. However, the deficit does not take into account the potential cost of the fx-protected lira deposit scheme introduced in November 2021[1]. At the current exchange rate, this cost is in the region of 0.5% of GDP[2] and could increase to 1% if the depreciation of the lira reaches 30% over the year.

Interest payments are stable at 2.6% of GDP. They have increased by only 0.3 percentage points since the end of 2019 while the debt ratio has increased from 30% to 38% of GDP. The debt burden could even reduce as yields on 10-year government bonds, which had stretched from 17% to 25% between the end of September 2021 and the end of March 2022, have since fallen slightly below 20%. In real terms (based on underlying inflation), the cost of borrowing in local currency for the State is dramatically negative (-30%) while it was still slightly positive in 2020–2021. If the exchange rate were to strengthen again, the debt ratio would reduce automatically and considerably, as the proportion of foreign-currency debt is 68%. The success of budgetary support, which is part of the government's macroeconomic strategy (negative real interest rates, competitive real exchange rates), therefore depends closely on the evolution of external accounts.

DWINDLING EXTERNAL LIQUIDITY

Unsurprisingly, the current account deficit and the trade balance have widened since the beginning of the year. The 12-month cumulative current account deficit reached USD 26 billion in April and the trade deficit reached USD 71 billion in May. This deterioration is only the result of the ballooning energy bill and net gold purchases. Excluding oil and gold, by contrast, the current account surplus widened, reaching almost USD 40 billion in April, reflecting the improvement in corporates' competitiveness on both external and domestic markets. However, the CBRT's international reserves continued to dwindle to USD 101.9 billion at the end of June 2022 compared to USD 128.5 billion at the end of November[3], as a result of the widening of the current account deficit but also strong portfolio investment outflows[4]. But, for the time being, corporates and banks are not experiencing any external refinancing difficulties (the rollover rate of medium- and long-term debt for non-financial enterprises remains well above 100% and that of banks remains between 90% and 95%).

In an attempt to curb the haemorrhage of foreign exchange reserves, the monetary and banking regulatory authorities have introduced new measures since the start of the year which strengthen or complement those taken at the end of 2021[5]. The ones aiming to rapidly support dollar liquidity are deliberately coercive[6]. Others are macro-prudential measures aiming at structurally improve the external balance[7].

Since the beginning of June, the lira has stabilised at around 17 TRL to 1 USD. However, this stabilization remains precarious because restoring financial stability via the rebalancing of external accounts is presently being counteracted by (i) the rise in commodity prices which fuels the inflation spiral, (ii) the accelerated tightening of US monetary policy which generates general distrust among investors towards emerging countries, and (iii) the specific distrust of the economic policy being followed in Turkey.

Article completed on 27 June 2022

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1 See Eco Emerging Editorial, January 2022. Around 14% of deposits, equivalent to around USD 50 billion, are covered by this mechanism.
2 In practice, the mechanism compensates depositors when the depreciation rate exceeds the policy rate rate (14%), which has been the case since the lira's depreciation by 17% against the US dollar since the end of 2021.
3 On 26/06, international reserves were USD 101 bn, including 41.6 bn in gold and 60.3 bn in foreign currency, which include the equivalent of approximately USD 53 bn of swap lines with Qatar and China.
4 USD 11 bn between October and April based on (exhaustive) balance of payments data and at least 3 bn more in May-June based on CBRT data from non-residents' transactions in the domestic bond and equity markets.
5 See Eco Emerging Editorial, January 2022.
6 Increase in the export income repatriation rate from 25% to 40%, ban on access to new bank loans for companies with foreign currency cash exceeding the equivalent of USD 300k or representing more than 10% of assets or annual turnover.
7 Increase in risk weights of TL commercial loans in the calculation of risk weighted average assets, selective increase in the reserve requirement ratio on bank loans to businesses, and central bank credit provision for long-term investment projects that support efficient production areas or promote import substitution.