# TURKIYE



## CHANGE OF DIRECTION

**Since the presidential and legislative elections in May, the Turkish lira has fallen sharply again and domestic interest rates have increased. Calm has returned in recent weeks with the monetary turnaround of the central bank (CBRT), now led by Hafize Gaye Erkan, and the return of Mehmet Simsek, who in the past has been the AKP government's guarantor to foreign markets and investors, at the head of the Ministry of Treasury and Finance. But their task of rebalancing a real economy in a state of overheating and faced with stubbornly high inflation is a challenge. More than the recent slowdown in growth, the likely risk of worsening twin deficits must be closely monitored. However, the alarmist analyses that conclude that there is a risk of a balance-of-payments crisis are exaggerated.**

Since the presidential and legislative elections in May, financial tensions in Türkiye have renewed. A much-anticipated start to monetary normalisation took place in the weeks following President Erdogan's re-election and the better-than-expected score of the AKP in parliament. Under the aegis of a new governor, Hafize Gaye Erkan, the central bank's key rate (the two-week repo rate) was raised from 8.5% to 15%.

President Erdogan also called on one of his former finance ministers, Mehmet Simsek, to reassure the financial community about the government's economic strategy.[1] Mr Simsek stressed the need for rational economic policy, i.e. budgetary policy and monetary policy based on clear rules (particularly monetary policy, the objective of which must remain price stability) and predictable rules (particularly budgetary policy, the objectives of which must be the control and stability of deficits and their financing). Mr Simsek advocates a policy based on the principles of market economics, open to the outside world with a free exchange system, the final objectives being (financial) stability, confidence and sustainability of growth.

**FORECASTS**

| | 2020 | 2021 | 2022 | 2023e | 2024e |
|---|---|---|---|---|---|
| Real GDP growth, % | 1.8 | 11.4 | 5.0 | 2.6 | 3.5 |
| Inflation, CPI, year average, % | 12.1 | 19.6 | 72.3 | 48.1 | 45.3 |
| Gen. Gov. balance / GDP, % | -3.5 | -2.8 | -1.9 | -6.0 | -2.5 |
| Gen. Gov. debt / GDP, % | 35.9 | 37.9 | 26.9 | 29.9 | 24.3 |
| Current account balance / GDP, % | -4.4 | -0.9 | -5.3 | -4.5 | -3.6 |
| External debt / GDP, % | 59.9 | 53.4 | 57.4 | 48.0 | 44.0 |
| Forex reserves, USD bn | 49.0 | 72.5 | 83.0 | 65.0 | 70.0 |
| Forex reserves, in months of imports | 2.6 | 3.1 | 2.6 | 2.0 | 2.1 |

TABLE 1 e: ESTIMATES & FORECASTS SOURCE: BNP PARIBAS ECONOMIC RESEARCH

## THE CHALLENGES FACING THE NEW ECONOMIC TEAM

Some calm has returned with the actions of the central bank (CBRT) and the statements of Mr Simsek. But yields on 10-year government bonds in local currency, which moved below 10% before the elections, have just stabilised at around 16% since mid-June. Above all, the Turkish lira, which lost just over 20% compared to its pre-election level (compared to 6.5% between the end of 2022 and the day before the elections), has not re-appreciated. In fact, the markets were expecting a more severe monetary tightening (the average forecast for the repo rate was 20%).

Against a backdrop of still significant economic growth until Q1 2023, monetary tightening is deemed insufficient to curb inflation (for the overall index and measured year-on-year, inflation slowed significantly from 85.5% in October 2022 to 39.6% in May; however, core inflation continued to rise sharply, standing at 2.9% month-on-month on average between February and May, and has even accelerated again since April, reaching 4.3% in May) [2], and to reduce the current account deficit. The markets are concerned about the recurrence of twin deficits (current and budgetary), which are to be monitored (i.e. above 5% of GDP each). A rebalancing of growth is indeed necessary.

**TURKIYE: RENEWED FINANCIAL TENSIONS**

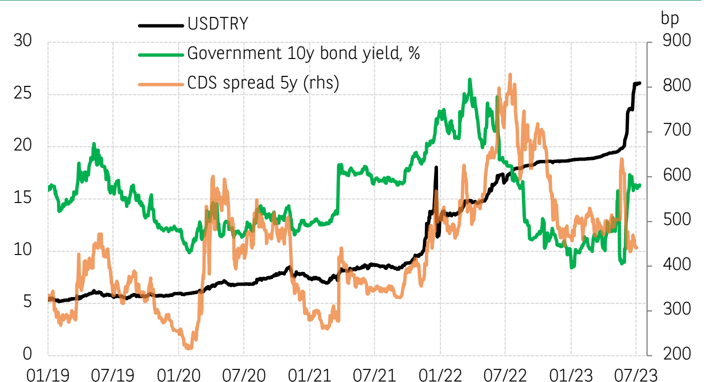


CHART 1 SOURCES : MACROBOND, BNP PARIBAS

*1 Together with Ali Babacan, Mehmet Simsek was the guarantor of the Erdogan government for the conduct of economic policy and public finances for many years : Mr Simsek, as Minister for Treasury and Finance between 2009 and 2015, then Deputy Prime Minister for the Economy from 2015 to 2018, Ali Babacan, as Minister for the Economy from 2002 to 2007, then Deputy Prime Minister for the Economy between 2009 and 2015.*
*2 According to ENAG, a collective of economists, mainly academics, who collect daily or even intraday data, mainly online, inflation was 8.5% month-on-month between 30/05 and 30/06 and 108.6% year-on-year (NB: inflation measured by ENAG has always been at least double the official inflation published by Turkstat, notably because it does not take into account administered prices).*

## FROM OVERHEATING TO SLOWING DOWN

Despite inflation and the depreciation/volatility of the lira, the economy has remained dynamic, even though activity slowed in Q1 2023 (+0.3% q/q after +0.9% in Q4 2022). Real GDP is 20% higher than at the end of 2019, the strongest performance amongst the main developed and emerging countries, including China. Business confidence has been eroded since mid-2022, but not more so than in other countries. The confidence of households, which had fallen from mid-2018 to mid-2022 when it reached a low, has rallied and returned to its average level for 2015-2017.

Household consumption has been particularly dynamic thanks to the catch-up of wages on inflation from H2 2022 (the minimum wage has multiplied by 3.9 since the end of 2019, including +55% in early March 2023, compared to x2.9 for the official consumer price index). The increase in employment (+11% at the end of March 2023 compared to the end of 2019) and the use of credit, particularly by cards, also supported household purchases. The number of people actively using credit cards increased from 20.7 million in December 2019 to 25.5 in March 2023. Faced with rapid inflation, this payment method, whose interest rates have been capped, has been as much an opportunity as a last-resort financing solution for households. Admittedly, the rate of payment incidents on cards to private individuals is relatively high (between 6.5% and 12%), but has fallen since 2021. Overall, Turkish households are not over-indebted. At the end of March, total outstanding bank loans represented 10% of GDP and 45% of the wage bill compared to 13% and 42% respectively at the end of 2019.

Corporate investment has been even more dynamic than private consumption. Investment in equipment is 40% higher than its previous high point in mid-2018. The increase in imports of capital goods (in dollars) is just as impressive. In particular, corporate investment has been boosted by the dynamism of exports. Furthermore, net external trade (exports minus imports) only contributed negatively to growth from Q3 2022. Contrary to households, companies as a whole have used much less credit; total outstanding commercial bank loans represented 37% of GDP and 56% of gross macroeconomic operating surplus[3] in March compared to 50% and 85% respectively at the end of 2019.

Before monetary tightening and the depreciation of the lira in recent weeks, a slowdown in growth was anticipated due to the recessive impact (at least in the short term) of the February earthquake and the economic turnaround of the main European trading partners, with Germany leading the way. Recent financial tensions can only exacerbate this, despite the a priori positive effect of the depreciation of the exchange rate on net external demand.

Households will be subject to both a further acceleration in inflation and higher credit rates (already, banks had raised the consumer credit rate sharply from 25% at the beginning of March to 41% in mid-June). However, the pre-election announcements made by President Erdogan should result in a sharp increase in public spending and transfers and prevent the economy from falling into recession.

## THE SPECTRE OF TWIN DEFICITS

Much more than the slowdown in growth, the risk of worsening twin deficits must be closely monitored. In April, the 12-month rolling sum of the current account deficit reached USD 57.8 billion, representing just over 6% of GDP. However, the drop in oil prices would save almost USD 20 billion on the energy bill (based on a price of USD 75 per barrel for Brent). In addition, tourism revenues should reach a record (of at least USD 45 billion). In our scenario of a moderate growth slowdown, the current account deficit would fall over the second half of the year so that it would come out at between USD 35 and 40 billion for 2023 as a whole, i.e. between 4% and 4.5% of GDP.

There is more uncertainty about the budget deficit. Between January and May, the general government budget balance posted an annualised deficit of 3.6% of GDP while, over the same period in 2022, this balance was positive. With the slowdown in activity, announcements during the campaign and the cost of the bank deposit protection scheme for households and companies having agreed to convert their deposits in foreign currency into lira (cost estimated at 1.5% of GDP since its implementation at the end of 2021 if the exchange rate against the dollar stabilises in the 25–27 range), the deficit could reach 10% of GDP according to the Economic Policy Research Foundation of Türkiye (TEPAV). Corrective action will probably be taken to prevent such slippage.

But if this is not the case, the current account deficit would most likely exceed 5% of GDP by a large margin and tensions on interest rates and the lira would reappear even if monetary tightening continued. In this scenario, some analyses are considering the eventuality of a balance-of-payments crisis given the erosion of foreign exchange reserves. The BoP crisis could even escalate into a financial crisis due to a significant and unprecedented central bank balance sheet imbalance and the exposure of companies to foreign exchange risk[4]. Foreign exchange reserves actually fell by USD 25.6 billion between the end of 2022 and mid-June to USD 102.8 billion (including gold stock) and USD 60.8 billion for foreign currency reserves. In net terms, they have become negative again. But net reserves show a biased picture of the country's available external liquidity in our view. Above all, let the new Minister for the Economy and Finance and the Governor of the Central Bank take the time to rebalance the economy and do not underestimate the resilience that the Turkish economy has demonstrated over the past few years.

**François Faure**
francois.faure@bnpparibas.com

*3 GDP – payroll + taxes (net of subsidies)*
*4 Türkiye's increasing balance sheet risks» - Brad W. Setser – Council of foreign relations – June 2023*