TÜRKIYE

FRAGILE FINANCIAL STABILISATION

Türkiye has enjoyed a period of financial calm since mid-2022 with exchange rate stability relative to the first half of the year, lower risk premiums and bond yields. Growth stagnated in Q3 2022, but monthly inflation slowed and the economic indicators available for Q4 2022 continued to be positive. For 2023, a slowdown is inevitable given the weaker levels of activity expected from the country's main trading partners. But domestic demand could mitigate the external shock and the fall in oil prices should help to reduce the current account deficit. However, it is still too early to draw any conclusions about the success of economic policy combining fiscal support, monetary easing, and measures to channel the growth of credit and to encourage *liraization*.

Over the past six months financial conditions in Türkiye have eased significantly. Since October, the lira has been more stable against the dollar (USD) after depreciating by 25% over the first six months of 2022, a depreciation which slowed sharply over the summer (-7%). The official foreign exchange reserves were reconstituted, reaching USD 128bn at the end of December compared to USD 100bn at the end of June. The risk premium measured by 5-year CDS spreads fell from 900 basis points in mid-July to 500 basis points at the end of December. More striking still, the yields on 10-year government bonds fell by 25% from the beginning of April to 9.7% at the end of December despite the acceleration in inflation, which over the same period went from 60% to 64.3% year-on-year.

Is this easing just temporary or, on the contrary, does it indicate the success of the monetary and financial strategy combining monetary easing (since mid-August 2022, the central bank's main key rate has been reduced from 14% to 9%), an increase in the regulatory measures affecting banks (90 between December 2021 and December 2022) mainly to channel credit growth, and incentives for *liraization?*

It is still too early to answer this question. On the one hand, activity is holding up, the monthly rate of inflation is falling and the budget deficit is much lower than was generally anticipated. On the other hand, the current account deficit exceeds the warning level of 5% of GDP, due to the increase in the energy bill, and the external financing sources are fragile. However, the risk of further financial stress before the elections in June 2023 is low.

SUSTAINED GROWTH DESPITE INFLATION

Over the first nine months of 2022, and compared to the same period in 2021, real GDP growth stood at 5.9% in spite of a slight contraction in Q3 (-0.1% q/q). Consumer spending was the main driver with an increase of 21%, a record since the national accounts were created[1]. Compared to 2019, the increase was 40%. The usual indicators (car sales, industrial production and imports of consumer goods) showed more moderate increases but were just as exceptional in their extent[2] . However, real wage income (+13% compared to 2019) rose at a slower pace than consumption despite dynamic employment (+11% since 2019). Acceleration in inflation led to a loss in purchasing power until mid-2022. Nevertheless, household confidence has recovered since the summer thanks to a second increase in the minimum wage in July and the announcement last June of a sharp increase in the State budget, in particular current transfers in the run-up to the presidential and legislative elections in June 2023[3]. In particular, consumption was supported by credit.

FORECASTS	2020	2021	2022e	2023e	2024e
Real GDP growth, %	1.8	11.4	5.0	2.8	3.5
Inflation, CPI, year average, %	12.1	19.6	72.3	39.4	33.4
Gen. Gov. balance / GDP, %	-3.5	-2.8	-1.9	-3.4	-2.6
Gen. Gov. debt / GDP, %	35.9	37.9	29.3	27.5	25.0
Current account balance / GDP, %	-5.0	-1.7	-5.9	-3.6	-3.6
External debt / GDP, %	60.1	54.0	56.6	53.3	47.3
Forex reserves, USD bn	49.0	72.5	83.0	85.0	90.0
Forex reserves, in months of imports	2.6	3.1	2.7	2.7	2.7

e: ESTIMATE & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS ECONOMIC RESEARCH

TÜRKIYE: BETTER FINANCIAL CONDITIONS

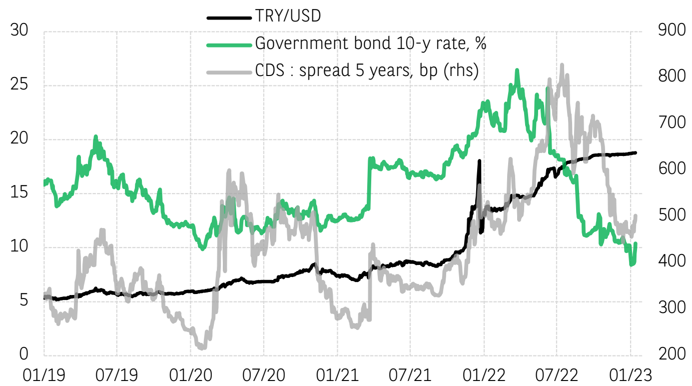

CHART 1 SOURCE: MACROBOND, REFINITIV, BNP PARIBAS

The increase in consumption over the past two years has gone well beyond just a catch-up effect: true, several factors (anticipated purchases of durable goods, negative real interest rates, dynamic labour market) can help to explain this, but the pace of growth appears difficult to extrapolate. Investment and net exports contributed much less to growth. Nonetheless, their composition contributes to macroeconomic stability and suggests an increase in potential GDP.

1 The previous records were in 1977 (19.6%) and 2021 (15.3%).
2 +12% for car sales (compared to 2019), +25% for industrial production of durable goods, +28% for non-durable goods, +39% for imports of consumer goods measured in dollars. However, the market for new cars for private individuals is a small market (550,000 per year on average over the last 5 years) and is volatile (following the significant upturn in 2020, sales fell by 8% in 2021 and again by 2.5% year-on-year January-November 2022).
3 The budget, which has been revised twice (in June and then in September as part of the medium-term fiscal programme), provides for an increase in current transfers of up to 10% of GDP in 2022 compared with 5% initially (and 8.5% in 2021).

Investment in machinery and equipment was very dynamic (+15.4% after 9.1% in 2021) unlike investment in construction (-12.4% after -6% in 2021). Imports were rather moderate (only 7.8% in 2022) given the strength of demand components, whose propensity to import is a priori the strongest (consumption, investments in machinery and equipment, exports[4]). Moreover, the increase in imports of capital goods exceeded that of consumer goods. At the same time, exports increased more vigorously than imports from the European Union (respectively 14% compared with 9.5% in 2022), Türkiye's main market (41% of its exports). There are more diversified geographically; the EU's share of total exports has decreased by 3 points since 2018 in favour of the United States and very recently Russia (+1.5 points each).

NO RISK OF RECESSION IN 2023

In October, the economic indicators improved once again and in the last quarter, exports grew by +6% compared to Q3 despite the loss in growth momentum in the Eurozone. Activity could therefore have bounced back in Q4. However, according to the central bank's surveys in the manufacturing sector, the opinion of companies on production and order books continued to be more pessimistic until November 2022 and companies considered that their stock levels were too high.

For 2023, the expected slowdown or recession in the main trading partners (Germany is the country's largest external market) is likely to eventually hinder exports. However, domestic demand could mitigate the external shock.

The wages catch-up should continue (a further 30% increase in the minimum wage in July) and, with the stabilisation of the lira, inflation should continue to slow (core inflation fell from 8% per month end of 2021-beginning of 2022 to 4% between February and August, then 2% between September and November 2022). In addition, households will benefit from the rise in current transfers, which should be focused on the first half of 2023[5] . It is unlikely that they will draw on their savings as much as in 2022, but a further drop in the savings rate is still a possibility as Turkish households are not over-indebted.

Productive investment should continue to be supportive of growth. The opinion of manufacturers about their investment plans remained quite positive until last November. The gross operating surplus[6] has recovered strongly in real terms since mid-2020 and, unlike consumer credit, corporate loans appear to have played only a secondary role in the recovery of investment in equipment.

In total, despite an external environment that is much less buoyant than in 2021 and 2022, the Turkish economy would not only escape recession in 2023, but growth could surprise on the upside once again.

EXTERNAL DEFICITS, A LIMITING FACTOR FOR FISCAL SUPPORT

The budget implementation for 2022 shows a central government deficit of only 1.2% of GDP in January-November with a primary surplus of 0.9%, and therefore a net interest burden which remains moderate at 2.1%. The government benefits from artificially low negative real interest rates by requiring banks to hold Treasury securities for reserve requirements, not only on deposits but also on loans[7].

The fiscal room for manoeuvre is significant and the government will use it. External imbalances, however, are a limiting factor for fiscal support.

At USD 43.5bn over a twelve-month rolling period to October, the current account deficit reached 6% of GDP. This results from the increase in the energy balance deficit (8% of GDP compared to 5% in 2021 and only 0.5% in 2020) and the growth differential with the rest of the world. According to the central bank, when adjusted for the growth gap and terms of trade, the current account has been in surplus since Q4 2021.

In 2023, the current account deficit should reduce with the fall in oil prices. The government forecast of 2.5% of GDP, which until now was considered very optimistic, has become more realistic because, at the current price level (80 dollars per barrel for Brent), the energy bill should reduce by around 2 points of GDP. However, it is unlikely that, excluding energy, the current account will improve by an additional 1.5 points of GDP because inflation has reduced the exchange rate-based gains in competitiveness.

In 2022, the current account deficit was covered up to 30% by the "errors and omissions" component. The latter includes some (probably underestimated) tourist revenues, as well as unrecorded flows from Russia (unlike the EU, Türkiye does not impose an embargo and serves as a bridge for Russia's foreign trade). For 2023, errors and omissions should normalise. However, they could be offset by a reduction in portfolio investment outflows if the elections do not result in a conflicted situation (in the event of political coexistence, for example), generating further outflows of capital.

Liraization has become the main objective of the authorities[8]. The incentive scheme for individuals and companies to convert their foreign exchange deposits into lira[9] has been a success, with the share of foreign exchange deposits held by companies and individuals combined having fallen from 63% at the end of 2021 to 46% at the end of 2022. The cost of this scheme for the State amounted to almost USD 5bn in 2022, or 0.7% of GDP, which remains moderate. However, with the fall in key rates and the stabilisation of the exchange rate, exits from the arrangement took place last December and caused further tensions on the lira.

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4 The headline elasticity has decreased by 30% since 2019 compared to 2009-2019.
5 Current transfers effected between January and November 2022 only reached 82% of the expected annual budget.
6 Measured, as a first approximation, by nominal GDP – compensation of employees – taxes net of subsidies on production.
7 The scale of the anticipated disinflation is not enough to explain the drop in nominal rates: in December, only 7% of the professionals surveyed by the central bank forecast a rate of inflation of less than 25% by the end of 2023, and only 5% a rate of less than 10% by the end of 2024.
8 In the title of the official central bank document detailing the monetary policy strategy, the term «liraization» appears explicitly.
9 The so called fx-protected deposit scheme was put in place at the end of 2021 and extended until the end of 2023.