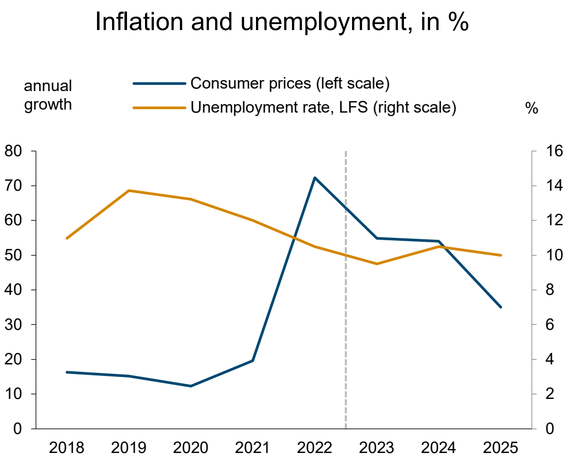
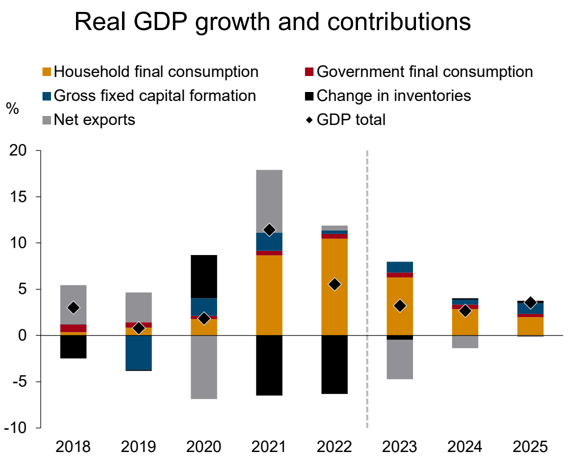
TURKEY: A balancing act between growth and disinflation

MERYEM GÖKTEN

In the first half of 2023, Turkey faced a challenge of unbalanced economic growth, fuelled primarily by strong household consumption. While this uptick provided a boost to the economy, it also created a delicate balancing act for the Turkish authorities. If they maintain their dedication to monetary stability, the opportunity exists to gradually rein in inflation over the coming years; however, that would come at the cost of economic slowdown. That said, the possibility of policy reversals in the future, once external financing becomes more stable or the budget deficit levels out, brings an element of uncertainty.

Figure 6.22 / Turkey: Main macroeconomic indicators





Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

In Q2 2023, Turkey's economy outperformed expectations, achieving a growth rate of 3.8% year on year. This performance can be attributed mainly to: (i) a significant surge in household consumption (of 15.6%), driven by high inflationary expectations and negative real interest rates, as people believe that durable goods will not only become more expensive, but will also serve as a reliable store of value; and (ii) expansion in the construction industry and increased investment activity, spurred on by the rebuilding work following the February earthquakes. However, the industrial sector experienced a contraction of 2.6%, and exports declined by 9% year on year due to weakened external demand, underscoring the persistent economic imbalances. By contrast, imports of goods and services grew by 20.3% in Q2, further indicating robust domestic demand.

Despite the strong growth in Q2, high-frequency indicators suggest a slowdown in the latter half of the year. Indices measuring both sectoral and consumer confidence experienced significant declines in July and August. Furthermore, the manufacturing purchasing managers' index (PMI), which had stayed above the 50% threshold in the first half of the year, dipped below that figure in July and August, signalling a loss of momentum in the manufacturing sector in Q3. Declining business and consumer confidence, coupled with increased inflation and interest rates, herald a slowdown in the second half of the year.

The country's persistently high inflation rate – once again far and away the highest in the CESEE region – remains a fundamental challenge for Turkey's economy. After seven consecutive months of decline, inflation briefly dropped to 38%, only to see an unexpected surge in July and August, when it reached 47.8% and 58.9%, respectively. The new central bank governor, Hafize Gaye Erkan, revealed an upward revision of the year-end inflation projection to 63% and a 2024 forecast of 33%. While the depreciation in the exchange rate is often pointed to as a primary factor, several factors contributed to this upsurge in inflation: rigidity in services inflation, sustained upward pressure on food prices, shifts in tax and pricing policies, and rising fuel and car prices. However, the significant growth in household consumption and imports poses the biggest challenge in the fight against inflation. The persistently negative real interest rates and the high inflation have prompted consumers to indulge in a spending spree, with the aim of preserving their wealth in the face of erosion in the value of their money. This consumer behaviour in turn exacerbates inflationary pressures, leading to a continuous uptick in prices.

Despite the central bank's reiteration of its commitment to price stability, doubts persist about the efficacy of the measures taken thus far. The central bank remains hesitant about adopting a more aggressive approach to interest rate hikes and instead continues to favour selective credit policies and quantitative tightening. Although the central bank adopted a more restrictive monetary policy after the May election, the initial rate hikes remained relatively modest. The unexpected 650-basis-point increase in August and the 500-basis-point increase in September raised the policy rate to 30%. Nonetheless, real interest rates remain deeply negative. Furthermore, recent measures – including the macroprudential rule adjustments introduced over the summer to curb consumer demand – have so far yielded limited results, especially regarding credit cards and lira-denominated consumer loans. The lira's substantial depreciation, coupled with external imbalances and volatile capital flows since the May elections, continues to cloud over the economic outlook.

Despite the decline in energy costs, the ongoing deficit in merchandise trade continues to be the primary factor driving the deterioration in the current account. After a brief improvement in June, Turkey's current account reverted to negative territory in July, registering a deficit of USD 5.5bn. This pushed the 12-month rolling deficit to a hefty USD 58bn (around 6.5% of forecast GDP). The widening goods deficit played a pivotal role in this swing, as it expanded from USD 3.76bn in June to USD 10.48bn in July. However, the services sector showed a net surplus of USD 6bn, with travel services contributing a net inflow of USD 4.8bn as the tourist season resumed. It is noteworthy that the current account deficit has been financed solely by central bank reserves. The depletion of these reserves underscores yet again the desperate need to balance the current account deficit and secure external financing, if economic stability is to be ensured.

The upcoming municipal elections in Turkey appear to carry a relatively low political cost for President Erdoğan, who is able to take advantage of the ongoing failure of the opposition to unite behind a single candidate. This situation may work to his advantage, potentially facilitating his victory in key cities like Istanbul and Ankara. Meanwhile diplomatic relations with the EU show some sign of improvement. However, Erdoğan's conflicting statements about EU cooperation could hinder immediate progress. Turkey's pursuit of strategic autonomy – by maintaining pragmatic relations with the EU, Russia and the Gulf countries alike – may place the country at odds with the EU. With migration and customs union upgrades remaining key points for discussion, little substantial progress in EU-Turkey relations is likely without democratic reforms.

Overall, recent economic developments reflect a growing sense of unease in Turkey's economic landscape. President Erdoğan's commitment to maintaining stringent monetary policies, a notable departure from his previous stance on the 'inflation lobby', underscores his appreciation of the seriousness of the situation, at least for now. President Erdoğan and his governments has prioritised two key objectives over the past two decades: keeping the budget deficit under control and stimulating economic growth. In the last five years, this approach has evolved into an ongoing juggling act, rather than an effective strategy to address underlying structural challenges. Balancing the trade-off between exports and imports, growth and inflation, and maintaining a stable current account has become increasingly difficult. As a result, the Turkish economy has been overheating for some time, as is evident from the rising inflation, increased consumer demand and heightened imports. The elevated household spending has led to an upward revision of our 2023 growth forecast to 3.2%. Consequently, the substantial surge in the July and August inflation figures requires an adjustment to our inflation forecast too, which now stands at 55% for 2023. To combat these inflationary pressures, the government is considering further measures, such as linking wage rises to the target inflation rate (currently set at 5%), rather than the actual inflation rate, and gradual interest rate hikes. Thus, we have revised our policy rate forecast for 2023 and 2024, respectively, to 40% and 25% (end of period), and our GDP growth rate forecast for 2024 downward to 2.7%.

Table 6.22 / Turkey: Selected economic indicators

	2020	2021	2022 1)	2022	2023	2023	2024	2025
				January-June			Forecast	
Population, th pers., average	83,385	84,147	84,980	.	.	86,179	87,213	88,260
Gross domestic product, TRY bn, nom.	5,049	7,256	15,012	5,944	10,145	24,000	37,900	53,000
annual change in % (real)	1.9	11.4	5.5	7.7	3.9	3.2	2.7	3.6
GDP/capita (EUR at PPP)	18,330	20,360	24,360	.	.	.	.	.
Consumption of households, TRY bn, nom.	2,847	3,983	8,564	3,390	6,176	.	.	.
annual change in % (real)	3.2	15.4	19.0	20.8	16.4	11.0	5.0	3.5
Gross fixed capital form., TRY bn, nom.	1,389	2,044	4,378	1,798	3,250	.	.	.
annual change in % (real)	7.3	7.2	1.3	3.4	4.4	4.0	2.0	4.0
Gross industrial production 2)								
annual change in % (real)	2.2	16.5	6.2	11.3	-2.0	-0.5	1.0	3.5
Gross agricultural production 3)								
annual change in % (real)	4.1	0.5	10.0	.	.	.	.	.
Construction industry 2)								
annual change in % (real)	-3.0	3.0	5.0	.	.	.	.	.
Employed persons, LFS, th, average 4)	26,808	28,827	30,725	30,092	31,182	31,700	32,500	33,300
annual change in %	-4.5	8.0	6.6	7.8	3.6	3.3	2.5	2.5
Unemployed persons, LFS, th, average 4)	4,063	3,916	3,592	3,666	3,399	3,330	3,810	3,700
Unemployment rate, LFS, in %, average 4)	13.2	12.0	10.5	10.9	9.8	9.5	10.5	10.0
Reg. unemployment rate, in %, eop				.	.	.	.	.
Average monthly gross wages, TRY 5)	4,594	5,846	10,276	.	.	16240	25010	34440
annual change in % (real, gross)	-8.5	6.4	2.0	.	.	2.0	0.0	2.0
Consumer prices (HICP), % p.a.	12.3	19.6	72.3	64.6	46.9	54.9	54.0	35.0
Producer prices in industry, % p.a. 6)	12.1	43.9	128.5	118.6	57.6	56.0	55.0	35.0
General governm. budget, nat. def., % of GDP								
Revenues	29.6	27.9	25.3	.	.	25.5	26.0	27.0
Expenditures	32.5	30.3	26.4	.	.	29.5	29.0	30.0
Deficit (-) / surplus (+)	-2.9	-2.4	-1.1	.	.	-4.0	-3.0	-3.0
General gov. gross debt, nat. def., % of GDP	39.6	41.8	31.7	.	.	46.4	48.0	48.0
Stock of loans of non-fin. private sector, % p.a.	35.3	32.4	56.9	58.1	60.1	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.1	2.1	2.5	1.6	.	.	.
Central bank policy rate, % p.a., eop 7)	17.00	14.00	9.00	14.0	15.0	40.00	25.00	10.00
Current account, EUR m	-28,126	-5,958	-45,522	-26,130	-34,199	-50,000	-41,000	-40,000
Current account, % of GDP	-4.5	-0.9	-5.3	-7.1	-7.3	-5.3	-4.1	-3.7
Exports of goods, BOP, EUR m	147,045	190,365	241,130	115,279	112,620	258,000	273,000	287,000
annual change in %	-9.7	29.5	26.7	33.8	-2.3	7.0	6.0	5.0
Imports of goods, BOP, EUR m	180,244	215,210	326,508	152,680	159,515	353,000	364,000	382,000
annual change in %	1.4	19.4	51.7	56.9	4.5	8.0	3.2	5.0
Exports of services, BOP, EUR m	33,370	52,206	86,836	33,707	40,124	94,000	102,000	110,000
annual change in %	-44.5	56.4	66.3	98.6	19.0	8.0	8.0	8.0
Imports of services, BOP, EUR m	20,893	25,102	38,537	17,211	21,981	41,000	44,000	47,000
annual change in %	-18.4	20.1	53.5	59.1	27.7	7.0	7.0	7.0
FDI liabilities, EUR m	6,706	11,319	12,735	6,476	4,446	14,008	.	.
FDI assets, EUR m	2,804	5,493	4,673	2,301.2	2,446.8	5,140	.	.
Gross reserves of CB excl. gold, EUR m 8)	40,776	64,182	77,714	55,069	61,796	.	.	.
Gross external debt, EUR m 8)	349,749	386,086	430,057	.	.	487,500	498,700	524,600
Gross external debt, % of GDP	55.8	55.9	49.9	.	.	52.0	50.0	49.0
Average exchange rate TRY/EUR	8.0547	10.5124	17.4088	16.2330	21.5444	25.60	38.00	49.50

1) Preliminary. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate in 2022. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Personnel costs. Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social security. - 6) Domestic output prices. - 7) One-week repo rate. - 8) Converted from USD.

Source: wiiw Databases incorporating national statistics. Forecasts by wiiw.