

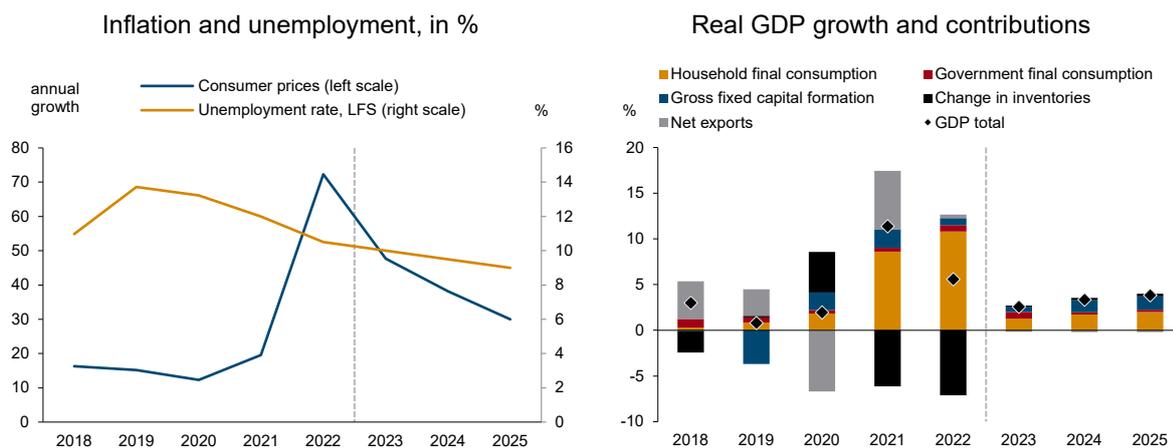


TURKEY: Election uncertainty looming

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Despite the various challenges, economic momentum was strong in the first half of 2022, but began to slow in Q4. In 2023, Turkey has been grappling with the fallout from February's devastating earthquakes and the political uncertainty surrounding the upcoming May elections. Growth will slow this year, due to a combination of external vulnerabilities and internal structural challenges. The easing of political instability and increased reconstruction investment are likely to stimulate growth in 2024-2025.

Figure 5.22 / Turkey: Main macroeconomic indicators



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

Despite the challenges it faced in 2022, Turkey's economy continued to grow; although the pace slowed (from the 11.4% witnessed in 2021) to 5.6%, this was still one of the highest growth rates seen in the CESEE region. Household consumption, which typically makes up well over 50% of the country's economic output, was the primary driver of growth: it increased by a significant 19.7% year on year in real terms, despite the high inflation. This surge in consumption was mainly driven by loose credit conditions, a 2% increase in real wages and pent-up demand following the COVID-19 pandemic. Government consumption also contributed positively to growth in 2022, with an increase of 5.2% year on year in real terms. In addition, a strong rebound in tourism, recovering global demand and opportunities arising from disruptions to Asian supply chains all continued to fuel exports and contribute to growth.

However, the high rate of inflation – by far the highest in the CESEE region – remains one of the main challenges facing the Turkish economy. Accelerating inflation was the most notable feature of the Turkish economy in 2022, with the year-on-year rate reaching a 24-year high of over 85% in October. In an effort to mitigate the adverse effects of soaring inflation, the Turkish government has implemented a range of measures, including hiking the minimum wage by 55% at the beginning of 2023 and increasing pensions for public-sector workers. Moreover, in an effort to stabilise the lira, the government has introduced a forex-protected lira scheme (known as 'KKM'), which features bank accounts that insulate the funds in them against exchange-rate fluctuations, and has also imposed strict regulations on foreign-currency transactions conducted by companies. However, the efficacy of the measures appears to be modest. After a significant surge of 6.65%, month on month, in January 2023, consumer prices grew in February and March by 3.15% and 2.29%, respectively. However, Turkey's annual inflation rate in March 2023 was 50.1%, showing a downward trend that is partly due to base effects.

The two devastating earthquakes that struck Turkey and Syria on 6 February 2023 will have a significant impact on the country's industrial output in 2023. Some 13m people in ten provinces have been affected by the disaster. With over 50,000 deaths, this was the deadliest event in the nation's recent history. In total, the provinces affected contribute 9.3% to GDP (almost 15% for the agricultural sector) and 8.5% to exports. The Turkish government has put the total estimated cost of the earthquakes at USD 103.6bn – equivalent to 9.5% of Turkey's forecast GDP for 2023. Although government spending on reconstruction will provide a boost in 2023, we anticipate that growth will be slower than in the last two years, due to disrupted supply chains, damaged infrastructure and machinery, loss of the labour force and reduced investment in the immediate aftermath of the earthquake. After a short-lived recovery in January, both consumer confidence and industrial production dropped, suggesting some early signs of the earthquake's impact.

Despite the recent recovery in exports, the current account deficit has surged to levels not seen since 2013, widening to 5.3% of GDP in 2022 (from 0.9% the previous year). This is largely attributable to the substantial expenses incurred as a result of energy and gold imports (net imports of energy and gold reached EUR 104bn in 2022). In order both to limit Turkish consumers' ability to hedge against inflation and to ease the pressure on the lira, following the February earthquakes Turkey introduced new restrictions on gold trading. Despite this move and the recent fall in energy prices, Turkey's current account deficit in January-February was 54% higher than in the same period last year. In 2022, more than half of the current account deficit was financed by 'net errors and omissions' – a category that consists primarily of mystery capital of unknown source. After recording outflows in January, net errors and omissions saw an inflow of about USD 1bn in February, which eased the pressure on Turkey's foreign reserves to fund the current account deficit. The opaque nature of this form of current account financing renders it impossible to reach any definite conclusions about how sustainable it is.

The upcoming presidential and parliamentary elections will determine whether the current policies continue or new economic policies are introduced; this only adds to the uncertainty surrounding the country's economic outlook. As the polls indicate a close race, with no candidate currently above 50%, the likelihood of a second round seems high. Despite the challenges posed by the state of the economy and the recent earthquakes, we believe Erdoğan may garner enough support in the second round to secure his position. If the current government and president win the elections, the current policies will most likely continue. The New Economic Model, introduced in 2022, prioritises a low policy rate (and a negative real interest rate), designed to boost exports and reduce the current account

deficit by lowering the domestic borrowing cost. Persisting with the New Economic Model in the short term could result in sustained high levels of inflation, substantial depreciation of the lira and volatile economic growth – all of which could increase the likelihood of a financial crisis.

In the event of an opposition coalition (Nation Alliance) victory, we anticipate that the government may contest the election, potentially leading to a rerun either nationwide or in certain provinces. As occurred in the 2019 local elections, this could result in a renewed opposition victory – which in turn could herald a new economic policy. Early in 2023, the Nation Alliance released a joint manifesto declaring its main economic objectives, which include lowering inflation to single digits within two years and restoring central bank independence. While the declaration does not spell out any concrete measures, it does highlight the coalition's intention of reversing certain unorthodox policies introduced by the current administration – such as repealing the KKM scheme and switching priority away from a low-interest-rate environment.

As Turkey gears up for the elections on 14 May, the nation's economic outlook remains challenging. The lira was under pressure in 2022 due to a tightening of monetary policy in the US and the euro area. While the Fed has suggested that the era of interest-rate hikes is drawing to a close, it may yet proceed to raise interest rates in the first half of 2023, thereby intensifying pressure on the lira and stoking inflation in Turkey. In the meantime, the Central Bank of the Republic of Turkey's (CBRT) commitment to continue its expansionary monetary policies, aligned with New Economic Model, is likely to fuel inflation. The CBRT reduced the benchmark rate by a total of 550 basis points between August 2022 and March 2023, ultimately reaching 8.5%. As a result, the real policy interest rate – calculated using current inflation – is at a profoundly negative level (-41.5% in March). Regardless of the election results, we do not anticipate any significant rise in the policy rate in 2023. A significant rate increase at this point could cause stress in the banking system, due to a not inconsiderable number of transactions that are tied to the current low interest rates. Hence, we expect inflation to remain at close to 50% (year on year) until the end of 2023, and to average over 47% for the year.

Household consumption is likely to slow in 2023, as pent-up demand dissipates and consumer purchasing power dwindles. Meanwhile, the government is expected to continue with its expansionary fiscal policy, with spending projected to grow by about 6.2% in real terms, as a result of public investment in infrastructure following the earthquakes and ahead of the May elections. However, lower industrial output and weak external demand will weigh on export performance. In addition, the impact on the Turkish economy of the Russian invasion of Ukraine is expected to escalate, as the country has partially halted the transit of Western-sanctioned goods to Russia. This will place a further strain on the already fragile relationship with Russia and could result in reduced Russian demand for Turkish exports (in 2022, 3.7% of all Turkish exports were destined for Russia). Given these developments, we have revised our growth projection for 2023 downward to 2.6% (from 3% in our previous forecast).

Looking beyond this year, the economy has strong growth potential; but achieving this will require a more stable form of policy making and a reduction in political risk. There is no doubt that the economy can produce bursts of very strong growth, as has been witnessed over the past two years; but this comes at the cost of extremely high inflation and rapid lira depreciation, and carries with it a high risk of macro-financial volatility and crisis. Addressing this will require a more orthodox and consistent approach to economic policy making. Among other things, if there is to be any reduction in the chronically high current account deficit (the financing of which has become more difficult in recent years

and leaves Turkey exposed to changes in foreign investor sentiment and US monetary policy), there will need to be further efforts to boost domestic production and a reduced reliance on credit-financed household spending (which contributes to the high demand for imports). Turkey's economic growth potential could be amplified if greater political and macroeconomic stability were to be achieved in 2024-2025, thereby paving the way for increased investment and foreign direct investment inflows. This will be particularly crucial in the aftermath of the recent earthquakes, when significant investment is required to ensure the country's recovery and to support the reconstruction efforts.

Table 5.22 / Turkey: Selected economic indicators

	2019	2020	2021	2022 ¹⁾	2023	2024	2025
					Forecast		
Population, th pers., average	82,579	83,385	84,147	84,980	86,179	87,213	88,260
Gross domestic product, TRY bn, nom.	4,312	5,048	7,249	15,007	22,700	32,400	43,700
annual change in % (real)	0.8	1.9	11.4	5.6	2.6	3.4	3.8
GDP/capita (EUR at PPP)	18,480	18,320	20,340	21,710	.	.	.
Consumption of households, TRY bn, nom.	2,441	2,847	3,983	8,633	.	.	.
annual change in % (real)	1.5	3.2	15.3	19.7	2.2	3.0	3.5
Gross fixed capital form., TRY bn, nom.	1,117	1,383	2,040	4,444	.	.	.
annual change in % (real)	-12.5	7.4	7.4	2.8	2.0	4.5	5.0
Gross industrial production ²⁾							
annual change in % (real)	-0.6	2.2	16.5	6.2	-0.5	2.8	3.5
Gross agricultural production ³⁾							
annual change in % (real)	4.3	4.1	0.5	10.0	.	.	.
Construction industry ²⁾							
annual change in % (real)	-8.0	-3.0	3.0	5.0	.	.	.
Employed persons, LFS, th, average ⁴⁾	28,081	26,808	28,827	30,725	31,700	32,500	33,300
annual change in %	-2.3	-4.5	8.0	6.6	3.3	2.5	2.5
Unemployed persons, LFS, th, average ⁴⁾	4,461	4,063	3,916	3,592	3,520	3,410	3,290
Unemployment rate, LFS, in %, average ⁴⁾	13.7	13.2	12.0	10.5	10.0	9.5	9.0
Reg. unemployment rate, in %, eop
Average monthly gross wages, TRY ⁵⁾	4,470	4,595	5,849	10,280	15480	21820	28930
annual change in % (real, gross)	7.9	-8.5	6.4	2.0	2.0	2.0	2.0
Consumer prices (HICP), % p.a.	15.2	12.3	19.6	72.3	47.7	38.2	30.0
Producer prices in industry, % p.a. ⁶⁾	17.6	12.1	43.9	128.5	65.7	58.4	38.2
General governm. budget, nat. def., % of GDP							
Revenues	29.8	29.6	28.0	26.0	25.5	26.0	27.0
Expenditures	33.0	32.5	30.4	28.5	29.5	29.0	30.0
Deficit (-) / surplus (+)	-3.2	-2.9	-2.4	-2.5	-4.0	-3.0	-3.0
General gov. gross debt, nat. def., % of GDP	32.6	39.7	41.8	43.5	46.4	48.0	48.0
Stock of loans of non-fin. private sector, % p.a.	10.2	35.3	32.4	56.9	.	.	.
Non-performing loans (NPL), in %, eop	5.4	4.1	3.1	2.1	.	.	.
Central bank policy rate, % p.a., eop ⁷⁾	12.00	17.00	14.00	9.00	9.00	9.00	9.00
Current account, EUR m	9,695	-28,125	-5,958	-45,849	-40,000	-37,000	-36,000
Current account, % of GDP	1.4	-4.5	-0.9	-5.3	-4.0	-3.0	-2.5
Exports of goods, BOP, EUR m	162,777	147,045	190,365	241,142	258,000	273,000	287,000
annual change in %	7.3	-9.7	29.5	26.7	7.0	6.0	5.0
Imports of goods, BOP, EUR m	177,804	180,244	215,210	326,697	343,000	360,000	378,000
annual change in %	-4.2	1.4	19.4	51.8	5.0	5.0	5.0
Exports of services, BOP, EUR m	60,155	33,370	52,206	86,650	94,000	102,000	110,000
annual change in %	20.5	-44.5	56.4	66.0	8.0	8.0	8.0
Imports of services, BOP, EUR m	25,614	20,893	25,102	38,558	41,000	44,000	47,000
annual change in %	6.0	-18.4	20.1	53.6	7.0	7.0	7.0
FDI liabilities, EUR m	8,526	6,706	11,319	12,434	.	.	.
FDI assets, EUR m	2,655	2,804	5,493	4,698	.	.	.
Gross reserves of CB excl. gold, EUR m ⁸⁾	69,974	40,776	64,182	77,714	.	.	.
Gross external debt, EUR m ⁸⁾	369,083	350,586	387,835	430,368	486,300	547,100	619,100
Gross external debt, % of GDP	54.4	55.9	56.2	49.9	48.2	43.9	42.5
Average exchange rate TRY/EUR	6.3578	8.0547	10.5124	17.4088	22.50	26.00	30.00

1) Preliminary and wiiw estimates. - 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, wiiw estimate in 2022. - 6) Domestic output prices. - 7) One-week repo rate. - 8) Converted from USD.

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