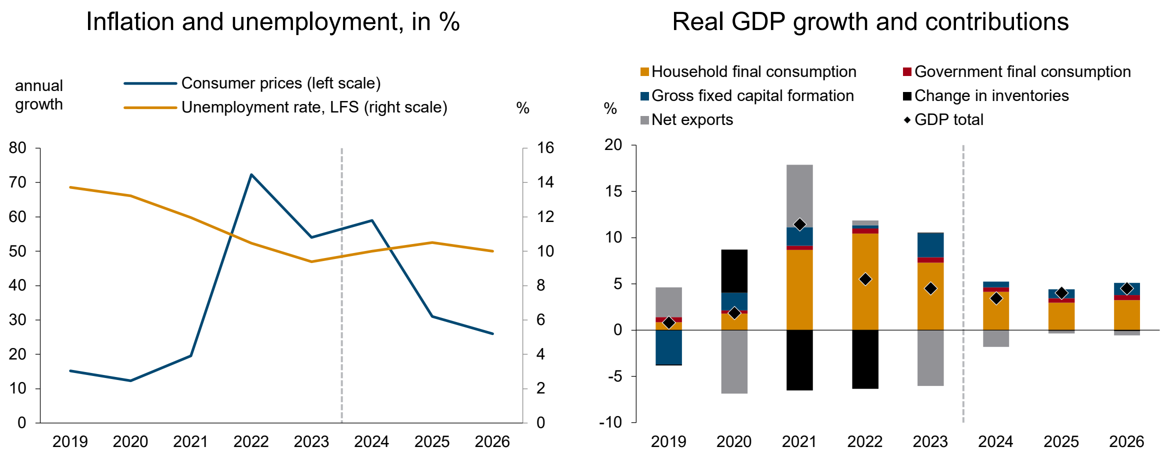
TURKEY: Monetary policy struggling to contain inflation

RICHARD GRIEVESON

In 2023, Turkey's economy grew by 4.5%, driven by strong domestic demand, but constrained by declining exports. The current account deficit improved modestly in the second half of the year. However, inflation surged to 68.5% year on year in March 2024, prompting a surprise policy rate hike to 50%. The rise in inflation expectations poses a challenge to the effectiveness of monetary policy. The government's defeat in Turkey's recent local elections reflects public outrage over inflation and the cost of living, and increases the uncertainty regarding future economic policies.

Figure 6.22 / Turkey: Main macroeconomic indicators



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

Turkey's economic growth exceeded market expectations in 2023. GDP growth reached 4% (year on year) in the last quarter of the year, and 4.5% for the entire year. Domestic demand emerged as the primary driver of the growth, fuelled mainly by an increase of 12.7% in household consumption, 7.5% in investment and 5.2% in government spending. However, real exports contracted by 2.7%. Consequently, while domestic demand contributed 10.5 percentage points to the overall growth in 2023, net exports exerted a downward pressure of 6 percentage points. Monetary expansion in the first half of the year and pre-election spending ahead of the May 2023 general election played a significant part in driving the growth. Post-earthquake reconstruction activities also contributed positively, with construction experiencing a growth rate of 7.8%, second only to the 9% growth recorded in financial and insurance activities.

Exports suffered from low demand in 2023 and may struggle in 2024 due to continued low demand and sanctions on trade with Russia. Last year was a challenging one for exports, leading to a significant trade deficit that exceeded USD 100bn for the second year in a row. Turkey's exports to its major trade partners (such as the EU, US and Iraq) declined on account of weaker external demand. Meanwhile, the country has seen significant export growth to Russia since the start of the war in Ukraine; this has led to sanctions against certain Turkish companies that have provided technology, goods and services to Russia. The impact of sanctions intensified in 2024 following the secondary sanctions announced by the US on foreign banks suspected of supporting Russia's actions in Ukraine. As a result, Turkish banks reportedly severed their ties with their Russian counterparts. The adverse effects of the sanctions have been especially noticeable in exports (rather than imports from Russia), with Turkish exports to Russia dropping by 37% in January-February 2024, compared to the same period of 2023.

While some progress has been made, there is still a long way to go to rebalance the economy away from the credit and current account deficit-fuelled growth model. The government remains committed to prioritising a 'soft-landing' approach, hoping to reduce inflation without sacrificing too much growth. Despite a gradual decline in the retail sales dynamics from August onwards, retail activity rebounded in December 2023. Notwithstanding the persistent high inflation and negative real interest rates, private consumption is likely to have stayed strong in Q1 2024, as households and firms continued to abandon the domestic currency. Although a slowdown is anticipated from Q2, domestic demand will maintain its positive contribution to overall annual growth this year. Despite the possibility that tighter financing conditions could dampen private investment, it is anticipated that earthquake reconstruction efforts will keep the total investment level up. As a result, we are revising our growth forecast from 2.9% to 3.4% for 2024. We expect growth to accelerate to 4% and 4.5% in 2025 and 2026, respectively, driven by easing financial conditions and increased net exports.

In 2023, the current account deficit experienced a modest improvement, declining from 5.4% of GDP in 2022 to 4.1%. This narrowing was driven by a strong performance by tourism, declining energy prices and reduced gold imports in the second half of the year. Additionally, the increased influx of portfolio investments made financing of the current account deficit easier. We anticipate that the current account deficit will narrow further to 3.1% of GDP in 2024. Stable energy prices, a slowdown in imports and a steady inflow of portfolio investments are expected to sustain this improvement and facilitate financing over the next three years. Furthermore, a recovery in demand from Europe in the coming years could boost Turkey's exports and help stabilise the current account deficit.

Despite the tighter monetary policy stance, the outlook for inflation is getting worse. Q1 2024 saw inflation rates exceed all expectations, leading to an annual inflation rate of 68.5% in March. Therefore, despite earlier signals from the Central Bank of the Republic of Turkey (CBRT) and Finance Minister Mehmet Şimşek indicating an end to rate hikes, the CBRT surprised the markets in March by raising the policy rate by 500 basis points to 50%. This move brought the real policy rate to -17.4%; though still substantially negative, this is a significant advance on the record level of -75.4% in November 2022. Furthermore, the CBRT has pledged additional macro-prudential measures, potentially focusing on controlling credit expansion (particularly credit card growth) and counteracting the downward pressure on deposit rates. We anticipate rate cuts starting in Q4 2024, as inflation will likely fall from July onwards, driven by base effects, thereby offering scope for a rate cut. However, we are adjusting our year-end forecast for the policy rate from 35% to 40%.

Monetary policy is struggling to contain inflation, largely due to the increase in inflation expectations. The surge in inflation in 2024 can be attributed to various factors, including inadequate tightening measures, consistently negative real interest rates, the impact of wage hikes, tax increases and significant hikes in the price of goods and services controlled by public authorities. These factors have collectively worsened inflation expectations, resulting in a widening gap between the CBRT's target and market expectations, also known as the 'credibility gap'. Inflation expectations for the year end, based on a CBRT survey, increased from 41.2% in January to 44.2% in March, surpassing the CBRT's year-end target of 36%. Anchoring inflation expectations is crucial if the CBRT is to ensure the effectiveness of its monetary policy, since expectations strongly influence pricing, spending and investment behaviour. With the CBRT struggling to align inflation expectations with its targets, it will become increasingly challenging to hit those targets, which will necessitate a tighter monetary stance. Therefore, we expect the average annual inflation rate for 2024 to remain rather high at 59%, with the end-of-year inflation projected to be 42%. Additionally, we forecast inflation to persist in the coming years, with average annual rates of 31 % in 2025 and 26% in 2026.

After 22 years of dominance, the governing Justice and Development Party (AKP) suffered an unexpected defeat in the March local elections. The main opposition party, the Republican People's Party (CHP), secured 38% of the popular vote, while the AKP obtained 36%. The results highlight the significance of inflation and cost-of-living challenges, particularly as they impact low-income earners and retirees. President Erdoğan, in his first post-election speech, acknowledged the outcome as a turning point and pledged to rectify his party's mistakes, though his next steps remain uncertain. Despite reaffirmations from the government, the election results have introduced a degree of uncertainty regarding its commitment to the current economic programme. Although the next presidential elections are four years away, President Erdoğan is seeking to change the constitution in the meantime in order to extend presidential authority and remove the absolute-majority rule for presidential elections. A potential referendum to amend the constitution could lead to the reversal of some current policies in the hope of gaining public support. In a probable scenario, the government might implement higher-than-expected increases in pensions and public-sector wages, along with an additional minimum wage adjustment in the second half of the year, confounding the stance of Finance Minister Şimşek and the CBRT. In a more extreme scenario, if the current economic programme fails to reduce inflation significantly in the second half of the year, President Erdoğan may revert to previous populist policies. This could involve increased redistribution of public resources, such as offering more public jobs, healthcare and housing to his voter base. Additionally, given his stance that interest rates are un-Islamic and the true cause of high inflation, he might consider reversing monetary policy.

The medium-term outlook for Turkey remains underwhelming. While the country is projected to be one of the fastest-growing countries in the region over the next three years, it is expected to perform at below its potential. Since last year's presidential election, both monetary and fiscal policy has been chaotic and uncoordinated, with short-term electoral priorities that result in a lack of fiscal discipline, the slow pace of monetary tightening and the introduction of complex macro-prudential regulations. The struggle to bring inflation down without sacrificing growth has affected inflation expectations and the growth outlook. This risk could lead to the economy being stuck in an environment of high inflation and high interest rates, resulting in growth that is only moderate, compared to past performance. If the country can effectively utilise this four-year period without elections to credibly control inflation, significant improvements could be achieved. Until there is a consistency of approach, we anticipate that both the inflation rate and the policy rate will remain in double digits.

Table 6.22 / Turkey: Selected economic indicators

	2020	2021	2022	2023 1)	2024	2025	2026
						Forecast	
Population, th pers., average	83,385	84,147	84,980	85,326	87,213	88,260	89,100
Gross domestic product, TRY bn, nom.	5,049	7,256	15,012	26,276	43,200	58,900	77,600
annual change in % (real)	1.9	11.4	5.5	4.5	3.4	4.0	4.5
GDP/capita (EUR at PPP)	18,320	19,950	23,810	25,200	.	.	.
Consumption of households, TRY bn, nom.	2,847	3,983	8,564	15,540	.	.	.
annual change in % (real)	3.2	15.4	19.0	12.8	7.0	5.0	5.5
Gross fixed capital form., TRY bn, nom.	1,389	2,044	4,378	8,506	.	.	.
annual change in % (real)	7.3	7.2	1.3	8.9	2.0	3.0	4.0
Gross industrial production 2)							
annual change in % (real)	2.3	16.4	5.0	1.6	1.0	2.0	3.0
Gross agricultural production 3)							
annual change in % (real)	4.6	0.5	7.7	6.0	.	.	.
Construction industry 4)							
annual change in % (real)	-3.0	3.0	5.0	6.5	.	.	.
Employed persons, LFS, th, average 5)	26,808	28,827	30,725	31,607	32,400	33,200	34,200
annual change in %	-4.5	8.0	6.6	2.9	2.5	2.5	3.0
Unemployed persons, LFS, th, average 5)	4,063	3,916	3,592	3,275	3,600	3,890	3,800
Unemployment rate, LFS, in %, average 5)	13.2	12.0	10.5	9.4	10.0	10.5	10.0
Reg. unemployment rate, in %, eop					.	.	.
Average monthly gross wages, TRY 6)	4,594	5,846	10,276	16,460	26430	35320	46280
annual change in % (real, gross)	-8.5	6.4	2.0	4.0	1.0	2.0	4.0
Consumer prices (HICP), % p.a.	12.3	19.6	72.3	54.0	59.0	31.0	26.0
Producer prices in industry, % p.a. 7)	12.1	43.9	128.5	49.9	45.0	30.0	25.0
General governm. budget, nat. def., % of GDP							
Revenues	29.6	27.9	25.3	28.0	27.5	27.0	27.0
Expenditures	32.5	30.3	26.4	33.3	31.0	30.0	30.0
Deficit (-) / surplus (+)	-2.9	-2.4	-1.1	-5.3	-3.5	-3.0	-3.0
General gov. gross debt, nat. def., % of GDP	39.6	41.7	31.7	32.0	35.0	34.0	33.0
Stock of loans of non-fin. private sector, % p.a.	35.3	32.4	56.9	53.9	.	.	.
Non-performing loans (NPL), in %, eop	4.1	3.1	2.1	1.6	.	.	.
Central bank policy rate, % p.a., eop 8)	17.00	14.00	9.00	42.50	40.00	30.00	20.00
Current account, EUR m	-28,130	-6,108	-46,201	-42,093	-34,500	-33,500	-33,500
Current account, % of GDP	-4.5	-0.9	-5.4	-4.1	-3.1	-2.7	-2.3
Exports of goods, BOP, EUR m	147,045	190,354	241,087	232,098	237,000	244,000	254,000
annual change in %	-9.7	29.5	26.7	-3.7	2.0	3.0	4.0
Imports of goods, BOP, EUR m	180,244	215,204	326,559	312,385	305,000	311,000	320,000
annual change in %	1.4	19.4	51.7	-4.3	-2.5	2.0	3.0
Exports of services, BOP, EUR m	33,370	52,169	85,365	92,293	98,000	105,000	112,000
annual change in %	-44.5	56.3	63.6	8.1	6.0	7.0	7.0
Imports of services, BOP, EUR m	20,893	25,196	37,467	44,255	56,000	63,000	72,000
annual change in %	-18.4	20.6	48.7	18.1	26.0	12.0	15.0
FDI liabilities, EUR m	6,684	10,955	13,049	9,820	.	.	.
FDI assets, EUR m	2,803	5,495	4,677	5,407	.	.	.
Gross reserves of CB excl. gold, EUR m 9)	40,776	64,182	77,714	83,910	.	.	.
Gross external debt, EUR m 9)	349,204	385,292	429,357	452,385	476,300	527,600	600,300
Gross external debt, % of GDP	55.7	55.8	49.8	44.3	43.0	43.0	41.0
Average exchange rate TRY/EUR	8.0547	10.5124	17.4088	25.7597	39.00	48.00	53.00

Note: Introduction of new index 2021=100 (new weights) for gross industrial production and producer prices in industry.

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees. - 3) Based on UN-FAO data, wiiw estimate in 2023. - 4) wiiw estimate. - 5) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 6) 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. - 7) Domestic output prices. - 8) One-week repo rate. - 9) Converted from USD.

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