

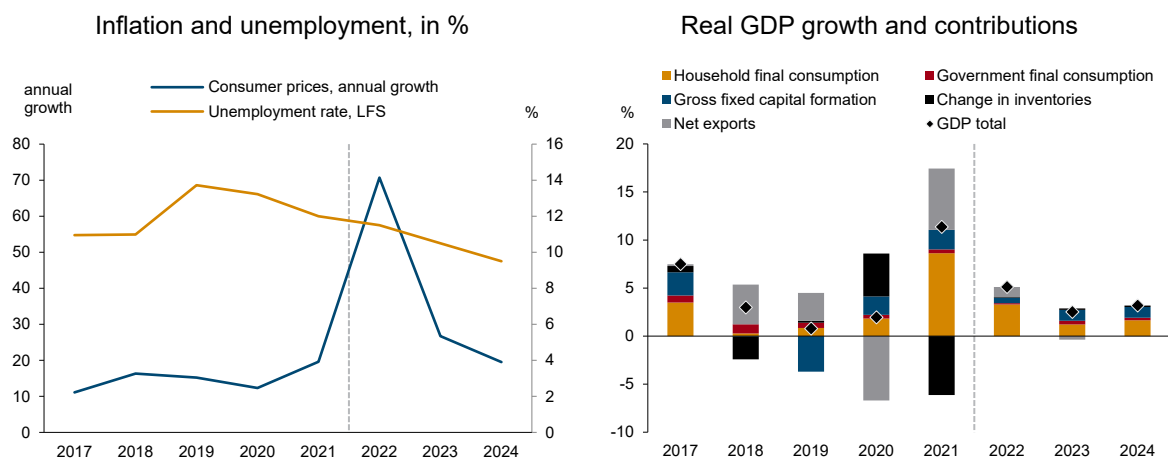


TURKEY: The slowdown has arrived

RICHARD GRIEVESON

After a strong first half year, driven by reopening effects and a boom in tourism, the economy looks set for a much bleaker winter. The boosts to external competitiveness that resulted from the weak lira were short lived and soon erased by inflation, while the main benefits of the rebound in tourism have already been reaped. The extremely high inflation is sharply reducing purchasing power and is putting pressure on industry. Risks are weighted to the downside, including the potential for domestic political noise ahead of the election, rising US interest rates and the geopolitical backdrop.

Figure 6.22 / Turkey: Main macroeconomic indicators



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

The economy performed very well in the first half of 2022, despite increasing headwinds. Growth stayed strong in Q2 2022, reaching 7.6% year on year in real terms, which was almost identical to the performance over the previous three months (7.5%). In quarterly terms, the pace of growth actually quickened to 2.1%, from 0.7% in Q1. This robust Q2 outturn came despite a further weakening of the lira, a rise in the already-high inflation and lower consumer confidence. A breakdown of Q2 growth indicates robust positive contributions from both consumption and net exports, while investment declined sharply. Both goods and services exports rose strongly, the former helped by a short-lived boost from the weaker lira (an effect that faded rapidly due to the high inflation) and the latter by a huge rebound in tourism inflows.

However, the most recent high-frequency indicators suggest a slowdown from the middle of the year. In July, the manufacturing purchasing managers' index (PMI) fell further below the key 50 level that separates expansion from contraction. Consumer confidence is likewise subdued. Moreover, hard data have increasingly started to mirror the negative sentiment: industrial output fell by 6.2% month on month in July, while retail sales contracted in monthly terms in both July and August. In September, consumer prices soared by 83.5% year on year, the biggest rise for 24 years. This is significantly squeezing real income growth. However, despite the clearly more challenging picture for H2 2022, we have revised our full-year growth estimate for 2022 upwards to 5.1%, reflecting the better-than-expected first half year.

The slowdown will intensify over the winter, reflecting a multitude of headwinds for the economy; accordingly, we have revised our forecast for 2023 growth downwards, to 2.5%. There will be no let-up over the winter in the squeeze on consumption caused by the sky-high inflation, suggesting that growth will struggle until at least the end of Q1 2023. However, this will partly be offset by an expected increase in government spending ahead of the presidential election next year.

A key driver of the positive performance in early 2022 was the recovery in tourism, with arrivals from the key countries of origin up dramatically. The latest data show a boom in the sector, with 21m foreign tourists arriving in the first seven months of this year, compared with 8m in the same period of 2021. Crucially, 11m of these tourists came from Europe, up from 3m a year earlier. Tourists from countries such as Germany, the UK and France tend to spend more on average than tourists from many other origins. Tourism from Russia also increased over this period – although, at around 2m in total, arrivals from this source are far less important for the sector. Tourism's strong performance drove a substantial increase in the services surplus on the balance of payments, which reached USD 42bn in January-July, up from USD 25bn a year earlier; the services surplus itself more than doubled, to USD 20bn.

Despite the increase in the services surplus, the current account deficit almost tripled in January-July, raising concerns about the economy's external vulnerabilities. The current account deficit reached USD 36.7bn in January-July 2022, up from USD 13.7bn a year earlier. While the value of goods exports increased by 20% year on year in nominal terms, the value of goods imports (which are also much bigger than exports) rose by 42%. The latter reflected a combination of rising energy prices and resilient domestic demand. Separate monthly data for August showed a trade deficit of USD 11.2bn, the highest monthly gap on record. According to data provided by the central bank, around two thirds of the current account deficit in the first seven months was financed by net errors and omissions. This makes it very difficult to judge the sustainability and resilience of the financing. We estimate a current account deficit equivalent to 5.3% of GDP this year, and expect the shortfall to remain greater than 4% of GDP throughout the forecast period. External financing needs are set to remain elevated, making Turkey reliant on hot money inflows and the support of external partners to prevent a balance-of-payments crisis. The combination of domestic policy loosening with Fed tightening has already led to a weakening of the lira, but it also creates risks to Turkey's ability to roll over external debt. Short-term external debt reached USD 134.6bn in July 2022, according to the central bank – around 20% of GDP.

The government's New Economic Model, launched in September 2021, has certainly had an impact on the economy; but we are still a long way off being able to declare it a success. The New Economic Model aims to support exports, increase private investment and reduce the size of the

current account deficit. While export performance has been decent, the overall effectiveness of the policy is questionable. Goods export growth relies on short-lived bouts of increased competitiveness, linked to the tumbling lira. The New Economic Model's aim of price stability, meanwhile, is far from consistent with the monetary policy of the central bank.

The combination of the New Economic Model and external factors means that the economy is hamstrung by sky-high inflation, which will not fall any time soon. Despite inflation topping 80%, the central bank has continued to cut interest rates; but this weakens the lira and provides an additional fillip to inflation via higher import costs. In late September, the central bank again ignored galloping inflation and cut the policy rate by 100 basis points to 12%. Combined with the September inflation outturn, this took the real interest rate beyond -70%. This may stimulate lending, but it will do nothing to bring down inflation or support the lira, and it serves to indicate that the authorities are doubling-down on their efforts to push the economy as hard as possible before the election. We expect consumer price inflation to average 70.7% this year, with producer price inflation reaching almost double that (130% for the year as a whole). In 2023, we forecast consumer price inflation to average 26.7%, indicating that it will remain a serious headwind for economic growth.

Given its high import requirements, Turkey is particularly exposed to rising energy costs.

According to the government, the country relies on imports for 74% of its energy needs. Energy costs have been surging since 2021 – a trend that only intensified following the Russian invasion of Ukraine. This has drastically increased costs for households and businesses alike, and has contributed to the elevated inflation more generally. The weak lira has further amplified this effect in local currency terms. The government has attempted to use its relatively good relations with Russia to secure discounts, but as yet with no (official) success. Up to half of Turkey's gas comes from Russia. So far, the only concession secured by Turkey is that it can pay for 25% of its Russian gas imports in roubles; that said, on its own this is unlikely to make much difference from a Turkish perspective.

The downside risks to the outlook are substantial. Persistently high inflation, a plunging lira, large external financing needs, the adverse external environment and general macro-financial volatility are already creating serious headwinds to economic growth. There are various ways in which these factors could intensify and have further repercussions for the economy. But the biggest challenge is that they may interact with one another – and that could amplify the effects significantly. Any further deterioration in the geopolitical situation that affects Turkey in particular would make things much worse. The combination of US monetary tightening and Turkish monetary loosening could also further seriously cloud the outlook. Despite these challenges, households, firms and banks have repeatedly proved themselves capable of riding out periods of stress in the economy.

The next presidential election must take place by the middle of next year. There is likely to be a sharp increase in political noise in the run-up to polling, and that could have a negative impact on the economy. Turkey's opposition represents a threat to President Erdogan, and defeat for the incumbent is not unthinkable. However, the opposition will be hamstrung by the need to come together and unite, despite being very broad based and holding divergent views on a number of issues. Moreover, even a narrow opposition victory could result in lengthy court challenges and re-runs, and would not necessarily result in a change in who holds power.

Table 6.22 / Turkey: Selected economic indicators

	2019	2020	2021 ¹⁾	2021 January-June	2022	2022 Forecast	2023 Forecast	2024
Population, th pers., average	82,579	83,385	84,147	.	.	85,157	86,179	87,213
Gross domestic product, TRY bn, nom.	4,312	5,048	7,249	2,989	5,927	13,000	16,900	20,800
annual change in % (real)	0.8	1.9	11.4	14.8	7.5	5.1	2.5	3.2
GDP/capita (EUR at PPP)	18,440	18,410	20,670	.	.	.	.	.
Consumption of households, TRY bn, nom.	2,441	2,847	3,983	1,635	3,429	.	.	.
annual change in % (real)	1.5	3.2	15.3	15.8	22.0	6.0	2.2	3.0
Gross fixed capital form., TRY bn, nom.	1,117	1,383	2,040	854	1,810	.	.	.
annual change in % (real)	-12.5	7.4	7.4	16.7	4.4	2.0	4.0	4.0
Gross industrial production ²⁾								
annual change in % (real)	-0.6	2.2	16.5	24.3	10.5	8.5	2.8	2.8
Gross agricultural production ³⁾								
annual change in % (real)	4.2	2.3	3.0	.	.	.	.	.
Construction industry ²⁾								
annual change in % (real)	-8.0	-3.0	3.0	.	.	.	.	.
Employed persons, LFS, th, average ⁴⁾	28,081	26,808	28,827	27,920	30,092	30,100	31,100	31,900
annual change in %	-2.3	-4.5	8.0	6.3	7.8	4.5	3.3	2.5
Unemployed persons, LFS, th, average ⁴⁾	4,461	4,063	3,916	4,036	3,666	3,910	3,650	3,350
Unemployment rate, LFS, in %, average ⁴⁾	13.7	13.2	12.0	12.7	10.9	11.5	10.5	9.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY ⁵⁾	4,470	4,595	5,849	.	.	15780	24390	32640
annual change in % (real, gross)	7.9	-8.5	6.4	.	.	58.0	22.0	12.0
Consumer prices (HICP), % p.a.	15.2	12.3	19.6	16.3	64.6	70.7	26.7	19.5
Producer prices in industry, % p.a. ⁵⁾	17.6	12.1	43.9	33.6	118.6	130.0	60.0	21.5
General governm. budget, nat. def., % of GDP								
Revenues	29.8	29.6	28.0	.	.	29.4	30.6	31.0
Expenditures	33.0	32.5	30.3	.	.	32.6	33.0	33.0
Deficit (-) / surplus (+)	-3.2	-2.9	-2.3	.	.	-3.2	-2.4	-2.0
General gov. gross debt, nat. def., % of GDP	32.6	39.7	41.8	.	.	43.5	46.4	48.0
Stock of loans of non-fin. private sector, % p.a.	10.2	35.3	32.4	18.7	58.1	.	.	.
Non-performing loans (NPL), in %, eop	5.4	4.1	3.1	3.7	2.5	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	12.00	17.00	14.00	19.0	14.0	12.00	12.00	12.00
Current account, EUR m	4,777	-31,325	-11,449	-11,199	-29,559	-35,400	-35,500	-35,600
Current account, % of GDP	0.7	-5.0	-1.7	-3.6	-8.1	-4.9	-4.6	-4.1
Exports of goods, BOP, EUR m	162,777	147,053	190,374	86,142	115,196	232,000	244,000	256,000
annual change in %	7.3	-9.7	29.5	27.2	33.7	22.0	5.0	5.0
Imports of goods, BOP, EUR m	177,804	180,242	215,190	97,275	152,668	293,000	308,000	323,000
annual change in %	-4.2	1.4	19.4	15.4	56.9	36.0	5.0	5.0
Exports of services, BOP, EUR m	56,149	30,903	49,434	16,487	30,411	74,000	80,000	86,000
annual change in %	12.5	-45.0	60.0	20.7	84.4	50.0	8.0	8.0
Imports of services, BOP, EUR m	25,612	20,896	26,803	11,575	17,029	39,000	42,000	45,000
annual change in %	6.0	-18.4	28.3	13.7	47.1	45.0	7.0	7.0
FDI liabilities, EUR m	8,547	6,815	11,770	3,741	5,048	13,500	.	.
FDI assets, EUR m	2,630	2,798	5,489	1,536.5	2,298.5	6,300	.	.
Gross reserves of CB excl. gold, EUR m ⁷⁾	69,975	40,776	64,182	48,100	55,069	.	.	.
Gross external debt, EUR m ⁷⁾	370,097	352,839	390,766	373,890	427,835	433,300	476,300	515,600
Gross external debt, % of GDP	54.6	56.3	56.7	54.2	59.2	60.0	62.0	59.0
Average exchange rate TRY/EUR	6.3578	8.0547	10.5124	9.5126	16.2330	18.00	22.00	23.80

1) Preliminary. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate in 2021. - 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) One-week repo rate. - 7) Converted from USD.

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