TURKEY'S UNHEARD VOICES

Turkey's 2024 Macroeconomic Outlook

ECONOMICS

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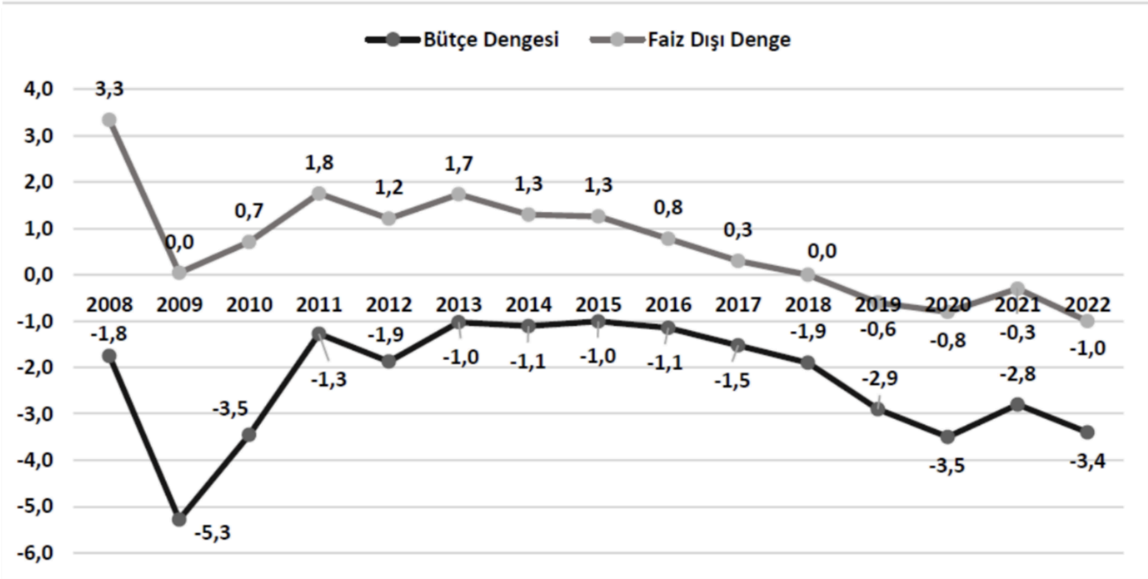
Abstract

In the third quarter of 2024, the Turkish economy faced significant challenges such as high inflation, exchange rate fluctuations, and budget deficits. Although the economic pressures caused by post-pandemic expansionary fiscal policies were attempted to be controlled through gradual interest rate hikes, inflation remained unchecked, further increasing the burden on public finances. The year 2024 is projected to be a period of slowing economic growth for Turkey, but with potential partial improvements in the current account balance and foreign trade.

Turkey's Economic Outlook

In the third quarter of 2024, we are experiencing an inflation period of 71.6%, deeply affecting the public and fought against rigorously by the government. Looking at the recent years and the developments shaping Turkey's current economic situation, it can be said that the biggest factor triggering this process was the pandemic.

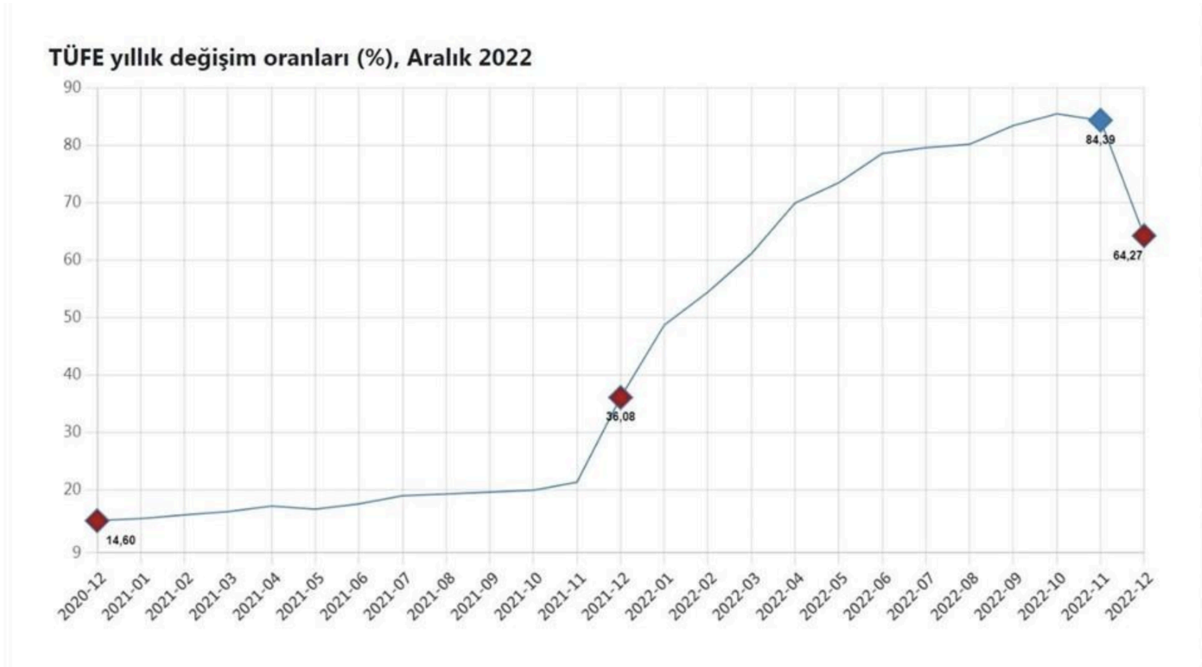
The COVID-19 crisis created a period in which almost all countries faced significant budget deficits and rising public debt. In response, countries quickly turned to fiscal policy measures. In Turkey, the government attempted to counteract the negative effects of COVID-19 through stability packages. Looking at the 2020 IMF data, it is seen that the government implemented numerous spending supports such as cash aid and unemployment assistance, alongside many tax cuts and deferrals. However, while tax cuts and below-market loans provided through public banks, along with increased transfer spending, helped improve the sectoral confidence indices that had declined at the beginning of the pandemic, they also imposed additional burdens on the budget. Suspending expansionary fiscal policies and deteriorating fiscal discipline were among the results of this situation. Consequently, budget deficits and public debt burdens increased.



According to the Public Sector General Balance Statistics by the Presidency of Strategy and Budget (Accessed: 28/07/24), even during the 2008 crisis, the primary balance did not fall below zero, yet it has been in the negative since 2019. As a significant indicator of debt sustainability, a negative primary balance indicates that the government cannot finance its expenses, excluding interest payments, with public revenues — meaning it struggles to pay off the principal of its debt. This burden on the budget has also created new financing needs. Since April 2020, various revenue-generating measures have been introduced, such as customs duties, increases in Special Consumption Tax (ÖTV), Banking and Insurance Transactions Tax (BSMV), and foreign exchange taxes. Complementary to these policies, austerity measures were also implemented in public institutions. Still, these economic burdens on the budget led to deteriorations in macroeconomic data. The low-interest loan policy applied through public banks particularly fueled increases in housing and vehicle prices, and thus inflation.

Since December 2021, rising exchange rates, global climate and food crises, the Russia-Ukraine war, disruptions in supply chains, and rising energy prices have narrowed the room for maneuver in fiscal policy, especially with the introduction of currency-protected deposit accounts.

Lowering policy interest rates can increase the money supply by enabling banks to provide cheaper loans. However, if this also raises inflation expectations, it can further fuel inflation. Therefore, interest rates are a fine line central banks must balance carefully. In Turkey's case, the move to lower interest rates further spurred inflation and resulted in a loss of value in the Turkish lira. Consequently, Turkey ended 2022 with an inflation rate of 64.27%.



Before the 2023 general elections, the chosen policy aimed to reduce inflation and the current account deficit while boosting growth by lowering interest rates and reducing firms’ borrowing costs. However, this policy led to a rapid depreciation of the exchange rate, which in turn caused the public to become even poorer. Government efforts to introduce various regulations and capital controls, along with the Central Bank depleting its reserves to control the sharp depreciation of the currency, led to a vicious cycle between inflation and foreign exchange, further increasing Turkey’s financial fragility. Therefore, after the 2023 general elections, a new economic policy focusing on reducing inflation and financial vulnerabilities was implemented. This new approach was a gradual interest rate hike policy.

Through gradual interest rate increases, the Central Bank aimed to reduce inflation without compromising its targets. However, in an environment of weak institutional structure, high dollarization, and inflation inertia, policy rate hikes that left real interest rates in negative territory failed to meet market expectations and led to a rapid depreciation of the currency in the summer of 2023. In addition to currency shocks, significant increases in administered prices, public employee and pension wages, and indirect tax rates in the same period caused inflation to rise to historically high levels in the third quarter of the year.

To limit the deterioration in the exchange rate and inflation, the Central Bank raised the policy interest rate to 42.5% by the end of 2023. However, this did not significantly improve pricing behaviors or help control domestic demand. Thus, the consumer inflation rate, which stood at 64% at the end of 2022, ended 2023 at 65%.

Looking at 2023 overall, substantial additional costs were added to public spending. According to various sources, the economic cost of the February 2023 earthquake centered in Kahramanmaraş is estimated to be around $100 to $150 billion. Additionally, under the "Retirement Age Completion" regulation, a significant number of employees over 40 years of age retired. Moreover, high real wage increases were provided to public employees during this period. The foreign exchange and interest shocks experienced in the second half of the year further increased public expenditures. As a result, budget expenditures rose by 124% in 2023 to reach 6.6 trillion TL. Despite various tax increases throughout the year, the 86% increase in budget revenues was 38 percentage points lower than the previous year's same period, causing the budget deficit to reach 1.4 trillion TL in 2023. According to the Finance Minister, 950 billion TL of this deficit stemmed from earthquake-related expenses.

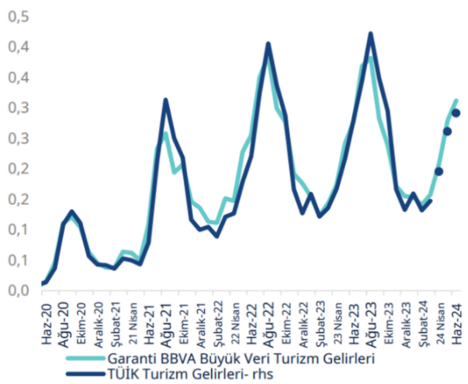
(Milyar TL)	2022	2023	Yükselmek (%)
Merkezi Yönetim Gelirleri	**2.802**	**5.210**	**86**
Vergi gelirleri	2.353	4.501	91
Merkezi Yönetim Harcamaları	**2.941**	**6.585**	**124**
Faiz Ödemeleri Hariç	2.631	5.911	125
Faiz Ödemeleri	311	675	117
Depremle ilgili Ödemeler		950	
Bütçe açığı	**(139)**	**(1.375)**	
Depremle ilgili Ödemeler	(139)	(425)	
Faiz Ödemeleri Hariç	172	(700)	

Looking ahead to 2024 in light of all these figures, the first noteworthy point is that Turkey has been removed from the FATF's grey list. Following the FATF's decision in June, the pace of reserve accumulation accelerated again. Additionally, short-term carry trade swaps began to yield some profit. Markets are pricing the Central Bank's policy rate to be 43% by the end of 2024. The continued dominance of demand over TL lending rates creates a counter-pressure on TL deposit rates.

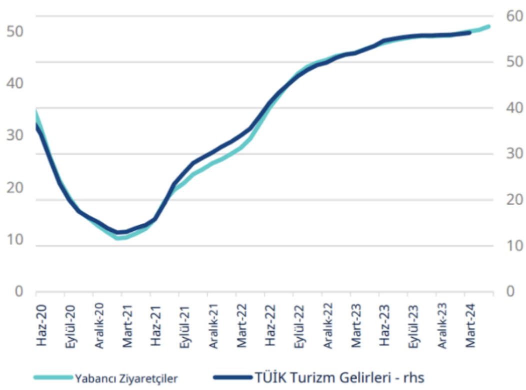
Turkey's economy, which recorded 4.2% growth in 2023, is expected to grow at a slower pace in 2024. Despite this, the aim is to maintain employment levels and reduce unemployment. However, problems in the labor market may arise due to two factors: slowing growth and high inflation. To control unemployment, effective active labor market policies and training programs need to be implemented.

As for the current account balance, a slight improvement is expected. Higher export performance and moderate import levels will play a key role in reducing the current account deficit. Additionally, higher tourism revenues and an increase in direct foreign investments will help support the current account by increasing foreign exchange earnings. According to Garanti BBVA's big data, if we project 2024 performance, tourism revenues are expected to reach around $58 billion throughout the year. It is considered achievable for the government to meet its target of $60 billion in tourism revenue for 2024.

GARANTİ BBVA BÜYÜK VERİ TURİZM GELİRLERİ (milyar $)



TURİZM GELİRLERİ & YABANCI ZİYARETÇİLER (12M toplam mn kişi, milyar$)



Due to earthquake costs, high public employee wages, and rising interest rates, the budget deficit is projected to be 5.9% in 2024. This high budget deficit may lead to an increase in public debt burden and financing costs. Therefore, ensuring fiscal discipline and implementing efficient spending policies are of great importance.

The most recent development occurred on July 8, when an agreement was signed between China's BYD — one of the world's largest automotive companies — and Turkey's Ministry of Industry and Technology, envisioning an investment of about $1 billion in Turkey. In June, Turkey applied an additional 40% customs duty on vehicles produced in China; however, according to a Presidential decree published on July 5, this exemption was removed for investors in the country. According to Anadolu Agency, BYD will invest approximately $1 billion to establish production facilities in Turkey for electric and hybrid vehicles and other sustainable transportation technologies, with an annual production capacity of 150,000 vehicles and an R&D center.

Meanwhile, the Central Bank of Turkey's total reserves reached the highest level in the republic's history during the week of June 7, rising to approximately $146.2 billion. Gold reserves also increased by $56 million, from $59.74 billion to $59.796 billion.

For the 2024–2026 period, we foresee the continuation of tight monetary policy in Turkey. It is expected that tight monetary policy will keep real interest rates in positive territory. Reducing inflation from 65% at the end of 2023 to the Central Bank's target of 5% will be a long process. In the short term, we expect the policy rate to peak at 45% in 2024. Assuming there is no continuation of fiscal loosening and no deterioration in institutional capacity or independence of major institutions, a limited interest rate cut may be possible at the end of 2024, considering the expected inflow of international portfolio investments and the outlook for the exchange rate and inflation.

As real interest rates rise, inflation is expected to trend downward in the medium term. Positive real interest rates will also be needed to reduce the pressure of domestic demand due to high public spending. In this context, we estimate that the consumer inflation rate will decline to approximately 24% by the end of 2025 — a level that, while still relatively high, is lower compared to other emerging economies.

The year 2024 offers significant opportunities and challenges for the Turkish economy. Sustaining economic growth, controlling inflation, and enforcing fiscal discipline will play a critical role in achieving economic stability. Moreover, improving external sector performance and managing risks effectively will be crucial for Turkey's economic future. Overall, it can be said that inflation peaked in May–June, and based on policy interest rates, it is expected to begin declining afterward. While the government anticipates an end-of-year inflation rate of around 38%, a figure between 40–45% is more likely.

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