COFACE ECONOMIC PUBLICATIONS

JUNE 2024

FOCUS

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Will the Turkish economy benefit from the authorities' U-turn towards greater orthodoxy?

EXECUTIVE SUMMARY

Starting in mid-2021, Türkiye shifted its economic policies and introduced a negative real interest rate policy within the framework of a new program, announced as the Türkiye Economic Program (TEP), based on increasing production, investments, employment, and exports through low interest rates, as well as reducing the current account deficit to eventually reach a surplus. To achieve these goals, the central bank had cut its policy rate from 19% to 8.5% between September 2021 and May 2023. However, as manufacturing production is heavily dependent on imported intermediate goods and energy, the Turkish lira depreciated by nearly 60% vs. the USD during this period and inflation surged from 19.3% in August 2021 to as high as 85.5% in October 2022. Following this sharp depreciation of the lira, exports rose by 13.4% on a nominal basis between 2021 and 2023, while imports jumped by 33%. This widened the trade deficit to USD 106 billion (9.5% of GDP) in 2023 compared with USD 46 billion in 2021 (around 6% of GDP). Consequently, the current account deficit rose from 0.9% of GDP in 2021 to 4.1% in 2023 partly due to the increase in global energy prices because of the war in Ukraine.

On the other hand, the negative real interest rate policy, which was not able to reduce the current account deficit through the lira's depreciation as expected, allowed companies to obtain cheap credits with interest rates standing far below inflation. As a result, companies can be considered as the real winners of this period, especially those with more capital-intensive production and strong pricing power.

~~After the March 2024 local elections,~~ economic conditions have become more restrictive for the ~~corporate sector.~~ Indeed, following these elections, Türkiye has shifted into a more orthodox economic policy set, focused on abandoning its negative real interest rate policy and bringing down skyrocketing inflation. The Central Bank raised the policy rate from 8.5% to 50% in March 2024 and tightened financial conditions significantly. Therefore, interest rates on commercial loans have approached 70%, raising the financial burden on companies considerably.

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However, Turkish companies still have some comparative advantages over their competitors. The country's proximity to major export markets, quality of technological equipment, educated labour force, diversified manufacturing fabric, etc., coupled with the likely return of EU countries to growth in 2024 and 2025, are expected to support Turkish exports from the second half of 2024. In addition, companies should benefit from more stable domestic macroeconomic conditions from 2025 onwards. The disinflation process, which will begin in the second half of 2024, will provide a new opportunity for Türkiye to attract foreign investment, stabilize the lira, lower interest rates, and reduce the financing burden on businesses. From this perspective, we can also see that the depreciation of the lira between 2021 and 2023 will support the narrowing of the current account deficit not mainly by increasing exports, but by decreasing imports. Indeed, in the first quarter of 2024, the current account deficit declined to USD 11 billion, from close to USD 25 billion in the same period of 2023. At that time, the surplus of the core current account balance (excluding gold and energy) rose from USD 2.7 billion to USD 5 billion. Imports excluding energy have been declining since January 2024. In the first four months of 2024, they fell by 8% year-over-year (YoY).

Can Turkish exports benefit from the sharp depreciation of the lira?

From mid-2021, Türkiye adopted an unorthodox economic policy called the Turkish Economic Program, which was based on increasing production, investment, employment, and exports through a negative interest rate policy. Initially, the program aimed to gradually reduce the current account deficit and achieve a current account surplus in the medium-term, supported by recent investments in the energy sector. The current account surplus was expected to reduce depreciation pressure on the lira in the medium-term and to lower imported inflation, enabling the economy to exit the depreciation-inflation spiral.

To achieve these objectives, the central bank cut its policy rate from 19% in September 2021 to as low as 8.5% in May 2023. Consequently, the interest rates on one to three-month deposits declined to around 13%, while 12-month inflation expectations rose to nearly 35%. On the other hand, the economic authorities introduced a significant number of macroprudential measures to encourage banks to lend cheaply, for interest rates on loans of 20-25%, far below inflation rates. Consequently, the Turkish lira depreciated by nearly 60% vs. the USD between September 2021 and May 2023.

One should note that even before the 2021-2023 period, the depreciation of the lira had only a partial, but not significant, impact on Türkiye's export performance. In fact, between early 2013 and late 2016, the lira depreciated by around 17% in real terms, while exports fell by 7% in nominal terms. This suggests that other factors, such as external demand, had a greater impact on export performance than the exchange rate.

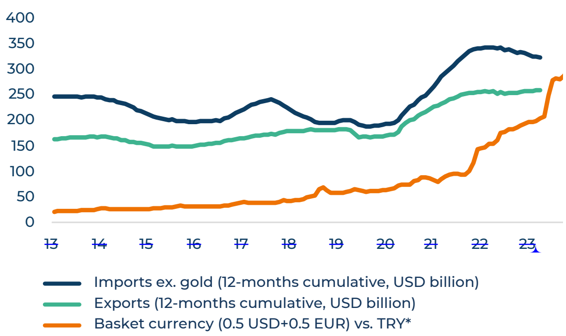
During the period of unconventional policies, and coupled with the unprecedented increase in global energy prices due to the start of the war in Ukraine in February 2022, the sharp depreciation of the lira widened Türkiye's current account deficit. Between 2021 and 2023, Turkish exports rose by 13% on a nominal basis while imports increased by 33%. This widened the trade deficit to USD 106 billion (9.5% of GDP) in 2023 compared with USD 46.2 billion in 2021 (around 6% of GDP). Consequently, the current account deficit rose to 4.1% of GDP in 2023, from 0.9% in 2021.

While this produced the opposite result of what was desired by the new economic model, it may be too early to assess the efficacity of the lira's depreciation. According to the economic theory, it is supposed to produce its full impact in the medium-term: after an initial unfavourable price effect in the short-term (higher import prices), volumes adjust, and exporters' price competitiveness enables them to gain market shares.

While the slight uptick in export volumes in recent months (+4.5% YoY in January-May 2024) could be the first impact of this policy 3 years later, exports were still only 10% higher in March 2024 than in September 2021 and analysis of previous episodes show that the depreciation of the lira has little impact on exports.

Looking at the performance of Turkish exports over the last decade, they are rather positively affected by rising external demand, especially in Europe, and the depreciation of the lira did not have much effect on exports. Typically, the narrowing of the current account deficit during periods of lira depreciation was due to falling domestic demand in Türkiye's case, which in turn depressed imports. Between 2013 and 2016, the Turkish lira depreciated by nearly 45% against a basket of currencies (composed of 0.5 USD+0.5 EUR), while the foreign trade deficit narrowed from around USD 100 billion (around 12% of GDP) to USD 53 billion (6% of GDP). However, during this period, exports declined by 7.6% while imports declined by 22.5%. In other words, exports declined despite the depreciation of the Turkish lira. The main reason for the narrowing of the trade deficit was the sharp decline in imports **(Chart 1)**. In the pre-pandemic period between 2017 and 2019, the lira depreciated by 40%, exports rose by 10% and imports declined by 12% - despite higher oil prices. The trade deficit declined from USD 74 billion (around 9% of GDP) to USD 29.5 billion (4% of GDP).

Chart 1 -Turkish exports and imports vs. basket currency



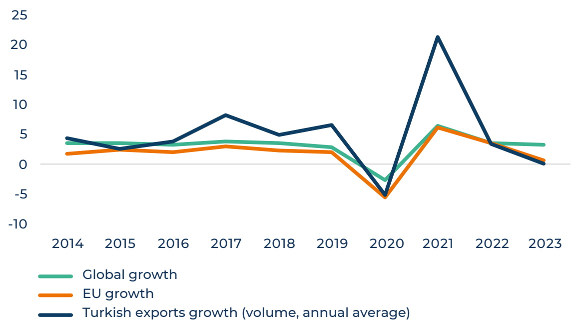
*RHS
Sources: TSI, Workspace, Coface

This suggests that even if there is a theoretical relationship between exchange rate changes and the level of exports and imports, other variables may also be influential. In the case of Türkiye, the main determinant of exports is the change in income across trading partners **(Charts 2 and 3 - See next page)**.

In fact, nearly 95% of Türkiye's total exports in nominal terms come from the manufacturing sector and are mostly directed towards European Union (EU) countries, whose share in the country's total exports is close to 40%. Half of the exports are intermediate goods, mostly processed raw materials for industries (i.e. medium-low technology basic metals, chemicals, and plastics).

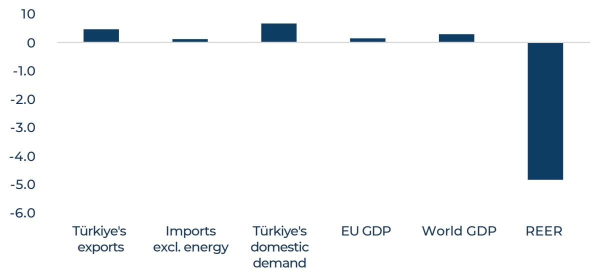
Textile and clothing, a low value-added sector, represent around 30% of Türkiye's exports. The share of high-tech products in manufacturing industry exports is only 3%, while the share of medium-tech products is around 80%. As competition in these product categories is fierce globally, Turkish companies face price reduction demands from their customers abroad in case of a lira depreciation. This means that the depreciation of the Turkish lira does not support exports as strongly as expected.

Chart 2 - Turkish exports vs. external demand (%, YoY)



Sources: TSI, IMF, Coface

Chart 3 - CAGR between 2013-2023 (%)



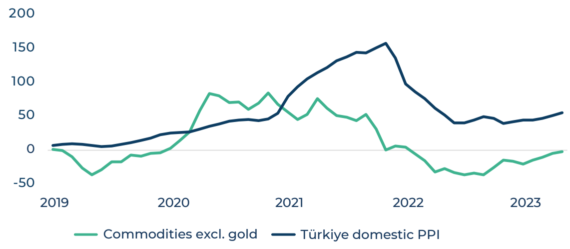
Sources: TSI, IMF, Coface

Another reason restraining the lira's depreciation impact on Turkish exports is the imported input dependence of sectors. According to a working paper published by Türkiye's Central Bank experts[1], the sectors that use the most imported inputs in Türkiye are chemicals, plastic and electronic products, motor vehicles, basic metals, machinery, electrical equipment, and pharmaceuticals. The ratio of imported intermediate inputs to total intermediate inputs of these sectors (import dependency) varies between 30-45%. High levels of imported input usage reduce the positive impact of the lira's depreciation on export revenues as it increases production costs in the first place.

How did negative real rates affect companies?

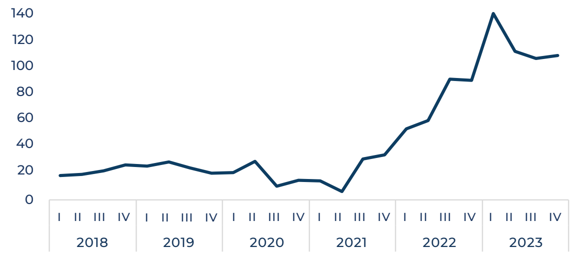
While the policy of negative real interest rates has not reduced Türkiye's current account deficit so far, it has led to skyrocketing inflation through an increase in local demand for dollars and a deterioration in terms of trade. As Türkiye's manufacturing production is heavily dependent on imported intermediate goods and energy (of which prices soared in 2022), both producer and consumer prices surged. Between September 2021 and June 2023, producer prices rose by 194% while consumer prices increased by 137%. The continuous depreciation of the lira's value and the unpredictability of the extent to which it would weaken led to a deterioration in companies' pricing behaviour. In other words, the deterioration of the domestic inflation outlook, negative real interest rates and the rapid depreciation of the Turkish lira led to a multiplication of production costs, which had already increased due to the war in Ukraine **(Chart 4)**. On the other hand, salary increases for employees due to rising inflation have led to a massive increase in unit labour costs incurred by firms **(Chart 5)**.

Chart 4 - Global commodity prices vs. Turkish PPI (YoY, %)



Sources: IMF, TSI, Coface

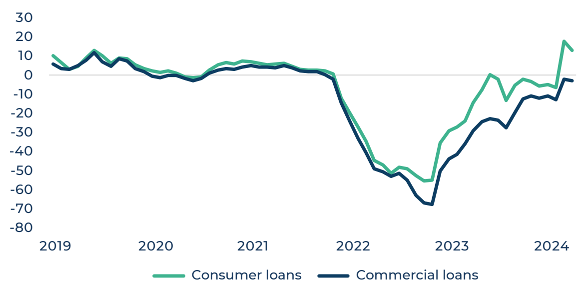
Chart 5 - Unit labour costs for industry (calendar-adj., YoY, %)



Sources: TSI, Coface

Despite a 270% increase in unit labour costs between 2021 and 2023, as well as the rise in raw materials, intermediate inputs and other costs, the profitability of firms did not decline during the period. On the contrary, both their operating profitability and the share of profits in national income increased. The main reason was that financing costs remained extremely low compared to the inflation rate **(Chart 6)**. In fact, in the last quarter of 2022, commercial loan rates averaged 17%, while inflation averaged 85% YoY in September-November. In addition, companies were able to pass on the increase in their input costs to customers. As a result, their operating profitability surged.

Chart 6 - CPI adjusted rates on loans (pp)

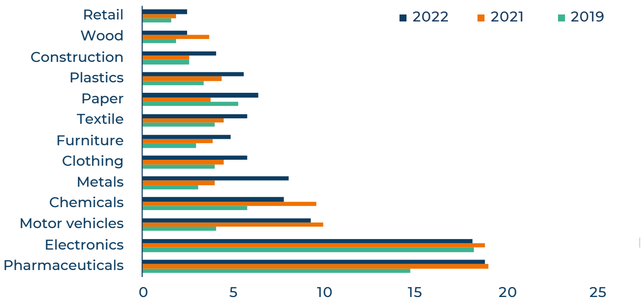


Sources: CBRT, TSI, Coface

1 - Üretimin İthal Girdi İçeriği ve İhracatın Reel Kur Esnekliği: Türkiye Örneği (Demirhan Demir Selçuk Gül Abdullah Kazdal Paper No: 23/05, October 2023)

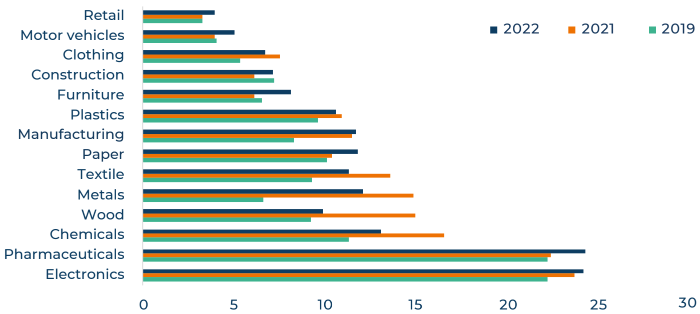
During this period, net profits rose sharply relative to the pre-pandemic period in the manufacturing, transportation, and construction sectors, the latter being generally considered as a high-risk sector. Across industries, net profitability in capital-intensive sectors like pharmaceuticals, electronics, automotive, and chemicals increased more than in labour-intensive sectors like retail and construction.
The main reason is that while unit labour costs have risen, borrowing rates have remained below inflation **(Chart 7)**. The fact that operating incomes rose faster than financing costs indicates that firms' profit margins rose faster than the cost of credit **(Chart 8)**. The low cost of borrowing over the period supported the increase in profit margins, especially as companies did not face problems in accessing credit (Turkish lira commercial loans jumped by around 100% YoY at the end of 2022).

Chart 7 - Net profit/ Total sales per sector (%)



Sources: CBRT, Coface

Chart 8 - Operating income/ interest rate expenses (%)



Sources: CBRT, Coface

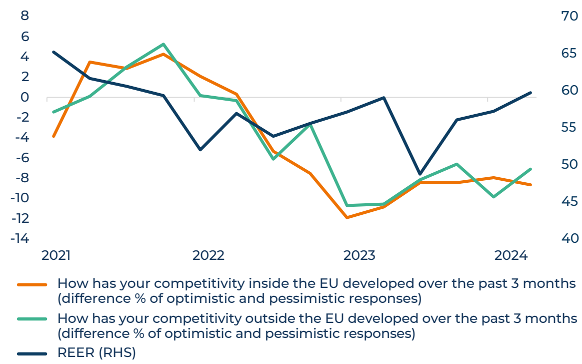
Furthermore, domestic demand remained strong due to the deterioration in inflation expectations, giving companies higher pricing power. The hyperinflationary environment supported business sales in two ways. First, the expectation of higher inflation led households to bring forward their purchases, resulting in higher sales for companies. Secondly, as the pricing behaviour deteriorated, companies were able to sell their products at prices well above their costs, as customers were willing to buy at any price, as goods and services would be much more expensive in the next week or month. Some of this spending was financed by savings, but a significant portion was financed by low-interest loans. Between 2021 and 2022, the household savings rate fell from 7.2% to 6.7% of GDP. On the other hand, the annual growth of consumer loans, which was close to 10% before the rate cut cycle began in 2021, rose to 60% in the second half of 2023. The rate of increase in credit cards spendings rose from 10% to 150% over this period, while the annual increase in retail sales rose from around 5% in real terms in early 2021 to over 30% in May 2023. Thus, business volumes and corporate profitability increased.

In 2024, corporate profitability is expected to remain squeezed across all sectors. Barring a sudden change in regulations or other unexpected economic and/or geopolitical shocks, the orthodox economic policies are expected to increase firms' financing costs and reduce their domestic sales. Turkish companies in labour-intensive sectors, which usually compete through low labour costs (with limited productivity) compared to their foreign peers, will face a loss of competitiveness. Higher borrowing and labour costs, as well as a slowdown in domestic demand, will weaken the financial structure of these companies. With the tightening of financial conditions and the increasing difficulties to access bank loans (the economic authorities have limited the monthly increase in loans to 2%), the number of companies applying for a concordat has already started to increase, particularly in the textile and construction sectors. These sectors are labour-intensive and more dependent on domestic production and sales than other sectors.

We expect this picture to gradually improve through 2025. However, not all sectors will benefit equally from the rebalancing of the domestic economy and the recovery of external demand. In this regard, sectors such as textiles, clothing, retail, wood, and construction, which are mostly dominated by financially fragile small and medium-sized enterprises (SMEs) without pricing power and where domestic demand is important for sales, are expected to face more challenges. On the other hand, more capital- and technology-intensive sectors such as pharmaceuticals, electronics, automotive and chemicals will benefit more from improving international economic conditions.

However, the recovery in exports seems to be lengthy, partly due to the slow recovery in world trade - which was still negative on an annual basis in March 2024. Regardless of the trend of the real exchange rate, the share of producers reporting a decline in their competitiveness in export markets both inside and outside the EU continued to increase in the 2021-2023 period **(Chart 9)**. Although there has been a slight recovery in the beginning of 2024, the fact that the data is still in negative territory indicates that the number of companies reporting that their competitiveness has improved is lower.

Chart 9 - Real effective exchange rate vs. Business survey on competitive position of companies



Source: CBRT, Coface

In the upcoming period, the lira is expected to appreciate on a real basis in line with the orthodox policies. In fact, although the cumulative inflation in the first five months of 2024 stood at 23%, the depreciation of the lira against the US dollar remained close to 9%. The authorities have also emphasized that this real appreciation of the lira would continue in the period ahead. This means that the depreciation of the lira against the dollar will be less than the Central Bank's year-end inflation expectation of 38%. However, this should not lead to a widening of the foreign trade deficit. In fact, imports of consumer and intermediate goods are expected to decline with the slowdown in domestic demand. Despite the real appreciation of the lira in the first five months, exports increased only by 4.5% YoY in nominal terms while imports fell by 9% YoY. This was mainly due to a 16% YoY decline in imports of raw materials and intermediate goods. In addition, in the first quarter of 2024, the terms of trade improved compared with the first quarter of 2023, but remained below the 100 threshold, which indicates that Türkiye still buys more expensive imports and sells its exports cheaper.

The main support to exports in the coming period is expected to come from the recovery in EU countries. Coface expects growth in the EU region to accelerate from 0.5% in 2023 to 1% in 2024 and 1.7% in 2025. Similarly, the MENA region which attracts around 20% of the country's exports will grow by 2.2% in 2024 and 3.6% in 2025. This is expected to support demand for Turkish exports, particularly for food, textile, clothing, chemicals, home furnishing, ferrous and non-ferrous metals.

Could Türkiye benefit from a return to orthodox policies?

We expect the economic policies implemented since June 2023 to create a more balanced economic outlook in the medium-term. In 2024, Coface expects real GDP growth to stand at 3%, below the country's estimated potential of nearly 5%. However, also because of these policies, annual inflation is expected to fall from 65% at end-2023 to 43% at end-2024, and the disinflation process is expected to continue throughout 2025. The slowdown in domestic demand from the second quarter of 2024 (especially gold and energy imports) is expected to contribute positively to both the disinflation process and the narrowing of the current account deficit thanks to the increase in the terms of trade. After reaching 4 % of GDP at the end of 2023, the current account deficit is expected to narrow to 3 % at the end of 2024.

Beyond the positive effects of macroeconomic rebalancing, Turkish firms still have comparative advantages over competitors. As Türkiye mostly exports food, nuts, automotive products, plastics, textiles, and clothing, it is usually compared with Vietnam, Egypt, Czechia, Romania, and Poland. Egypt's exports mostly consist of petroleum and petroleum products followed by chemicals and agricultural products while Vietnam's exports are mainly based on transportation, textiles, footwear, electronics, and food commodities. Romania's exports are quite similar to Türkiye's, such as automotive, machinery, textiles and apparel, chemical products, and metals. Poland and Czechia's exports are dominated by more complex products containing higher value added than Turkish export products, such as machinery, electrical equipment, computer, and optical goods. As a result, Turkey's trade competition with countries such as Egypt, Vietnam, and Romania is more concentrated in labour-intensive sectors such as textile, clothing, food etc., while that with the Czech Republic and Poland is concentrated in more technological sectors such as automobiles and electronics.

Between 2002 and 2023, the share of Türkiye's merchandise exports in global merchandise exports increased from 0.6% to 1.1%, indicating that Türkiye's integration into world trade and participation in the global value chains had increased. The Turkish industrial base is well-diversified as the production is spread across both labour-intensive products, such as textiles, clothing, food, wood products, as well as capital-intensive products, such as machinery, defence and transportation. While the technological content of Turkish manufacturing production is lower than that of its Eastern European competitors like Poland or Czechia, it is still higher than that of Vietnam or Egypt. Türkiye's exports are more limited in variety and can be produced in more countries. Indeed, the country's competitiveness in medium - and low-tech sectors (plastics, basic metals) is relatively high while its competitiveness in high-tech sectors (medical and pharmaceutical products, communication equipment, medical instruments, etc.) remains low.

Recent reforms aimed at shifting the country to a higher value-added production structure and reducing energy dependence have led to improved economic and social indicators. These developments are expected to support the business environment in sectors such as chemicals, automotive, infrastructure and defence in the coming period.

The young and dynamic population is also an advantage for Türkiye. The country's labour force is approximately 35 million (the second largest in Europe). Approximately 5 million are young people between the ages of 15 and 24. This puts Türkiye ahead of its competitors in Europe in terms of the availability of workforce.

In addition to the advantages of Türkiye's geographical location, the new economic cooperation initiatives that the country is promoting in its region are also expected to benefit trade volumes in the coming period. One of them is the so-called "The Middle Corridor" project, which aims to connect Asia and Europe to increase economic, political and socio-cultural interaction. It starts in Türkiye, passes through the Caucasus region via Georgia and Azerbaijan, then crosses the Caspian Sea, traverses Central Asia and reaches China. It is one of the key elements to revive China's Belt and Road Initiative (BRI), a strategy that aims to connect Asia with Africa and Europe through land and sea networks. In this context, these trade initiatives can be seen as export opportunities for Turkish companies.

However, despite these benefits for Türkiye, there are also several risks associated with these initiatives, including structural problems in transport, security issues along the routes, concerns about political instability, etc.

To conclude, the Turkish economy is expected to benefit from these orthodox policies by reducing macroeconomic imbalances that occurred during the period of negative interest rates. The stabilization of the lira since the end of Q124 and the anchoring of inflation expectations after the introduction of tight monetary and fiscal policies are the first indicators that these policies are working. The tightening of domestic financial conditions can be seen as a positive development in terms of reducing Türkiye's trade deficit through lower imports (for now). This is expected to reduce the current account deficit from 4% of GDP in 2023 to 3% in 2024, in turn reducing the depreciation pressures on the lira. On the other hand, the value of the lira is only a relative factor in export growth. The recovery of external demand will be more decisive. Therefore, growth in Türkiye's major export markets, particularly the EU, North Africa, the Middle East, and the US, is expected to support Turkish exports in the period ahead.

On the domestic front, financial conditions will remain tight until at least the last quarter of 2024 to counter inflationary pressures. As a result, profitability will decline, and bankruptcy risks will remain high throughout 2024 in sectors that lack pricing power and produce for the domestic market. Orthodox policies are expected to primarily reduce inflation, restore business and household confidence in the economy over the medium-term, and improve the investment climate. Although these policies will sacrifice a part of the growth rate for disinflation, new regional cooperation and trade corridors are expected to support Turkish firms' exports.

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