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Turkey – Maintaining the new course, for prosperity… and posterity

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Summary: A diversified and industrialized economy, a NATO member since 1952, a founding member of the OECD in 1961 and a member of the G20, Turkey[1] enjoys an enviable geostrategic position. Its development and human capital indicators are also satisfactory, which can largely be put down to the first decade of the Erdoğan-AKP era (2002-2012). They have, however, deteriorated in recent years. The key issues for socioeconomic development for the coming years include 1/ political and geopolitical stability within a troubled region; 2/ the achievement of high-income status and a prosperity benefiting the entire population; 3/ a decisive step forward in policies for climate change adaptation and energy transition, effectiveness and independence.

The first decade following the accession to power of the Justice and Development Party (AKP) in 2002 was marked by the success of the restoration of macroeconomic stability in the aftermath of the 2001 financial crisis, and was coupled with rather remarkable socioeconomic development. During the second decade, the government's action focused more on societal and moral issues, to the detriment of macroeconomic fundamentals and structural reforms. The third decade, which is beginning at the same time as the second centenary of the Republic of Turkey, founded in 1923, needs to place the economy, prosperity and national cohesion at the heart of the priorities. To ensure the posterity of his action, President Recep Tayyip Erdoğan could now devote what should be his final term as the country's leader to this task (2023-2028).

The orthodox shift in economic policy, initiated following the general elections in May 2023 won by President Erdoğan, would not appear to have been undermined by the AKP's defeat in the local elections in March 2024. Following a decade marked by a radical strengthening of the prerogatives of the Head of State, these elections are a victory for representative democracy, in a highly polarized society which has sanctioned the failure of the executive to safeguard the standard of living and social and economic gains of the population. In the wake of this electoral cycle and with no new national elections until 2028, the socio-political risk would appear to be moderate. Drawing on the two pillars, namely the banking sector and public finances, it will be crucial to secure the "normalization" of economic policy in order to remove the macroeconomic imbalances generated or exacerbated by the economic choices of the executive. This especially includes rampant inflation fueled by credit and the depreciation of the lira, along with the external position, the traditional weak link. In June 2023, the appointment of Mehmet Şimşek and Hafize Gaye Erkan to the key positions of Minister of Finance and Governor of the Central Bank of the Republic of Turkey (TCMB), respectively, was welcomed by investors, whose confidence, as with local economic agents, needs to be restored. In February 2024, the resignation of Mrs. Erkan served as a reminder of the difficulty of imposing long-term continuity. Her successor, Fatih Karahan, Deputy Governor since July 2023, will have the task of maintaining the course of monetary orthodoxy. The economic policy strategy in place for a year now is akin to a three-stage rocket: 1/ a gradual normalization of the monetary policy to ensure an orderly macro-financial adjustment

[1] Since 31 May 2022, in all its official languages, the United Nations has referred to the Republic of Turkey using its Turkish name Türkiye. This publication maintains the name used by the French Ministry for Europe and Foreign Affairs at the time of its publication.

and a soft landing of the economy; 2/ fiscal consolidation as of 2025, particularly in view of the cost of reconstruction after the earthquakes in February 2023; 3/ the adoption of structural reforms (at a standstill for a decade) to improve the business environment, support non-price competitiveness, productivity, attractiveness to investors, medium/long-term economic growth potential, and the green transition.

Thematic area: **Macroeconomics**

Geographical area: **Turkey**

Key indicators

		2017	2018	2019	2020	2021	2022	2023*	2024*
Socio-political	**HDI (rank / 191 countries)**	50	49	48	48	48	45	-	-
	UMIC poverty rate ($6.85 a day/PPP)	10,9	10,9	12,6	-	-	-	-	-
	Gini coefficient	43,5	42,4	43,8	43	44,4	-	-	-
	Fragile States Index (rank / 179 countries)	115	121	120	120	123	118	128	-
	Governance (percentile, World Bank)	38	36	36	35	34	32	-	-
Economic growth model	**GDP ($ BN)**	858,9	780,2	760,5	720,2	818,3	905,8	1 108,5	1 113,6
	GDP per capita (current USD)	10 629	9 514	9 146	8 613	9 664	10 622	12 849	12 765
	Real GDP growth rate (%)	7,5	3,0	0,8	1,9	11,4	5,5	4,5	3,1
Public finances	**Fiscal revenues (% GDP)**	31,2	30,8	30,1	29,4	27,8	26,6	28,4	29,9
	Public spending (% GDP)	32,8	34,0	34,9	34,1	30,8	27,7	33,9	35,4
	Fiscal balance (% GDP)	-1,7	-3,2	-4,8	-4,7	-3,0	-1,1	-5,5	-5,4
	Public debt (% GDP)	27,8	29,9	32,4	39,4	40,4	30,8	28,9	30,9
	Public debt interest (% revenues)	4,3	4,9	6,3	6,5	6,0	4,7	6,5	8,8
	Average effective rate of public debt (%)	4,8	5,5	6,3	5,9	4,2	3,1	6,0	9,1
External accounts	**Current account balance (% GDP)**	-4,7	-2,6	1,4	-4,4	-0,9	-5,4	-4,1	-2,8
	External debt (% GDP)	53,2	57,4	58,5	61,3	53,2	50,4	45,0	-
	Foreign exchange reserves (months of imports)	4,0	3,5	4,1	2,6	3,1	2,6	2,9	-
	Exchange rate variation / USD (%)	-6,7	-28,3	-11,4	-19,1	-43,4	-30,6	-36,4	-
Financial system and monetary policy	**Average annual inflation (%)**	11,1	16,3	15,2	12,3	19,6	72,3	53,9	59,5
	Central Bank key interest rate (%)	8,00	24,00	12,00	17,00	14,00	9,00	42,50	45,00
	Credit to private sector (% GDP)	84,1	82,6	79,6	89,3	89,5	66,3	-	-
	Solvency ratio (%)	16,8	17,3	18,4	18,7	18,4	19,5	-	-
	Return on equity (%)	13,6	13,5	10,8	10,8	13,3	37,9	-	-
	Non-performing loans - NPL (% gross loans)	2,8	3,7	5,0	3,9	3,0	2,0	-	-
	NPL net of provisions (% equity)	3,2	5,9	8,3	5,0	3,3	1,2	-	-
	Liquid assets (% short-term liabilities)	66,2	64,0	64,8	58,5	84,6	90,9	-	-
	Sovereign exposure of banks (% assets)	10,8	11,9	14,3	16,4	15,8	18,8	18,3	-
Climate	**ND-GAIN ranking (rank / 181 countries)**	52	52	52	51	52	-	-	-
	GHG emissions per capita (rank / 184 countries)	86	90	93		-	-	-	-

Sources: IMF, WB, UNDP, Climate Watch, University of Notre Dame, local sources, AFD calculations. *: forecasts or estimates at best date.

1. A test of representative democracy generally reassuring, between a division in Turkish society and a protest vote against the economic policy…

Re-elected in the second round of the presidential election with a parliamentary majority in May 2023, Recep Tayyip Erdoğan had to accept his defeat and that of his AKP party in the local elections of 31 March 2024, the first major electoral setback in two decades of hegemony, and the first national victory for the Republican People's Party (CHP) since 1977, with 38% of the vote compared to 36% for the AKP.[2] The embodiment of a strong, charismatic man who has restored pride among the Turkish people by putting the country back on the international geopolitical stage, in the footsteps of the former Ottoman Empire, President Erdoğan has underestimated the popular protest over the erosion of purchasing power, crystallized around the theme of improving minimum pension levels, an unfulfilled promise of the presidential campaign. The violations of civil liberties, the authoritarian turn, the economic problems, the impoverishment caused by galloping inflation, and the controversy in the aftermath of the earthquakes in February 2023 (organization of the earthquake relief effort, non-compliance with seismic standards, corruption) had not overshadowed the societal, identity and religious issues during the general election in May 2023. Turkish voters had not wished to take the risk of the adventurism of a divided opposition with a poor representation, following an election campaign marked by a media domination by the presidential camp. Ten months later, the local elections gave a completely different verdict, with the CHP winning in the country's five main cities, and the re-election of the mayors of Istanbul and Ankara. The AKP also lost certain traditional strongholds in the south of the country. There would appear to be a moderate risk of social-political instability, despite the persistent risks of terrorist attacks and a divided society, split between the supporters of a secular Republic and the upholders of a political Islam, undermining the secularization initiated by Mustafa Kemal Atatürk and whose army was perceived as its guarantor for 80 years. The instrumentalization of the status of the Kurdish minority (about 20% of the population), as with that of Syrian refugees and other migrant populations, and, more generally, concerns over the dilution of "Turkish identity", will continue to be powerful drivers of the populist-nationalist domestic and foreign policy of President Erdoğan.

In a context of global geopolitical fragmentation, Turkish foreign policy is based on a transactional, pragmatic, and even opportunistic approach, defending national economic and political interests. With the "variable geometry" of its relations with Russia, Turkey, a NATO member, has condemned the invasion of Ukraine (to which it has also sold drones) and blocked access to the Black Sea for Russian warships, but without backing the Western sanctions against Russia. The ambiguity of this positioning allows Ankara to act as a mediator between Kyiv and Moscow, which was central to the negotiations of the Black Sea Grain Initiative in July 2022. At the same time, this position of non-alignment maintains the complexity of the volatile relations with the USA and European Union (EU), which had been eased somewhat since 2021, as with the Gulf countries, Egypt, Greece and Israel. However, these relations have experienced a marked cooling since the outbreak of the current conflict on 7 October 2023. This policy reflects the "zero problems with neighbors" doctrine theorized by the former Minister of Foreign Affairs and Prime Minister, Ahmet Davutoğlu, and deployed in the 2000s. This subsequently turned into "zero neighbors without problems" in the following decade, in particular after Turkey's failure to capitalize on its regional outreach as a model of Islam-compatible democracy having partly inspired the Arab Spring, and its rapprochement with Iran and Russia. Quite

[2] The CHP had already taken the government of several major cities from the AKP during the previous election in 2019, including Ankara and Istanbul (as a result of a second election following the annulment of the first).

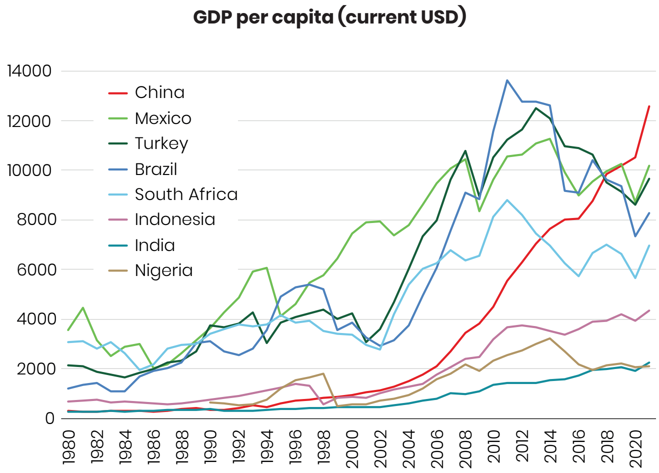
symbolic of this balancing act and Turkey's key role in view of its geostrategic position, in August 2023, Turkish and US navy and air forces conducted joint exercises, followed in September by sanctions by the Biden administration against five Turkish companies accused of helping Russia. The Dörtyol oil terminal in south-west Turkey is reported to have become a staging post for shipments of Russian oil to Europe.[3]

2. ...undermining socio-economic gains

The result of the first decade of prosperity of the Erdoğan-AKP era (2002-2012), Turkey has had satisfactory development indicators for an upper-middle-income country (UMIC) for the past 20 years. According to data from the International Monetary Fund (IMF) and World Bank, the country ranked in 48th place worldwide in 2022, in terms of GDP per capita at purchasing power parities (PPP), human development indicators, (2021), and human capital indicators (2020). However, with the very unfavorable exchange rate, GDP per capita in current USD has fallen by 15% since the peak in 2013, to USD10,619 in 2022, ranking the country 72nd worldwide (see Graph 1).

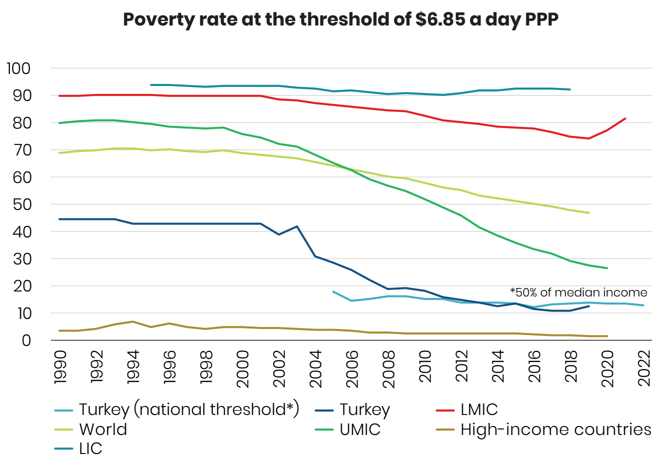
Behind the economic growth, supported by an expansionary policy mix which has contributed to the macroeconomic imbalances, first of all inflation, socioeconomic indicators have stagnated or even regressed over the last decade. Income inequalities are relatively high and have increased in recent years, with a GINI index standing at 0.44 after social transfers. There are marked regional inequalities, between a north-west region dominated by industry and services, in particular government and tourism, and the rural and agricultural south-east. The significant progress achieved since 2004 in terms of the poverty rate has leveled off, both at the threshold of USD6.85 PPP/day (the reference for UMICs) and at the national threshold of 50% of median income, in a country where social safety nets are limited (see Graph 2). With a poverty rate at around 13%, Turkey is well placed compared to the UMIC average (27%), but remains far behind the high-income countries the authorities aim to join by 2026. Most importantly, the national statistical institute (TurkStat) estimates

Graph 1 – A brake on prosperity over the last decade



Source: IMF.

Graph 2 – A halt to poverty reduction



Source: World Bank, TurkStat.

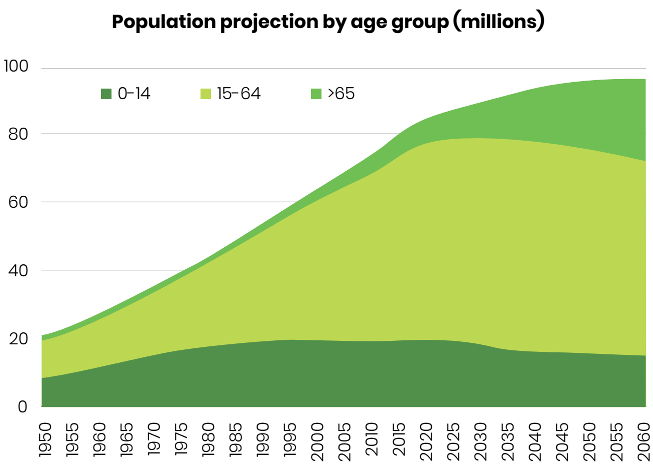
[3] Financial Times article, "The Turkish terminal helping disguised Russian oil reach Europe", 30 January 2024.

that 31% of the population is at risk of poverty and/or social exclusion, especially among the youngest cohorts.

Rigidities in the labor market, the mismatch between labor supply and demand, as well as certain socio-cultural factors, contribute to the existence of a large informal sector (almost 30% of jobs with no social security), a structural unemployment rate of around 10%, which is much higher among young people, a high underemployment rate, and a low employment rate (53%), especially for women (36%) and older people (only 32% among 55-64 year-olds). The political and economic context has contributed to the emigration of many graduates, constituting a brain drain, with the main contingent aged under 30. Official statistics indicate an improvement in labor market conditions since 2021, following a deteriorating trend since 2013, which increased in 2019 and was exacerbated in 2020 with the health crisis. The unemployment rate is estimated to have been reduced to below 9% at year-end 2023, perhaps partly helped by the pre-election gift from the government allowing early retirement for potentially more than two million workers. Beyond economic dynamics, rigid employment regulations, including for fixed-term contracts and temporary or temping contracts, contribute to the massive recourse to informal and semi-formal work, individually, in unregistered companies, and even in formal companies. The proportion of informal jobs, which is extremely high in the agriculture sector, has declined significantly in recent years (from 48% in 2005 according to the OECD to less than 30% in 2022 according to TurkStat), despite a downward rigidity in the non-agriculture sector between 2013 and 2019, reaching a plateau of around 20%. The influx of refugees, in particular from Syria 2014-2016,[4] has enlarged the labor force and initially the informal economy. In contrast to "flexicurity", the severance pay system, which is very costly for companies, is a disincentive for formal job creation and hinders labor mobility. This is especially because the unemployment benefit system does not provide sufficient social protection, despite the fact that the social security contributions of employers (15%) and employees (13%) are relatively high, but are largely intended to cover the costs of the universal health insurance system. It is therefore essential to make the labor market more flexible, by strengthening the unemployment benefit system and reforming the severance pay system. Furthermore, the high minimum wage level compared to the median wage (about 70%) reduces formal employment opportunities for low-income workers. This is especially the case for women and young workers. The minimum wage, which is revised every six months, has increased fivefold in two years and reached TRY 17,002 net per month in January 2024 (equivalent to €515). At the same time, the average nominal wage has doubled, adding to fears of a wage-price spiral and an indexation of the economy. Furthermore, real wage growth (deflated by consumer prices) in industry was largely decorrelated from the trend in labor productivity in 2022-2023.

In the longer term, the population dynamics pose challenges associated with the aging of the population and the expected decline in the working age population (see Graph 3). Turkey is in an advanced phase of demographic transition,

Graph 3 – Challenges of aging and the decline in the working age population



Source: OECD, United Nations (2022).

[4] The UNHCR estimates that Turkey is host to the world's largest refugee population, with 3.6 million Syrians, in addition to about 320,000 nationals of other countries, in particular from Africa.

with a population growth rate which stood at almost 3% per year in the 1950s-1960s and has now reached less than 1%. The United Nations and OECD project that the total population will increase from 85 to 96 million by 2026. The working age population (15-64 years) is expected to reach a ceiling of 62 million around 2040, before falling by about 5 million in the two following decades. At the same time, the number of people aged over 65 is expected to double by 2040 to 15 million, and reach more than 24 million by 2060. The old-age dependency ratio (population over 65 years-old in relation to the working age population) is thus expected to rise from 13% today to 42% by 2060, inevitably posing a challenge in terms of financing and economic growth potential.

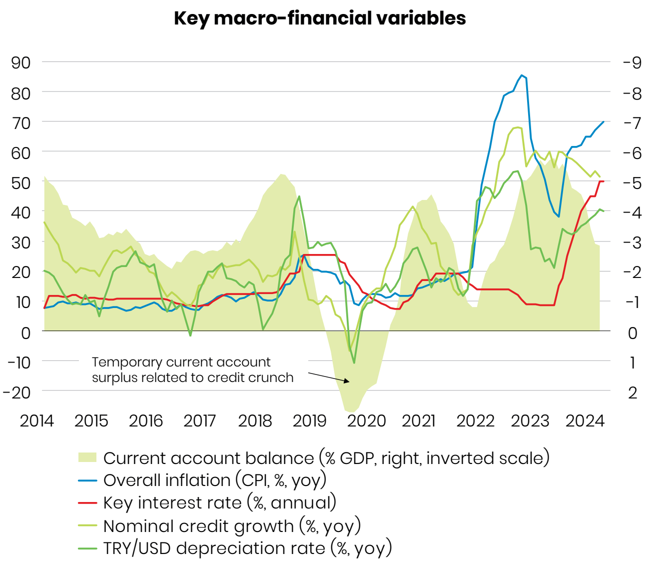
3. The difficult path towards macro-financial stabilization after the drift of “Erdoğanomics”

The turnaround in the economic policy framework, in particular in terms of the monetary and exchange rate policy implemented since June 2023, has thus brought a beneficial end to the risky and hazardous experimentation which was contrary to the basic concepts of macroeconomics and the economic and financial openness of Turkey. The unraveling of the battery of measures deployed since December 2021 to forcibly de-dollarize the economy, capture foreign exchange, and stabilize the lira (including a form of foreign exchange control for residents and financial repression on banks) requires a gradual steering by the Central Bank, the benefits of which are expected in the medium term.

The strategy to stimulate economic activity via an ultra-loose monetary policy, credit support, and a competitive exchange rate, meant to drive investment and exports and consolidate the country’s external position, has failed. The increasingly important role of consumption in driving the growth model has exacerbated macroeconomic imbalances, both internally (inflation) and externally (current account deficit). Macro-financial consolidation requires a reduction in domestic demand in the short term and a long-term strengthening of growth potential and the external position. A rebalancing (at least partial) of the current account balance is expected, under the assumption that the competitiveness of industrial exports will be maintained and that there will be a reduction in energy dependence. But it also requires a renewed attractiveness for capital flows, in particular non-debt creating FDI.

The deterioration in the business environment and the economic policy framework since the attempted military coup in July 2016 and the foreign exchange crisis in August 2018 took a new turn in December 2021, with an even more unpredictable monetary and foreign exchange policy. This new phase followed a pragmatic but brief return to monetary orthodoxy between November 2020 and March 2021 to stem a latent foreign exchange crisis associated with the deterioration of external accounts, fueled by the recovery in credit demand during the health crisis. The expansion of bank credit since 2010 has been a powerful engine of economic growth, as well as the current account deficit and a depreciation exchange rate-inflation spiral (see Graph 4). Significantly, the withdrawal of foreign investors from Turkish financial markets over the last decade infers that the pressures on the lira in recent years are largely attributable to local economic agents who mistrust their own currency. The lack of credibility of the monetary policy is not recent, as the annual inflation target has only been met twice since it was established in 2006. However, the easing bias of the monetary policy, its reactive more than proactive nature, its unpredictability, and political interference have become more marked with the succession of endogenous and exogenous shocks to the Turkish economy since 2016. At the same time, this monetary policy has been detrimental or even central to the macro-financial instability and

Graph 4 – Return to the monetary compass



Source: TCMB, IMF, AFD calculations.

volatility. This situation reflects Mundell's impossible trinity (1960), by which it is impossible to reconcile perfect capital mobility (effective in Turkey since 1990), a fixed exchange rate (or stable in the framework of a de jure flexible exchange regime as in Turkey), and a monetary policy independent of international developments. More specifically, the economic and financial openness of Turkey and its dependence on foreign capital flows are incompatible with a heterodox monetary policy. Yet the Turkish authorities have always refused to establish capital and foreign exchange controls on foreign investors, or return to a form of financial autarky.

The financial engineering and burdensome regulatory regime, which is binding on banks and companies, deployed since December 2021 were intended as a response to new pressures on the lira, the reduction in foreign exchange reserves to defend the exchange rate, and the surge in inflation, amid monetary easing dictated by the executive. The battery of measures adopted were more palliative than curative and aimed to "re-liraize" the economy, catch foreign exchange liquidity, and support the lira, in particular through:

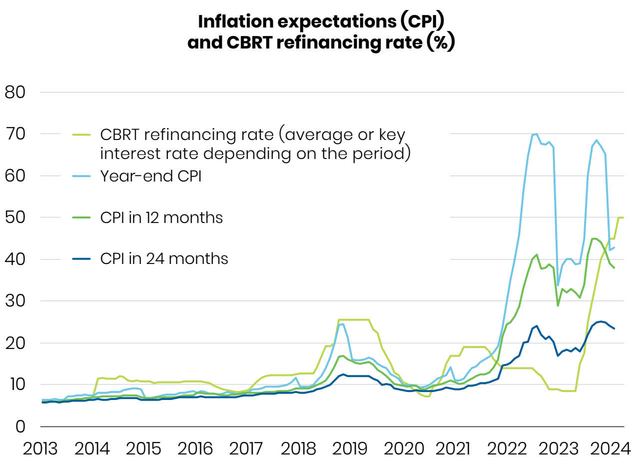
- The scheme for lira bank deposits protected from the foreign exchange risk (*Kur Korumalı Mevduat*, KKM);
- Recourse to non-deliverable forwards for exporters, which are obliged to convert 40% of their foreign exchange revenues into lira;
- The prohibition on banks to lend in lira to companies with "too much" foreign currency;
- The forced conversion of and increase in commissions on foreign currency deposits;
- The obligation of collateral in government securities for loans allocated by commercial banks at rates 1.8 times higher than the reference rate. This captive demand for securities and the cut in the reference rate have resulted in a sharp fall in the yield curve, easing financing conditions for the Treasury, and enabling an extension of the maturity of domestic debt.

Re-elected, President Erdoğan accepted a new turnaround with the appointment of the Mehmet Şimşek /Hafize Gaye Erkan ticket, two former investment bankers in New York, as Minister of Finance and Governor of the Central Bank (TCMB), respectively. Their roadmap consists in standardizing, streamlining, and gradually simplifying the economic policy, starting with the monetary policy. The objective is to restore confidence and market rules in asset pricing (rate, exchange rate, shares, gold, real estate, etc.), mitigate the risk of a financial and real estate bubble, improve the effectiveness of monetary policy transmission, adjust the macro-prudential framework, anchor inflation expectations, reduce risk premiums, stabilize the lira, and avoid a hard landing for the economy.

Since June 2023, the transparency and independence of the TCMB have been highlighted through communication based on a "discourse of truth" and "forward guidance", coupled with macroeconomic projections deemed more credible. The resignation of Mrs. Erkan in February 2024 would not appear to be due to differences of opinion with the presidential office. Her successor, Fatih Karahan, Deputy Governor in the Erkan team, a former economist at the U.S. Federal Reserve (Fed), and the sixth Governor of the TCMB in five years, has shown determination to stay on track. He also declared that some of the President's policies complicated the fight against inflation, in particular referring to the 49% increase in the minimum wage in January. Some voices continue to be heard, pointing to an underestimation of inflation, and it will take time for the response function of the TCMB to be clear and predictable for the markets. The strategy deployed by the new economic team is based on three areas:

- **Restoration of the key interest rate as the main monetary policy instrument** (see Graph 5). The one-week repo rate was raised from 8.5% to 50% between June 2023 and March 2024, while maintaining negative real interest rates in view of the official inflation rate of 68.5% yoy in March 2024 (against 124.6% according to the estimate of the think tank ENAGrup), including +70.5% for food prices and +37.3% for energy prices. The official inflation rate ended the year above the projection established by the TCMB in July 2023 (58%), and in line with its update in early November (65%). The increase in the official production price index, which had doubled in 2022 (+97%), slowed to +51% yoy in March 2024, suggesting a slight easing of pressure on business margins. The TCMB recognizes the importance of inflation inertia in view of the cumulative effects of the depreciation of the lira, the increase in food prices and taxes, as well as a price-wage spiral, as wage demands are based on inflation expectations and not on actual inflation. Furthermore, an individually rational behavior of overconsumption by households during a period of frequently changing prices led to self-fulfilling expectations on price rises. Inflation expectations were raised to 44% at the end of 2024 in the latest survey of the TCMB, which had set the target at 36%. The TCMB is targeting a return to single digit inflation by 2026. The new surprise key interest rate hike by 500 bp, combined with a widening of the rate corridor (at +/- 300 bp around the one-week repo rate) two weeks before the local elections of 31 March reinforced the signal of an independent TCMB determined to take action against inflation;

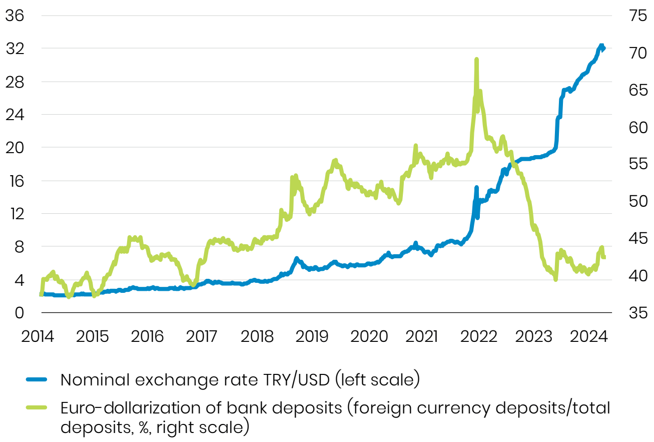
Graph 5 – Anchor inflation expectations through substantial monetary tightening



Source: TCMB survey.

- **Exit from the KKM scheme.** The objective is to increase the stock of classic deposits in lira by 3.5% per month by adjusting commission fees and the compulsory reserves on deposits, and also increasing the deposit rate in connection with the rise in interest rates. The objective is to encourage the closure of KKM deposits reaching maturity (90% of total deposits have maturities of less than six months) and/or the switch to foreign currency deposits. It is estimated that KKM deposits accounted for up to a quarter of total deposits in mid-2023 and that their total cost stood at TRY 894 billion (equivalent to USD33 billion) in August 2023, borne mainly by the TCMB and, to a lesser extent, the Treasury. The share of foreign currency deposits in total deposits remains below 45% (a peak at 69% at the end of 2021), and the transfer of KKM deposits to classic deposits in lira would appear to be working well (see Graph 6);
- **Quantitative tightening to absorb excess liquidity in lira and supervision/orientation of bank credit for the benefit of productive sectors (investment, exports) and to the detriment of consumption and real estate.**

Graph 6 – Relative stabilization of the dollarization of deposits despite the continued depreciation of the lira

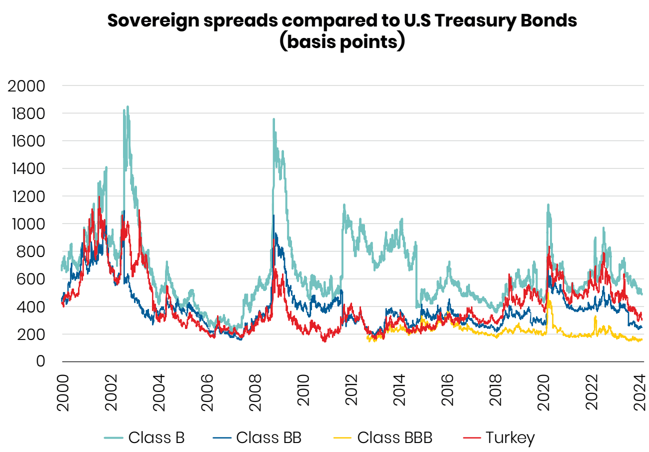


Source: TCMB, AFD calculations.

Overnight rates fluctuate in the TCMB's rate corridor depending on market liquidity conditions. The TCMB provides liquidity through currency swaps, but the net financing of open market operations (OMO) has been negative in recent months, and the excess liquidity has been sterilized through purchase auctions for one-week deposits;

This orthodox U-turn has begun to produce results, although investors remain cautious. The lira depreciated by 23% against the U.S. dollar between June 2023 and February 2024, signaling the withdrawal of TCMB's operations on spot foreign exchange markets in order to preserve foreign currency reserves, without, however, confirming the return to a purely floating exchange rate regime. The amount of foreign exchange reserves rebounded from USD58 billion to USD86 billion in gross terms between June 2023 and February 2024. International reserve assets (foreign exchange plus gold) stand at USD141 billion. When currency swaps (USD49 billion) and commercial bank deposits with the TCMB (USD74 billion) are deducted, foreign exchange reserves thus remain negative in net terms (-USD37 billion), but net international reserve assets are moderately positive with gold included (+USD11 billion). The World Bank has doubled its exposure to Turkey to USD35 billion. Net portfolio investment flows on domestic financial markets, which were negative to the amount of USD8 billion between December 2021 and May 2023, have turned positive again since June (+USD4.6 billion, including USD1.1 billion in bonds and USD3.5 billion in shares), helped by a rise in the bond yield curve (reversed following the sharp rise in short-term rates) and a stock market frenzy that needs to be watched. Sovereign spreads and CDS premiums fell from more than 600 bp in May 2023 to 300 bp in April 2024. This trend is favored by positive idiosyncratic factors and supported by beneficial external factors for most emerging and developing countries with the prospect of monetary policy easing in developed countries (see Graph 7). Sovereign and financial institutions, in particular commercial banks, have thus been able to raise new external financing in recent months. In January 2024, Moody's upgraded its outlook on the foreign currency long-term sovereign credit rating from stable to positive (B3/P). In March 2024, Fitch upgraded its sovereign rating by a notch assigning a positive outlook (B+/P), coupled with an improvement in the ratings of 18 local banks. S&P followed suit in early May (B+/P).

Graph 7 – Substantial easing of sovereign spreads



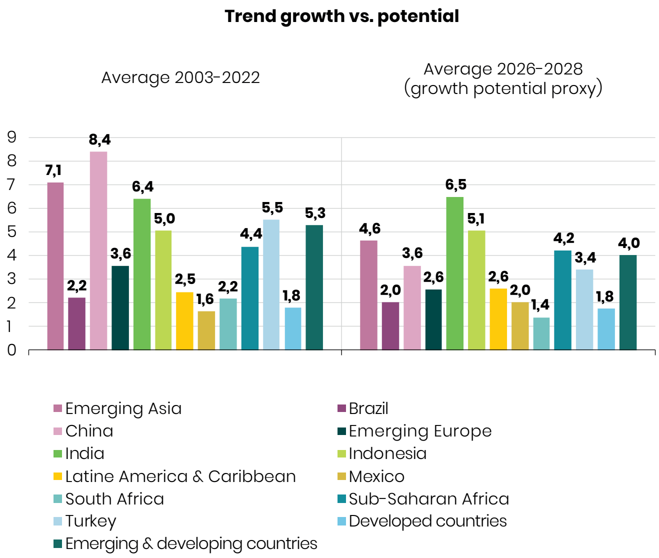
Source: J.P. Morgan EMBIG.

4. Improve the business climate and relaunch reforms to support growth, competitiveness, and the structural transformation of the economy…

The stabilization of the macroeconomic framework needs to be coupled with fundamental reforms in order to escape the middle income trap. To achieve this, Turkey can rely on two pillars that remain relatively strong: the banking system and public finances. Despite a tradition of hoarding (gold and cash) and short-term financial savings inherited from past crises (1994 and 2001), as well as a recent dissaving in the inflationary environment, economic agents have maintained their confidence in the banking system, the pillar of the financial system and cornerstone of the Turkish economic model. The TCMB is counting on commercial banks to make a trade-off between their balance sheets/income statements and macro-financial stability considerations, to enable an effective transmission of the monetary policy. At the same time, public finances have experienced a trend towards slippage, but this has remained relatively under control in recent years. Fiscal consolidation is expected as of 2025, with the consequent favorable public debt path and a reduction of liquidity and sustainability risks in the short and medium term.

The Medium-Term Program (MTP 2024-2026) published by the government in September 2023 defines a more credible framework than in the previous ones and has especially been officially endorsed by President Erdoğan. It aims to achieve high-income status in 2026 (>14,000 in current USD), which the IMF projects for 2029. After a level of economic growth of 5.5% over the last two decades, the World Bank and OECD estimate medium-term growth at almost 4%, after a decline of about 1 point of total factor productivity, while the Turkish authorities estimate it at 4.5-5%. The IMF's medium-term projections suggest a more limited estimate of growth potential (at around 3.5%). The latest Word Economic Outlook (WEO) has revised up the forecast for the investment rate at around 25% of GDP in the medium term. This is more reasonable than the previous forecast of October 2023 which envisaged a marked fall in the investment rate to about 12% of GDP on average between 2025 and 2028 (see Graph 8).

Graph 8 – Structural slowdown in global economic growth



Source: IMF.

Without being specifically set out in the MTP, the main priority areas of reform are quite clearly identified and include:

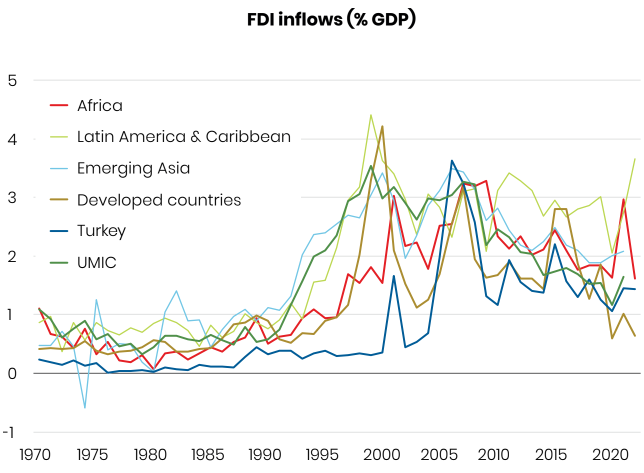
- Making the labor market more flexible and strengthening social safety nets;
- Improving employability through a better match between training (initial and continuing) and business needs, and increasing the capacity of universities (1 million places for 2.2 million candidates), although the meritocratic system works properly, in order to stop the brain drain;
- Adopting sectoral reforms: industry, tech, agriculture, energy;
- Reforming taxation by increasing direct taxes and reducing indirect taxes;
- Reforming the pension system (pension contributions and contributions to private pension funds insufficient);

- Promoting local and foreign investments to foster innovation, productivity and a moving up in the value chain;
- Providing more support to small and medium-sized enterprises (SMEs), in particular through public banks;
- Restoring a level playing field in public competitive bidding, and the independence and effectiveness of the civil and criminal justice system (there had been a decline in its quality following the dismissal of numerous judges after the attempted military coup in July 2016), as well as fundamental rights, while business law is largely based on European law and private bidding processes are highly competitive;
- Strengthening the role of Turkish development banks in the intermediation of donor financing.

Turkey's economic fabric is made up of large numbers of SMEs, which are major providers of jobs, as well as major groups and conglomerates, which are competitive internationally and benefit from good governance. In a climate of increasing macroeconomic, (geo)political and legal uncertainty over the last decade, longstanding foreign investors present in industry and services have stayed and learned to adapt, as has been the case for local companies.

But many potential investors have refrained from entering a competitive market, despite the fact that there are no restrictions on upstream dividends, except briefly during the health crisis (see Graph 9).

Graph 9 – FDI flows below the country's clear potential



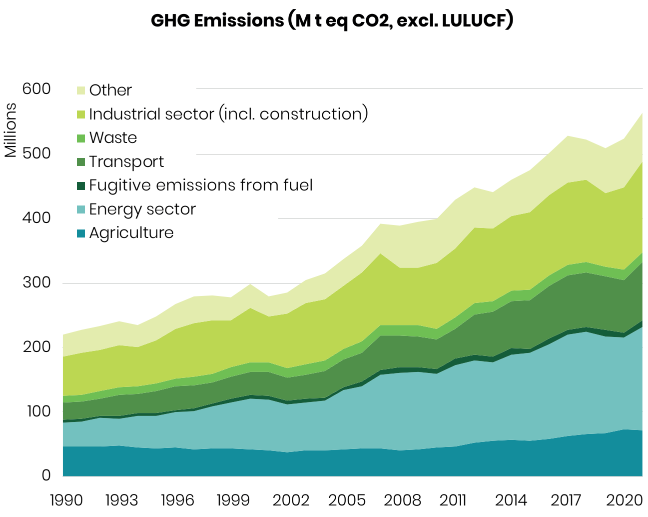
Source: UNCTAD.

Turkey's geostrategic position constitutes an advantage in the current geopolitical context of the reconfiguration of value chains and nearshoring to the European market. With the pipelines running through the country, the liquefied natural gas (LNG) terminals it houses, and the mining products, for which it handles the transit, Turkey is a key hub and trade route between Russia, the Caucasus, Central Asia, the Middle East and Europe. However, it could face competition from the India/Middle East trade corridor plan announced at the G20 New Delhi Summit in September 2023. Despite a diversification strategy for export markets (in particular in Africa), the EU remains its main market with more than 40% of total exports, especially for manufactured goods. The Turkish authorities are expected to call for a reinforcement of the Customs Union, while targeting new free trade agreements to boost exports. The European Green Deal and the EU Carbon Border Adjustment Mechanism (CBAM) pose a major challenge for Turkish companies, and are among the reasons for the acceleration of the green and digital transformation. Finally, macro-financial stabilization would improve the visibility of Turkish export companies, which are reluctant to establish long-term contracts with their suppliers.

5. ...including the green transformation

Turkey is already suffering from the impacts of climate change through the recurrence and increasing intensity of climate hazards, with potentially significant consequences for the agriculture sector in the most rural, poorest and driest regions in the south-east of the country, but also in major urban areas. Despite a high level of greenhouse gas (GHG) emissions and a high-carbon energy mix, Turkey's exposure to the energy transition is viewed as being relatively moderate, given that the economic diversification, the level of socioeconomic development, and the expected improvement in the institutional and business environment minimize the country's vulnerability. Following a certain wait-and-see policy, the Turkish authorities are now showing a determination to speed up the adaptation and mitigation policies, in particular in terms of transition, effectiveness, and energy independence.

Graph 10 – Rise in GHG emissions



Source: United Nations Framework Convention on Climate Change (UNFCCC).

Turkey's greenhouse gas (GHG) emissions account for 1.3% of global emissions. They rose by 123% between 2002 and 2022, compared to a global growth of 42% over the period. However, they have increased at a slightly slower pace than economic activity. This is due to an improvement in the energy intensity of GDP (15th worldwide in 2022) and recent efforts to decarbonize the energy mix, although final energy consumption still relies heavily on carbon. At the same time, per capita emissions have increased and reached 8.1 tons of CO_2 equivalent in 2022, a higher level than the global average and the level of UMICs. The sectors with the highest emissions are the energy sector, followed by the industrial sector (including construction), and transport sector (see Graph 10).

Turkey is the OECD country whose energy demand has grown the most rapidly over the last two decades. Over the same period, it ranks second worldwide behind China for the increase in demand for electricity and natural gas. Dependence on imports amounts to 74% of its energy consumption, more than 80% of which is made up of fossil fuels. The country is the 14th in the world to have crossed the 100 GW mark in combined power generation capacity. Given the strong energy demand, the coal phase-out will be slow and "natural" (less than 4% of the energy mix projected in 2053, compared with the current 20%). The Ministry of Energy does not plan new financing in the sector and expects a slight increase in production until at least 2035. Similarly, natural gas (26% of the energy mix) will continue to play an important role through the start of production in offshore fields which could cover 30% of domestic demand by 2028.

The authorities are showing a determination to accelerate the green transformation of the economy and mitigation policies through the energy transition. Published in 2023 following the ratification of the Paris Agreement in 2021, Turkey's Nationally Determined Contribution (NDC) targets a peak in GHG emissions in 2038 at the latest, with a "net zero" target in 2053, without quantifying the economic and financial cost. The World Bank considers this objective to be achievable, provided that there are major transformations in a number of economic sectors, starting with the electricity sector, which requires substantial investments but a priori bearable for Turkey (USD68 billion in NPV for 2022-2030 and USD165 billion for 2022-2040, or 1.2% of aggregated GDP projected over the period). A green taxonomy in line with that of the EU is currently being prepared, along with a "climate" law and a "water" law, and including the social aspects of sustainability (gender, inequalities). The financial regulator (BDDK) is finalizing guidelines on the management of the physical, climatic and transition aspects of the financial risks. The agriculture, agri-food, electricity, paper, timber, mining, cement, steel, and tourism sectors are identified as being the most exposed. Banks have rather ambitious strategies to decarbonize their assets and channel financing according to criteria for respecting the Sustainable Development Goals (SDGs) and the environmental, social and governance (ESG) aspects. The investment efforts for renewable energies are illustrated by the fact that 86% of new installed capacity between 2018 and 2022 is from renewable sources. These sources accounted for 54% of the energy mix in 2022, dominated by hydropower (31%), followed by wind energy (11%), solar energy (9%), and geothermal and biomass energy (3%), meaning that Turkey ranks 5th in Europe and 12th worldwide in terms of installed capacity. The country's first nuclear power plant (Akkuyu, on the south coast), operated by the Russian company Rosatom, was commissioned in April 2023. Two other nuclear power plant projects have been announced. The National Energy Plan for 2035 envisages an increase in the combined capacity of power plants to 190 GW by 2035, with renewable energies expected to account for 73% of this increase (solar energy x5 and wind energy x3).

The international economic, commercial, (geo)political and regulatory developments on issues related to the energy transition pose both a threat and an opportunity for Turkey. For example, the effective entry into force of the CBAM in 2026 under the European Green Deal constitutes a major commercial issue for Turkey, encouraging or even obliging companies exporting to the EU to make permanent changes. Assisting the financial sector and Turkish companies towards a more virtuous path, in line with European standards, is essential for both the economy and the Turkish authorities, so that they can adapt to the constraints of this market which remains crucial. Furthermore, Turkey's export competitiveness in green technologies and products with environmental benefits has a positive rating in the Green Complexity Index (GCI), with the country ranking in 26th place worldwide. Turkey ranks 6th for Green Complexity Potential (GCP) and is well placed to competitively develop other green complex products.

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List of graphs

List of acronyms and abbreviations

AKP	*Adalet ve Kalkınma Partisi* (Justice and Development Party)
BDDK	*Bankacılık Düzenleme ve Denetleme Kurumu* (Banking Regulation and Supervision Agency, Turkey)
CBAM	Carbon Border Adjustment Mechanism
ESG	Environmental, Social and Governance [aspects]
EU	European Union
Fed	U.S. Federal Reserve
GCI	Green Complexity Index
GCP	Green Complexity Potential
GHG	Greenhouse gas
IMF	International Monetary Fund
KKM	*Kur Kurumali Mevduat* (deposits with protected exchange rate)
LNG	Liquefied natural gas
LULICF	Land-Use, Land-Use Change and Forestry
NATO	North Atlantic Treaty Organization
NDC	Nationally Determined Contribution
OECD	Organisation for Economic Co-operation and Development
PPP	Purchasing power parity
SDGs	Sustainable Development Goals
SMEs	Small and medium-sized enterprises
TCMB	*Türkiye Cumhuriyeti Merkez Bankasi* (Central Bank of the Republic of Turkey)
TRY	Turkish lira
TurkStat	*Türkiye İstatistik Kurumu* (National Statistical Institute, Turkey)
UMIC	Upper-middle-income country
UNFCCC	United Nations Framework Convention on Climate Change
YOY	Year-on-year

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