Bank Audi

TURKEY ECONOMIC REPORT

NOVEMBER 2023

TABLE OF CONTENTS

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THE RETURN TO A MORE CONVENTIONAL AND CONSISTENT POLICY MIX THAT REDUCES NEAR-TERM MACRO-FINANCIAL STABILITY RISKS

Return to a more conventional and consistent policy mix

Turkey sees the return to a more conventional and consistent policy mix that reduces near-term macro-financial stability risks and eases balance of payments pressures. There is still uncertainty regarding the magnitude, longevity and success of the policy adjustment to bring down inflation, partly due to political considerations. Authorities are seeking to rebalance domestic demand away from consumption and towards investment and supporting exports. The IMF forecasts growth to reach 4% in 2023 before slowing in 2024, as reduced credit availability and easing of policy stimulus after the March local elections will be somewhat mitigated by earthquake reconstruction efforts and improved external demand.

Turkey's current account worsens amid growing foreign trade deficit

This year, Turkey's current account balance has worsened vis-à-vis figures from the same period of 2022. A deficit of US$ 40.8 billion is recorded for the first nine months of 2023, denoting a widening of 6.9% year-on-year against the same period of the year prior. This deficit was mainly driven by a deficit of US$ 72.3 billion in the Balance of Goods and partially offset by a surplus of US$ 39.8 billion in the Balance of Services.

Fiscal policy turning expansionary on pre-election spending and earthquake-related costs

Turkey's fiscal policy turned expansionary in 2023 and the budget deficit expanded significantly, mainly reflecting the material pre-election spending, the cost of the February earthquakes' relief and reconstruction efforts, and the slowdown in revenue growth compared to 2022. The central government budget deficit (on a cash basis) increased more than six folds over the first nine months of 2023, reaching circa TL 461 billion (US$ 21.2 billion), compared to a deficit of TL 68 billion during the same period of 2022.

Drastic rise in monetary policy rates

The year 2023 saw a reversal in its long-standing low-rates policy, as the Central Bank of Turkey embarked into an aggressive monetary tightening since May elections amid a strong commitment to lowering inflation and exiting the FX-protected deposit scheme. The Turkish monetary policy has undergone a U-turn since May Presidential elections. The Central Bank of Turkey has delivered starting June 2023 six large interest rate hikes for a total of 3,150 bps, which took the benchmark one-week Repo Rate to an unprecedented high level of 40.0% in November 2023, citing the need to establish the disinflation course and anchor inflation expectations as soon as possible.

A year of overall stability for the Turkish banking sector

The past year has been a year of overall stability for the Turkish banking sector. Measured by the aggregation of assets in the sector, banking activity reported a tiny growth in US$ terms of 0.6% in the first nine months of 2023, moving from US$ 768 billion in December 2022 to US$ 773 billion in September 2023. Likewise, deposits rose from US$ 474 billion to US$ 488 billion over the same period, a growth of 2.8%. As to loans, they slightly contracted by 3.3% to reach US$ 392.3 billion. Finally, shareholders equity reported US$ 70 billion at end-September 2023, against US$ 75 billion at end-2022.

Extended Turkish equity price rally in 2023, bonds bouncing back after policy shift

Turkish stocks extended their price rally over the year 2023, tracking global and emerging equity strength stoked by bets that the US Federal Reserve tightening cycle may have reached its end, and on hedging activity against rampant inflation and large real negative interest rates. Concurrently, the Turkish bond market shifted to a positive territory in 2023, as the return to a more conventional monetary policy after May Presidential elections helped lifting investor confidence.

Growth projected to slow from 4% in 2023 to 3¼% in 2024

Looking forward, as monetary policy tightens and the overall policy stance becomes less accommodative, growth is projected to slow from 4% in 2023 to 3¼% in 2024, and the current account deficit to narrow to about 3% of GDP in 2024. Sequential inflation should also fall in 2024 and is projected at 46% year-on-year by December. These projections reflect recent developments and policy actions, and discussions during the IMF staff visit to Turkey. The inflation trajectory remains highly uncertain, due to risks of backward indexation, inflation expectations, high commodity prices and additional lira depreciation.

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Turkey sees the return to a more conventional and consistent policy mix that reduces near-term macro-financial stability risks and eases balance of payments pressures. There is still uncertainty regarding the magnitude, longevity and success of the policy adjustment to bring down inflation, partly due to political considerations. Authorities are seeking to rebalance domestic demand away from consumption and towards investment and supporting exports. The IMF forecasts growth to reach 4% in 2023 before slowing in 2024, as reduced credit availability and easing of policy stimulus after the March local elections will be somewhat mitigated by earthquake reconstruction efforts and improved external demand.

Turkey's new economic team is enacting measures aimed at cooling the overheated economy and stabilizing the exchange rate without undermining financial and fiscal stability. Most importantly, the CBRT, under new leadership, has raised its key one-week policy rate by 31.5 percentage points since June. Monetary tightening is aimed at fighting inflation and curbing demand by increasing borrowing costs, particularly for consumers.

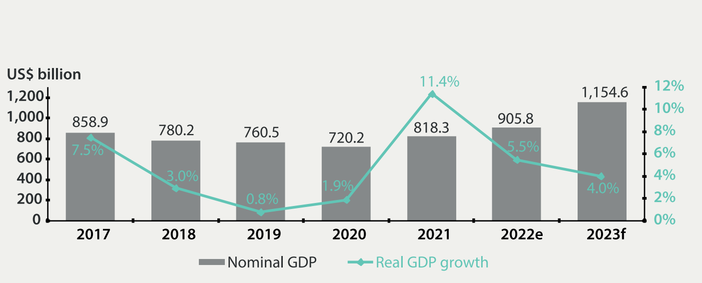
As a matter of fact, the authorities should be commended for raising the policy rate from 8.5% to 40%, which together with other quantitative measures has significantly tightened financial conditions. This has in turn boosted confidence, reduced pressures on the lira, and begun to cool domestic demand and ease distortions created by negative real interest rates. Gross reserves (including Gold) reached US$ 122.5 billion at end-September, but net of on- and off-balance sheet short-term liabilities remain negative. High inflation remains Turkey's main risk and policy challenge. Annual inflation rose to 61.4% in October, as strong core inflation pressures were exacerbated by the pass-through of the lira depreciation, minimum wage increases and continued strength of domestic demand.

At the external level, exports stabilized in the first ten months of 2023 relative to the 2022 similar period. They moved from US$ 209.4 billion to US$ 210.1 billion respectively. The tourism sector shows arrivals rising by 12.4% over the first nine months of 2023 to reach 45.2 million. Turkey's current account deficit will remain high in 2023, reaching 4.2% of GDP reflecting strong domestic consumption and gold imports. IMF forecasts the external deficit will ease to 3.0% of GDP in 2024 on the back of slower growth and improving external demand.

At the public finance level, fiscal policy has turned expansionary in 2023. Earthquake-related spending, large wage hikes, and various subsidies have raised spending, with the 2023 general government deficit projected at 5½ percent of GDP, despite the appropriate recent tax increases. The government introduced a series of tax increases in mid-2023 and intends to maintain an underlying central government deficit (without taking into account earthquake reconstruction costs) below 3% of GDP.

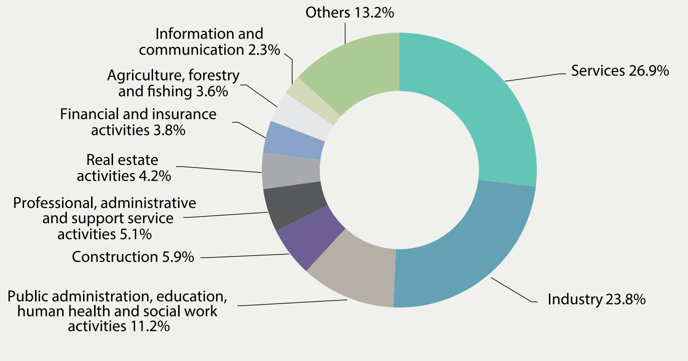
At the capital markets level, the stock market witnessed a flourishing performance this year, with a 36% rise in the BIST 100 price index, raising market capitalization from US$ 332 billion at end-2022 to US$ 375 billion at end-October 2023. The rise in prices was accompanied by a surge in trading volumes. The latter

GROSS DOMESTIC PRODUCT PERFORMANCE



Sources: IMF, Bank Audi's Group Research Department

BREAKDOWN OF GDP BY SECTOR (H1 2023)

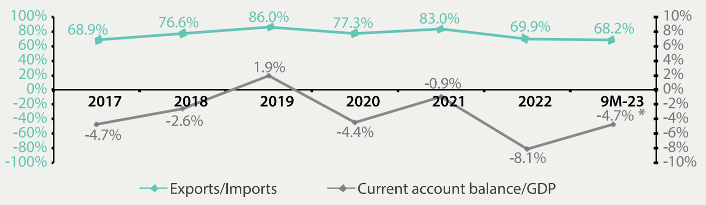


Sources: Central Bank of Turkey, Bank Audi's Group Research Department

reported 1,489 billion shares in the first ten months of 2023, approaching the total of full-year 2022 (1,644 billion shares) and exceeding the total of 2021 (1,203 billion shares). Likewise, the fixed income market witnessed improved risk perception, with the CDS spread, falling from 510 basis points at end-2022 to 400 basis points at end-October 2023 (against 563 basis points at end-2021).

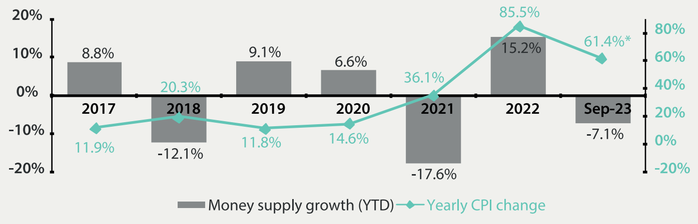
The in-depth developments in the real sector, external sector, public sector and financial sector of the economy are detailed in the forthcoming sections. The concluding remarks are left to the outlook of the Turkish economic, financial and monetary conditions looking ahead.

FOREIGN SECTOR INDICATORS



Sources: Turkish Statistical Institute, CBRT, IMF, Bank Audi's Group Research Department
**Nine-month figures annualized as a percentage of GDP*

MONEY SUPPLY GROWTH AND INFLATION



** As at end-October*

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

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1. ECONOMIC CONDITIONS

1.1. REAL SECTOR

1.1.1. Agriculture

Turkey's primary sector takes an upturn this year

The agriculture sector entered into a recovery mode this year, following its downturn due to the droughts that have damaged soil conditions in the previous year, along with lower harvesting areas and the outbreak of rice blast disease. The sector reported a real growth of 0.3% in the first half of 2023, against a contraction of 0.1% in real terms in the first half of 2022. In parallel, the share of the sector in the country's GDP remained at 3.6% in the first half of 2023, compared to the first half of 2022.

At the level of crop production, the latter traced an upward trajectory in 2022, sweeping away all losses registered over the previous year. Total cereals and other crops surged by 13.9% in 2022, after declining by 11.0% in 2021 to stand at 71,512 thousand tons.

A closer look at sub-categories shows that the largest expansion in 2022 was in dry pulses production (24.1%), followed by raw materials used in textiles with 22.2%, cereals (21.3%), tobacco (12.7%), potatoes, dried legumineus (5.8%), sugar beets (4.1%) and oil seed (2.5%). In contrast, plants for perfumery and pharmacy reported a drop of 7.3%.

Al the level of total fruits, nuts and spices crops reported an annual rise of 7.8%, up from a growth of 5.5% in 2021. While for vegetables and other crops, production decreased by 0.5% in 2022, following a 1.8% rise in the previous year.

The production bounced back by 8.8% in 2022 due to improved weather conditions, higher yield per hectare, increased harvested areas and better seed technology and irrigation systems, which have helped Turkish farmers to mitigate against future droughts.

On the other hand, cost for fertilizers and fuel have increased significantly because of weaker Turkish Lira, rising international commodity prices, supply chain issues and the Russia-Ukraine war. Hence, the government raised the support payments to farmers for fertilizers and fuel to offset higher fertilizers costs.

While the earthquake that occurred in February 2023 and the draught experienced from October 2022 to February 2023, remain a downside risk to production, growth in production is anticipated to improve in 2023, provided that spring rainfall has caused above average vegetation for wheat crop development,

CROP PRODUCTION IN 2022 (CEREALS, VEGETABLES AND FRUITS)

000s tons	Volume	Share		Volume	Share		Volume	Share
Cereals	**38,672**	**54%**	**Vegetables**	**25,304**	**80%**	**Fruits**	**16,418**	**61%**
o.w. Wheat	19,750	28%	o.w. Tomatoes	13,000	41%	o.w. Citrus fruits	4,711	18%
o.w. Barley	8,500	12%	o.w. Watermelon	3,395	11%	o.w. Pome fruits	5,566	21%
o.w. Maize	8,500	12%	o.w. Cucumber	1,939	6%	o.w. Stone fruits	3,033	11%
Sugar beets	**19,000**	**27%**	o.w. Melon	1,587	5%	o.w. Bananas, Kiwis, Avocado, Figs	1,488	6%
Potatoes, dried legumineus	**6,511**	**9%**	o.w. Pepper (green)	979	3%	o.w. Other fruits	1,619	6%
Oil seeds	**3,101**	**4%**	**Bulb and root vegetables**	**3,860**	**12%**	**Grapes**	**4,165**	**16%**
Dry pulses	**1,308**	**2%**	o.w. Dry onion	2,350	7%	**Olive production**	**2,976**	**11%**
Raw materials used in textiles	**2,750**	**4%**	o.w. Carrots	789	2%	**Tea production**	**1,300**	**5%**
Plants for perfumery, pharmacy	**88**	**0%**	**Other vegetables**	**2,425**	**8%**	**Nuts**	**1,609**	**6%**
Tobacco	**82**	**0%**	o.w. Leafy or edible stem vegetables	2,013	6%	**Spices crops**	**347**	**1%**
Total Cereals and other crops*	**71,512**	**100%**	**Total Vegetables & other crops**	**31,589**	**100%**	**Total Fruits, nuts & spices crops**	**26,815**	**100%**

**Excluding fodder crops*

Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

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particularly in major wheat-growing regions, and as the government may also extend its financial support to the sector in an effort to limit food price inflation, as per Fitch Solutions.

Within this context, the Ministry of Agriculture and forestry unveiled that production quantities of cereals and other crops are expected to increase by 7.7% in 2023, while fruits, beverage and spices crops are estimated to grow by 2.2%, when compared with the previous year, along with vegetables production that are forecasted to rise by 0.3% over the year.

1.1.2. Industry

Challenging domestic and global environment weighing on Turkey's industrial sector

Turkey's industrial sector came under pressure during the first half of 2023 amid challenging domestic and global conditions. In nominal terms, the share of the sector in Turkey's GDP decreased from 28.2% in the first half of 2022 to 23.2% during the same period of 2023. In real terms, the sector registered a contraction of 1.8% over the first half of 2023, following a growth of 6.8% in the same period of 2022.

Turkey's recurrent currency crisis negatively impacted production, as inflationary pressures caused by the depreciation of the lira, coupled with rising raw material prices globally amplified manufacturers' operating costs and reduced domestic sales.

Within this context, Turkey's Industrial Production Index, which measures the amount of output from the manufacturing, mining, electric and gas industries, reported a mere yearly rise of 1.2% during the first nine month of 2023, against a higher growth of 8.5% in the same period of last year, as per Turkstat.

Looking at the breakdown of the sector, the manufacturing sector, which contributes to almost 20.3% of nominal GDP, dropped by 0.3% year-on-year during the first half of 2023 against a growth of 9.2% in the same period of last year.

The Purchasing Managers' Index (PMI) for manufacturing stood at 48.4 in October 2023, below the 50-point line that separates expansion and contraction. Turkish manufacturers endured a challenging demand environment, with new orders increasingly difficult to secure, as per the latest PMI survey data. As a result, production was scaled back and firms also acted to lower their employment and purchasing activity. In particular, the renewed reduction in employment ended a five-month sequence of job creation. Panelists also reported a mix of resignations and retirements. Despite lower staffing levels, firms were still able to reduce backlogs of work to the largest extent for almost a year.

On the other hand, Turkey's construction sector, which makes up 5.9% of GDP, reported a yearly expansion of 5.4% in real terms during the first half of 2023, versus a decline of 8.3% in the first half of 2022. In fact, the government's preference to utilize large-scale infrastructure projects to fuel economic activity provides

VEHICLES PRODUCTION

(unit)	2020	2021	2022	22/21	10M-22	10M-23	10M/10M
Automobile	854,913	782,212	810,889	3.7%	633,369	779,328	23.0%
Pick-up	358,182	399,949	436,588	9.2%	357,763	329,592	-7.9%
Minibus	51,464	46,878	46,911	0.1%	39,678	44,555	12.3%
Tractor	38,103	55,503	49,541	-10.7%	39,718	48,409	21.9%
Truck	23,126	38,465	46,575	21.1%	37,255	44,232	18.7%
Bus	7,893	5,517	8,342	51.2%	6,244	8,651	38.5%
Midibus	2,043	2,153	3,335	54.9%	2,548	3,982	56.3%

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

a degree of upside for the sector's growth trajectory, as exemplified by the Canal Istanbul project and the 2053 Transport and Logistics Master Plan.

In conclusion, a currency collapse, elevated costs of raw materials and an unfavorable macroeconomic environment weighed on Turkey's industrial sector's activity, which also has undermined investor confidence, leaving the sector without a stable financing environment to support day-to-day activities. However, Turkey's favorable position as a transit country and a gateway to Europe, places it in good stead for attracting foreign investment for large-scale infrastructure projects, particularly in transport.

1.1.3. Trade and Services

Turkey's tertiary sector continues to recover in 2023

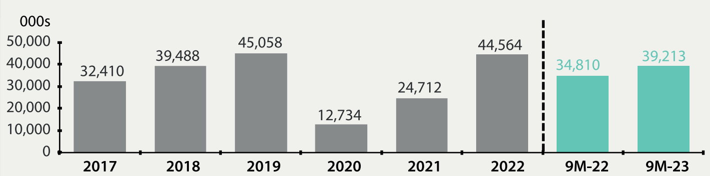
Turkey's trade and services sector continued to recover in 2023. However, some components of the tertiary sector have slowed down their growths during the year due to high inflation and local currency weakness.

The tertiary sector (which encompasses wholesale trade, information and communication, financial and insurance activities, real estate activities, professional, administrative and support service activities, public administration, education, human health and social work activities and other service activities) had a share of 55.8% of nominal GDP in the first half of 2023. This figure denotes a 3.3 percentage point increase against the same period of 2022 showing growth in the contribution of the sector to the economy, as per data from TURKSTAT.

Looking at Turkey's consumer outlook over the short term (2023-2024), spending growth is being artificially driven by high inflation. This comes as consumers are incentivized to spend rather than save as future value erodes relatively quickly. While forecasts show a slowdown in inflation between 2023 and 2024, the continued depreciation of the local currency poses downside risks to quicken the trend. These factors have created economic pressures on both retailers and consumers. Disposable income per household in US$ is forecast to decrease by 16.4% year-on-year in 2023 to reach US$ 9,737 per household. These factors, while not majorly affecting the tertiary sector, are expected to weigh on the growth potential of some sub-sectors.

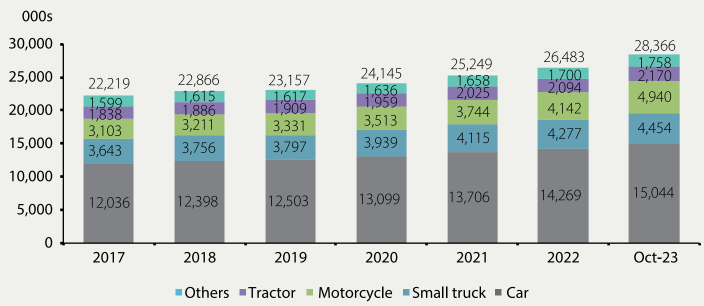
In details, looking at Turkey's telecommunications sector, the total number of mobile phone subscribers is expected to reach 94.1 million in 2023 showing a 4.2% increase against the year prior. This growth stands 0.5 percentage points down from 2022' forecast (4.7%). This softening trend is expected to continue over the medium term (2023-2027) at an average growth rate of 1.7% per annum. In parallel, post-paid mobile subscriptions have taken more than half of the market share suggesting higher potential for revenue. However, difficult macroeconomic conditions within the country pose downside risk to the sector looking forward, as per Fitch Solutions.

NUMBER OF FOREIGNER ARRIVALS



Sources: Ministry of Tourism and Culture, Bank Audi's Group Research Department

NUMBER OF ROAD VEHICLES



Sources: Turkish Statistical Institute, Bank Audi's Group Research Department

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At the level of real estate, average rent per m2 per month in US$ is forecast to continue on a downward trend in both Ankara and Istanbul when looking at Office rental, Retail rental and Industrial rental. Additionally, Net Rental Yield rates in both cities are expected to stagnate in all the aforementioned types of rentals. Residential and non-residential building' industry value growth is expected to decline marginally by 0.3% in 2023 following a 15.3% drop in 2022. The value of the aforementioned industry is also forecast to increase by an average of 5.3% per annum over the long term (2023-2032). Liquidity issues and economic uncertainty have weakened the performance of the Turkish real estate sector as they weigh on commercial real estate. Additionally, regional instability and Turkey's drift away from Western partners pose downward risks on inward investment and investor confidence looking forward. On the other hand, the Chinese Belt and Road Initiative is expected to create long term opportunities to expand the country's commercial real estate market size.

At the level of tourism, the number of visitors arriving to Turkey has continued to recover even surpassing tourism levels noted pre-pandemic. In the first nine months of 2023, 45.2 million visitors arrived into Turkey, up from 40.3 million in the same period of 2022 recording an increase of 12.4%. The increase in the number of visitors has slowed down from levels seen in the year prior albeit surpassing pre-pandemic numbers (41.6 million visitors in the first nine months of 2019). Total arrivals into Turkey are expected to continue expanding at an average of 4.0% per annum in the medium term (2023-2027).

It is worth noting that 86.7% (39.2 million individuals) of all visitors into Turkey were foreigners in the first nine months of 2023, up marginally by 0.2 percentage points from levels during the same period of 2022, as per data from Turkey's Ministry of Culture and Tourism (MoCT).

Tourism receipts also posted an amelioration of 20.1% in the first nine months of 2023 against the same period of 2022 to reach US$ 42.0 billion in the former. This increase follows an increase of 67.6% in the same period of 2022/2021.

It is worth mentioning that despite the Russia-Ukraine conflict, Russian tourists still represent a key source of arrivals for Turkey constituting around 13.2% of total foreign arrivals in the first nine months of 2023, as per data from Turkey's MoCT.

Looking at the hospitality subsector, the occupancy rate within Turkey's accommodation establishments reached 50.6% in the first eight months of 2023. At the level of occupancy rates in popular touristic provinces, Istanbul recorded an occupancy rate of 68.3%, Antalya an occupancy rate of 98.7% and Muğla an occupancy rate of 71.7% in August 2023.

Finally, the economic confidence index in Turkey rose to 96.5 in October 2023, up from 95.4 in the previous month. At the level of the tertiary sector, the services confidence index increased by 0.6 points against the prior month to reach 113.6 in October 2023. On the other hand, retail trade confidence dropped by 3.8 points against the month prior to reach 113.9 in October 2023. All sub-indices within the services confidence index noted increases with the exception of business situation over the past three months, which decreased against the month prior. Sub-indices within the retail trade confidence index decreased against the month prior with business activity-sales expectation over the next three months decreasing the most (5.1 points), as per TURKSTAT.

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1.2. EXTERNAL SECTOR

Turkey's BoP standing worsens amid growing foreign trade deficit

During the first nine months of 2023, Turkey's Balance of Payments (BoP) standing has worsened vis-à-vis figures from the same period of 2022. This comes amid widening deficits in the Balance of Goods, Services & Primary Income, the Capital Account and the Financial Account.

In details, looking at Turkey's Current Account, a deficit of US$ 40.8 billion is recorded for the first nine months of 2023. This figure denotes a widening of 6.9% year-on-year in Current Account deficit against the same period of the year prior. This deficit was mainly driven by a deficit of US$ 72.3 billion in the Balance of Goods and partially offset by a profit of US$ 39.8 billion in the Balance of Services.

In parallel, Turkey's Capital Account deficit widened by 6.3 times year-on-year to reach US$ 167 million in the first nine months of 2023. Additionally, Turkey's Financial Account recorded a deficit of US$ 39.6 billion in the first nine months of 2023, up from a deficit of US$ 17.6 billion in the same period of 2022. This entails a widening of the deficit in the Financial Account by 124.5% year-on-year in the aforementioned period.

At the level of foreign trade for the first 10 months of 2023, Turkey's Balance of Trade (BoT) recorded a deficit of US$ 93.9 billion, up from a deficit of US$ 91.0 billion in the same period of 2022. This figure shows a widening in the BoT's deficit by 3.2% year-on-year during the period. However, when looking at a month-on-month basis, the widening of the BoT deficit has been on a slowing trend since August recording decreases ranging from 47.8% to 14.9% monthly.

In details, Turkish exports reached US$ 210.1 billion over the first 10 months of 2023, representing a marginal increase of 0.3% year-on-year as per the Turkish Ministry of Trade.

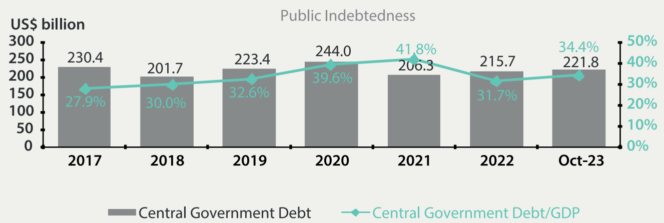
The breakdown of domestic exports by commodity shows that the main exports over the first 10 months of the year were vehicles (11.9% of total exports), boilers and machinery appliances (9.9%), mineral fuels, oils and products thereof (6.3%), electrical machinery, equipment and parts thereof (6.0%) and precious stones, metals, pearls and articles thereof (5.0%). The geographic distribution of domestic exports indicates that 8.4% of total exports went to Germany, followed by the United States of America with 5.8% of the total, Italy with 4.9% of the total, Iraq with 4.9% of the total and the United Kingdom with 4.8% of total domestic

SELECTED PUBLIC FINANCE INDICATORS

TL billion	2021	2022	22/21	9M-22	9M-23	9M/9M
Central government budget revenues	**1,407.4**	**2,802.4**	**99.1%**	**1,975.3**	**3,440.0**	**74.2%**
o.w. Tax revenues	1164.8	2353.3	102.0%	1648.0	2982.0	81.0%
o.w. Non-tax revenues	242.6	449.1	85.1%	327.3	457.9	39.9%
Central government budget expenditures	**1,599.6**	**2,941.4**	**83.9%**	**2,020.8**	**3,952.6**	**95.6%**
o.w. Primary expenditures	1,418.8	2,630.5	85.4%	1813.6	3481.7	92.0%
o.w. Interest	180.9	310.8	71.9%	207.1	470.5	127.2%
Central government budget cash balance	**-128.6**	**-147.8**	**14.9%**	**-67.8**	**-460.5**	**579.2%**

Sources: Ministry of Finance, Bank Audi's Group Research Department

PUBLIC INDEBTEDNESS



Sources: Ministry of Finance, IMF, Bank Audi's Group Research Department

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exports over the same period.

In parallel, Turkish imports reported a rise of 1.2% over the first 10 months of 2023 when compared to the same period of 2022, to reach US$ 304.0 billion. The breakdown of domestic imports by commodity shows that the main imports over the first 10 months of 2023 were mineral fuels and oils (18.9% of total imports), followed by boilers and machinery appliances (11.2%), precious stones (9.7%), vehicles (8.6%) and electrical machinery (7.7%). The breakdown of imports by country of origin shows that most of the inward merchandise came from China with 12.6% of the totals, followed by Russia with 12.5%, Germany with 7.8%, Switzerland with 5.8% and USA with 4.3% of total imports over the same period.

It is worth noting that, when looking at performance in Turkey's foreign trade sector during October 2023, exports reported an increase of 7.4% against the same month of 2022. This figure stands much higher than the average rate of change in exports on a month-on-month basis for the first nine months of 2023 (0.2%). Additionally, imports registered an increase of 1.2% against the same month of 2022. This figure stands lower than the average rate of change in imports on a month-on-month basis for the first nine months of 2023 (1.7%). This shows a gradual improvement in the BoT standing as efforts within Turkey are made to increase exports and decrease imports.

The decrease in imports was mainly noted for mineral fuels and oils, raw materials and precious stones. In details, imports of mineral fuels and oils decreased by 28.9% to reach US$ 57.3 billion in the first 10 months of 2023, down from US$ 80.6 billion in the same period of the year prior. The imports of raw materials (grouping iron, steel, plastic, aluminum, rubber and copper) used to make up 19.7% of total imports in the first 10 months of 2022, makes up 17.0% of the total in the same period of 2023. The import of articles included in raw materials noted year-on-year decreases ranging between 21.0% and 5.7% with the exceptions of articles of iron and steel as well as copper, which registered year-on-year increases. On the other hand, while the import of precious stones increased by 67.6% year-on-year in the first 10 months of 2023, the import of this chapter of products has slowed down markedly during October 2023 registering a decrease of 23.6% against the same month of the year prior.

Looking forward, according to Goldman Sachs, upward and downward risks remain present towards Turkey's exports. On the side of downward risks, weaker demand from Turkey's western partners (especially the EU) amid an economic slowdown is expected to limit export growth potential. However, on the side of upward risks, Turkey's exports are expected to benefit from new regulations easing the access of exporters to credit amid significantly tighter financial conditions.

1.3. PUBLIC SECTOR

Fiscal policy turning expansionary on pre-election spending and earthquake-related costs

Turkey's fiscal policy turned expansionary in 2023 and the budget deficit expanded significantly, mainly reflecting the material pre-election spending, the cost of the February earthquakes' relief and reconstruction efforts, and the slowdown in revenue growth compared to 2022. This helped smoothing out the shocks to activity from tight monetary policy, and allowed more room for the Central Bank of Turkey to raise rates sufficiently enough.

On the spending side, a growth of 95.6% in central government budget expenditures was recorded over the first nine months of 2023 compared to the same period of 2022, to reach TL 3,953 billion (US$ 182.35 billion), mainly driven by earthquake-related spending, large wage hikes, and various subsidies. This is mainly explained by a 92.0% expansion in primary expenditures to reach TL 3,482 billion (US$ 160.6 billion), and as interest expenditures more than doubled to hit TL 471 billion (US$ 21.71 billion), noting that the latter remain very sensitive to exchange rate developments given that around two thirds of sovereign debt is FX-denominated. A breakdown of primary expenditures shows a 96.0% yearly increase in current transfers to reach TL 1,624 billion, while compensation of employees grew by 117.8% year-on-year to reach TL 960.9 billion. In fact, the end-2022 waiver of the minimum retirement age requirement for workers that entered the labor force before September 1999 represents a notable fiscal cost, on top of minimum wage hikes starting July 2023 and other generous income policies. Within this context, it is worth mentioning that the current transfers and compensation of employees accounted for 79% of the total year-on-year rise in primary

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expenditures over the first nine months of 2023. On another hand, interest expenditures showed a 121.6% increase in domestic interest payments during the first nine months of 2023 to TL 261 billion, as well as a 63.9% surge in foreign debt interest to TL 103 billion.

In parallel, the central government budget revenues witnessed a hike in growth of 74.2% during the first nine months of 2023 when compared to the same period of 2022 to reach a total of TL 3,440 billion (or US$ 158.7 billion), mainly driven by an 74.2% year-on-year increase in general budget revenues to TL 3,365 billion (US$ 155.2 billion), of which tax revenues rose by 81.0% to reach TL 2,982 billion (US$ 137.57 billion). It is worth noting that Turkey has hiked value-added tax by 2% in July 2023. The VAT rate charged on goods and services rose to 20% from 18%, while that on basic goods increased to 10% from 8%. Concomitantly, general budget revenues showed that non-tax revenues such as enterprise and ownership revenues, grants and aids, capital revenues and interests, shares and fines and others expanded by 39.9% year-on-year over the covered period.

That being said, the central government budget deficit (on a cash basis) increased more than six folds over the first nine months of 2023, reaching circa TL 461 billion (US$ 21.2 billion), compared to a deficit of TL 68 billion during the same period of 2022. This is mainly explained by the accommodative fiscal policy, even when excluding earthquake-related spending. Within this context, the IMF forecasts the fiscal deficit to reach $5^{1/2}$% of GDP in 2023, compared to a deficit of 1.7% of GDP in 2022.

Last but not least, the central government debt stock reached TL 6,277 billion (or US$ 222 billion) as at end-October 2023, as per the latest figures released by the Ministry of Finance, recording a significant increase of 64.7% from TL 3,811 billion as at end-October 2022. This is driven by a 64.6% rise in in the external debt over the first nine months of 2023 to reach TL 3,310 billion at end-October (accounting for circa 53% of the total debt stock), and a 64.8% increase in the domestic debt over the covered period to reach TL 2,967 billion at end-October 2023 (accounting for the remaining 47%). The general government debt is estimated at around 34.4% of GDP in 2023 compared to 31.7% of GDP in 2022. The currency composition of government debt shows that the foreign currency debt accounted for 64.6% of the total debt stock at end-October 2023, spiking from 31.3% a decade ago, in a sign of increased currency risk.

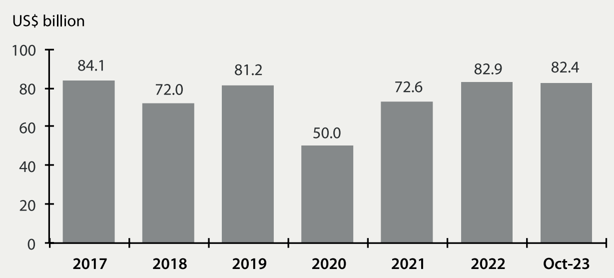
In the coming period, the IMF sees that in order to be consistent with disinflation goals, the 2024 budget deficit should be below the Medium-Term Plan forecast. This would entail eliminating above-inflation compensation increases, introducing forward-looking, rather than backward-looking, pension and wage settings, and replacing blanket energy subsidies with targeted assistance. The IMF also recommends that other options to tighten the underlying fiscal stance, while allowing for earthquake reconstruction and protecting the most vulnerable, should also be pursued.

MONETARY SITUATION

Flows in US$ million	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**9M-23**
Net foreign assets	**10,473**	**-8,997**	**20,424**	**32,155**	**-20,152**	**32,772**	**10,224**	**-28,373**
Foreign assets	7,474	6,460	-293	13,508	-18,067	24,265	13,224	-10,178
Foreign liabilities	2,999	-15,457	20,717	18,647	-2,085	8,507	-3,000	-18,195
Domestic Assets	**-30,472**	**56,129**	**-93,550**	**16,749**	**57,075**	**-137,711**	**64,802**	**-11,790**
Claims on private sector	-20,274	53,758	-96,429	-1,738	32,940	-117,296	31,810	-10,513
Claims on public sector	-10,070	61	5,935	17,675	23,120	-18,404	27,283	-1,505
Claims on non-bank financial institutions	-128	2,311	-3,056	812	1,014	-2,011	5,709	228
Total Money Supply	**-19,869**	**47,064**	**-70,853**	**46,570**	**36,923**	**-104,938**	**75,026**	**-40,162**
Money Supply (M1)	2,276	1,522	-23,310	11,055	-1,592	-14,172	18,651	-7,163
Quasi-Money	-13,655	28,670	-42,816	39,129	33,913	-56,260	45,413	16,413
Other Items (Net)	-8,490	16,872	-4,727	-3,615	4,602	-34,506	10,962	-49,413

Sources: Central Bank of Turkey, Bank Audi's Group Research Department

CENTRAL BANK RESERVES



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

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1.4. FINANCIAL SECTOR

1.4.1. Monetary Situation

Monthly inflation on course to decline on monetary policy shift

The year 2023 saw a reversal in its long-standing low-rates policy, as the Central Bank of Turkey embarked into an aggressive monetary tightening since May elections amid a strong commitment to lowering inflation and exiting the FX-protected deposit scheme.

The Turkish monetary policy has undergone a U-turn since May Presidential elections. The Central Bank of Turkey has delivered starting June 2023 six large interest rate hikes for a total of 3,150 bps, which took the benchmark one-week Repo Rate to an unprecedented high level of 40.0% in November 2023, citing the need to establish the disinflation course and anchor inflation expectations as soon as possible. This came within the context of worse-than-expected deterioration in inflation expectations and, hence, in the Bank's medium-term inflation outlook, as the Central Bank of Turkey revised its year-end inflation forecast for 2023 from +58.0% year-on-year to +65.0% year-on-year, citing higher food and energy import prices. The Bank also raised its inflation expectations for end-2024 by 3% to 36% year-on-year.

Inflation hit 61.4% year-on-year in October 2023, and the Central Bank of Turkey expects annual inflation to continue rising in the coming months. Yet, the Bank assessed that the pass-through from upward VAT adjustments, substantial wage hikes, salary adjustments for public servants and FX weakness, which led to an inflation momentum of around +9% month-on-month since June 2023, is now complete. Therefore, the Central Bank sees the underlying trend in monthly inflation on course to decline. Within this context, latest figures showed that Turkey's monthly inflation slowed further to 3.43% in October 2023 (down from 4.75% m-o-m in September 2023).

In parallel, the Turkish Lira continued its downward spiral over the year 2023, crashing to new fresh lows of 28.30 against the US dollar at end-October, compared to TL/US$ 18.71 at end-December 2022, which marks a collapse of 51.3%. Within this context, it is worth mentioning that the Turkish Lira is the second worst-performing currency in emerging markets this year, after Argentina.

As to currency volatility, the Turkish Lira three-month realized or historical volatility, which reflects the actual volatility derived from a time series of currency spot prices over a specific historic time horizon, slowed to 12.95% mid-November 2023 after peaking at 44.07% ahead of May Presidential elections. This compares to a TL volatility of 13.09% at end-December 2022.

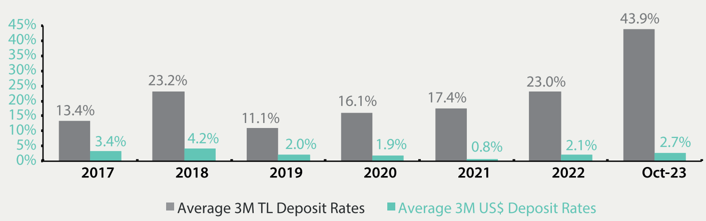
With the aim of strengthening its tightening efforts, the Central Bank of Turkey introduced in 2023 important regulatory measures, which included new conversion targets from FX-protected deposits (offering TL savers

BANKING SECTOR INDICATORS

in US$ billion	2016	2017	2018	2019	2020	2021	2022	Sep-23
Banking Aggregates								
Assets	778.3	862.7	734.8	758.0	826.5	697.7	767.9	772.9
Deposits	414.7	453.4	387.1	433.6	467.8	401.6	474.4	487.7
Loans	494.5	555.8	455.1	448.4	484.1	370.9	405.8	392.3
Shareholders' equity	85.4	95.0	80.1	83.0	81.1	54.1	75.2	69.5
YTD Growth rates								
Assets	-4.3%	10.8%	-14.8%	3.2%	9.0%	-15.6%	10.1%	0.6%
Deposits	-3.5%	9.4%	-14.6%	12.0%	7.9%	-14.1%	18.1%	2.8%
Loans	-3.5%	12.4%	-18.1%	-1.5%	8.0%	-23.4%	9.4%	-3.3%
Shareholders' equity	-5.6%	11.2%	-15.7%	3.6%	-2.3%	-33.3%	39.0%	-7.6%

Sources: BDDK, Bank Audi's Group Research Department

BANKING SECTOR DEPOSIT RATES



Sources: Central Bank of Turkey, Bank Audi's Group Research Department

protection against exchange rate volatility) to conventional Lira deposits, and incentivizing banks to pay competitive TL deposit rates. In fact, 3M TL deposit rates topped currently the 46% level after closing at 16.1% at end-2022. This compounded with efforts to lift rates in loan and TurkGB markets (rates on consumer and commercial loans have both risen sharply and currently stand close to 60% and 50%, respectively). Also, the Central Bank sold Sukuks to banks, a move that would reduce the amount of lending under the Central Bank's FX swap window, currently the main lending facility.

In parallel, the Central Bank of Turkey was able to replenish its gross foreign exchange reserves after May elections, as the authorities' policy shift helped reducing risks and lifting investor confidence. This came along the rapid depreciation of the Turkish Lira against the US dollar after May elections, which eased pressures on international reserves. That being said, the CBRT's gross foreign exchange reserves, which contracted by US$ 26.4 billion over the first five months of 2023 on the back of current account financing to reach US$ 56.5 billion at end-May 2023, bounced back to US$ 82.4 billion at end-October 2023. This marked a slight downward tick relative to US$ 82.9 billion at end-2022.

In the coming period, Turkey's accelerated path towards rate normalization is projected to continue amid an accommodative fiscal policy, with first interest rate cuts expected in the third quarter of 2024. Sequential inflation is forecast to fall in 2024 amid aggressive monetary tightening policy and as exchange rate pressures ease. Within this context, it is worth mentioning that real rates are at present in positive territory relative to the projected inflation at end-2024, a gauge that is preferred by policymakers when talking about monetary tightening.

1.4.2. Banking Activity

A year of overall stability for the Turkish banking sector

The year 2023 has been a year of overall stability for the Turkish banking sector. Measured by the aggregation of assets in the sector, banking activity reported a tiny growth in US$ terms of 0.6% in the first nine months of 2023, moving from US$ 768 billion in December 2022 to US$ 773 billion in September 2023. Likewise, deposits rose from US$ 474 billion to US$ 488 billion over the same period, a growth of 2.8%. As to loans, they slightly contracted by 3.3% to reach US$ 392.3 billion. Finally, shareholders equity reported US$ 70 billion at end-September 2023, against US$ 75 billion at end-2022.

According to Moody's banking sector outlook published in mid-August 2023, asset risk will continue to be elevated. In 2022, problem loans fell to 2.4% of total loans from 3.7% in 2021, primarily driven by robust collections and the impact of high credit growth on the ratio. Nevertheless, new problem loans formation almost doubled in 2022 compared with a year earlier because high inflation and currency deprecation reduced borrowers' repayment capacity. High asset and collateral values in the current high inflationary environment have supported higher collections which Moody's expects to remain broadly stable over the outlook horizon. However, they expect Turkish banks asset quality to deteriorate in 2023 as slowing growth and still high inflation weigh on borrowers' repayment capacity. They believe that small and medium sized businesses with predominantly domestic operations and unsecured retail borrowers are most exposed to repayment capacity deterioration compared to exporters and large corporations. The ability of the manufacturing and services sector to pass on inflation to customers remained resilient, supported by robust exports and consumer spending. However, their ability to sustain this will be tested as the economy slows while inflation remains elevated and borrowing costs rise while domestic consumer spending cools.

The funding profile of Turkish banks has improved but remains vulnerable; liquidity remains strong. Despite economic volatility, Turkish banks' funding and liquidity positions improved markedly, particularly in foreign currency. The loan-to-deposit ratio improved to 93% in December 2022 from 97% a year earlier, building on a trend running since 2018. Deposit dollarisation fell to 40% of total deposits as of April 2023, from a peak of 65% as of year-end 2021 following the government's introduction of the foreign exchange-indexed local currency deposit scheme in December 2021. Moody's expects the unwinding of this currency deposit scheme could pressure the banks' funding structure either through an increase in dollarisation of deposits or shifts in asset allocation preferences of depositors. Banks have also reduced their reliance on short-term wholesale foreign funding to US$ 56 billion in February 2023 from US$ 75 billion in December

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2018 while maintaining foreign currency liquid assets at around US$ 100 billion. Overall, the liquid reserves position of the sector remains strong but is concentrated at the central bank.

With respect to capital adequacy, reported capitalization remains strong but downside risks remain. Moody's expects exchange rate depreciation and credit growth to keep Turkish banks' capital under pressure. The sector's aggregate capital adequacy ratio, including regulatory forbearance, was 17% of risk-weighted assets at the end of April 2023, down from 19.5% in December 2022. During the outlook period, pressure on Turkish banks' capital will be mitigated by internal capital generation and profit retention. Capital levels at state-owned banks remains weaker compared with privately owned lenders but state-owned banks' capitalization has been supported by cash injections from the government. In 2023, the government placed TRY111.7 billion in the three largest state-owned banks. Such injections have replenished their capital buffers following the weakening of the Turkish lira and domestic currency loan growth.

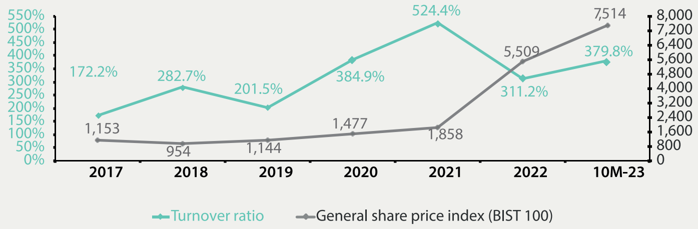
Regarding profitability, banks' earning power measured by return on average assets cooled to 3% in the first half of 2023, compared with 3.7% for 2022, amid pressure on the sector's core margin. The cooling off is driven by the unwinding of the previous macro-prudential measures and lower income from inflation-linked securities. The central bank has since taken steps following the elections in 2023 towards unwinding some of these measures. These steps include removing the first-tier cap on lending rates, lowering security maintenance requirements on foreign currency deposits and raising the policy rate in several consecutive rate hikes since June. Moody's expects these steps to ease the pressure on the bank's core margins over the outlook horizon. Income from inflation-indexed Turkish government securities will continue to contribute to banks' profitability as inflation will remain elevated. However, the contribution will decline because of lower inflation expected compared with 2022. Operating costs will continue to rise because of still high inflation, while asset quality deterioration will keep provisioning expenses high. Overall, Moody's expects net income to tangible assets to decline from the peak levels of 2022.

SELECTED STOCK MARKET INDICATORS

	2018	2019	2020	2021	2022	10M-23
Market capitalization (in US$ billion)	150.5	186.7	240.3	163.7	332.0	374.9
Market capitalization/GDP	19.3%	24.5%	33.4%	20.0%	36.7%	32.5%
Trading value (in US$ billion)	425.5	376.1	924.7	858.7	1033.1	1186.3
Traded volume (in millions)	436,596	548,083	1,511,484	1,203,335	1,644,043	1,489,168
Number of contracts (000s)	230,789	264,516	670,982	691,301	975,341	1,397,459
Change in share BIST 100 price index	-17.3%	19.9%	29.1%	25.8%	196.6%	36.4%
Price/Earnings ratio (times)	9.12	10.72	18.64	9.17	8.55	6.97
Dividend Yield (%)	3.28	2.35	0.83	2.39	1.30	1.48
CDS spread (bps)	362	280	304	563	510	400

Sources: Borsa Istanbul, Bank Audi's Group Research Department

STOCK MARKET PERFORMANCE



Sources: Borsa Istanbul, Bank Audi's Group Research Department

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1.4.3. Equity and Bond Markets

Extended Turkish equity price rally in 2023, bonds bouncing back after policy shift

Turkish stocks extended their price rally over the year 2023, tracking global and emerging equity strength stoked by bets that the US Federal Reserve tightening cycle may have reached its end, and on hedging activity against rampant inflation and large real negative interest rates. Concurrently, the Turkish bond market shifted to a positive territory in 2023, as the return to a more conventional monetary policy after May Presidential elections helped lifting investor confidence.

In details, Borsa Istanbul extended its winning streak over the first ten months of 2023, mainly as local investors sought to add Turkish stocks to their holdings as an inflation hedge, and given some upbeat corporate earnings, and due to appealing market valuations as Turkish stocks traded at a P/E of 7.0 times in October 2023 versus a P/E of 8.6 times at end-2022. That being said, the TL-denominated BIST 100, which represents the 100 largest companies by market capitalization, hit 7514.10 at end-October 2023, which marks an increase of 36.4% over the first ten months of the year.

The total number of traded companies on the Borsa Istanbul rose from 511 companies at end-December 2022 to 563 companies at end-October 2023. On the back of new listings, and given rising equity prices, which have outpacing the 34% currency collapse over the first ten months of 2023, the market capitalization expanded by 12.9% in US dollar terms, moving from US$ 332.0 billion at end-December 2022 to US$ 374.9 billion at end-October 2023.

Concurrently, the total number of contracts reached 1,397.5 million during the first ten months of 2023, up from 700.1 million during the corresponding period of 2022. The total trading value reached US$ 1,186.3 billion during the first ten months of 2023 compared to US$ 708.2 billion during the first ten months of 2022, up by 67.5% y-o-y. Accordingly, the turnover ratio, measured by the annualized total trading value to market capitalization, reached 379.8% over the first ten months of 2023, up from 354.3% during the corresponding period of 2022.

At the level of the bond market, Turkish bonds shifted to a positive territory after May 2023 Presidential elections, as a U-turn in Turkey's monetary policy since June 2023 sent a clear message to investors that policymakers are serious about addressing unrelenting pressure on the currency and reining in inflation expectations, and helped lifting overall investor confidence.

That being said, most Turkish bonds swept away all losses incurred over the first half of 2023, ending the first ten months of the year on a positive note. A closer look at sovereigns shows that papers maturing in 2024, 2027 and 2031 registered price expansions of 1.13 pt, 1.90 pt and 0.50 pt respectively, while sovereigns maturing in 2041 posted price falls of 1.88 pt. As to papers issued by financial institutions, Akbank'25 closed up by 0.31 pt over the first ten months of 2023. Yapi Ve Kredi Bankasi'24 recorded price gains of 0.63 pt. Prices of Export Credit Bank of Turkey'24 expanded by 0.44 pt. In contrast, QNB Finansbank'24 posted price decreases of 2.25 pts. As to the cost of insuring debt, Turkey's five-year CDS spread contracted by 110 bps over the first ten months of 2023 to reach 400 bps at end-October, mainly on improved sentiment after Turkey embarked into more conventional and consistent policy mix that reduces near-term macro-financial stability risks and eases balance of payments pressures.. This followed a 53 bps contraction in 2022.

On another note, almost half a year into a rewrite of economic policies, the 10-year Turkish Lira benchmark bond index yield hit a multi-year high of 29.3% at end-October 2023 compared to 10.8% at end-2022. Within this context, it is worth mentioning that surging yields on Turkish bonds, when paired with the recent low currency volatility, created an attractive proposition for carry trades, which involve borrowing at a low interest rate and investing in an asset that provides a higher rate of return.

Under these conditions, money managers continue to call Turkish authorities to take another step up the ladder of interest rates and possibly allow a weaker currency to make lira bonds investable again. Should policymakers maintain a 40% or higher policy rate and the lira remain broadly stable for few months, Turkish lira bonds would become more attractive for foreign investors. Within this context, it is worth noting that

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non-resident holdings stood at US$ 1.08 billion at end-October 2023, down from US$ 1.25 at end-2022, noting that they have peaked at US$ 70 billion a decade earlier.

Regarding new issues, Turkey tapped international debt markets four times over the year 2023, raising a total of US$ 10 billion from the sale of US$ 7.5 billion conventional bonds and US$ 2.5 billion Sukuk. First, Turkey raised US$ 2.75 billion in January 2023 from the sale of 10-year bonds at a coupon of 9.375%. Also, Turkey issued in March 2023 a US$ 2.25 billion six-year bonds at a coupon of 9.375%. In April, Turkey raised US$ 2.5 billion from the sale of green bonds at a coupon of 9.125%. The country returned to international bond markets early-November 2023, with the sale of US$ 2.5 billion five-year Sukuk at a yield of 8.5%. The latest sale added to an emerging markets-wide rush to take advantage of lower yields after a recent rally in benchmark US Treasuries, which has been caused by many investors predicting the US Federal Reserve is finished with interest-rate hikes for this cycle.

As to credit ratings, Fitch Ratings revised in September 2023 the outlook on Turkiye's long-term foreign currency Issuer Default Rating to "stable" from "negative" and affirmed the IDR at "B". The revision of the outlook to "stable" reflects, as per Fitch, the return to a more conventional and consistent policy mix.

Also, Standard & Poor's revised in September 2023 its outlook on its "B" unsolicited long-term sovereign credit ratings on Turkiye to "stable" from "negative", while affirming all ratings, including its unsolicited national scale rating of "trA/trA-1", on Turkiye. The "stable" outlook reflects, as per S&P, balanced risks to Turkiye's creditworthiness from the reimposition of orthodox monetary policy settings, as the Central Bank of the Republic of Turkiye (CBRT), under new leadership, raises interest rates in an effort to reverse the deposit base's dollarization and bring down elevated inflation.

Looking forward, while negative net foreign asset position at the Central Bank of Turkey and sticky inflation continue to present barriers to attracting money to Turkey, the longevity and success of monetary policy tightening in bringing down inflation shall lay the groundwork for foreign investors to return to the bond market.

CONCLUSION

The genesis of Turkey's imbalances is expansionary monetary, credit, and fiscal policies. These have eroded the country's competitiveness and undermined confidence in the Turkish lira. Negative real borrowing rates have distorted economic behavior, leading to a surge in import-rich consumption, a deterioration in Turkey's balance of payments, a drain on reserves, and persistently high inflation. The new economic team acknowledges these challenges in the Medium-Term Program (published Sept. 6, 2023), which explicitly aims to increase the predictability of policy settings and establish a road map for what will be a complicated adjustment as per S&P. The heart of the challenge for Turkish policymakers is how to restore confidence in lira (local currency) assets.

Looking forward, as monetary policy tightens and the overall policy stance becomes less accommodative, growth is projected to slow from 4% in 2023 to 3¼% in 2024, and the current account deficit to narrow to about 3% of GDP in 2024. Sequential inflation should also fall in 2024 and is projected at 46% year-on-year by December. These projections reflect recent developments and policy actions, and discussions during the IMF staff visit to Turkey. The inflation trajectory remains highly uncertain, due to risks of backward indexation, inflation expectations, high commodity prices and additional lira depreciation.

The balance of risks is to the downside. On the domestic front, the key risk is that the policy shift now underway loses its strong momentum, eroding confidence and leading to increased FX demand and reserve drain. Externally, the key downside risks are higher commodity prices, a slowdown in trading partners' demand, and global systemic financial instability. On the upside, unexpected sources of external financing could materialize, or, should investor confidence recover fully, a virtuous cycle of inflows and a stronger exchange rate could bring down inflation faster than expected, while boosting growth.

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At the monetary level, further policy rate increases are needed to durably reduce inflation, accompanied by lower reliance on quantitative measures to increase the role of price signals in money and credit markets, which would help anchor a market-priced yield curve. Allowing the markets to allocate capital based on a higher policy rate would ensure that funds go to the most productive use. This would also support the lira, facilitating disinflation via the exchange rate channel, traditionally the most potent in Turkey. The effect of higher rates on banks so far appears manageable: banks, especially private ones, appear to have prepared for higher rates mainly by reducing the asset duration.

At the fiscal level, to be consistent with disinflation goals, the 2024 budget deficit should be below the Medium-Term Plan forecast. This would entail eliminating above-inflation compensation increases, introducing forward-looking, rather than backward-looking, pension and wage settings, and replacing blanket energy subsidies with targeted assistance. Other options to tighten the underlying fiscal stance, while allowing for earthquake reconstruction and protecting the most vulnerable, should also be pursued.

If we were to assess the Turkish outlook looking forward, we need to look at a number of strengths but also some risk drivers. Starting with positive points, the most important are probably the large and diversified middle-income economy with favorable demographics, the moderate public debt burden and the banking sector's good track record of managing currency volatility, the fairly diversified goods export structure, in addition to the stronger growth performance and structural indicators, such as GDP per capita and Human Development, relative to rating peers.

Yet, a number of risk factors continue to dominate the near term outlook. Among these, we mention the unpredictable policymaking that exposes Turkey to currency stress and high inflation; the material erosion of institutional and governance strength over past several years; and the ongoing turbulent geopolitical environment and high political risk.

Finally, it is important to stress that the IMF welcomes the authorities' policy shift since the election. According to their staff visit report in October, the recent actions to raise the policy rate, increase taxes, and liberalize some financial sector measures have reduced risks and lifted investor confidence, compressing spreads and improving the reserve position of the Central Bank of the Republic of Turkey (CBRT). IMF says the authorities should build on the current momentum. This requires prioritizing disinflation by binging the ex-ante real policy rate into contractionary territory, continuing to liberalize financial regulations to improve the functioning of money and credit markets, and containing the fiscal deficit at large.