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Turkey

A complex equation

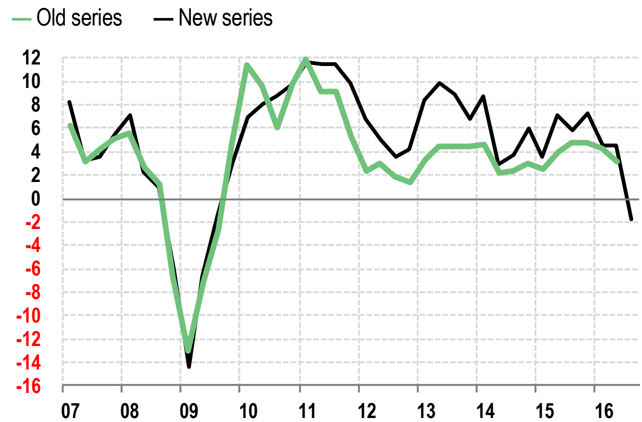
- **The extent of the upward revision of past economic growth figures from 2012-15 does not remove the external vulnerability and the limited credibility of monetary policy.**
- **Economic growth lost its steam in H2 2016 in the aftermath of the aborted coup in July.**
- **Political and security concerns are likely to continue dragging down confidence among economic agents and investors, as well as the Turkish lira and economic activity in 2017.**

Major upward adjustments to the national accounts

In December, Turkstat, the National Statistics Institute, published national accounts for the third quarter, accompanied by a revised methodology and revised historical GDP figures, resulting in some good news and bad news. The bad news was the extent of the economic decline following the attempted coup on 15 July. According to the new published data, real GDP fell 1.8% year-on-year in Q3; the failure to publish figures adjusted for seasonal variations and changes in the number of working days means that sequential analysis is not relevant. The upward revision of Q3 2015 GDP growth also raised the base for comparison, leading to a larger year-on-year drop. Most of the reduction in economic activity was caused by a slump in consumer spending (-3.2% year-on-year). The tourist season was disastrous, with summer revenues down 40%. The unemployment rate rose to 11.8% seasonally-adjusted. Investment stagnated (-0.6%), whereas public-sector consumption rose sharply (+23.8%), as expected given the government's expansionary fiscal policy. Exports (-7%) suffered from weak external demand. On the supply side, only the real-estate and construction sectors continued to show growth.

The biggest surprise – and a pleasant although rather puzzling one – was the extent of the upward revision of past economic growth figures from 2011 onwards, following the adoption of European standards (ESA 2010) that comply with international standards (SNA 2008). According to the new figures, real GDP grew at a CAGR of 6.1% between 2012 and 2015, as opposed to only 3.3% under the old standards. Real GDP was revised upward by almost 11% and nominal GDP by 19%. As a result, the breakdown between real and nominal GDP is not an issue. Most GDP components were upgraded. However, consumer spending, which has been the main growth driver since 2013, has been revised lower from mid-2015 onward, suggesting that consumer confidence has become less resilient given the difficult socio-political and geopolitical context. The largest revision concerns investment. Some expenditure such as R&D has been reclassified as investment. Most importantly, despite the lack of detail about gross fixed capital formation (public or private sector; expenditure on machinery/equipment or construction), Turkstat states that the old figures significantly understated the construction boom. This puts a new complexion on Turkish investment, one that is more consistent with the growth in lending to companies seen in the last few years. Even factoring in companies' working capital requirements and the scale of the debt they had to refinance, the old figures showed a lack of correlation between investment and lending that was hard to explain.

Real GDP growth, % y/y



Sources : Turkstat, Bloomberg

A rewriting of macroeconomic narrative, although the country's weaknesses still exist

The new methodology seems to be more robust (chained volume series that remove the effect of price changes, more data from observed sources instead of surveys, reclassification of certain criteria) and the new statistics are meant to reflect the economic reality more accurately: 74% of the gap between the old and new data series is apparently due to measurement errors. However, the new figures mean that the previous analysis of Turkey's economic slowdown since 2012 and lack of productivity growth – following a good decade (average growth of 5%) punctuated by two years of overinvestment (2010-2011) in response to the recessionary impact of the global crisis – is now null. The low domestic savings rate – singled out as the Turkish economy's Achilles heel and the cause of its dependence on foreign savings – turns out to be a myth. The investment rate has been revised upward by 5 points to 28% and Turkey's external deficit has been revised down by 1 point of GDP because of upgraded GDP figures. Those changes have pushed up the domestic savings rate by more than 6 points. At around 21% of GDP, it is now in line with the average seen in developed countries, higher than figures in Central and Eastern Europe and Latin America, but well below Asian levels. Overall, therefore, the Turks are substantially richer and less spendthrift than previously thought, while ratios regarding the public finances have also improved from relatively good levels.

However, Turkey's external position remains vulnerable. Nominal GDP in US-dollar terms has been trimmed by the sharp decline in the Turkish lira, which has fallen 50% against the euro-dollar basket

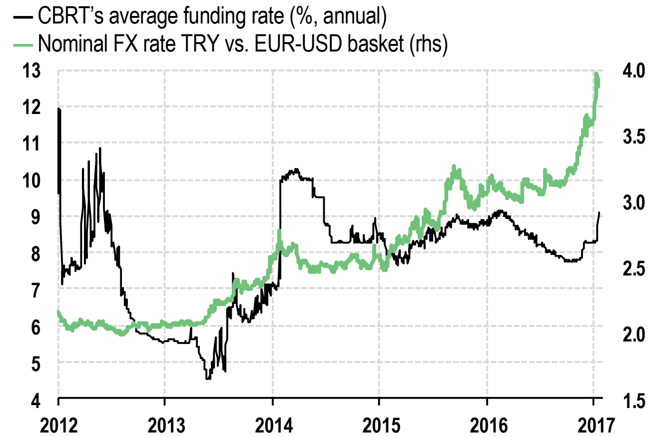
since May 2013. The country's external borrowing requirements remain substantial at almost USD 200 bn in 2016, equal to almost 25% of estimated GDP, because of a current-account deficit of around USD 35 bn and external debt repayments of around USD 135 bn. USD 200 bn is also the amount of foreign-currency debt owed by Turkish non-financial companies, most of which is onshore (i.e. owed to local banks) and involves medium- to long-term maturities. Set against those foreign liabilities, FX reserves declined slightly year-on-year at USD 92 bn in December 2016. They provide a relatively thin safety cushion, especially since “free” FX reserves (i.e. excluding commercial bank deposits at the central bank) only amount to USD 37 bn. Since peaking in May 2013, when the Fed announced its tapering plan and Turkey's social unrest began, local-currency assets (bonds and stocks) held by non-residents have fallen from USD 152 bn to USD 61 bn, due to around USD 9 bn of net portfolio investment outflows but more importantly because of currency and valuation effects.

…notably given deteriorating political and security situation

Terror attacks by IS and the PKK are becoming more common, especially since Turkey started its military involvement in Syria in August, and a state of emergency was reimposed in July. The crackdown on institutions and businesses has widened beyond Gulenist circles and is continuing, making social divisions worse. On 22 January, the Turkish parliament adopted a plan to revise the constitution, introducing a strong executive presidency (removing the position of prime minister and replacing it with that of a president who is the head of the government and the majority party; giving the president more powers over the judiciary, etc.). A referendum should take place in the next three months. That could be followed by early parliamentary elections in order to make the reform applicable immediately instead of in 2019, and to replace existing MPs, some of whom are suspected to be Gulenists. In addition to the difficult domestic and regional context, diplomatic relations with the USA and EU have become strained again and Turkey has moved closer to Russia, while Donald Trump's election victory has had a negative impact on all emerging markets.

The lira has fallen sharply, dropping 35% against the dollar since July 2016, including 32% since Moody's cut Turkey's sovereign credit rating to junk in late September (a move that Fitch followed on 27 January), 23% since the US election in November and 10% since the start of 2017. The authorities are nervous, and President Erdogan has suggested to holders of foreign-currency assets that they convert them into lira to show patriotism. Although some public- and private-sector companies have apparently complied with that request, the conversion of bank deposits into euros and dollars has accelerated, clearly showing the concerns of savers. There have been rumours that capital controls will be introduced. However, the government has quickly denied them, conscious of the devastating impact that constraints on capital outflows will have on capital inflows, which are crucial if the balance of payments is to remain sustainable. Higher taxes on foreign-currency deposits, which would not constitute capital controls, would in theory have little effect on the behaviour of savers, who are looking more for safety than high returns. A simple ban on foreign-currency deposits cannot be ruled out.

Interest rates and foreign exchange rate



Sources : CBRT, Datastream, BNP Paribas

In its 2017 monetary and exchange-rate policy programme, the central bank (CRBT) reiterated its "official" target of price stability within a floating exchange-rate system. Nevertheless, shock therapy such as the sharp hike in interest rates carried out in January 2014 does not appear to be on the cards. Political pressure and the flagging economy mean that monetary policy remains rather loose. The limited action taken in November (symbolic increase in the one-week repo rate and overnight lending rate) was not enough to stem the rapid decline in the lira or the major inflationary pressure also resulting from higher oil prices and increases in wages and certain taxes. Since 16 January, the CBRT has focused on its "late liquidity window", the interest rate of which was hiked by 100 bp to 11% at the latest monetary policy committee on 24 January. The one-week repo rate was unchanged (8%) and the o/n lending rate was hiked by 75 bp to 9.25%.

Our baseline scenario does not include stagflation. However, the high level of political and security risk is likely to remain a drag on the lira, confidence among economic agents and foreign investors, and therefore economic activity.