Turkey

Avoiding a relapse

Mired in stagflation, the Turkish economy might have to forego its "stop and go" tradition given the need for deleveraging in the private sector and a less favourable international environment. Disinflation continues but remains vulnerable to bouts of forex volatility. (Geo)political risks and the dollarization of the economy make monetary policy management more complex. A swelling public deficit and uncertainty about the direction of fiscal policy are sources of concern. Reducing the current account deficit will not suffice to reassure investors since capital inflows and foreign exchange reserves are both diminishing faced with the country's substantial external refinancing needs.

Escaping stagflation

The IMF has revised downwards its 2019 GDP growth forecast for Turkey, from 0.4% last October to a negative 2.5% in April. The June consensus of economists (Bloomberg) calls for GDP to contract 1.5% this year. Our less pessimistic scenario is based on a year-end recovery, although there are still several downside risks linked to exogenous factors.

After a 3-quarter technical recession, GDP rebounded in Q1 2019 in line with expectations (+1.3% q/q, working day and seasonally adjusted data) although growth still contracted 2.6% year-on-year (y/y) due to major base effects. Household consumption increased 0.8% q/q in Q1 (wdsa), thanks to government measures to boost purchasing power in the run-up to the March municipal elections (wage increases, including a 26% increase in the minimum wage; a discount on electricity bills for low-income households; and a tax rebate for new car purchases) and bank lending by state-owned banks. Public consumption accelerated by 5.1%, but total investment (public and private) declined by 0.7% for the fourth consecutive quarter, notably due to financial troubles in the private sector. Foreign trade continued to make a positive contribution to GDP despite the 4.7% q/q drop in exports (imports were down 5.5%), which nonetheless increased by 4% y/y.

Although exports and tourism revenues were bolstered by the weak Turkish lira (up 12.1% and 9.4% y/y, respectively, in value terms in May), high-frequency economic indicators continued to look very downbeat in Q2. Industrial output (-2% y/y in 3 month-moving average in May) and retail sales (-5.1% in April) both stalled again. Sales of new automobiles plunged by 50% y/y despite the extension of the tax rebate. Since April 2018, manufacturing PMI has held below 50, the threshold between expansion and contraction. Business and household surveys indicate another dip in confidence in May and June compared to the first four months of the year. For more than a year, economic agents have continued to be "pessimistic" about economic prospects (score of less than 100). Bank credit has also contracted again over the past two months.

Conditions in the labour market continue to deteriorate. In a year, the unemployment rate has increased from 10.1% to 14.1% in March, and youth unemployment is now verging on 25%. Reflecting demographic pressures and the increase in the participation rate (52.9%), the total active population increased by 2% in a year, while the employed labour force declined by 2.5%. All in all, the number of registered unemployed workers surged by 41.5% to 4.5 million in the year to March. The construction sector, one of the main economic growth engines in recent years, experienced a major bloodletting (employment declined by 26% over the past year). In the manufacturing and commercial services sectors, the decline in employment was limited to 1.9% and 1%, respectively.

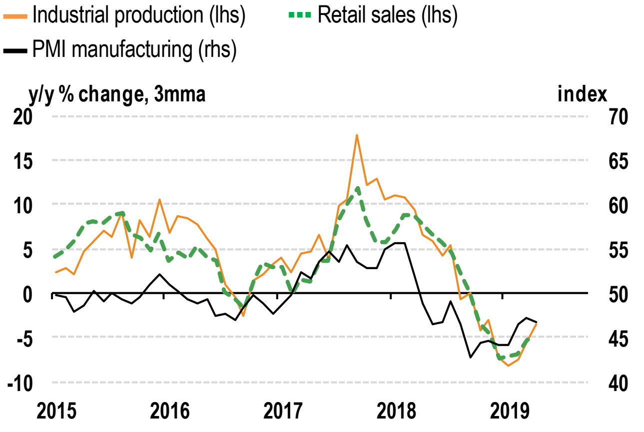
The corollary of sluggish domestic demand was an ongoing slowdown in inflation. With mild food prices, the consumer price index (CPI) slipped to 15.7% y/y in June, from 18.7% in May.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	7.4	2.6	0.0	2.5
Inflation (CPI, year average, %)	11.1	16.3	16.3	11.0
Budget balance / GDP (%)	-1.5	-2.0	-2.6	-2.2
Public debt / GDP (%)	28.3	30.4	31.2	31.2
Current account balance / GDP (%)	-5.6	-3.5	-2.5	-3.3
External debt / GDP (%)	53.3	56.7	60.7	59.2
Forex reserves (USD bn)	82.6	72.0	69.0	68.0
Forex reserves, in months of imports	4.0	3.6	3.7	3.4
Exchange rate USDTRY (year end)	3.8	5.3	6.0	6.7

e: BNP Paribas Group Economic Research estimates and forecasts

2- Short-term economic indicators



Source: Turkstat, Markit, BNP Paribas

Warding off dollarization

Constrained by the volatility of the forex market, the Central Bank of the Republic of Turkey (CBRT) has maintained its key 1-week repo rate unchanged at 24% since September 2018. The very high level of ex-ante real interest rates and the absence of a rate cut at the 12 June monetary policy committee meeting led to the firing of CBRT governor Murat Cetinkaya on 6 July.

The Turkish lira could come under pressure again. It appreciated 9% against the US dollar between early May and early July, after plunging 15% in March-April, undermined by geopolitical tensions and uncertainty about the real level of so-called "free" FX reserves (estimated at about USD 25 bn), due to the opacity of currency swaps between CBRT and the state-owned banks. Despite the rapid contraction in the current account deficit (USD 3.1 bn in January-May 2019 compared to USD 28 bn in the year-earlier period), capital flows have dried up (the financial account surplus declined from USD 18.5 bn to USD 3.2 bn over the same period), resulting in another reduction in FX reserves. Net outflows of portfolio investment (equities and bonds) by non-residents have reached USD 2.3 bn since March. Between May and December 2019, external debt servicing (principal plus interest) is estimated at USD 73 bn, the equivalent of gross FX reserves (excluding gold, but including the FX deposits of commercial banks).

CBRT is confronted with an increase in the dollarization of the economy (53% of bank deposits were in foreign currencies in June). Under these conditions, to support the lira, CBRT temporarily suspended its repo operations in May and lowered the maximum reserve requirement from 40% to 30% on deposits in the local currency to hard currency deposits. CBRT also took the prudential measure of raising the reserve requirement ratio on bank liabilities in foreign currency.

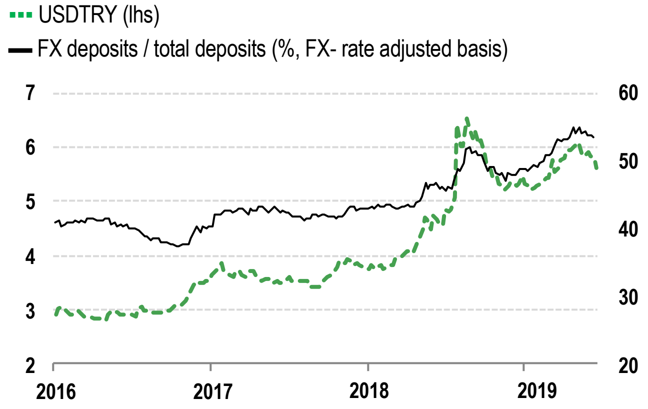
Although the regulatory and fiscal measures introduced to reduce the dollarization of the economy might seem to be coercive, they will probably remain ineffective, though necessary, without macroeconomic stabilisation. Only a credible monetary policy and the anchorage of inflation expectations will restore confidence in the Turkish lira as a store of value, a foundation of stability and the formation of solid domestic savings in local currency.

Public finances: hit the brakes rather than the accelerator

The conjunction of an expansionist fiscal policy over the past three years with recessionary economic conditions has triggered a rapid deterioration in the public accounts in recent months. Even though Moody's and Fitch further downgraded Turkey's long-term sovereign rating in foreign currency, public finances are not a major source of concern in the short term.

It remains to be seen, however, whether the post-electoral period will be propitious for fiscal tightening and structural reforms, or to the contrary, whether the deteriorated cyclical environment and possible US sanctions will lead to more counter-cyclical measures and/or heterodox methods such as using FX reserves to cover the government's financing needs.

3- Nominal FX rate and dollarization of bank deposits



Source: CBRT, BNP Paribas

The government's target of a budget deficit of 1.5% of GDP this year, based on the hypothesis of 2.4% growth, already seems unrealistic. The government deficit exceeded 3% of GDP in the 12 months to May (80% of the full-year nominal deficit target has already been reached) and was nearly 5% of GDP based on the IMF definition, which excludes exceptional revenues (proceeds from privatisation, central bank profits, etc.). In the first five months of the year, revenues declined by 2.4% y/y in real terms, while primary spending increased by 13.5%. At the same time, interest payments have increased by 50% in five months, to 2.2% of GDP. The increase in interest payments on local currency debt reflects the indexation to inflation and the increase in the refinancing rate (to 22.2% from 13.4% a year earlier), while on foreign currency debt (50% of total debt), interest automatically increases due to the depreciation of the exchange rate.

Public debt accounts for only 31.5% of GDP, and its sustainability is not an issue. Yet debt outstanding is increasing rapidly (up 27% y/y in May), and public guarantees and contingent liabilities are factors to watch. The main explanation for the swelling debt is the increase in the deficit, and the second is the translation effect of the lira's depreciation on debt outstanding. The domestic debt profile has become riskier: 36% of securities are issued in foreign currency (mainly the EUR) and the average maturity of new securities is less than 29 months, compared to 59 months a year earlier. Since June, CBRT has opened an overnight liquidity line (at the repo rate -100 bp) for primary dealers, which is capped depending on their purchases of public securities. From January to March, the government preferred to borrow on the international markets, taking advantage of low interest rates, especially for euro issues (4.625% in EUR and 7.625% in USD). As a result, Eurobond outstanding has increased by 43% over the year, surpassing the annual net borrowing programme. Since March, sovereign spreads have widened by about 100 bp again to 500 bp.

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