TURKEY

GROWTH AMID IMBALANCES

The November 2020 announcement that monetary policy would move in a new direction had tamed financial tensions. However, as the Central Bank Governor was removed in March 2021, uncertainty came back. Exchange rate depreciation pressures have reappeared and interest rates and risk premiums have risen. Growth support will be the top policy priority, but at the price of maintaining significant macroeconomic imbalances. Credit risk is not reflected into the non-performing loan ratio but the forbearance period which is allowing the postponement of their reporting will end at mid-2021. The observed corporate investment recovery is welcomed, as a precondition to improve potential growth, but other conditions such as productivity growth are still missing.

HISTORY REPEATING ITSELF

Turkey's 2020 economic performance came as a big surprise, with a GDP growth of 1.8% (a rather rare performance worldwide), but also with much bigger-than-expected imbalances: the current account deficit swelled to 5.1% of GDP and inflation hit 14.6% year-on-year in December. Against this background, the exchange rate depreciated sharply and volatility largely surpassed that of most of the other emerging currencies.

The outlook for 2021 is not different, with growth over-performance, high inflation and a very fragile exchange rate. This environment is mainly the by-product of monetary policy changes: after a heightened period of monetary tightening (+875 basis points between November 2020 and March 2021), which temporarily stabilised the Turkish lira, the removal of the Central Bank Governor on 21 March 2021 has raised expectations for a more discretionary policy.

Since 2011, Turkey's monetary policy has followed switches between a series of accommodating phases with regard to inflation followed by periods of late tightening: maintaining the key rate too low for too long only stirred up inflation via demand fuelled by domestic lending. Moreover, high inflation fed and maintained the depreciation of the lira, which exerted feedback pressures towards monetary policy tightening. A 10% currency depreciation generally leads to a 2 percentage point increase in inflation after 3 months (see *Conjoncture* of January 2021). This explains why inflation accelerated in Q1 2021.

Notwithstanding significant GDP growth, the local economy is fragile. Turkey still has a dual labour market with a substantial informal sector. Unemployment exceeds the official rate (12.2% in January 2021) and the Covid period has increased the gap. According to Turkstat's alternative estimate using a methodology closer to International Labour Office (ILO) guidelines, unemployment was closer to 30%. In early March some restrictions introduced during the second wave of the pandemic were lifted, but they had to be reinstated after the number of new cases surged again from the end of March (surpassing 40,000 new cases per day for the first time on 1 April). Tourism is bound to be affected again this summer (foreign currency revenues are expected to be 50% lower than normal, after -80% in 2020): the pandemic is still spreading actively both internationally and locally, even though vaccination programmes are underway (10.8% of the Turkish population had received a first shot at 31 March).

With low tourism revenues, rising oil prices and the depreciation of the Turkish lira (which encourages gold purchases, which is imported), the current account deficit will remain high (4% of GDP) and will not be covered by net capital inflows. The situation will be exacerbated by uncertainty over monetary policy and by the rise in US long-term rates. As a result, foreign reserves and the exchange rate will remain under pressure.

This scenario also implies that domestic interest rates will remain at high levels, notably on public debt. Before 21 March, short-term rates were already high due to the restrictive monetary policy in place since November, but the yield curve was rather strongly inverted (with lower

FORECASTS

	2019	2020e	2021e	2022e
Real GDP growth (%)	0.9	1.8	4.5	3.5
Inflation (CPI, year average, %)	15.5	12.3	16.4	11.0
Budget balance / GDP (%)	-3.5	-4.8	-4.0	-3.0
Public debt / GDP (%)	32.8	40.4	42.0	41.0
Current account balance / GDP (%)	1.2	-5.1	-4.0	-3.0
External debt / GDP (%)	57.1	61.0	63.4	64.0
Forex reserves (USD bn)	79.0	50.0	40.0	44.0
Forex reserves, in months of imports	4.2	2.8	2.1	2.2

e: ESTIMATES & FORECASTS

TABLE 1 SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

EXCHANGE RATE: TRY PER USD

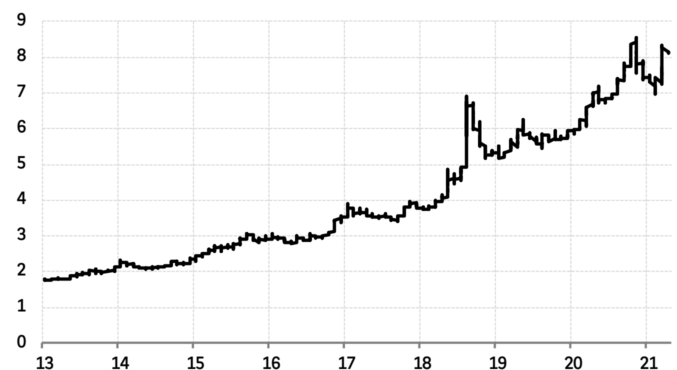

CHART 1 SOURCE: CEIC, BNP PARIBAS

yields for longer maturities). Since then, the yield curve has flattened. The yield on 3-year instruments (the average maturity of government bonds issued locally in TRY) was 18.5% on 6 April. The sovereign risk premium has also returned to nearly the level that prevailed at the end of October 2020 (with a CDS premium of 445bp at 6 April, vs 304 bp at 21 March).

MIND CREDIT RISK

Although the public debt ratio is relatively moderate at 40% of GDP, structurally higher interest rates and currency depreciation (nearly half of Turkey's debt is in foreign currency) restrict the current policy space, because the interest expenditure is likely to reach 3 points of GDP in 2021. The resurgence of the coronavirus and the impact of accelerating inflation on the local population are likely to trigger new public spending. In parallel, monetary policy will no longer be tightened – it could even be eased in the next few months.

Given their determination to contain the deficit, the authorities are likely to continue using off-balance sheet items to further support the economy (drawing on public banks or unemployment funds). Under this environment, credit dynamics will be a key factor. In spring 2020, lending was used as the main support mechanism for the economy, much more so than in the other emerging countries. In contrast, monetary tightening in November 2020 resulted in a contraction in lending in early 2021. It switched from a credit impulse of nearly 7 points of GDP in Q2 2020, to a negative flow of nearly 1 point of GDP at Q1 2021. Reserve requirement ratios were raised in several phases (the latest was on 24 February), which helped draw down the banking sector's lending capacity. Although the future direction of credit policy is not clear yet, the restrictive policy in place is unlikely to be extended beyond Q1 2021.

The strong increase in lending (bank loans to corporates reached 40% of GDP in 2020 from 30% a year earlier) and the 3-month moratorium on loan payments by non-financial companies in Q2 2020 delayed the risk of an increase in non-performing loans (NPL). As a share of total loans outstanding, the NPL ratio even declined from 5.2% in February 2020 to 4.1% in February 2021. The regulator established tolerance for late loan payments, which would not be classified as NPLs until mid-2021 (extension of the late payment from 90 days to above 180 days to be considered non-performing). For the stage 2 loans, which are loans that are likely to become (but are not yet) non-performing, classification rule was extended from 30 days to above 90 days. Yet the volume of stage 2 loans increased to nearly 1.7% of total loans outstanding, raising fears that there would be a similar increase in the NPL ratio after the end of the forbearance period.

At the same time, the banks have increased their equity capital. They managed to maintain their CET1 ratio at 14% in February 2021, the same as in February 2020. It means that the banks managed to cover their increased exposure to credit risk. Meanwhile, the return on assets (ROA) did not change much, at about 1.5%.

CORPORATE INVESTMENT IS RECOVERING

The significant increase in lending in Q2 2020 certainly supported companies that were short of liquidity (due to higher inventories and late payments), but it also fuelled a rebound in corporate investment. Investment in machinery and equipment rose 21% in 2020, contributing nearly 2 points to GDP growth, ahead even of household consumption, which contributed around 1.9 points.

3-YEAR GOVERNMENT BOND RATE (%)

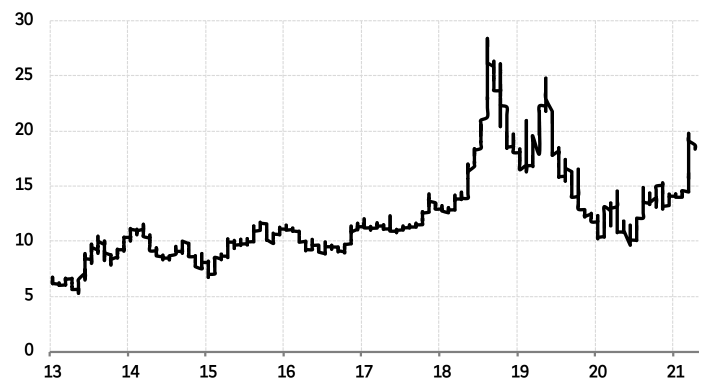

CHART 2

SOURCE: REFINITIV, BNP PARIBAS

The year 2021 is likely to show a more limited growth, mainly because credit dynamics will not be the same. Yet this will not prevent another upturn in corporate investment, which is especially welcome because Turkey's growth potential has been undermined by sluggish investment in 2018-19 and by a reduction in total factor productivity since 2013. Imports of capital goods have picked up, unlike many other items, which contributed slightly to the deterioration in the external deficit.

In the past, when Turkish growth accelerated, it was often the result of an accumulation of capital. Yet the decrease in the level of total factor productivity suggests that other measures must be adopted, notably to support greater participation of the working age population in the formal labour market. It may help to generate positive externalities between physical capital and human capital. Two years of sluggish growth (0.9% in 2019 and 1.8% in 2020) have eroded the level of employment, which was already weak, underscoring the need for new efforts in order to return to more stable growth.

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