TURKEY

LEANING AGAINST THE WIND

Since late spring, Turkey has enjoyed a rapid, buoyant recovery. This is rather typical for an economy regularly hit by external shocks that are magnified by capital outflows. Turkey has managed to bounce back yet again thanks to strong economic policy support. The bad news is that it is accumulating several imbalances, including another significant current account deficit and a sharp increase in credit growth, which is accelerating faster than during previous recovery phases. These two factors, which put downside pressure on the lira while driving up inflation, signal a deterioration in the quality of growth and imply higher debt ratios.

A COMBINATION OF GROWTH AND IMBALANCES

Turkey continues to report a growth over-performance compared to peers. Like most of the other emerging countries, GDP contracted markedly in the second quarter (-11% q/q). Yet leading indicators point to a rapid, ample turnaround, with a manufacturing output largely back to pre-crisis levels.

This does not mean that all is going for the better. Turkey was hit by a drastic drop-off in tourism revenues (which are expected to decline by 80% in 2020), creating a shortfall of USD 24 bn. This is the main driver behind the sharp widening of the current account deficit, triggering an equivalent shortfall in foreign currency reserves.

Turkey's economic performance is a mix of stark contrasts, which have persisted for years. Excluding short periods of severe slowdowns, economic growth has been surprisingly robust, but with persistent imbalances. Growth fuels imports, which in turn erode the trade balance. This structural trade deficit fuels significant financing needs, which puts pressure on the exchange rate.

As a result, the lira came under renewed downward pressure this summer, after being squeezed in the midst of the crisis this spring. The central bank (CBRT) set up foreign currency swap lines with the commercial banks, and captured part of their USD liquidity. CBRT also increased its gold reserves, taking advantage of the increase in precious metal prices.

Even so, its foreign currency reserves diminished sharply, reflecting not only the current account deficit, but also the disaffection of both residents and non-residents. Residents increased their gold purchases (weighing on the current account balance) while, non-residents sold Turkish assets, notably public debt securities. These holdings dwindled to 3% in August 2020, down from nearly 12% a year ago, contributing to capital outflows.

Turkey should be among the first countries to be back to pre-Covid GDP levels (before year-end 2021), but it will face two persistent macroeconomic imbalances, larger than in peer economies. The vicious circle between foreign currency outflows and the depreciation of the lira continues to fuel double-digit inflation. The prospects for a gradual growth recovery around the world in 2021 and still constrained cross-border tourism activities raise fears of only a partial rebound in tourism. This situation would maintain the current account deficit at significantly high levels.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	2.9	0.9	-2.0	4.5
Inflation (CPI, year average, %)	16.2	15.5	12.1	11.9
Budget balance / GDP (%)	-1.4	-3.5	-7.5	-4.5
Public debt / GDP (%)	29.9	32.6	45.1	46.7
Current account balance / GDP (%)	-2.6	1.2	-3.7	-3.0
External debt / GDP (%)	56.5	55.7	64.7	68.6
Forex reserves (USD bn)	73.0	79.0	48.0	38.0
Forex reserves, in months of imports	3.5	4.2	2.7	2.0
Exchange rate USDTRY (year end)	5.3	6.0	8.0	8.7

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PRODUCTION (LEVEL)

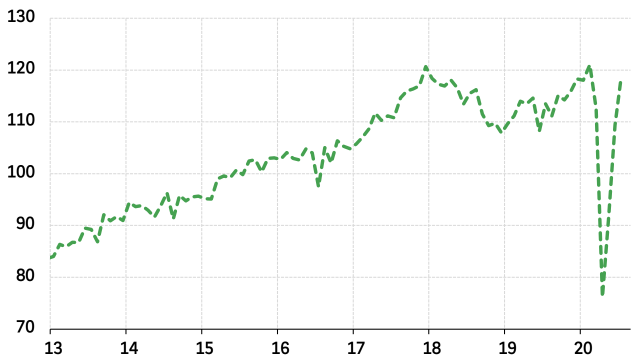

CHART 1

SOURCE: CEIC, BNP PARIBAS

A TEXTBOOK CREDIT BOOM

In recent years, economic policy was systematically growth supportive, and the recent period was no exception. Conventional monetary policy (involving one or more key rate adjustments) has remained accommodative. The main key rate was lowered from 12% at year-end 2019 to 8.25% in May, even though inflation has remained relatively stable at about 12%. This gap triggered a need for a sudden reversal of the monetary policy strategy. From July, the effective policy rate was tightened (the Central Bank can implement discretionary switches to other instrument in order to fine-tune liquidity at higher rates, without any monetary policy committee decisions). In September, a formal increase of all policy rates was decided, by 200 bps, in order to limit TRY depreciation risks, but real policy rates remain negative.

One of the major consequences of the accommodating bias of monetary policy is the acceleration of domestic credit since March 2020. In Turkey, credit growth to the non-financial private sector is structurally strong in nominal terms (as is inflation), but it goes hand-in-hand with strong nominal GDP growth. Since the beginning of the year, however, credit growth in the non-financial private sector has risen to a pace of about 40%, but nominal GDP growth has been much slower. Although this mismatch might be only temporary, it raises fears of a headlong rush into debt.

Following the 2018 recession, the banking system began accumulating non-performing loans (5.4% of loans outstanding at year-end 2019). This increase halted with the credit support measures implemented after the outbreak of the Covid-19 pandemic. Moratoriums on debt payments and ample corporate credit lines even triggered a slight decline in the nominal amount of non-performing loans. Above all, strong credit growth simply led to their dilution, to 4.2% of loans outstanding in July 2020.

More importantly, the increased debt burden is also a potential source of higher credit risk in the future. Regarding major non-financial corporates, domestic loans have partially replaced their external debt, which has fallen by as much. Yet this substitution effect was only partial, and total corporate debt increased.

Aware of the impact that rapid credit growth has on the lira's depreciation, the central bank recently reversed its credit stance with a 300 basis point increase in the required reserve ratio on foreign currency deposits.

RATHER UNORTHODOX BUDGET FINANCING

The fiscal stimulus is expected to widen the fiscal deficit to about 7.5% of GDP in 2020, while the debt ratio is expected to rise to 45% of GDP from 32.6% in 2019. CBRT has accumulated the equivalent of 10% of its assets in public debt securities, which is the target it indicated when announcing its securities purchasing programme in March. The Central Bank was able to cover part of the State's financing needs as well as to alleviate the impact of reduced public securities holdings by non-residents, while limiting its purchases in order to maintain credibility.

So far, the increase in 10-year rates has been fairly mild although it was not completely eliminated (13.8% on 21 September, from 12% in mid-March). Higher interest rates coupled with the increase in debt should lead to an increase in the debt service. The interest expenditure burden has already been rising constantly since 2018, and should reach 3 points of GDP in 2021. At the same time, the average maturity on public debt has diminished from 4.2 years in 2017 to 2.9 years in 2020. As a result, market volatility has a higher impact on public finance than it did in the past.

Public debt financing was not a problem before the health crisis, but it now risks becoming a source of fragility for the country. Holdings of public debt securities by Turkish banks increased by 70% between year-end 2019 and the end of August 2020. Most of these holdings were with state-owned banks (public debt accounts for 12% of their assets vs. 9% at year-end 2019). This has increased the sovereign-bank nexus, the interdependence between sovereign risk and banking risk.

NOMINAL GDP GROWTH VS. NOMINAL CREDIT GROWTH (%)

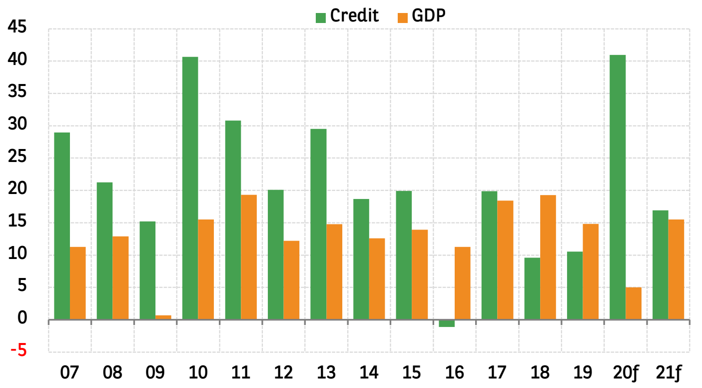

CHART 2

SOURCE: CEIC, BNP PARIBAS

THE PATHS TO REBALANCING

Turkey's external refinancing needs (and possibly in the future, its public debt refinancing needs) are structurally high, which accentuates the shocks to Turkish growth: given the high volatility of portfolio investment, these high refinancing needs strain foreign currency liquidity and the exchange rate, drive up risk premiums, and end up encouraging saving and borrowing in foreign currencies.

The first solution would be to limit imports. In Turkey's case, imports are high for three reasons: energy, gold and the import content of merchandise exports. It is difficult to imagine reducing imports generated by exports (excluding gold) without altering the nature of Turkey's production facilities for some of its foreign investors. Gold imports increase during periods when the lira depreciates sharply, and limiting them would not solve their cause, which is entailed by foreign currency shortages. In contrast, reducing the energy deficit, the primary cause of the trade deficit, seems to be the most favoured approach by the Turkish authorities. Various projects to exploit natural resources in the Black Sea and the Eastern Mediterranean should be analysed against this background.

A second solution would be to act on the causes of the current account imbalance, namely the shortfall in savings compared to investment. This imbalance largely reflected the shortfall in savings with regard to private sector investment, although this is less true today after the decline in net investment. The steady swelling of the fiscal deficit (excluding appropriate adjustments during crisis periods) has modified the current account deficit's financing problem. Against a background of fickle capital flows, it can lead to a crowding-out effect of the private sector through a rise in long-term bond yields (in order to attract foreign inflows and finance the current account deficit). This clearly shows the importance of fiscal consolidation once the Covid crisis is over.

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