Turkey

Prepared for (soft) landing?

The Turkish economy is facing problems of a sort it has dealt with in the past: a global crisis, that will trigger a sharp fall in exports, coupled with a contraction of external financing. Unlike in 2018, Turkey's economy does not appear to be overheating, whilst the fall in oil prices and the emergence of a current account surplus are two factors that will reduce the risk. That said, the relatively weak levels of currency reserves, the high level of external debt and the recent rise in non-performing loans are all significant risk factors. In front of the current shock, the economic policy response will have to address foreign currency liquidity needs properly in a context of dwindling capital flows.

The second shock in two years

Turkey is one of the last European countries to be hit by partial economic paralysis from COVID-19. Before the pandemic struck, economic growth had been accelerating including during the first quarter of 2020 (industrial production rose 7.3% y/y in the three months to end-January), as the country recovered from the recession experienced in the 2nd half of 2018 and responded to the rescue measures introduced since then.

This does not mean that the country will avoid a shock, as demonstrated by the first signs of deterioration of economic indicators in March. For example, the index of expected production levels at companies has slipped back to the low points seen during the 2018 crisis. At the same time, consumer surveys saw no deterioration in March, with consumer perceptions still dominated by the on-going disinflation.

The shock in the 2nd quarter of 2020 will be severe in two ways:

- Turkey will not escape the major shock to international trade that the pandemic has triggered. It is likely that there will be a substantial fall in exports (-20% in the second quarter), most notably in exports of goods and particularly vehicles (15% of total goods exports). Turkey will probably also see a fall in tourist numbers in the summer of 2020; tourism represents 20% of exports of goods and services.
- Secondly, as the COVID-19 pandemic affects the country, Turkey will see a sharp fall in domestic demand, with a contraction in household consumption. Investment will return to a downtrend, and could close the year 25% below its mid-2018 level.

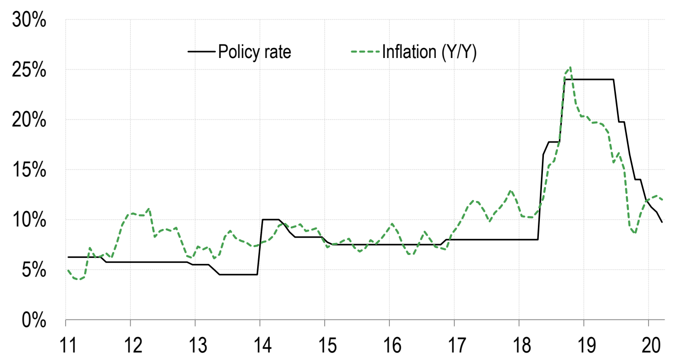
In the end, Turkish GDP is likely to decrease by -2% in 2020. With a high carry-over at the end of Q1 2020 of close to 4%, this implies strongly negative growth over the remainder of the year. Once the shock is over, we expect growth to rebound fairly strongly as of 2021. As shown in the 2018 crisis, the depreciation of the lira in difficult times helps absorb the shock. A weaker currency pushes up the prices (and thus reduces the level) of imports, helping support local production. The sudden narrowing of the trade deficit (from 6.9% of GDP in 2017 to 2.2% in 2019) reflects this. Credit supportive monetary policy is another fundamental factor expected in this rebound, in another parallel with the aftermath of the 2018 crisis: bank lending grew by 11% in 2019.

1- Forecasts

	2018	2019	2020e	2021e
Real GDP growth (%)	2.9	0.9	-2.0	4.5
Inflation (CPI, year average, %)	16.2	15.5	10.0	9.0
Budget balance / GDP (%)	-1.4	-3.5	-7.0	-4.5
Current account balance / GDP (%)	-2.4	1.1	3.0	1.0

e: BNP Paribas Group Economic Research estimates and forecasts

2- Inflation and policy rate



Source : Central Bank, Turkstat

Meanwhile, inflation is likely to fall in line with the sharp drop in oil prices. It is likely to average 10% over the year, slowing from 12.2% in the first quarter to around 8% at the year-end, before picking up a little again. However, a return to stronger growth in 2021 is likely to come too late to prevent a fresh rise in non-performing loans. These had already doubled between mid-2018 and the end of 2019, reaching 5.4% of total bank lending.

Whatever it takes in Turkish motion?

The assumption that Turkish growth will prove relatively resilient is based on the country's rapid economic policy response, with the announcement on March 17th of an arsenal of measures by the Central Bank backed by the announcement of a TRY 100 billion fiscal package (2.3% of GDP).

The Central Bank was the first to react, acting to protect the liquidity of the banking system and prevent both a contraction in credit and an increase in business payment defaults. The first element of its response was to cut its policy rate by 100 basis points, to 9.75%. This marked the continuation of a monetary easing cycle that began

in July 2019 (cumulative 1425 basis points cut since then) and is now likely to continue.

The Central Bank then cuts its reserve requirement coefficient on foreign currency deposits by 500 basis points for banks that meet the credit growth constraints, thus freeing up USD 5.1 billion in foreign currency liquidity for the banks. Moreover, banks can use the Reserve Option Mechanism, which acts as an automatic countercyclical stabiliser allowing taking foreign currency liquidity when needed. This mechanism allows banks to keep a certain percentage of their lira reserve requirements in foreign currency or in gold. If needed, they can draw on these currencies. During the 2018 crisis, this made USD 30 bn available to them (of the USD 49 bn of reserve requirement in blocked accounts held in foreign currencies). At the end of March 2020, these reserves stood at USD 23 bn and were already coming into use by banks.

Meanwhile, the Central Bank has introduced dollar, euro and gold swap lines (at a rate 125 bp below its policy rate). It has announced TRY 60 bn (USD 9 bn) in credit lines to exporters and a 90-day extension of maturities for rediscount credits due to mature before 30 June (covering a total volume of USD 7.6 bn of credits), among other measures. It also announced that it would buy government debt in order to help finance the growing unemployment benefit system deficit and that it would accept asset-back securities and mortgage-backed securities as collateral in TRY and foreign currency Central Bank operations.

On top of this, the government extended the maturities on bank debt at all companies affected by COVID-19 by 90 days. Other major measures included the deferral by 6 months of VAT and social security contribution payments for the worst affected sectors (tourism, retail, metals, automotive, textiles) and the doubling from TRY 25 bn to TRY 50 bn of the loan guarantee fund.

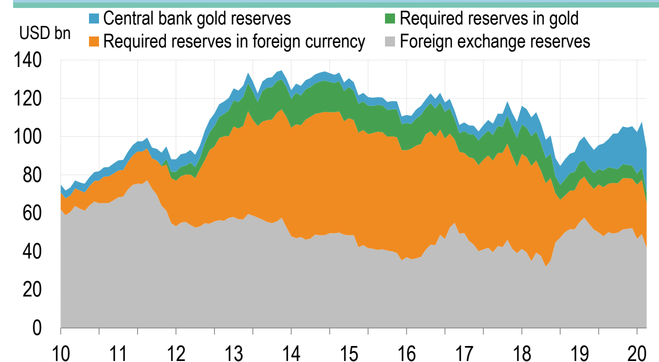
A relatively contained government debt ratio is an asset

There are no major worries about the public finances, despite the expansionist fiscal policy implemented since 2018. Nominal GDP growth had been strong (14% in 2019), wiping out the effect of a bigger budget deficit on the debt/GDP ratio.

It is likely that fiscal policy will remain highly supportive, particularly in tackling the social impact of COVID-19 (unemployment, healthcare costs), given that unemployment remains high (13.7% of the active population in the final quarter of 2019). Given the fiscal measures announced, and the expected adjustment of the automatic stabilisers, the deficit is likely to reach 7% of GDP, taking government debt towards 35% of GDP by the end of 2020. Whilst this would be a significant increase, the absolute ratio remains relatively low. It also remains likely that the government will extend its support measures to a larger number of sectors, as the fall in business levels spreads across the economy, resulting in a fresh increase in the budget deficit.

The Turkish policy mix is focused on maintaining significant credit growth, which helps support nominal GDP growth and facilitates public and private debt repayment. As a result, it is highly likely that the Central Bank will continue to cut its policy rate, maintaining negative real interest rates. The Turkish lira looks set to continue its depreciation trend with a significant likelihood that it will once again break through the threshold of TRY7 per dollar before the end of 2020. This would limit the imported disinflation from lower oil prices (which we expect to average USD 38/barrel over 2020, compared to $65 on average in 2019).

3- Decomposition of Turkish foreign exchange and gold reserves



Source: Central Bank

Lower oil prices are likely to boost the current account surplus in 2020, taking it to a rarely seen level of about 3% of GDP. However, a contraction of capital flows is also likely. If the rollover rate of the external debt of non-financial and banks is at least 70%, the downward pressure on currency reserves should be kept under control. This is an important factor given that reserves were only USD 43 bn in March 2020, excluding banks' required reserves held in foreign currencies.

According to the IIF, with just USD 2 bn of payments on dollar-denominated bonds, pressure on foreign currency liquidity will not come from the public sector. Instead it could come from Turkish banks and non-financial companies, with payments due of USD 10.5 bn and USD 12 bn respectively. Any difficulties in refinancing future payments could further increase credit risk.

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