
# TURKEY: Accepting reality and hoping for the best

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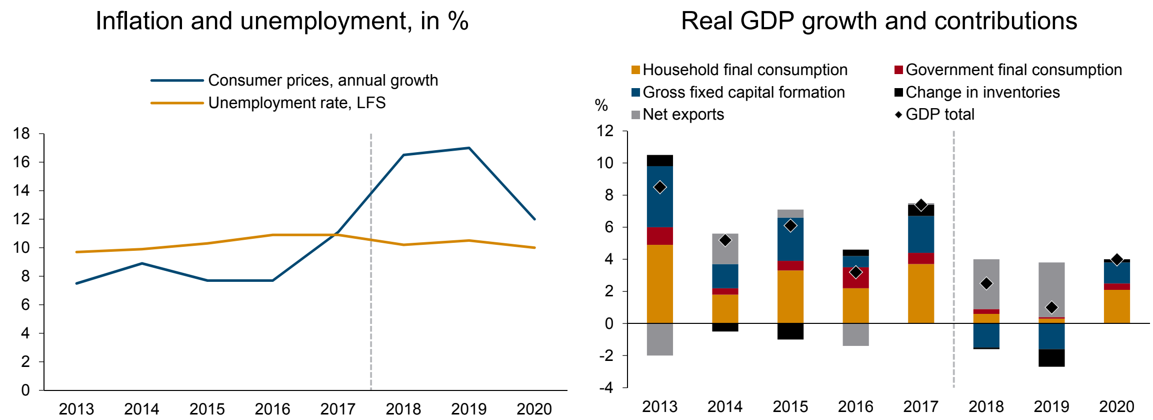
**Turkey's economy is heading for recession, and is set to face at least several difficult quarters. US monetary tightening, and domestic and international political risk factors, have combined with an unbalanced and debt-reliant growth model to create a perfect storm for Turkey. The policy response by the authorities, including monetary tightening and an attempt to calm international tensions, have significantly reduced the chances of a full-blown crisis. Our core scenario is that the economy will start to recover by end-2019.**

**Figure 56 / Turkey: Main macroeconomic indicators**




Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

**The Turkish economy is undergoing its worst crisis for a decade.** Since the start of 2018 the lira has depreciated by around 50% against the euro, and consumer price inflation has rocketed to over 20%. The crisis reflects a combination of long-term structural imbalances in the economy, major external headwinds, and domestic policy missteps.

**Some of the roots of the crisis are medium-term in nature.** The most important of these is the persistently high current account deficit that Turkey has run for many years, and the fact that the majority of this has been financed by short-term capital inflows, much of which have been debt-creating. During the post-crisis period of ultra-loose global monetary conditions, Turkey has been one of the emerging markets which has seen its private sector load up on cheap foreign currency credits, predominantly in

US dollars. This very unbalanced growth model relied on net hot money inflows of 4-6% of GDP per year.

**A second medium-term risk factor which has come sharply into focus this year is the insufficient independence of institutions in general, and the central bank in particular.** Investors have long questioned the central bank's ability to respond to inflationary pressures in a timely manner. The central bank has not met its 5% inflation target since 2011, and the president, Recep Tayyip Erdoğan, has several times argued that higher interest rates cause higher inflation (something that is at odds with the thinking of most economists). Mr Erdoğan's now infamous interview with Bloomberg in London in May 2018, where he repeated this claim and hinted at taking more direct control over the central bank after the presidential election in June, appears to have particularly rattled the foreign exchange market. More generally, there have been growing questions about the capacity and independence of Turkish state institutions. According to the World Bank's governance indicators, Turkey's government effectiveness, regulatory quality, rule of law and control of corruption have all declined since 2013-14.

**In addition to medium-term structural issues, four shorter-term factors have contributed to the collapse in the lira this year.** First, while the US Federal Reserve has been tightening policy for some time now, the dollar has strengthened significantly since April, bringing emerging markets with weaker fundamentals and higher external exposure (such as Turkey or Argentina) more into the firing line. In the CESEE region, Turkey is much more exposed to the re-orientation of global capital flows than most other countries, reflecting its reliance on dollars rather than euros for most external funding (unlike the Fed, the ECB is going nowhere fast with monetary policy tightening). Second, the oil price has continued to rise, and has generally been 40-50% above equivalent 2017 levels during the year, putting additional pressure on Turkey's already strained external financing capacity. Third, domestic political risk has risen, exacerbating the general deterioration in foreign investors' willingness to finance emerging markets' external deficits. Following the election in June, a new government was announced without the reassuring presence of ministers from the previous administration who were viewed as more economically orthodox and investor friendly. Fourth, tensions with the US have risen, particularly in relation to the detention by Turkey of a US pastor. Although the pastor was released in mid-October, the potential for tensions with the US remains, not least in relation to a Turkish bank's role in helping Iran to evade US sanctions, and the general unpredictability of US policy-making under the current president.

**The authorities needed to take four steps quickly to prevent a full-blown crisis, but have so far only done two of them.** These steps were: i) a major tightening of monetary policy to support the lira; ii) produce a credible medium-term economic plan, including a tightening of fiscal policy; iii) outline steps to support the banking sector in anticipation of a sharp rise in bad loans; iv) reduce tensions with the US. The first two have largely been done (see below), and there has been welcome progress on point iv in line with our expectations. Point iii, however, is still missing.

**The central bank has finally taken decisive action to stem the chaos in the foreign exchange market.** In September the benchmark one week repo rate was hiked by 625 basis points to 24%. In some ways this was probably unnecessary: by the time of the hike the economy was likely already in recession. However, the hike was a strong statement, indicating to the market a continued ability to act independently, and a statement of intent about maintaining foreign financing of the current account deficit. We expect the hike to improve investor confidence, and it will certainly help with the financing of the external deficit. This is particularly important considering that Turkey's foreign currency reserves are inadequate according to the IMF.

**A recession is now guaranteed, and full-year growth for 2018 will only be moderately positive, while 2019 will be even worse.** The economy is heading into a deep recession, which will last until at least the middle of 2019. We expect investment and imports in particular to decline strongly, reflecting much tighter monetary policy and a collapse in domestic demand. Private consumption will also decline. On the flipside, the massive depreciation of the lira will provide some support to the export sector, and as a result external demand should contribute positively to growth for at least a few quarters.

**While the downturn will be significant and painful, we expect growth to be back in positive territory by the end of 2019.** This will reflect in part the severity of the contraction now (which means that by H2 2019 base effects will be highly supportive of growth). During the next few quarters, the Turkish economy will undergo a very significant external adjustment, with a collapse in imports and strong growth in exports set to narrow considerably the current account deficit. Certain strong domestic fundamentals will also help the recovery, or at least to mitigate the extent of the downturn. Turkey's fiscal and sovereign debt position is strong, meaning that the government is highly unlikely to run into financing difficulties (although fiscal policy will be tightened as part of the policy response).

**Two things are now key to watch: the banking sector and the relationship with the US.** In relation to the banking sector, we expect the sharp depreciation of the lira to badly affect capital levels and asset quality, reflecting the fact that many companies are highly leveraged in foreign currency but do not have offsetting dollar or euro revenue streams. The non-performing loan (NPL) ratio will certainly rise. So far, the government has not been specific on how it plans to help the banking sector if it runs into trouble. Depending on the depth and length of the crisis, this may become necessary. At the same time, the banking sector is going into the crisis with good asset quality and high capital levels – a strong starting point, which makes it much more likely that the sector will survive the downturn without suffering a major crisis. Besides, the chances of the downturn turning into a broader financial crisis have been mitigated by strong central bank action, even if this was very much delayed.

**Turkey's relationship with the US remains a downside risk factor to the economic outlook.** So far, the US has put only limited sanctions on Turkey. However, despite the release of the jailed pastor, there is a risk that tensions escalate, particularly in relation to ongoing investigations in the US concerning alleged support by Turkey to Iran to evade US sanctions on the latter. Put simply, Turkey's economy would not be able to handle anything like the sanctions that the US has put on Russia over the last few years. Turkey's large external financing needs (in contrast to Russia) mean that macroeconomic stability would be endangered, and the economy would be facing a much bigger crisis.

**Beyond the next 12-18 months, and assuming that the banking and corporate sectors can weather the current difficulties without a full-blown crisis, the outlook for Turkey is not too bad.** The challenges posed by the current downturn should not be underestimated. However, Turkey's growth potential remains good, reflecting in part a positive demographic outlook (in contrast to most of the rest of CESEE). The question is how much the authorities learn from the current recession and take the opportunity to implement a more sustainable growth model. Certainly, the current downturn will force an external adjustment. However, without greater investment in productive capacity and a shift away from debt-fuelled consumption and construction investment, as the economy recovers from late 2019 the external shortfall will simply widen again, probably financed primarily by hot money. This means that Turkey will be again exposed to external developments, which in the end will probably result in another crisis.

## Table 31 / Turkey: Selected economic indicators

| | 2014 | 2015 | 2016 | 2017 1) | 2017 January-June | 2018 January-June | 2018 Forecast | 2019 Forecast | 2020 Forecast |
|---|---|---|---|---|---|---|---|---|---|
| Population, th pers., average | 77,182 | 78,218 | 79,278 | 80,313 | . | . | 80,900 | 81,700 | 82,500 |
| Gross domestic product, TRY bn, nom. | 2,044 | 2,339 | 2,609 | 3,107 | 1,384 | 1,672 | 3,700 | 4,400 | 5,100 |
| annual change in % (real) | 5.2 | 6.1 | 3.2 | 7.4 | 5.3 | 6.2 | 2.5 | 1.0 | 4.0 |
| GDP/capita (EUR at PPP) | 17,700 | 18,800 | 18,600 | 19,400 | . | . | . | . | . |
| Consumption of households, TRY bn, nom. | 1,242 | 1,412 | 1,561 | 1,834 | 831 | 996 | . | . | . |
| annual change in % (real) | 3.0 | 5.4 | 3.7 | 6.1 | 3.8 | 7.8 | 1.0 | 0.5 | 3.5 |
| Gross fixed capital form., TRY bn, nom. | 591 | 695 | 765 | 932 | 418 | 517 | . | . | . |
| annual change in % (real) | 5.1 | 9.3 | 2.2 | 7.8 | 5.9 | 5.8 | -5.0 | -5.5 | 4.2 |
| Gross industrial production 2) | | | | | | | | | |
| annual change in % (real) | 5.8 | 6.2 | 3.4 | 8.9 | 3.9 | 7.3 | 5.0 | 2.0 | 2.8 |
| Gross agricultural production 3) | | | | | | | | | |
| annual change in % (real) | -2.9 | 5.2 | 0.5 | 2.0 | . | . | . | . | . |
| Construction industry 2) | | | | | | | | | |
| annual change in % (real) | 3.0 | 1.7 | 2.9 | 3.8 | . | . | . | . | . |
| Employed persons, LFS, th, average | 25,931 | 26,619 | 27,216 | 28,197 | 27,722 | 28,652 | 29,000 | 29,400 | 30,100 |
| annual change in % | 5.4 | 2.7 | 2.2 | 3.6 | 2.1 | 3.4 | 3.0 | 1.5 | 2.5 |
| Unemployed persons, LFS, th, average | 2,854 | 3,050 | 3,332 | 3,451 | 3,563 | 3,245 | 3,290 | 3,450 | 3,340 |
| Unemployment rate, LFS, in %, average | 9.9 | 10.3 | 10.9 | 10.9 | 11.4 | 10.2 | 10.2 | 10.5 | 10.0 |
| Reg. unemployment rate, in %, eop | . | . | . | . | . | . | . | . | . |
| Average monthly gross wages, TRY 4) | 1,820 | 2,014 | 2,280 | 2,470 | . | . | 2690 | 3220 | 3710 |
| annual change in % (real, gross) | 1.3 | 2.8 | 5.2 | -2.5 | . | . | -2.0 | 2.2 | 2.8 |
| Consumer prices (HICP), % p.a. | 8.9 | 7.7 | 7.7 | 11.1 | 10.8 | 11.6 | 16.5 | 17.0 | 12.0 |
| Producer prices in industry, % p.a. 5) | 10.1 | 5.3 | 4.3 | 15.8 | 15.3 | 16.7 | 21.5 | 23.0 | 14.0 |
| General governm. budget, nat.def., % of GDP | | | | | | | | | |
| Revenues | 31.9 | 31.9 | 33.0 | 30.2 | . | . | 32.8 | 32.8 | 33.5 |
| Expenditures | 32.7 | 32.9 | 34.7 | 32.2 | . | . | 35.8 | 35.7 | 35.7 |
| Deficit (-) / surplus (+) | -0.8 | -1.0 | -1.7 | -2.0 | . | . | -3.0 | -2.9 | -2.2 |
| General gov.gross debt, nat.def., % of GDP | 28.8 | 27.6 | 28.3 | 28.3 | . | . | 27.9 | 27.7 | 28.0 |
| Stock of loans of non-fin.private sector, % p.a. | 19.4 | 19.4 | 15.2 | 19.9 | 21.6 | 19.4 | . | . | . |
| Non-performing loans (NPL), in %, eop | 2.8 | 3.1 | 3.2 | 2.9 | 3.1 | 3.0 | . | . | . |
| Central bank policy rate, % p.a., eop 6) | 8.25 | 7.50 | 8.00 | 8.00 | 8.00 | 17.75 | 24.00 | 22.00 | 15.00 |
| Current account, EUR mn | -33,010 | -28,919 | -29,917 | -41,758 | -19,556 | -25,897 | -30,200 | -19,500 | -20,900 |
| Current account, % of GDP | -4.7 | -3.7 | -3.8 | -5.5 | -5.6 | -7.7 | -4.8 | -3.2 | -3.2 |
| Exports of goods, BOP, EUR mn | 127,237 | 136,978 | 135,795 | 147,218 | 75,394 | 70,915 | 151,000 | 159,000 | 167,000 |
| annual change in % | 4.4 | 7.7 | -0.9 | 8.4 | 11.7 | -5.9 | 2.8 | 5.0 | 5.0 |
| Imports of goods, BOP, EUR mn | 175,310 | 180,353 | 172,701 | 198,906 | 96,153 | 98,702 | 197,000 | 197,000 | 207,000 |
| annual change in % | -3.7 | 2.9 | -4.2 | 15.2 | 12.2 | 2.7 | -1.0 | 0.0 | 5.0 |
| Exports of services, BOP, EUR mn | 39,175 | 42,419 | 34,125 | 38,588 | 15,432 | 16,620 | 43,000 | 46,000 | 48,000 |
| annual change in % | 7.9 | 8.3 | -19.6 | 13.1 | 5.3 | 7.7 | 11.0 | 7.0 | 5.0 |
| Imports of services, BOP, EUR mn | 19,050 | 20,563 | 20,366 | 21,250 | 10,253 | 9,865 | 21,000 | 21,000 | 22,000 |
| annual change in % | 3.2 | 7.9 | -1.0 | 4.3 | -1.6 | -3.8 | 0.0 | 0.0 | 5.0 |
| FDI liabilities, EUR mn | 9,865 | 16,216 | 12,077 | 9,643 | 4,693 | 4,022 | 7,400 | . | . |
| FDI assets, EUR mn | 5,379 | 4,595 | 2,845 | 2,418 | 1,568 | 1,664 | 2,700 | . | . |
| Gross reserves of NB excl. gold, EUR mn 7) | 88,058 | 85,355 | 87,331 | 70,119 | 79,033 | 64,804 | . | . | . |
| Gross external debt, EUR mn 7) | 334,150 | 367,651 | 388,190 | 379,226 | 385,864 | 391,972 | 407,600 | 440,000 | 445,400 |
| Gross external debt, % of GDP | 47.5 | 47.6 | 49.8 | 50.3 | 51.2 | 62.5 | 65.0 | 72.0 | 69.0 |
| Average exchange rate TRY/EUR | 2.9065 | 3.0255 | 3.3433 | 4.1206 | 3.9379 | 4.9551 | 5.90 | 7.20 | 7.90 |

1) Preliminary. – 2) Enterprises with 20 and more employees; for construction wiiw estimate in 2017 - 3) Based on UN-FAO data, wiiw estimate in 2017. - 4) Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social securtiy. wiiw estimate in 2016 and 2017. - 5) Domestic output prices. - 6) One-week repo rate. – 7) Converted from USD.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.