TURKEY: Sailing close to the wind again

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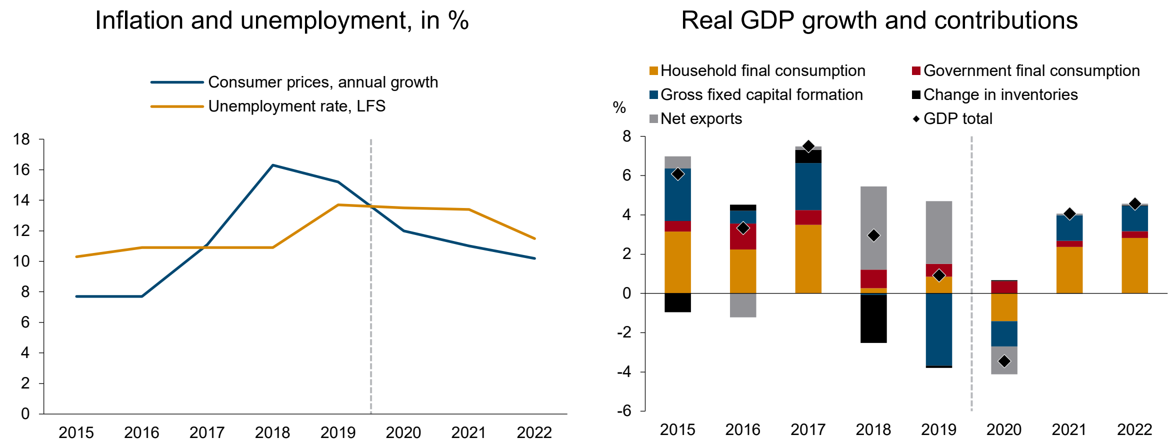
The economy staged an impressive rebound in Q3, but this relied heavily on credit, resulting in a weaker lira, higher inflation and a widening of the current account deficit. Growth in Q4 will therefore slow, with the full-year 2020 decline likely to be a bit over 3%. In 2021, we expect a strong bounce-back, with growth above 4%. The risks, as ever, are the financing of the external deficit, delayed monetary policy reaction and geopolitics.

Figure 4.22 / Turkey: Main macroeconomic indicators



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

The Turkish economy finds itself again in the midst of heightened volatility, with a robust rebound from a deep downturn in Q2, but a host of headwinds potentially set to slow this momentum. In 2020, the economy has had to deal not only with a global pandemic, but also with a further dramatic decline in the value of the lira and the fallout from various international tensions.

The economy slowed substantially in Q2 as a result of COVID-19. Turkey's economy contracted by 10% year on year in Q2 2020 (working-day adjusted), the sharpest decline on this basis since the first quarter of 2009. In quarterly terms, the contraction was even more severe: 11% (working-day and seasonally adjusted), almost double the scale of the downturn in Q1 2009, and comfortably the sharpest quarterly real GDP decline in the statistics office series going back to 1998. On a quarterly basis, fixed investment fell by 7.2%, government spending by 1.2% and household consumption by 8.9%. However, the most dramatic collapse came on the external side, with imports of goods and services down by 15.8% and exports by 33.6%, no doubt heavily influenced by a near collapse in tourism inflows (consistent with trends across Europe during that period).

In the third quarter of the year, the Turkish economy staged a very strong recovery, leading us to revise up our growth forecast for this year by over 2 percentage points. Although V-shaped recoveries are a Turkish speciality, the fact that the economy picked up so quickly from such a shock is still noteworthy. Measured by retail sales, the initial COVID-19 shock in April wiped out eight years of growth. However, by July the working-day and seasonally adjusted index of retail sales was almost back to February 2020 levels, and was at its second-highest point for at least a decade. In industry, the story was fairly similar: in April, the index was at roughly its 2011 level, and yet by July it had sprung back to above the January 2020 outturn and was close to February's production peak. As a result of this vigorous bounce-back, we have revised up our 2020 forecast by more than 2 percentage points. We now expect a full-year contraction of only 3.5% in 2020, followed by growth of 4.1% in 2021.

The macroeconomic developments have come against the background of a rapidly weakening lira; as a result of this, the Turkish central bank sharply tightened monetary policy, which will at least partly stall the recovery. At the end of September, the central bank increased its one-week repo rate by 200 basis points (bps) to 10.25%, with the lira at that point down by over 20% against the US dollar since the start of the year. Following the 2018 crisis, the real policy rate had been adjusted sharply upwards to protect the lira and tame inflation, and in 2019 it averaged almost 4% (CPI adjusted). However, sharp cuts to the base rate and still high inflation saw the real policy rate decline to an average -2.9% in Q2 2020 and -3.1% in July and August.

Although the central bank reacted quite strongly in September, further tightening will be necessary to move the real policy rate back into positive territory. We expect the central bank to have to raise the benchmark rate by about another 175bps by the end of the year, and by another 200bps next year (up to 14%). That would leave the rate comfortably positive in real terms, and will be necessary to support the lira at a time of heightened volatility (also related to geopolitical factors; see below), but will naturally slow the current economic recovery.

This centrality of monetary policy for Turkish economic growth is due to the reliance on credit. As usual, the role of credit growth has been important in the sharp bounce-back from the Q2 contraction. The nominal value of loans to non-financial corporations increased by 33.8% year on year in August, while the equivalent for households was 48.3%. Amid strong monetary tightening more recently, it seems unlikely that this rate of growth – and the support for economic growth more broadly – will be maintained. So far at least, the rapid expansion of credit amid a global pandemic has not had any impact on asset quality, with non-performing loans falling to just 4.1% of the total in August, down from 5.3% at the start of the year.

The most recent available high-frequency indicators suggest that the economy was still expanding at a rapid pace in September, but give some indications that the recovery could face challenges in the near term. IHS Markit's manufacturing Purchasing Managers' Index, for example, posted a headline reading of 52.8 in September, above the 50 level that separates expansion from contraction. Firms reported hiring at the fastest pace since February 2018, while both output and new orders rose for the fourth consecutive month. Nevertheless, the headline reading was down from 54.3 in August, and the impact of currency weakness appeared to be a key theme of the September survey. Although some firms reported improved external competitiveness as a result, the key fallout was higher input costs. These higher input costs – and the (questionable) extent to which firms can pass them on to consumers – will be a key theme for the Turkish economy in coming months. This will mean either a further sharp rise in inflation or a squeeze on firms' margins at a time when many are struggling with the after-effects of the Q2 downturn. Moreover, the September survey showed that the rate of increase in new orders and output was lower than in previous months.

Monetary tightening may stop the weakening of the lira, but the depreciation that has already happened will drive up inflation further in the coming months. Consumer price inflation has been very steady in recent months, standing at just under 12% in July, August and September (on an annual basis). We expect the consumer price index to have risen by 12% as a whole in 2020, implying a further increase from current levels in the remainder of the year. In 2021, we expect average full-year inflation of 11%, although this is reliant on further strong tightening by the central bank. If this does not materialise, then inflation will be significantly higher next year.

The shape and speed of the recovery from here will naturally be influenced by the spread of the pandemic and measures to contain it. Since the start of September, restrictions on economic life have increased fairly significantly. In September, both the Oxford Blavatnik School of Government Stringency Index and Google mobility data suggested more extensive restrictions (and consequently lower mobility relative to the baseline) for Turkey, compared to many of its CESEE peers, including other big countries like Russia and Poland. Combined with high inflation and a tighter monetary policy stance, this could imply a materially slower rate of growth in Q4 than in Q3.

Turkish foreign policy is increasingly assertive, and it is likely that this will have at least some economic implications. The most obvious example of the economic blowback from international tensions came in 2018, when a spat with the US contributed to a sharp sell-off of the lira and necessitated a massive central bank response. Events in 2020 cannot be compared to that (not least because the key relationship, with the US, is relatively calm). Nevertheless, tensions with the EU over gas exploration close to Cyprus, and potentially with Russia over Turkey's role in the current Azerbaijan-Armenia conflict, are a risk. These tensions have certainly already contributed to the weakening of the lira.

Internationally, the most important factors to watch for in the case of Turkey remain its political relationship with the US, the strength of the dollar and US monetary policy. This is particularly relevant, given the renewed widening of the current account deficit this year, which again leaves Turkey reliant on foreign capital flows, chiefly in US dollars. Neither the EU nor Russia is able to hurt the Turkish economy nearly as much as the US can, and Turkey is exposed to any volatility in the value of the dollar and international capital flows linked to the upcoming US presidential election. However, the recent announcement by the US Federal Reserve that it will keep policy rates close to zero until at least 2023 is excellent news for Turkey, and will be a key factor of stability for the external accounts in the coming years. Over the past decade, even hints by the Fed of moderate tightening have at times resulted in strong capital outflows from Turkey. A few more years of massive dollar liquidity does not guarantee anything, but it makes a serious crisis in Turkey less likely than would otherwise be the case.

It is probably fair to say that a Democratic victory in November in the US would be bad news for Turkish President Recep Tayyip Erdogan. There is no serious pro-Turkish lobby in Washington, but there are plenty of potential threats, not least related to possible sanctions on parts of the banking sector (owing to allegations of Turkish help for Iran in evading US sanctions). Whether by accident or design, these potential threats have not materialised under the current US president, who – at least at times – has seemed to be fairly positive towards President Erdogan. Under a Democratic administration in Washington, this may change.

Table 4.22 / Turkey: Selected economic indicators

	2017	2018	2019 1)	2020 1Q	2020 2Q	2020 1-2Q	2020	2021 Forecast	2022
Population, th pers., average	80,313	81,407	82,579	.	.	.	82,700	83,600	84,400
Gross domestic product, TRY bn, nom.	3,134	3,758	4,320	1,074	1,042	2,115	4,700	5,400	6,200
annual change in % (real)	7.5	3.0	0.9	4.4	-9.9	-3.2	-3.5	4.1	4.6
GDP/capita (EUR at PPP)	19,420	19,530	19,040		.	.	.	.	.
Consumption of households, TRY bn, nom.	1,827	2,098	2,441	604	597	1,201	.	.	.
annual change in % (real)	5.9	0.5	1.5	4.5	-8.6	-2.4	-2.5	4.2	5.0
Gross fixed capital form., TRY bn, nom.	936	1,115	1,118	276	292	568	.	.	.
annual change in % (real)	8.3	-0.3	-12.4	-0.3	-6.1	-3.3	-5.0	5.0	5.0
Gross industrial production 2)									
annual change in % (real)	9.1	1.1	-0.6	5.7	-16.7	-5.8	3.0	3.0	3.0
Gross agricultural production 3)									
annual change in % (real)	2.0	0.5	0.5	.	.	.	.	.	.
Construction industry 2)									
annual change in % (real)	3.8	-5.0	-8.0	.	.	.	.	.	.
Employed persons, LFS, th, average	28,197	28,734	28,081	26,753	25,858	26,306	26,700	27,400	28,100
annual change in %	3.6	1.9	-2.3	-2.2	-8.5	-5.4	-5.0	2.5	2.5
Unemployed persons, LFS, th, average	3,451	3,535	4,461	4,228	3,826	4,027	4,170	4,240	3,650
Unemployment rate, LFS, in %, average	10.9	10.9	13.7	13.6	12.9	13.3	13.5	13.4	11.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY 4)	2,470	2,820	3,250	.	.	.	3740	4300	4900
annual change in % (real, gross)	-2.5	-2.0	0.0	.	.	.	2.8	3.5	3.5
Consumer prices (HICP), % p.a.	11.1	16.3	15.2	12.1	11.7	11.9	12.0	11.0	10.2
Producer prices in industry, % p.a. 5)	15.8	27.0	17.6	8.9	6.1	7.5	15.0	13.0	11.0
General governm. budget, nat.def., % of GDP									
Revenues	29.9	29.8	29.7	33.0	28.5	30.8	27.5	31.5	33.8
Expenditures	31.9	32.5	32.9	34.9	34.9	34.9	35.0	36.2	36.6
Deficit (-) / surplus (+)	-2.0	-2.8	-3.2	-1.8	-6.4	-4.1	-7.5	-4.7	-2.8
General gov.gross debt, nat.def., % of GDP	28.0	29.9	31.7	.	.	.	32.0	31.2	31.0
Stock of loans of non-fin.private sector, % p.a.	19.9	9.6	10.5	14.7	28.4	28.4	.	.	.
Non-performing loans (NPL), in %, eop	2.9	3.9	5.4	5.0	4.4	4.4	.	.	.
Central bank policy rate, % p.a., eop 6)	8.00	24.00	12.00	9.75	8.25	8.25	12.00	14.00	9.00
Current account, EUR mn	-35,800	-16,699	7,973	-7,144	-10,828	-17,972	-16,500	-20,600	-25,700
Current account, % of GDP	-4.7	-2.5	1.2	-4.5	-7.9	-6.1	-2.8	-3.3	-3.9
Exports of goods, BOP, EUR mn	149,978	151,636	162,896	38,919	28,816	67,734	151,000	159,000	167,000
annual change in %	8.7	1.1	7.4	-1.4	-27.1	-14.3	-7.0	5.0	5.0
Imports of goods, BOP, EUR mn	201,348	185,533	177,763	47,636	36,670	84,306	174,000	186,000	199,000
annual change in %	15.7	-7.9	-4.2	13.7	-15.4	-1.1	-2.0	7.0	7.0
Exports of services, BOP, EUR mn	46,927	50,286	57,851	10,293	4,485	14,777	40,000	42,000	44,000
annual change in %	12.1	7.2	15.0	6.7	-66.9	-36.3	-30.0	5.0	5.0
Imports of services, BOP, EUR mn	23,963	23,709	24,663	6,384	5,065	11,449	23,000	25,000	27,000
annual change in %	2.5	-1.1	4.0	11.7	-13.2	-0.9	-5.0	8.0	8.0
FDI liabilities, EUR mn	9,831	11,105	7,837	2,171	416	2,587	6,269	.	.
FDI assets, EUR mn	2,417	3,082	2,615	495	347	841	2,092	.	.
Gross reserves of NB excl. gold, EUR mn 7)	70,202	63,666	69,975	55,437	42,219	42,219	.	.	.
Gross external debt, EUR mn 7)	378,386	386,525	386,496	391,458	376,698	376,698	377,200	376,700	359,500
Gross external debt, % of GDP	49.8	58.7	56.9	65.4	62.9	62.9	63.0	60.0	54.5
Average exchange rate TRY/EUR	4.1206	5.7077	6.3578	6.7391	7.5650	7.1521	7.85	8.60	9.40

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

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