Turkish economy contracted sharply in Q4 2018: more difficult quarters ahead, but recovery likely by 2020

The recession is likely to continue for at least the first half of this year, and there are several downside risks to growth.

The Turkish economy contracted by 3% year on year in Q4, and officially entered a technical recession. This downturn reflects a combination of factors, including the collapse in the value of the lira in the middle of 2018. The economy has already undergone a strong external adjustment, with imports falling sharply and exports growing strongly. Investment has collapsed and private consumption is also struggling. Business and consumer sentiment has taken a knock from the spike in inflation, weaker lira, and much higher domestic interest rates. After the lira collapsed, inflation rocketed and capital outflows increased sharply, the central bank responded with a hefty tightening of monetary policy.

The economy will remain in recession for at least 1-2 more quarters. The shocks that hit the economy in 2018 are still making their way through the system. Real interest rates will remain firmly in positive territory this year, with the central bank set to remain wary of renewed lira volatility, which will weigh on investment. Turkey's labour market is suffering, with employment growth now negative for the first time since 2009, led above all by a collapse in construction jobs (the construction boom is firmly over). Employment growth in services and industry has also weakened.

The risks of a return to the huge volatility of mid-2018 cannot be ruled out, but several stabilising factors suggest that these risks are lower than was the case last year. First, the improvement in relations with the US has been key, helped above all by the release of a jailed US pastor in Turkey. Second, there has been a much more dovish tone from the US Federal Reserve in recent months, with monetary tightening now set to continue at a much slower pace than previously expected (if at all). Third, Turkey's external borrowing needs will be much reduced relative to previous years, on the back of a smaller current account deficit (although rollover of existing external debt commitments remain significant). Fourth, high domestic real interest rates will be a source of stability for the external accounts, and support continued capital inflows. Fifth, tourism has recovered. Sixth, lower oil prices should help with a general easing of inflation.

For 2019 and 2020, however, we see several big risks that will be key to determining the fortunes and stability of the Turkish economy. First, it will be important to see how well the banking sector can hold up, amid an expected deterioration in asset quality on the back of lira depreciation and recession. Second, relations with the US will remain key. Any renewed downturn in relations between the two countries could increase speculation of new US sanctions on Turkey, thereby negatively affecting investor confidence and willingness to finance Turkish debt rollovers. Third, there remains the question of the economy's ability to meet its still-significant external debt rollover needs more generally (short-term foreign exchange debt totalled around USD 116bn at end-2018, equivalent to around 16% of last year's GDP).

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