TURKEY: Back to boom and bust

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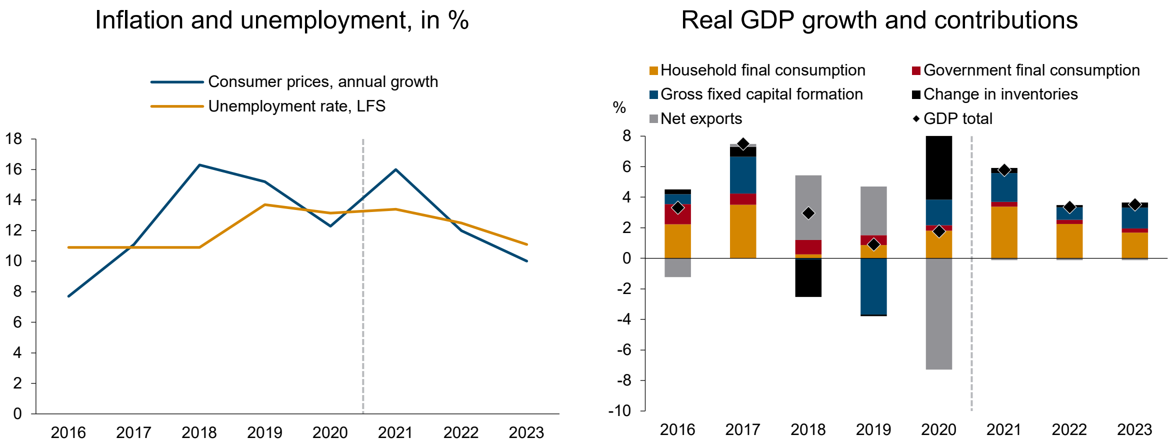
Uniquely in CESEE, the Turkish economy posted positive full-year economic growth in 2020, reflecting credit expansion in response to the pandemic. A period of higher nominal interest rates stabilised the lira, but is likely now at an end thanks to yet another change at the top of the central bank. Growth will be strong this year but slow by 2022, either due to high real interest rates to get inflation under control, or a lira collapse and balance of payments crisis.

Figure 4.22 / Turkey: Main macroeconomic indicators



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

The Turkish economy has so far weathered the pandemic relatively well, posting the only full-year positive growth rate in CESEE last year. This performance reflected a strong credit-driven rebound from Q2's downturn in the second half of 2020, as the government used its favourite method to stimulate aggregate demand. As elsewhere, growth performance differed widely between sectors of the economy. Private consumption overall rebounded strongly thanks to the credit stimulus and pent up demand from Q2, while industry performed well on the back of the weaker lira and rapid unwinding of the Q2 breakdown in global supply chains. By the end of 2020, both the seasonally-adjusted indices of industrial output and retail trade were above pre-pandemic levels. However, key areas of the services economy struggled due to pandemic-related restrictions. Foreign tourism, a key pillar of growth, had a very bad year. Total arrivals reached 12.9m in 2020 according to the central bank, down from 44.7m in 2019.

Most recently available high-frequency data suggest that the strong economic performance continued up to the end of 2020 and into the early part of this year. The manufacturing purchasing managers' index (PMI), compiled by the Istanbul Chamber of Industry and IHS Markit, was at 51.7 in

February, above the 50 level separating expansion from contraction. Meanwhile consumer confidence reached a 31-month high in March 2021.

In public health terms, Turkey has suffered from the pandemic but not to the same extent as many other parts of CESEE. According to Worldometer data, as of late March Turkey had recorded 357 deaths from COVID-19 per million, just over half of the level for Russia (659), and only a fraction of the rates for the worst-affected countries in Europe such as Czechia (2355), Hungary (1965) or Belgium (1958). Data measuring the level of government restrictions or impact on mobility indicate that Turkey is a fairly average case by CESEE standards, meaning that the reason for the relative lack of public health impact may lay elsewhere. It seems reasonable to assume that at least part of the reason is Turkey's young population, which is in stark contrast to almost anywhere else in CESEE. However, in a context of mutations and indications that younger people are now more badly affected, there are risks to the public health outlook this year. As in many other countries, Turkey is in the grip of a third wave of the pandemic, with cases rising rapidly at the time of writing, albeit still well below the peaks of the second wave in November-December.

The labour market has suffered in the pandemic, and we expect the rate of unemployment to rise further in 2021. The total number of people registered as employed in Turkey in 2020 fell by over a million, from 28.1m in 2019 to 26.8m last year. However, job losses in the services sector most affected by the pandemic have been partly offset by gains elsewhere, especially in the industrial sector on the back of rising exports. The headline unemployment rate actually fell in 2020, to 13.2%, from 13.7% in 2019, but this reflected people who lost their job moving to inactivity. As a result, the labour force declined by almost 1.7m in 2020 according to Turkstat, despite population growth of 1.1m over the same period.

The initial expansionary monetary response to the pandemic was followed by several important changes to the policy set-up towards the end of 2020, which appeared to show a greater awareness of the economy's vulnerabilities and acceptance that a different growth model was required. It appears that the pandemic and its fallout delivered a shock to President Erdogan and his inner circle. Turkey burnt through its foreign currency reserves in a failed attempt to support the lira. This was followed by the removal of Berat Albayrak, the President's son in law and economy minister, and the instalment of a new central bank governor, Naci Agbal. These changes were welcomed by the market, especially after the new governor raised the nominal policy rate by 875 basis points to 19%, putting the real rate well into positive territory. During the first couple of months of 2021, the lira was the best performing emerging market currency in the world.

The move towards a more orthodox policy stance could also be understood as an attempt to better protect the economy in the context of the US election and Turkey's more assertive foreign policy role. Although Turkey sparred with the US over the detaining of Pastor Andrew Brunson in 2018, in general it appears that the Erdogan government got off lightly under the Trump presidency. Various potential flashpoints, including the purchase of a missile defence system from Russia, allegations that Halkbank helped Iran to evade US sanctions, and Turkey's involvement in Syria, all could have led to a much more bitter fallout between Turkey and the US. Many in Washington were indeed pushing for such an outcome, but it seems that President Trump largely prevented this. Under the new US administration Turkey may not be so well protected, and concern about possible future US sanctions could have played into the decision to try to ringfence the economy with more orthodox policy. However, with its large current account deficit and external borrowing needs, Turkey is a long way from such ringfencing. More than almost any other country in CESEE, Turkey is vulnerable to US sanctions, reflecting the fact that the dollar remains the primary funding currency and large short-term external financing needs.

In recent developments that are familiar to those following the Turkish economy, this period of stability is now over. In late March, President Erdogan sacked Mr Agbal and appointed in his place a loyalist, Sahap Kavcioglu. Mr Kavcioglu is a former AKP deputy, and a supporter of Mr Erdogan's view that high interest rates cause inflation. It seems almost certain that this appointment will be followed by a reversal of recent interest rate hikes, in a bid to use expansionary credit policy to drive economic growth. In recent newspaper columns Mr Kavcioglu argued against using high interest rates to keep down inflation, saying that they only attracted portfolio flows and not the productive investment that Turkey needs. He also seems to support the previous policy of Mr Albayrak to use foreign currency reserves to support the lira.

The decisive shift back towards expansionary policy produced the predictable immediate market reaction: a sharp drop in the value of the lira and the stock market. Turkey may get away with it for some time, as it has before, reflecting the unprecedented levels of global dollar liquidity since 2008. However, at some point–feasibly this year–Turkey will again hit up against the reality that running negative real rates with a large dollar-financed current account and zero investor confidence in the independence of the central bank is not sustainable. This will result in a weaker lira, higher inflation, struggles to attract capital to plug the current account deficit, and a sharp slowdown in growth. The fact that this is taking place in a climate of rising US treasury yields (see global overview) is a particularly big problem. Higher US yields will suck dollars back and away from markets like Turkey, substantially increasing the risks of a balance of payments crisis. It may also not help that Mr Kavcioglu was vice President of Halkbank during a period when it is accused of helping Iran to evade US sanctions (Mr Kavcioglu is not implicated in the charges; Halkbank denies any wrongdoing, and the trial is due to start this spring). Any expanded US sanctions on Turkey will exaggerate the gravity of the situation.

The real surprise about the late March change of course is the timing: the period of policy 'orthodoxy' this time lasted only a few months. It seems that Mr Erdogan was enraged by the central bank's decision to further raise rates on March 18th; three days later the bank had a new governor. Although the broad implications are the same–Turkey will continue to go through boom and bust cycles–the length of these cycles may be becoming shorter. The timing may also reflect complacency after several months of a strengthening lira and market stability. There is also some speculation that President Erdogan is going for an early election (the next is not due to take place until 2023), and that the change at the top is part of a gamble to use loose policy to drive a boom for a couple of quarters until the election, and deal with the consequences afterwards. However, this would be a very risky strategy. Mr Erdogan's AKP party is struggling in the polls; one poll by Research Istanbul showed its support at below 30% in March for the first time in almost two decades. Much of this disquiet is likely related to economic factors. Although headline growth has been mostly strong during the AKP's time in office, in recent years it has been accompanied by persistently high inflation, which has eaten substantially into real incomes. As a result, many people do not perceive the last few years to have been especially good in economic terms. Despite strong headline growth, in per capita terms adjusted for purchasing power standards, Turkey's performance over the past decade has been fairly mediocre by emerging market standards.

The risk of a serious financial crisis in Turkey is arguably as high as it has been since 2008. Whatever the beliefs of Mr Erdogan and his inner circle, they remain stuck with the same three options as before: i) keep rates high to get a grip on inflation but at the expense of economic growth, ii) accept a substantial and persistent weakening of the lira accompanied by high inflation, macroeconomic volatility and social problems, or iii) implement capital controls. The first option now seems highly unlikely given the recent change at the top of the central bank. The third option also still seems politically difficult to imagine, albeit now moderately more likely. Therefore, the most likely scenario is the second, which means that the economy is again in for a rocky ride.

In this context, making any kind of prediction about short and medium-term macroeconomic trends is particularly challenging. It is possible that the authorities will get away with it for a while, and that the economy will boom this year on the back of improved global growth and sentiment as the health situation improves. However, this ‘positive’ scenario would also mean an even faster rise in US rates, putting additional pressure on Turkey’s external financing ability. Conversely, a negative scenario with a bad third wave of the pandemic would also dent investor confidence and cause a renewed flight to safety and away from economies like Turkey.

Our best guess is that growth will benefit in the short run, and so we have revised up our forecast for this year. Since 2017, during periods of negative real interest rates the economy has grown at an average of around 6%; we therefore use this as a baseline for this year. However, this will come at a cost, as it will be followed by a sharp hike in real rates and at least a couple of quarters of weak growth or even contraction. We have therefore revised down our forecast for next year to around 3.5%. A scenario like 2018 is not hard to imagine, when loose policy produced a boom followed by a sharp tightening of policy and a slump in economic activity. Then, the net result was a growth rate of 3%, followed by just 0.9% in 2019, despite the economy having grown by 7.5% in 2017 and 6.8% on average in 2010-17. The timing of the boom and bust cycle is naturally highly uncertain. The risks to this forecast are primarily to the downside.

Table 4.22 / Turkey: Selected economic indicators

	2017	2018	2019	2020 1)	2021	2022	2023
						Forecast	
Population, th pers., average	80,313	81,407	82,579	83,385	84,385	85,398	86,423
Gross domestic product, TRY bn, nom.	3,134	3,758	4,320	5,048	6,200	7,200	8,200
annual change in % (real)	7.5	3.0	0.9	1.8	5.8	3.4	3.5
GDP/capita (EUR at PPP)	19,360	19,160	18,540	18,960	.	.	.
Consumption of households, TRY bn, nom.	1,827	2,098	2,441	2,846	.	.	.
annual change in % (real)	5.9	0.5	1.5	3.2	6.0	4.0	3.0
Gross fixed capital form., TRY bn, nom.	936	1,115	1,118	1,373	.	.	.
annual change in % (real)	8.3	-0.3	-12.4	6.5	7.0	3.0	5.0
Gross industrial production 2)							
annual change in % (real)	9.1	1.1	-0.6	2.2	5.1	3.1	2.8
Gross agricultural production 3)							
annual change in % (real)	5.2	-1.3	0.5	3.0	.	.	.
Construction industry 2)							
annual change in % (real)	3.8	-5.0	-8.0	-3.0	.	.	.
Employed persons, LFS, th, average	28,197	28,734	28,081	26,808	27,500	28,200	28,900
annual change in %	3.6	1.9	-2.3	-4.5	2.5	2.5	2.5
Unemployed persons, LFS, th, average	3,451	3,535	4,461	4,063	4,260	4,030	3,610
Unemployment rate, LFS, in %, average	10.9	10.9	13.7	13.2	13.4	12.5	11.1
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.
Average monthly gross wages, TRY 4)	2,470	2,820	3,250	3,750	4460	5120	5770
annual change in % (real, gross)	-2.5	-2.0	0.0	2.8	2.5	2.5	2.5
Consumer prices (HICP), % p.a.	11.1	16.3	15.2	12.3	16.0	12.0	10.0
Producer prices in industry, % p.a. 5)	15.8	27.0	17.6	12.1	17.3	13.3	11.3
General governm.budget, nat.def., % of GDP							
Revenues	29.9	29.8	29.7	28.5	30.0	31.0	32.0
Expenditures	31.9	32.5	32.9	33.0	33.5	33.5	33.5
Deficit (-) / surplus (+)	-2.0	-2.8	-3.2	-4.5	-3.5	-2.5	-1.5
General gov.gross debt, nat.def., % of GDP	28.0	30.2	32.6	36.7	40.4	43.5	46.4
Stock of loans of non-fin.private sector, % p.a.	19.9	9.6	10.2	35.3	.	.	.
Non-performing loans (NPL), in %, eop	2.9	3.9	5.4	4.1	.	.	.
Central bank policy rate, % p.a., eop 6)	8.00	24.00	12.00	17.00	14.00	12.00	10.00
Current account, EUR m	-35,796	-16,735	6,220	-32,152	-26,500	-26,600	-27,700
Current account, % of GDP	-4.7	-2.5	0.9	-5.1	-3.8	-3.6	-3.5
Exports of goods, BOP, EUR m	149,908	151,682	162,818	147,299	155,000	163,000	171,000
annual change in %	8.6	1.2	7.3	-9.5	5.0	5.0	5.0
Imports of goods, BOP, EUR m	201,279	185,579	177,819	180,461	189,000	198,000	208,000
annual change in %	15.6	-7.8	-4.2	1.5	5.0	5.0	5.0
Exports of services, BOP, EUR m	46,936	50,108	56,908	30,138	38,000	40,000	42,000
annual change in %	12.1	6.8	13.6	-47.0	25.0	5.0	5.0
Imports of services, BOP, EUR m	23,969	23,555	25,082	21,698	23,000	24,000	25,000
annual change in %	2.7	-1.7	6.5	-13.5	5.0	5.0	5.0
FDI liabilities, EUR m	9,804	11,041	8,084	6,770	.	.	.
FDI assets, EUR m	2,419	3,017	2,611	2,716	.	.	.
Gross reserves of CB excl. gold, EUR m 7)	70,202	63,666	69,975	40,776	.	.	.
Gross external debt, EUR m 7)	378,289	386,686	386,777	376,000	404,000	404,500	414,000
Gross external debt, % of GDP	49.7	58.7	56.9	60.0	58.0	54.5	52.0
Average exchange rate TRY/EUR	4.1206	5.7077	6.3578	8.0547	8.90	9.70	10.30

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees; for construction wiiw estimate. - 3) Based on UN-FAO data, wiiw estimate from 2019. - 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.