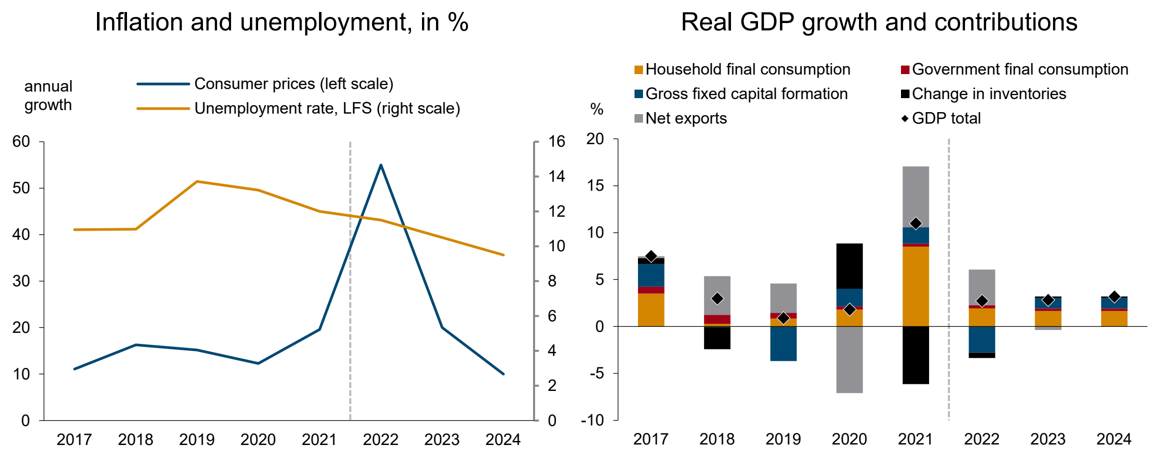
TURKEY: Back to the eye of the storm

RICHARD GRIEVESON

Even before Russia invaded Ukraine, Turkey was in big trouble, with inflation at eye-watering levels, a currency that had halved in value in just a few months, a rapidly expanding current account deficit and rising pressure on external financing due to aggressive Fed tightening. Now the situation is even more difficult, owing to Turkey's strong economic ties with Russia and its heavy reliance on commodity imports. The best-case scenario is a sharp slowdown in growth; meanwhile, the risk of a renewed period of macroeconomic and financial instability has increased.

Figure 4.22 / Turkey: Main macroeconomic indicators



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

Turkey's economy grew by 11% last year, one of the fastest rates of growth across CESEE. This achievement was all the more remarkable for the fact that Turkey was the only CESEE country to avoid full-year negative growth in the pandemic year of 2020, so that base effects were much less favourable than anywhere else in the region. That Turkey achieved such high growth is largely a reflection of the very expansionary policy mix – not least the credit-financed spending generated by ever-more negative real interest rates. Growth was also supported by a 24.9% real increase in exports, on the back of the strong global recovery and improved price competitiveness due to lira depreciation. Altogether in 2021, household consumption added 8.5 percentage points (pp) to growth, with a further 6.5 pp coming from net exports. Investment added 1.7 pp, while government consumption played its usual minor role in economic performance.

However, even before the Russian invasion of Ukraine, there were signs that some momentum was being lost (though it remained strong). Industrial output expanded by 7.6% year on year in January – still a healthy rate, but the weakest outturn for a year and a half. Retail sales volume growth also slowed to 7.9% in January, its lowest rate of expansion since before the pandemic.

Much of the weaker momentum at the start of this year can be attributed to the crisis in Turkish markets towards the end of 2021, which was triggered by massive monetary loosening in the second half of the year. Some 400 basis points of interest rate cuts in the face of high and rising inflation caused the lira to roughly halve in value in just a few months. In combination with rising international commodity prices, this pushed inflation up to eye-watering levels: by March of this year, consumer prices were growing at over 61% year on year. In the face of all this, the central bank has resolutely stuck to its course of keeping the nominal policy rate at 14%, thus driving real rates very deep into negative territory. While this has contributed to another boom in lending, the consequent levels of inflation are having a seriously negative impact on real incomes and on consumer and business confidence.

In this already challenging environment, Russia's invasion of Ukraine is an economic and financial disaster for Turkey. As a country heavily reliant on commodity imports, with strong economic ties to both countries, and with a currency that tends to weaken sharply at times of elevated risk aversion, Turkey finds itself somewhat in the eye of the storm. About 75% of all its wheat imports come from Ukraine and Russia. Meanwhile, its exports to Russia were worth about USD 6bn last year. There are few available data points to gauge the concrete impact so far, but what information is available suggests that the effects have already started to be felt. In March, Turkey's manufacturing Purchasing Managers' Index (PMI), for example, fell below the crucial 50 level (which separates expansion from contraction) for the first time in 10 months. Business confidence also fell in March, while consumer confidence remains profoundly gloomy. The lira has also weakened further since the invasion.

One area where the impact will immediately be felt is in Turkey's external accounts, with the current account deficit set to widen considerably in 2022. The collapse of the value of the lira, combined with the doubling of oil prices over the last year, means that in local currency terms the cost of energy imports has skyrocketed. Much the same can be said of imported food. Although one month's data should always be treated with caution, it is notable that, according to the central bank, in January 2022 the current account deficit increased by 300% year on year, driven above all by the increase in the value of goods imports. As the year wears on, the external balance may also suffer from a reduction in tourism flows from Russia. Turkey hosted 4.7m Russian tourists in 2021 – 19% of all visitors, and the most from any single country. There are, however, two factors that will partially offset the increase in the current account deficit. First, goods exports will rise sharply in volume terms, reflecting the improvement in external competitiveness caused by the weaker lira. And second, the steep increase in import prices will weaken demand, which in turn will lead to slower growth in goods imports. We expect the current account shortfall to reach the equivalent of 6.3% of GDP this year, compared to 1.8% in 2021.

The authorities are pursuing an unorthodox policy in their attempt to stabilise the lira, and further currency weakness looks likely. A resistance to conventional monetary tightening, reinforced by the president's view that higher interest rates lead to higher inflation, meant that even in the face of sharp depreciation in late 2021, the central bank did not raise the policy rate. Instead, the authorities introduced a new policy, encouraging residents to save lira deposits in special accounts that compensate for currency loss. This seems to have had some impact on the lira: although the currency has continued to depreciate, the pace has slowed considerably since the measures were announced. The president's unorthodox views on inflation no doubt play an important role in this stance. But in addition, it would seem that, faced with the existing currency depreciation and rocketing international commodity prices, the authorities have given up trying to control inflation, and will instead seek to pump as much stimulus as possible into the economy ahead of the 2023 election. Needless to say, that is an extremely high-risk strategy.

As a result of this position, inflation will remain high for some time, even by Turkish standards. We expect consumer price inflation to average 55% this year, while producer price inflation could be around 20 pp above that. Import prices will be a major part of this story, due to the double effect of lira depreciation and increases in dollar-denominated commodity prices. Wages may keep up – the authorities have increased the minimum wage by 50% for this year – but that will not fully cushion the blow, especially for the poorest households. Surveys show rising dissatisfaction with the government over the cost of living.

Putting all this together, clearly the economy is going to struggle this year. Growth may remain positive, but not by much. We expect a real expansion of 2.7% in 2022 – a sharp slowdown from last year, but otherwise not too far above the average rate for 2018-2020. This great volatility in the growth rate reflects the high-risk policy mix that prioritises short-term growth momentum above all else and that has locked Turkey into a boom-bust cycle. We expect the drivers of growth to be similar to last year, with credit-financed consumption and exports playing a key role. The latter will again be supported by the sharp depreciation of the currency, and the former by the negative real interest rates. Government spending will make a marginally positive contribution, while investment will subtract from growth, amid high uncertainty and caution among businesses.

The Turkish private sector has shown itself to be remarkably resilient over the past few years, and this resilience will again be tested in 2022. Since 2018, there have been two quite dramatic currency collapses; given the scale of FX short-term debt, these could have resulted in a more serious economic crisis. Hedging of foreign currency exposure has certainly helped, as has the smaller current account deficit (until recently). In addition, the foreign presence in local debt and equity markets has been much reduced, limiting the impact of capital flight at times of increased risk aversion. In recent years, Turkey's credit ratings have been cut deeper into 'junk' territory, so that some portfolio managers can no longer invest in Turkey, while many others no longer want to.

Despite this, the big risk for Turkey remains its external finances, and this risk is higher than usual due to both domestic and external factors. Domestically, a deeply negative real interest rate offers no protection for the lira, and although the rather unusual policy outlined above may have reduced 'domestic' capital flight (i.e. locals converting lira into dollars), it is unlikely to deliver lasting protection. Internally, a myriad factors create external financing risks, including higher commodity prices (and the consequent expansion of the current account), general global risk aversion and increasingly aggressive Fed tightening. The latter is very important for Turkey: it was one of the countries most affected when the initial 'taper tantrum' of 2013 caused capital flight from emerging markets, and each episode of US monetary tightening since then has created elevated external financing risks. With the external financing requirement set to rise sharply this year, at the very least Turkey can expect to pay higher interest rates to roll over its external debt.

The geo-politics and geo-economics of the war are very important for Turkey, and Ankara now has a role as the only realistic interlocutor between Russia and Ukraine – or indeed Russia and the West. Turkey supplied the Bayraktar TB2 drones that seem to have played a big part in the Ukrainian success so far; but it has also resisted joining most of the sanctions on Russia, and has very successfully positioned itself as a mediator. The US seems to be taking a softer line on Turkey than in the recent past.

The medium-term outlook remains quite underwhelming for Turkey, and it seems that the economy will continue to struggle to tap its undoubted potential. We maintain our view that the Turkish economy could develop in a very positive way – ensuring rising per capita incomes and a generally higher standard of living for its citizens, and at the same time offering an interesting destination for foreign investors. However, at present (and for some time past), the policy mix is too chaotic and too focused on short-term priorities, and it has created a damaging boom-bust cycle of ever-increasing frequency. Until that changes, we believe that the average growth rate is likely to be around 3% per year – a disappointing outturn, given the economy's potential.

Table 4.22 / Turkey: Selected economic indicators

	2018	2019	2020	2021 1)	2022	2023 Forecast	2024
Population, th pers., average	81,407	82,579	83,385	84,147	85,157	86,179	87,213
Gross domestic product, TRY bn, nom.	3,759	4,318	5,047	7,209	11,500	14,200	16,100
annual change in % (real)	3.0	0.9	1.8	11.0	2.7	2.8	3.2
GDP/capita (EUR at PPP)	19,180	18,470	18,410	21,700	.	.	.
Consumption of households, TRY bn, nom.	2,099	2,441	2,845	3,970	.	.	.
annual change in % (real)	0.5	1.5	3.2	15.1	3.5	3.0	3.0
Gross fixed capital form., TRY bn, nom.	1,115	1,117	1,382	2,016	.	.	.
annual change in % (real)	-0.2	-12.4	7.2	6.4	-10.0	4.0	4.0
Gross industrial production 2)							
annual change in % (real)	1.1	-0.6	2.2	16.5	3.1	2.8	2.8
Gross agricultural production 3)							
annual change in % (real)	-0.9	4.1	3.0	3.0	.	.	.
Construction industry 2)							
annual change in % (real)	-5.0	-8.0	-3.0	3.0	.	.	.
Employed persons, LFS, th, average 4)	28,734	28,081	26,808	28,827	30,100	31,100	31,900
annual change in %	1.9	-2.3	-4.5	8.0	4.5	3.3	2.5
Unemployed persons, LFS, th, average 4)	3,535	4,461	4,063	3,916	3,910	3,650	3,350
Unemployment rate, LFS, in %, average 4)	11.0	13.7	13.2	12.0	11.5	10.5	9.5
Reg. unemployment rate, in %, eop	.	.			.	.	.
Average monthly gross wages, TRY 5)	3,597	4,470	4,595	5,630	13790	20190	24870
annual change in % (real, gross)	-0.7	7.9	-8.5	2.5	58.0	22.0	12.0
Consumer prices (HICP), % p.a.	16.3	15.2	12.3	19.6	55.0	20.0	10.0
Producer prices in industry, % p.a. 5)	27.0	17.6	12.1	43.9	75.0	22.0	11.0
General governm. budget, nat. def., % of GDP							
Revenues	29.8	29.8	29.6	30.0	29.4	30.6	31.0
Expenditures	32.5	32.9	32.5	33.5	32.6	33.0	33.0
Deficit (-) / surplus (+)	-2.8	-3.2	-2.8	-3.5	-3.2	-2.4	-2.0
General gov. gross debt, nat. def., % of GDP	30.2	32.7	39.5	40.4	43.5	46.4	48.0
Stock of loans of non-fin. private sector, % p.a.	9.6	10.2	35.3	32.4	.	.	.
Non-performing loans (NPL), in %, eop	3.9	5.4	4.1	3.1	.	.	.
Central bank policy rate, % p.a., eop 6)	24.00	12.00	17.00	14.00	14.00	14.00	12.00
Current account, EUR m	-17,586	4,777	-31,325	-12,484	-37,300	-37,400	-37,500
Current account, % of GDP	-2.7	0.7	-5.0	-1.8	-6.3	-5.8	-5.5
Exports of goods, BOP, EUR m	151,681	162,777	147,053	190,413	232,000	244,000	256,000
annual change in %	1.2	7.3	-9.7	29.5	22.0	5.0	5.0
Imports of goods, BOP, EUR m	185,543	177,804	180,242	215,159	293,000	308,000	323,000
annual change in %	-7.8	-4.2	1.4	19.4	36.0	5.0	5.0
Exports of services, BOP, EUR m	49,925	56,149	30,901	48,276	72,000	78,000	84,000
annual change in %	6.4	12.5	-45.0	56.2	50.0	8.0	8.0
Imports of services, BOP, EUR m	24,153	25,612	20,898	26,818	39,000	42,000	45,000
annual change in %	0.8	6.0	-18.4	28.3	45.0	7.0	7.0
FDI liabilities, EUR m	10,662	8,547	6,815	11,586	.	.	.
FDI assets, EUR m	3,019	2,630	2,798	5,491	.	.	.
Gross reserves of CB excl. gold, EUR m 7)	63,666	69,975	40,776	64,182	.	.	.
Gross external debt, EUR m 7)	372,689	370,292	352,739	389,426	353,800	400,200	399,100
Gross external debt, % of GDP	56.6	54.5	56.3	56.8	60.0	62.0	59.0
Average exchange rate TRY/EUR	5.7077	6.3578	8.0547	10.5124	19.50	22.00	23.80

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 2020. - 4) From 2021 new methodology in line with the Integrated European Social Statistics Regulation (IESS). - 5) Personnel costs. 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 in 2021. - 5) Domestic output prices. - 6) One-week repo rate. - 7) Converted from USD.

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