Turkey

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Economic activity has rebounded rapidly, fueled initially by a massive credit expansion. The expansion came at the price of increasing already existing imbalances. Although some stabilization has been seen lately, inconsistent and unpredictable monetary policies has sparked a marked deterioration in financial market sentiment.

Country Risk Analysis

Recent economic developments

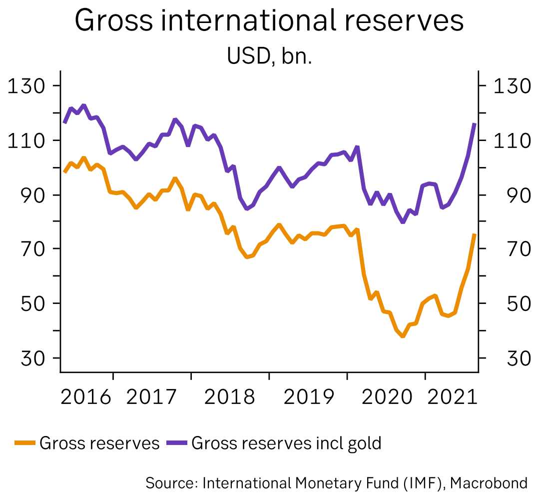
Rapid bounce-back in economic activity. Turkey's growth performance over the past year has been stronger than expected and better than most emerging markets. Strong domestic demand in general and investments in particular lifted GDP by more than 21% yoy in Q2. The number naturally benefited from favourable base effects from the previous year and the quarterly rise was more modest (0.9% qoq). Unfortunately, the economic expansion has come at the price of increased macro imbalances such as a higher current account deficit, rising inflation and a depreciating currency.

Depreciating currency adds to global inflation pressures. Inflation has been on a rising trend since early 2021 driven partly by global increases in food and energy prices. On top of that, the past year's depreciation of the exchange rate is feeding through to prices, generating inflation rates above those of most emerging economies. The headline inflation rate is at nearly 20% while core inflation, which has become the central bank's favoured measure, recently hit 17%. Inflation expectations have been heading up in tandem.

External balances weakened in 2020 but have stabilised in 2021. External vulnerability had been rising in the years prior to the pandemic, meaning buffers were relatively low when entering the past year's downturn. A low level of savings is a key reason behind a long-running deficit on the current account. The deficit rose to -5.1% of GDP in 2020, but balances have been improving in 2021, mainly on the back of a recovery in the tourism sector.

New foreign borrowing finances the deficit. Capital inflows have been low in the past few years but have picked up significantly in 2021. Since foreign direct investment (FDI) continued to decline last year, the current account deficit was mainly financed by a drawdown of foreign reserves. Although the banking sector has been deleveraging since 2018, portfolio flows and external borrowing by banks and corporates are normally the main means of financing the deficit. Despite some further deleveraging in 2020 the broader private sector still accounted for more than three quarters of overall gross external debt. Total debt rose to 61% of GDP by early 2021, mainly due to lira depreciation. An increasing share, about one third, is short-term. Net debt is also higher than average. Rating agency Fitch estimate that the corporate sector's foreign liabilities will exceed their foreign assets by about USD 130 bn in 2021. According to the central bank, near-term risks are mitigated by corporates having foreign currency cash balances that exceed short-term debt.

Reserves have recovered but are not fully usable. Reflecting the declining trend in capital inflows over the past years, foreign currency reserves have gradually been depleted. With capital flows gradually returning, reserves started edging up in mid-2020 and recently received an extra boost from the IMF's one-off allocation of SDRs (USD 6 bn). Gross reserves surpassed USD 81 bn in August. However, this includes deposits that the banks have to hold with the central bank as reserve requirements (with the option to do so in foreign exchange) and central bank swaps, mostly with domestic banks. These foreign currency funds are in practice only borrowed from the banking system. The IMF recently concluded that net reserves (subtracting also the Treasury's FX deposits at the central bank) are negative to the tune of USD 70 bn.



Rating agencies have kept sovereign ratings stable. Following one downgrade with a maintained negative outlook in September 2020, the major sovereign credit rating agencies have remained on the side lines over the past year. However, another agency upped the outlook for the sovereign from negative to stable in early 2021, mainly arguing that economic policy making had become more orthodox. This was before the March firing of the central bank governor (see below).

Country risk premiums have risen. Starting at the time of the firing of the Governor, financial market sentiment turned sour. Bond spreads versus Germany rose to levels not seen since 2019. After the new management starting to cut policy interest rates in September, sentiment worsened further. This has also been reflected in CDS spreads rising steadily, erasing the gains made since the start of the previous interest rate tightening cycle. Meanwhile, the exchange rate has depreciated to long-term lows versus the US dollar while the stock market has underperformed that of European peers.

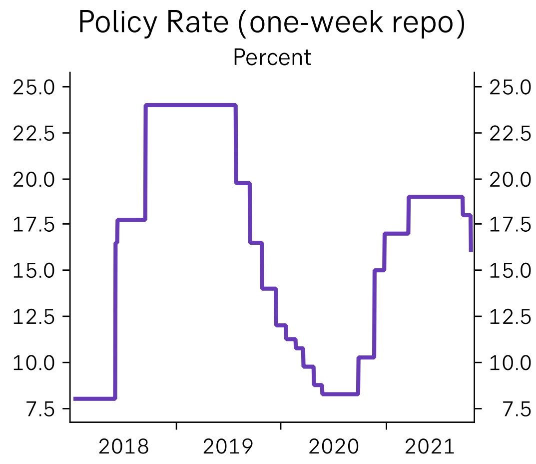
Economic policies

Fiscal response to the downturn was modest. The authorities' policy response to the downturn mainly came from loose monetary conditions and the state-owned banks fuelling a credit boom, facilitated by regulatory changes. The fiscal policy response, on the other hand, was modest. With government revenues outperforming expectations, the general government deficit was limited to 5.2% of

GDP. The government is on track for meeting its target for a *central* government deficit of 3.5% of GDP in 2021.

Government debt rose but remains moderate. Gross general government debt rose to 39.8% of GDP in 2020 (32.7% in 2019). This is still moderate. Contingent liabilities come on top of that debt number but are manageable. A relatively high and rising share of foreign denominated debt (more than half) makes it vulnerable to lira depreciation. Nevertheless, the IMF expects the debt ratio to edge down to 38% this year helped by strong nominal growth.

Central bank's erratic behaviour causes uncertainty. Starting in late 2020, the implementation of a stronger monetary policy framework and a period of policy tightening had gradually succeeded in stabilising the exchange rate and FX reserves. These fortunes turned in March, however, when the central bank governor unexpectedly was removed after just four months in office. This once again reflected the central bank's very limited independence. Policy uncertainty increased and inflation expectations rose. An unexpected policy rate cut in September (inflation far exceeds the bank's 5% inflation target) added to these uncertainties. A second rate cut recently took the main policy rate to 16%, which means a negative real rate irrespective of if deflated by headline CPI or using core inflation.



Source: Central Bank of the Republic of Turkey (TCMB), Macrobond

Banking sector's external funding needs is a vulnerability... Low savings by households and corporates have since many years forced Turkish banks to seek funding abroad to meet domestic credit demand. Banks' reliance on market funding in general is among the highest in emerging markets. A key vulnerability for the system is thus banks' needs for refinancing of these loans. So far in 2021, there are no indications that banks have had any difficulties in rolling over longer-term debt, despite the volatile market conditions. Similarly, larger Turkish corporates have been able to issue new longer-term debt in global markets in 2021, at lower interest rates than the government.

…but sector remains broadly stable. Another source of banks' financing, foreign currency deposits, often a sign of lack of confidence in the central bank, rose as a share of total bank deposits in 2020 but have subsequently remained broadly stable. More than half of total bank deposits are in US dollars. Although potentially a source of volatility, these deposits have historically proven relatively stable. Meanwhile, aggregate soundness indicators relating to profitability and to capital adequacy have weakened somewhat over the past year while the share of non-performing loans edged down to 3.6% of total loans in Q1 2021. On a separate note, The Financial Action Task Force (FATF) recently added Turkey to its grey list of jurisdictions that need increased monitoring due to risks of money laundering and financing of terrorism. This implies a downside risk to capital flows.

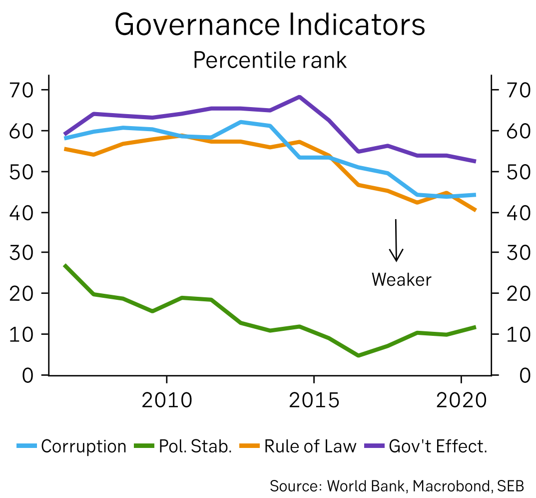
Political and security situation

Governing coalition losing public support. President Erdogan's approval ratings plunged to near record lows during the summer on the back of wildfires, migrant inflows and economic woes. Similarly, the support for the ruling AKP-MHP alliance is also down. At the same time, the opposition has grown stronger over the past year. Elections are due by 2023 at latest, but some experts predict snap elections already by mid-2022. As elections approach, a further clampdown on the opposition is expected as are efforts to ramp up domestic support by various foreign-policy initiatives. Meanwhile, the risk of social unrest is rising, reflected for example in the mass demonstrations this summer.

Geopolitical factors further raise political risk. Relations with the EU and the US remain tense. Although tensions relating to the Eastern Mediterranean have eased, migration flows, the Turkish presence in northern Syria and President Erdogan's declaration of closer military cooperation with Russia remain issues that cause uncertainty and raises risks. The US which has already sanctioned officials connected to Turkey's defence industry, has warned the NATO ally not to buy more Russian weaponry, and may table new sanctions in the near-term. Some observers expect Turkey to become increasingly isolated and therefore increasingly eager to reach out to Russia. At the same time, the government was among the first to reach out to the Taliban in Afghanistan and has recently taken steps to normalise relations with Egypt and the UAE.

Structural issues

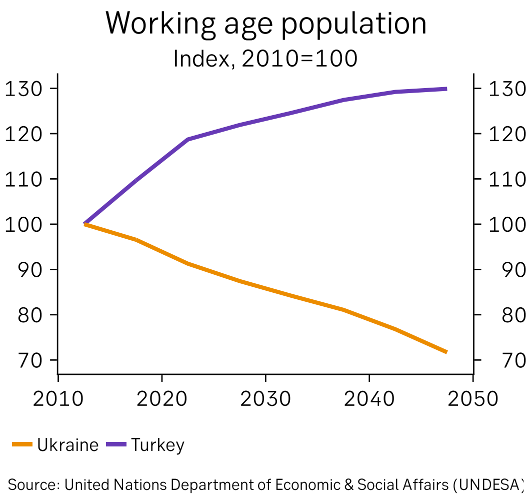
Weakening quality of governance. A weakening quality of governance and institutions reduces the predictability of policies. The deterioration in these factors in recent years is reflected for example in an increasingly authoritarian regime and clampdown on opposition and media (and in World Bank governance indicators). On the other hand, structural factors such as per capita incomes and the quality of the business climate are stronger than most peers, despite the former declining for the past 8 years.



Outlook

Uncertain outlook. In the near-term, the authorities are likely to continue pursuing economic growth at the cost of various imbalances. Helped by carry-over effects from last year, this will lift GDP growth to about 9% in the current year. For 2022, the outlook will be more challenging as a further moderation in the credit stimulus will take away an important growth driver. Continued fiscal stimulus may only partly compensate for this. As a result, GDP growth is likely to slow to about 2.7%. Meanwhile, erratic monetary policy is expected to preserve an environment of high inflation and a volatile exchange rate. Inflation is forecasted to end at about 17% in 2021 and to average 14.5% in 2022, significantly above most emerging markets.

Long-term growth potential capped by low productivity. Longer-term growth is supported by a favourable demographic structure, with a growing working age population for decades to come. However, inefficiencies in the labour market makes it challenging to create new jobs at the pace required. In addition, productivity growth has decreased. This is a key reason for relatively dismal estimates of potential GDP growth around 3%. To raise growth, the IMF highlights the need to improve the quality of education, to strengthen the business environment and to improve the regulatory predictability, among other measures.



Domestic risks from erratic policies and social tensions. Given that the central bank largely is in the hands of politics, there is a clear risk that political pressures will push monetary easing too far. This could spark an accelerated depreciation which could weaken corporates' balance sheets and worsen bank asset quality. This in turn would risk trigger deleveraging and lower growth. Alternatively, it could lead to a new credit boom which would likely fuel inflation and lead to a widening current account deficit. The risk of a response in the form of capital controls cannot be excluded. Another risk highlighted by the IMF as a high probability/high impact risk is that social tensions increase further on the back of rising prices and discontent with the handling of the pandemic.

External risk from global investor sentiment. The high external refinancing needs makes the country vulnerable to shifts in global market sentiment. The widely anticipated interest hikes in advanced economies may come sooner or be more significant than expected which could lead to higher global risk aversion and higher risk premia for Turkey's borrowings. This, in turn, would impact growth and external balances.

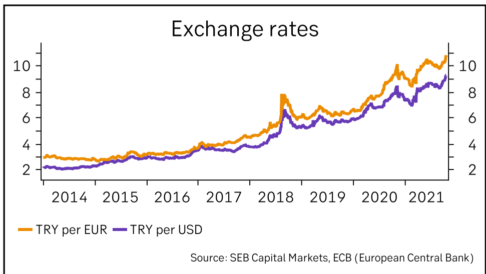
Turkey: Key Economic Indicators

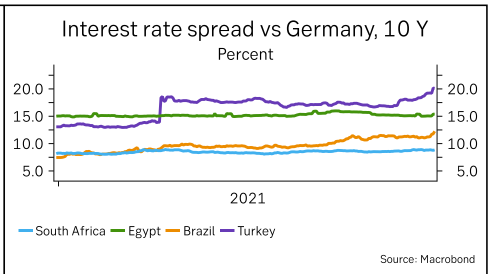
	2017	2018	2019	2020	2021	2022	2023	2024
Macroeconomic								
GDP (% chg)	7,4	3,3	0,8	1,6	9,7	2,7	2,7	2,6
GDP (USD bn)	859	786	760	717	814	858	934	1026
GDP/capita (USD)	10576	9537	9093	8486	9560	10019	10866	11887
Investments/GDP	29%	29%	25%	26%	26%	26%	26%	26%
Trade/GDP	46%	51%	50%	52%	56%	57%	56%	55%
Oil production, bpd ('000)	49,2	54,9	57,5	61,7	64,7	62,0	63,8	65,9
Money & Prices								
CPI inflation (%, eoy)	11,9	20,3	11,8	14,6	18,1	12,9	9,4	8,7
Money supply, M2 (% chg)	10,8	11,1	11,1	12,6	11,2	10,8	10,3	10,2
Interest rate, short-term	12,5	19,3	20,2	11,0	18,7	15,8	12,5	10,5
Oil price (USD, Brent)	54,3	71,1	64,4	41,8	71,4	66,2	58,5	57,6
Government Finances								
Budget balance/GDP	-2,2	-3,9	-5,6	-5,2	-4,9	-5,6	-5,9	-5,9
Govt debt/GDP	28%	30%	33%	40%	38%	38%	39%	40%
Interest rate costs/revenues	9%	10%	12%	13%	17%	20%	19%	19%
Balance of Payments (USD bn)								
Current account	-40,8	-21,7	6,8	-37,3	-26,4	-27,5	-27,5	-34,0
as % of GDP	-4,7	-2,5	0,8	-5,4	-3,3	-3,2	-2,9	-3,3
Exports of goods	169,2	178,9	182,2	168,4	211,8	222,7	236,1	251,4
Imports of goods	227,8	219,6	199,0	206,3	246,2	267,1	285,5	308,0
FDI, net	8,3	9,2	6,3	4,6	5,2	6,4	6,7	7,1
as % of GDP	1,3	1,6	1,2	1,0	1,6	1,3	1,3	1,3
Loan repayments	69,2	68,0	69,2	55,3	37,2	29,5	17,0	11,8
External Debt & Liquidity (USD bn)								
Total debt	451,5	427,4	416,4	433,1	469,2	485,5	505,1	530,8
o/w short term debt	110,2	93,7	96,7	114,3	129,7	132,9	136,8	142,0
as % of GDP	47,7	57,4	50,0	55,9	53,6	50,8	48,5	46,3
Official gross reserves (ave.)	82,7	71,4	77,1	48,5	72,9	74,6	80,0	85,3
months of imports	4,6	4,1	4,5	2,8	3,0	3,3	3,3	3,3
Exchange rate vs USD	3,65	4,82	5,68	7,01	8,32	9,3	9,68	9,84

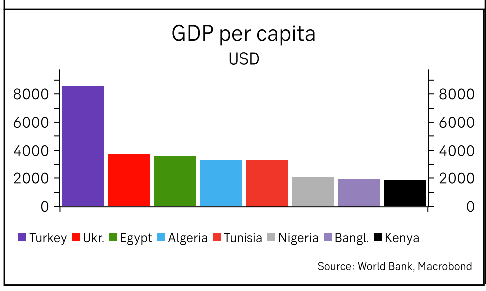
Source: Oxford Economics, IMF

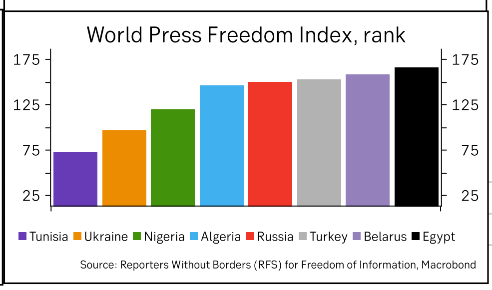
Rating history (eoy)				
Fitch	BB+	BB	BB-	BB-
Moody's	Ba1	Ba3	B1	B2

Type of government:	Presidential democracy
Next elections	Parliamentary 2023, presidential 2023
Other:	
Latest PC deal	-
Latest IMF arrangements	Stand-By arrangement, expired 2002









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