TURKEY: ‘Blowing in the wind’ of international capital flows

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Turkey is in the thrall of a renewed emerging markets volatility; in fact Turkey is one of the two economies most strongly affected by it (the other one being Argentina). The higher vulnerability of Turkey which shows up in a reversal of foreign capital flows and strong pressures on the exchange rate is the result of a history of high current account deficits, relatively low reserves, a delayed response by the Turkish Central Bank (TCB) to increase interest rates and the relatively short-term nature of foreign loans taken up over the recent period. wiiw expects the recent vigorous response by the Turkish Central Bank, which increased interest rates by roughly 400-500bp, to reduce the 2014 growth rate of GDP to 2.2% and then a gradual return to the longer-run potential growth path of 4.5% by 2016. The significant devaluation will improve the current account balance but impact negatively on inflation, which will remain higher than the TCBs target rate.

These are turbulent times for Turkey, economically and politically. Economically, we have seen the new year coming in with strong devaluation pressures on the Turkish lira and dramatic policy responses by the Turkish Central Bank (TCB) hiking up interest rates to high levels thus attempting to stem haemorrhaging capital outflows. Politically, Prime Minister Erdoğan’s 10-year rule has come under strong pressure, first with very heavy-handed actions by the authorities when civil opposition groups opposed the conversion of Istanbul’s Ghezi Park into a shopping mall and then when severe corruption cases were brought against some of Erdoğan’s closest minsters and his son and he reacted with mass dismissals and attacks against the investigating judiciary and police. This all comes at an inopportune time for the Prime Minister as 2014 and 2015 are election years, with regional elections in March 2014, presidential elections in August 2014 and parliamentary elections in 2015 although these might be brought forward. The political turn of events has taken the international community by surprise and has also shaken somewhat the assessment of Turkey as a country following a path in which dynamic economic development combines with political moderation and democratisation.

Returning to the economy: International capital markets have been playing hot-and-cold games with a range of emerging market economies (EMEs) ever since there was a hint of phasing out the ‘quantitative easing’ policy by the US Federal Reserve Bank. This widely expected ‘tapering’ (reducing the massive liquidity injections by the Fed) caused immediate reactions on international financial markets, leading to a reversal of capital flows vis-à-vis the EMEs. During the international financial crisis EMEs had been hosts of considerable capital inflows where relatively high returns could still be obtained, while these were very low in consequence of the very lax monetary policy pursued in the advanced economies which were suffering from double-dip recessions.

The announcement and then the start of ‘tapering’ led to reverse these capital movements as expectations turned towards higher yields in the United States and in due course also in the euro area. The countries amongst the EMEs most vulnerable to such swings were countries with high current account deficits which were dependent on high external financing requirements of such deficits and which had built up external debt. As is usual in such circumstances, there is a dangerous feedback loop: a reversal of capital inflows leads to changes in exchange rate movements which in turn leads to a re-pricing of foreign loans, resulting in a worry about repayment of some of these FX loans, causing an increase in interest rates on further loans, which makes the re-financing of foreign debt more costly, which worries international investors … and they run for the exit. This is what we saw happening in a range of EMEs (Argentina, South Africa, Indonesia, Turkey) towards the end of 2013 and the beginning of 2014 and Turkey is the one country which was hit particularly strongly by these developments.

Arguments why Turkey is strongly affected by the recent attacks on EMEs range from particularly high external financing needs due to persistent high current account deficits combined with a relatively low level of reserves; furthermore, an unfavourable maturity structure of foreign loans which requires a faster rolling-over, high energy import dependency which makes current account adjustments difficult and, finally, a rather late response by the Turkish Central Bank to allow interest rates to rise rather than attempt to counter exchange rate pressures through FX sales from reserves. Finally, i.e. on 28th January 2014, the TCB reacted very strongly: it increased the one-week repo rate from 4.5% to 10.0% and adjusted its overnight interest rate corridor from 3.5-7.75% to 8.0-12.0%. Also the lending rate for primary dealers was raised from 6.75% to 11.50% and the late liquidity lending rate from 10.25% to 15.0%. Hence overall interest rates tightened by as much as 450 to 550bp. Through these actions the TCB also gave a signal of independence from political interference as political pressures had been high earlier on to keep interest rates low.

However, the dramatic shift towards a tight monetary policy regime will have strong implications on GDP growth in the current year. This is not unlike the impact of restrictive monetary policy in 2012 which brought down GDP growth from 9.0% and 8.8% in 2010 and 2011 respectively to 2.2% in 2012. Both monetary policy in the first half of 2013 had been relaxed (trying to reverse the unexpected overshooting of the GDP slowdown in 2012) with real interest rates being about minus 2%, and fiscal policy provided a stimulus with nominal primary spending growing at more than 15% for most of 2013. Public investment spending in particular provided the stimulus. Apart from that there was a strong upswing in private domestic spending in the first half of 2013 especially fuelled by strong credit growth which reached a peak of close to 40% in mid-year. Corporate lending was particularly high. The consequence was deteriorating current accounts where the deficit reached EUR 43 billion in 2013 compared to EUR 37 billion the previous year (the estimate for 2013 is that the current account deficit will be close to 7.0% of GDP as against 6.1% in 2012). This deficit was financed mostly by short-term flows with little contribution by FDI flows. Inflation was also accelerating to 7.5% p.a. (January-November 2013), substantially above the TCB target of 5.5% p.a.

The general assessment is (see e.g. IMF Country Report 13/363 Article IV Consultation) that the rather unorthodox measures employed by the TCB (see wiiw Turkey analysis in the June 2013 Forecast Report) to both keep capital inflows at bay through low interest rates in the first half of 2012 and contain credit growth through a reserve requirement policy which attempted to soak up FX inflows, were not too effective. They could not contain the high increase especially of corporate FX debt which in the current context makes repayment of that debt vulnerable to exchange rate volatility. The lira-euro exchange rate jumped from a low level of 2.2 lira per euro in May 2013 to a peak of 3.12 lira per euro in January 2014. Since then it has come down somewhat (currently traded at 3.0 lira per euro) but this obviously generates a much higher burden on the corporate sector than was envisaged when loans were taken out in mid-2013.

Banks do not seem to be too vulnerable as their capital buffers are high and with a capital adequacy ratio of 16%. There is little direct FX balance sheet exposure of banks but they are exposed to the indirect risks of non-financial corporates given that their FX borrowing had jumped from USD 78 billion in 2008 to USD 165 billion by the end of 2013. A sharp downturn in growth will markedly reduce the earnings position of corporates in 2014 in the domestic market and hence their earnings will depend on the pick-up of export activity; the latter is itself dependent on the development of economic activity particularly in the EU and, of course, competitiveness where the depreciation of the currency will be of assistance.

The longer-term development of exports is favourable as export activity is based on an increasingly diversified structure of economic activity both with regards to products as well as with regards to regions and types of enterprises involved in export activity. As reported in previous wiiw country analyses, Turkey's export activity has widened to include a much wider range of enterprises in the interior of the countries which produce more traditional, labour-intensive types of products and catering also to more regional non-EU markets (as compared to the export industries located around the traditional Western export regions which have seen a significant upgrading over the recent years). These developments make Turkish exports more sensitive to exchange rate developments and hence the recent substantial devaluation will assist export activity in 2014. The lacklustre export performance in 2013 was due to earlier appreciation pressure, the low growth in the EU and to a level effect as very high gold exports in 2012 accounted for an exceptional increase in exports in that year. On the import side one has to remember that a significant share of the negative trade balance is accounted for by high net imports of energy (the current accounts in per cent of GDP without fuels amounted to +0.5% in 2012 and to -0.9% in 2013, while with fuels it was -6.2% in 2012 and -7.4% in 2013). Hence policies to reduce the high reliance on energy imports are an essential element of a longer-term strategy to reduce Turkish vulnerability on the current accounts.

Other issues long debated amongst Turkey analysts are measures to increase Turkey's savings rate which is seen by some as being causally responsible for the high current account deficits. In our opinion the low savings might be more a function of the availability of cheap foreign loans and the exceptionally low (real) interest rates over the past years. The corrections underway both on international financial markets as well as the change in TCB policy are likely to contribute to correct this situation. The impact of the change in policy on the inflation front will be double-edged: on the one hand, there will be an upward pressure on inflation as a result of the strong devaluation; on the other hand, reduced growth will dampen inflation. Overall, inflation will remain above the TCB's target rate of 5.5%. We might continue to observe some fiscal over-spend (as was the case in 2013) compared to official fiscal plans as 2014 is a multiple election year so that we might witness a restrictive monetary policy scenario combined with maintaining somewhat elevated public spending.

Summarising the growth prospects for 2014 to 2016: we expect a strong impact of the change in monetary policy, of capital flow reversals and thus of tightened credit markets on domestic demand and project GDP growth to be in the region of 2.2% in 2014 (significantly lower than the government forecasts and also those of most other forecasters). Devaluation and the expected pick-up of growth in the EU will lead to a significant improvement in the current accounts and growth will depend predominantly on more favourable net exports. For 2015 and 2016 we expect a gradual return to the potential long-term growth path of the Turkish economy of 4.5 5.0% p.a.

Table 1 / Turkey: Selected Economic Indicators

	2009	2010	2011	2012	2013 1)	2014	2015 Forecast	2016
Population, th pers., average	72050	73003	73950	74954	75860	76600	77400	78200
Gross domestic product, TRY bn, nom.	952.6	1098.8	1297.7	1415.8	1579.8	1710	1880	2100
annual change in % (real)	-4.8	9.0	8.8	2.2	3.8	2.2	3.5	4.5
GDP/capita (EUR at exchange rate)	6100	7500	7500	8200	8200	8800	9900	11700
GDP/capita (EUR at PPP - wiiw)	10900	12200	13400	13700	14300	.	.	.
Consumption of households,TRY bn, nom.	680.8	787.8	923.8	994.3	1119.1	.	.	.
annual change in % (real)	-2.3	6.7	7.7	-0.6	4.7	0.2	2.0	4.2
Gross fixed capital form., TRY bn, nom.	160.7	207.8	283.2	286.9	306.2	.	.	.
annual change in % (real)	-19.0	29.9	18.0	-2.7	2.6	-3.0	3.0	10.0
Gross industrial production								
annual change in % (real)	-9.8	12.8	10.0	2.4	2.5	4.5	6.5	10.0
Gross agricultural production 2)								
annual change in % (real)	3.6	2.4	6.1	3.1	3.9	.	.	.
Construction industry								
annual change in % (real)	-16.3	18.6	11.4	0.7	7.5	0.0	8.0	10.0
Employed persons - LFS, th, avg.	21271	22593	24099	24819	25700	26300	27200	28800
annual change in %	0.4	6.2	6.7	3.0	3.5	2.5	3.5	6.0
Unemployed persons - LFS, th, average	3053	2696	2324	2202	2400	.	.	.
Unemployment rate - LFS, in %, average	12.6	10.7	8.8	8.2	8.5	9.0	9.0	8.5
Reg. unemployment rate, in %, average						.	.	.
Average monthly gross wages, manuf.ind., TRY	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	6.3	8.6	6.5	9.0	7.5	6.0	6.5	6.8
Producer prices in industry, % p.a. 3)	1.0	6.2	12.3	6.1	5.7	6.0	5.5	5.5
General governm. budget, EU-def., % of GDP 4)								
Revenues	36.6	37.3	36.6	36.2	37.6	37.0	37.5	.
Expenditures	43.1	40.2	37.4	38.6	39.3	40.0	39.0	.
Net lending (+) / net borrowing (-)	-6.5	-2.9	-0.8	-2.4	-1.7	-3.0	-1.5	.
Public debt, EU-def., % of GDP 4)	46.1	42.4	39.9	36.2	34.6	36.0	35.5	.
Central bank policy rate, %, p.a., end of period 5)	9.0	6.5	5.8	5.5	4.5	8.0	5.5	.
Current account, EUR mn	-8696	-34215	-53891	-37750	-48950	-24000	-42000	-59000
Current account, % of GDP	-2.0	-6.2	-9.7	-6.2	-7.9	-3.5	-5.5	-6.5
Exports of goods, BOP, EUR mn	78616	91292	103086	127050	123100	148000	170000	190000
annual change in %	-17.7	16.1	12.9	23.2	-3.1	20	15	12
Imports of goods, BOP, EUR mn	96145	133962	166978	177900	183200	192000	211000	243000
annual change in %	-26.7	39.3	24.6	6.5	3.0	5	10	15
Exports of services, BOP, EUR mn	25470	27776	29427	33550	35000	39000	44000	48000
annual change in %	1.0	9.1	5.9	14.0	4.3	12	12	10
Imports of services, BOP, EUR mn	12345	15033	15051	16000	17600	18000	19000	21000
annual change in %	-1.1	21.8	0.1	6.3	10.0	5	8	8
FDI inflow, EUR mn	6261	6803	11581	10290	9550	9000	11000	12000
FDI outflow, EUR mn	1110	1108	1710	3170	-2340	2000	3000	3000
Gross reserves of CB, excl. gold, EUR mn	49088	60411	60637	75733	84000	.	.	.
Gross external debt, EUR mn	186765	218417	235157	256757	280000	.	.	.
Gross external debt, % of GDP	42.4	39.7	42.4	42.0	44.9	.	.	.
Average exchange rate TRY/EUR	2.1631	1.9965	2.3378	2.3135	2.5335	2.53	2.45	2.30
Purchasing power parity TRY/EUR	1.2136	1.2336	1.3121	1.3745	1.4547	.	.	.

1) Preliminary and wiiw estimates. - 2) Gross value added of agriculture, forestry and fishing. - 3) Domestic output prices. - 4) According to ESA'95 excessive deficit procedure. - 5) From 2010 one-week repo rate, overnight lending rate before.
Source: National statistics (Central Bank, Turkish Statistical Institute - TSI, etc.), Eurostat. Forecasts by wiiw.