TURKISH ECONOMY

SHIFTING SANDS

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Shifting sands…

In 2020, countries across the world implemented vital measures against the scarring effects of the pandemic. Chief among these were balance sheet expansion (printing money) of central banks and massive fiscal support. When pandemic hit, the Turkish economy was far more fragile due to high dollarization and elevated inflation; and was therefore fairly limited in the steps it could take. The country has no chance to significantly expand central bank balance sheet as the advanced economies did as a policy response due to its high inflation numbers. And as a remedy, in 2020, Turkey had built a response of historically large credit expansion with negative real rates.

The Turkish economy posted a positive real GDP growth at 1.8% yoy in 2020 amid this significant credit impulse through the year (40% yoy, almost 3x acceleration as compared to a decade average). The early stimulus relied primarily on rapid monetary and credit expansion, including policy rate cuts, cheap and rapid lending growth by state-owned banks, and regulatory measures (Asset Ratio) designed to boost credit.

Despite some fiscal space, direct fiscal measures amounted to just 2.5 percent of GDP, mainly in the form of tax deferrals, but also including employment support and allowances. These combined measures boosted economic activity in the second half of 2020 to above pre-pandemic levels, with Turkey becoming one of the few countries posting positive GDP growth in 2020.

Although this policy choice helped achieve positive growth in an unprecedented year, the costs were higher inflation and the sizeable need for external financing today. These combined measures helped economic activity rebound strongly but also led to an unavoidable rise in inflation (currently @16.2% yoy by March 2021), deteriorated external balances and depleted central bank's reserves.

Macro Indicators (Period Average)

	2004-2012	2013-2015	2016-2020
GDP (bnUSD)	877,7	867,1	717,0
GDP (YoY, %)	5,7	6,5	3,3
CPI	8,8	8,0	12,7
CBRT Funds Rate	12,8	7,8	13,9
Budget Balance (% GDP)	-2,4	-1,1	-2,2
Current Account Balance (% GDP)	-5,1	-4,4	-3,0
External Debt (% GDP)	37,5	43,5	53,1
Private Sector	22,5	30,2	35,5
Public Sector	12,7	12,9	17,1
USDTRY (eop, %)	20,1	43,0	131,8

Source: TDM, TUSIAD Calculations

From November 2020 - March 2021, thanks to effective monetary policy implementation to fight against inflation, capital inflows accelerated, predictability in financial markets increased and the risk premium (CDS) decreased from 550 to 300 bps level. The lira regained some of its value, becoming the best performing currency among its peers, during the period.

More recently, the sustainability problem in macroeconomic policy implementation have reemerged following the sudden replacement of Central Bank Governor in March 2021. In the very short term, the diminished predictability and repetitive policy changes result in the depreciation of the Lira and once again rise in country's risk premium and finally threat over inflation outlook and growth.

Following this recently emerged news flow, we now address two most imminent issues facing the Turkish economy in the short term which are elevated inflation and soaring external financing need. Both of these factors will be the main determinants of growth for the rest of 2021. We also be closely watching the potential changes and developments in credit policies in the near term.

As we have observed in the past, if the country returns to a policy of supporting economic growth with low interest rates and high credit impulse, without addressing elevated inflation, we must be cognizant of the risk of increased vulnerabilities. These previously experienced imbalances would hinder longer-term growth and employment, even if the high growth rates are within reach in the very short term with a cost of inflation.

Mounting risks over inflation…

Inflation in Turkey was 14.6% yoy at the end of 2020, while the country's average inflation in the last three years was 13.5% yoy. After the successful fight against inflation from 2002 to 2013 and the implementation of effective inflation targeting policies, the failure to take the necessary micro-structural steps in the post-2013 period (such as in the food-agriculture sector), and the mistakes in monetary policy implementation, inflation gradually entered a stubborn upward trend.

The pressure of balance of payments over the economy, mainly stemming from the inadequate policy choice in between 2018 to 2020 was resulted in significant devaluation of the lira. And hence complicated the fight against inflation.

While the rising inflation and a marked decrease in purchasing power reduced both predictability and confidence in the economy, the dollarization rate has also increased over the years. Note that, dollarization rate (the share of foreign currency deposits in total deposits) which was 25% in 2013, has now reached 55% at the beginning of 2021. While the effectiveness of monetary policy decreases in a semi-dollarized economy, the repetitive changes in Central Bank governorship in recent years and the deterioration in policy construction make it even far more difficult to drop inflation. As a result of a decline in the ability to develop sound economic policies, structural inflation increased in recent years and reached a sticky level, in the 12-14% range.

Following these developments, we now expect inflation - at 16.2% yoy March 2021 – to remain in double digits throughout 2021 and to end the year above 13% yoy.

In the near term, there appears four major risks over short-term inflation outlook which may deteriorate the previously estimated disinflationary outlook for the second half of this year:

- Ongoing rise in global commodity and food prices
- Recent depreciation of the Lira and pass-through into inflation
- Deterioration in inflation expectations and rising inertia (backward indexation) problem
- Reacceleration in consumer loans

We deem that a further measured monetary policy tightening is likely to be needed in near future as the inflation expectations fail to stabilize and new risks have emerged. Any premature easing should also be avoided, to control inflation and prevent capital outflows.

Rising external financing need amid a shaky global environment…

Another issue which creates structural imbalances has been the increasing need over the years for external financing. Since 2013, the share of total external financing requirement in has increased from 15% to 30%.

The vulnerability driven by high inflation and the high current account deficit increases the risk premium and makes foreign borrowing costs higher. With high dollarization at home, and fluctuating global environment, the hurdles in attracting capital from abroad may result in continued pressure over the Lira going forward.

We calculate an external financing need of USD220bn (30% GDP) in 2021. USD180bn of this is private sector (bank & non-bank) and public external debt payments, and USD40bn of it is stemming from our current account deficit forecast. Despite the still loose financial conditions in the global arena, we deem emerging markets to face further difficulties in attracting capital through 2021, due to volatile global environment with rising inflation fear in advanced economies and potential taper talk in global financial markets. During this period, economies with only strong macro indicators be able to attract sufficient capital inflows among others.

Macro Projections

	2019	2020	2021E TUSIAD	2021E Bloomberg*
GDP (bnUSD)	761	717	750	750
Growth (%, real, YoY)	0,9	1,8	4,5	5,0
Inflation (%, eop)	11,84	14,6	13,1	14
Current Account Balance (bnUSD)	6,8	-36,8	-40,0	-22,5
Current Account Balance (%GDP)	0,9	-5,1	-5,1	-3,0
Budget Balance (bnTRY)	-124,8	-172,7	-245.0 **	-262,0
Budget Balance (%GDP)	-2,9	-3,4	-4.3 **	-4,6

Source: TDM, TUSIAD Calculations

* Consensus

** NEP 2021-23

E: Expectations

Growth: A deleveraging story…

At the beginning of the year, we assume "Vaccine-powered recovery in global economic activity" as the most likely scenario. Global economic activity continues to accelerate amid the strength of the manufacturing sector and continuing vaccination. Herd immunity is expected to be achieved by 3Q21 in developed countries, to be followed by the EMs in the year-end.

Under this scenario, at the beginning of the year, we projected a 4.5% yoy real GDP growth in Turkey in 2021. However, news risks have emerged affecting our growth forecast like the unrest in financial markets, depreciation of the currency and rising external financing costs.

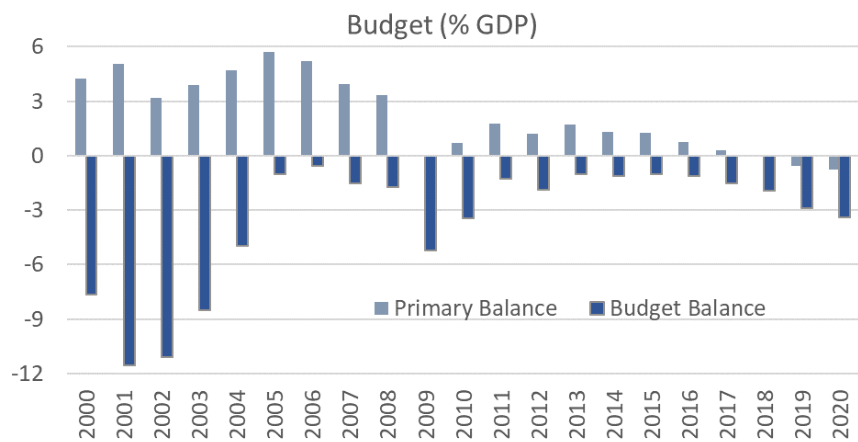
It is likely that BoP dynamics and capital inflows will be less helpful throughout the year and support growth less than we originally forecasted at the beginning of the year. In contrast with this downside risks, we also will need to review our growth forecast in case a new credit package is introduced.

Recall that the final quarter of 2020 registered an annual real growth rate of almost 6%, we observe that growth slowed to 4% - 5% level as of the first quarter of 2021. All in all, despite the ambiguities, we currently maintain our full year 2021 growth forecast of 4.5% at this stage; with 5 ppts of this growth originates from domestic demand while net foreign demand is estimated to slash 0.5 ppts from total. According to the first quarter indicators, economic activity is currently tracking 5% yoy real growth.

Fiscal Balance

In 2020, the budget deficit was TRY173bn (3.5% GDP), while the primary deficit was TRY38.8bn (0.8% GDP). The IMF-defined primary deficit, which excludes one-off revenues, was TRY128bn (2.6% GDP). Under the 2021-2023 New Economy Program (NEP), the budget deficit is projected at TRY245bn, 4.3% of GDP in 2021.

In brief, we deem that in 2021, the policy position that should be adopted to control fiscal policy must focus on spending discipline and control over specific expenditures rather than generating revenues through tax rises. With the help of these savings, rather than generating revenues via tax rises, more fiscal room will be provided to transfer funds to support the workforce during the pandemic.



Banking Sector Selected Indicators

	2014	2015	2016	2017	2018	2019	2020
Total Assets (bnTRY)	1994	2357	2731	3258	3867	4491	6106
real growth (yoy, %)	6,4	8,6	6,7	6,6	-1,3	3,8	18,7
% GDP	97,1	100,3	104,0	104,0	102,9	103,9	121,0
Total Loans (bnTRY)	1241	1485	1734	2098	2394	2656	3576
as of total assets (%)	62,2	63	63,5	64,4	61,9	59,1	58,6
% GDP	60,4	63,2	66,0	67,0	63,7	61,5	70,8
Non-Performing Loans (bnTRY)	36,4	47,5	58,2	64,0	96,7	150,8	152,6
% Total Loans	2,9	3,2	3,4	3,1	4,0	5,7	4,3
Deposits (bnTRY)	1053	1245	1454	1711	2036	2567	3455
Total Equities (bnTRY)	232,0	262,3	300,3	359,1	422,1	494,2	599,6
Net Profit for The Period (bnTRY)	24,6	26,1	37,5	48,6	54,1	49,0	58,5
Return on Assets (%)	1,23	1,11	1,37	1,49	1,40	1,09	0,96
Return on Equity (%)	10,6	9,9	12,5	13,6	12,8	10,0	9,8

Source: BRSA, TDM

Macroeconomic Indicators

	2014	2015	2016	2017	2018	2019	2020
GDP Growth (%)	4,94	6,08	3,32	7,5	2,96	0,92	1,76
Nominal GDP (bnTRY)	2,055	2,351	2,627	3,134	3,758	4,32	5,048
Nominal GDP (bnUSD)	940	867	869	859	797	761	717
Nominal GDP per capita (USD)	12,178	11,085	10,964	10,696	9,792	9,213	8,599
CPI Inflation (%, eop)	8,2	8,8	8,5	11,9	20,3	11,8	14,6
Unemployment Rate (%)	9,9	10,3	10,9	10,9	11	13,7	13,2
Central Gov't Budget Balance (bnTRY)	-23,4	-23,5	-29,9	-47,8	-72,8	-124,7	-172,7
% GDP	-1,1	-1	-1,1	-1,5	-1,9	-2,9	-3,4
Central Gov't Primary Balance (bnTRY)	26,5	29,5	20,3	8,9	1,1	-24,8	-38,8
% GDP	1,3	1,3	0,8	0,3	0,0	-0,6	-0,8
Central Gov't Debt Stock (% GDP)	29,8	28,8	28,9	28	28,4	30,8	35,9
Domestic Debt	20,2	18,7	17,8	17,1	15,6	17,5	21
External Debt	9,6	10,1	11,1	10,9	12,8	13,3	14,9
Foreign Trade Balance (bnUSD)	-84,6	-62,6	-52,9	-74,2	-54	-29,5	-49,8
Total Exports (bnUSD)	166,5	151	149,2	164,5	177,2	180,8	169,7
Total Imports (bnUSD)	251,1	213,6	202,2	238,7	231,2	210,3	219,5
Current Balance (bnUSD)	-38,8	-27,3	-27	-40,8	-21,7	6,8	-36,7
% GDP	-4,1	-3,2	-3,1	-4,8	-2,7	0,9	-5,1
USDTRY (eop)	2,32	2,92	3,52	3,78	5,27	5,94	7,43
yearend, %	9,22	25,41	20,6	7,18	40,01	12,48	24,91
EURTRY (eop)	2,83	3,19	3,71	4,52	6,03	6,62	9,13
yearend, %	-3,65	12,61	16,52	21,72	33,81	10,26	36,84
EURUSD (eop)	1,218	1,091	1,054	1,18	1,15	1,113	1,228
Benchmark Interest Rate (comp, eop)	7,97	10,78	10,65	13,4	19,68	11,74	14,96

Source: CBRT, TURKSTAT, Ministry of Treasury and Finance of Turkey