Turkey: Rebalancing challenges for the economy and lira

Turkey's economy has weathered the pandemic better than many other countries, thanks to a supportive policy mix. But the unprecedented stimulus has also created growing macroeconomic imbalances. In this article, we examine what this could mean for the economy and the lira in 2021

The impact of the pandemic on Turkey has turned out to be less severe than for many other countries owing to a supportive policy mix, but this has come with a deterioration in inflation and external imbalances. Policymakers have responded with a number of positive steps to restore macroeconomic stability, with these efforts more evident on the monetary and credit side. While the policy mix has been successful so far, the uptrend in commodity prices and a recent increase in short-term external leverage could pose challenges:

- **The strong uptrend in commodity prices that started in 4Q20 is poised to create challenges.** Inflation has remained on an upward trend in recent months and we believe that commodity prices are likely to further weigh on input costs, and hence the inflation outlook. Thus, monetary policy should remain tight for even longer to contain inflationary effects while a further rate adjustment is also a possibility.

Higher commodity prices can also limit the improvement we expect on the current account balance. Tight credit policies and demand control has become even more important for the external outlook.

- **While having improved, Turkey's external balance sheet remains vulnerable, given high external financing requirements** (US$189bn or 27% of GDP at end-2020) in addition to the current account deficit (INGF: -3.0% of GDP in 2021). Moreover, last year's decrease in gross FX reserves to US$51.6bn at end-2020 (from US$81.2bn at end-2019) means that these only cover 26% of combined external financing needs. However, all in all, short-term external debt repayment obligations seem manageable and we have seen a gradual build-up in FX reserves from the lows of US$40.4bn in November 2020 to US$54.5bn at end-February.

The expected start-of-the-year TRY overshoot is now behind us (with most of the TRY-specific positive news in the price). Although USD/TRY may return to the 7.30 level once the sell-off in UST stabilises, we look for a higher USD/TRY by year-end (7.80) as CPI will remain in double digits and the Central Bank of Turkey may start easing from late 3Q onwards. But compared to the taper tantrum in 2013, TRY is fundamentally stronger.

Macro forecasts

	2019	2020	2021F	2022F
Real GDP (%YoY)	0.9	1.8	5.0	4.5
Nominal GDP (US$bn)	764	716	774	821
GDP per capita (US$)	9,213	8,534	9,209	9,640
CPI (average, %YoY)	15.2	12.3	14.3	10.5
Consolidated government balance (% of GDP)	-2.8	-3.4	-4.2	-3.6
Consolidated primary balance (% of GDP)	-0.5	-0.8	-0.9	-0.2
Total public debt (% of GDP)	33.1	35.9	36.9	35.7
Current account balance (% of GDP)	0.9	-5.1	-3.0	-2.5
Net FDI (% of GDP)	1.2	1.1	1.3	1.4
FX reserves ex gold (US$bn)	81.2	51.6	58.9	70.1
Import cover (months of imports)	4.9	3.0	3.1	3.4
Gross external debt (% of GDP)	56.8	61.6	58.7	56.5
Central bank key rate (year-end, %)	12.00	17.00	14.00	10.50
USD/TRY exchange rate (year-end)	5.95	7.43	7.80	8.50

Source: National sources, ING estimates

1 Strong impulse to mitigate downside risks in 2020

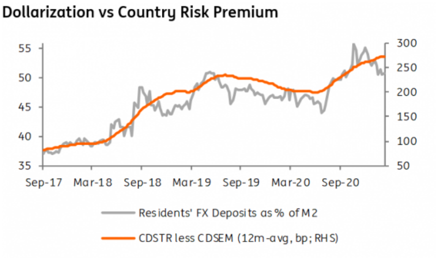
The impact of the pandemic on Turkey turned out to be less severe than was the case for many other countries, with GDP growth of 1.8% in 2020 thanks to a supportive policy mix especially in the first half - notably strong monetary, credit, and fiscal expansion to limit the downside in activity:

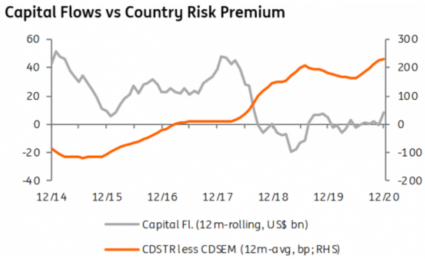
- On the monetary side, while cutting the policy rate markedly, the CBT also responded with significant liquidity injections to the system along with some macro prudential measures linking lending to the reserve requirement mechanism so as to sustain credit flow to the real sector and preserve financial stability.
- On the credit side, policymakers expected the banking sector to shoulder part of the burden for the economic fallout, leading to the largest ever credit impulse primarily driven by state banks, with private banks eventually also joining.

- Finally, the budget deficit rapidly widened in 2020, increasing fiscal funding needs and leading to higher domestic borrowing.

Unprecedented stimulus contributed to a recovery from the pandemic but has also caused growing macroeconomic imbalances, with rising inflation and widening external deficits. A jump in the risk premium has been a major factor for further dollarization and capital outflows. Accordingly, since early November policymakers have responded with a policy shift to restore macroeconomic stability including changes in the economy management team, with efforts more evident on the monetary and credit fronts.

Dollarization, capital flows and country risk premium





Source: Refinitiv, CBT, ING

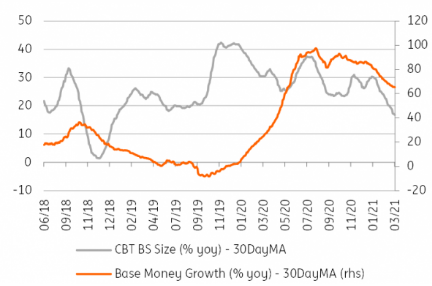
2 Shift in the policy framework since November

Monetary policy: Following last year's early policy moves backwards, we have seen a tightening on the monetary side including rate hikes along with a simplification of the monetary policy framework and greater acknowledgement of the risks. Subsequently, investor sentiment towards Turkish assets has turned more constructive in recent months. The Central Bank of Turkey's recent policy guidance to maintain "the level between the actual / expected inflation rate path and the monetary policy interest rate path" until reaching the 5% inflation target (projected to be in 2023 according to its latest forecasts) is a commitment of a tighter-for-longer stance with a signal to keep real policy rate high enough to pursue "a strong, continuously sustained disinflationary balance".

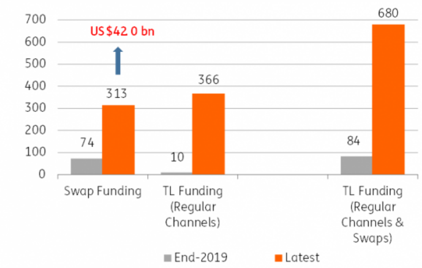
This is encouraging as it shows a long-term perspective with reference to the inflation target. So, as a first pillar of the current framework, the CBT has turned more vocal on keeping a tight stance for a longer period given the risk of inflation expectations and pricing behaviour diverging from the medium-term target path. It has kept the door open for additional front-loaded tightening. With this shift in policy stance and subsequent currency appreciation, policymakers likely anticipate disinflation in the period ahead. However, the recent rise in US rates weighing on the Turkish lira along with other emerging market peers could challenge these expectations.

CBT balance sheet, base money growth and CBT funding

CBT BS & Base Money



Total CBT Funding (incl. swaps, TRYbn)



Source: CBT, ING

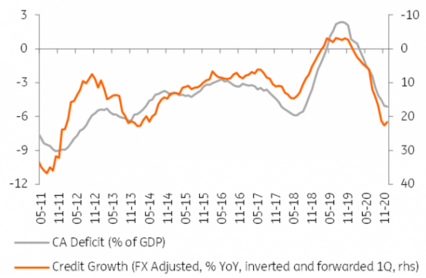
Credit policy: In its efforts to decelerate credit formation, Turkey's Banking Regulation and Supervision Agency first relaxed, then removed the asset ratio, reduced the general maturity limit for consumer loans, cut macro-prudential limits on offshore swap transactions and loosened limits on TRY transactions with foreign banks. In addition to a slowdown in credit formation, the measures will also support non-resident flows.

These steps, together with the contribution from the restrictive CBT stance, have been impactful on both corporate and consumer lending. The growth in the 13-week moving average FX adjusted lending volume returned to single digits in late 2020, after peaking at 140% for TRY commercial loans in mid-May, and at 125% in mid-August for consumer loans.

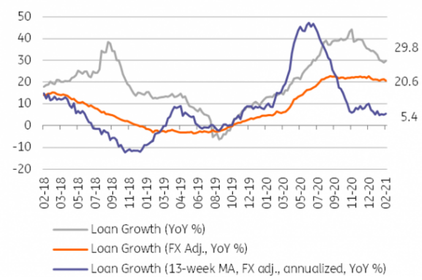
Even with the strong association between credit growth and the current account balance, we observed less impact from the pandemic on core imports (excluding gold and energy). This resulted in a higher trade deficit last year (along with other pandemic related effects on the goods and services balances). Policymakers' objectives under the second pillar are likely to include an improved external outlook, with a slowdown in credit expansion that should also contribute to easing exchange rate and inflation rate pressures.

Current account deficit vs credit growth and banking sector volume expansion

C/A Deficit vs Credit Growth



Banking Sector Volume Expansion



Source: CBT, BRSA, ING

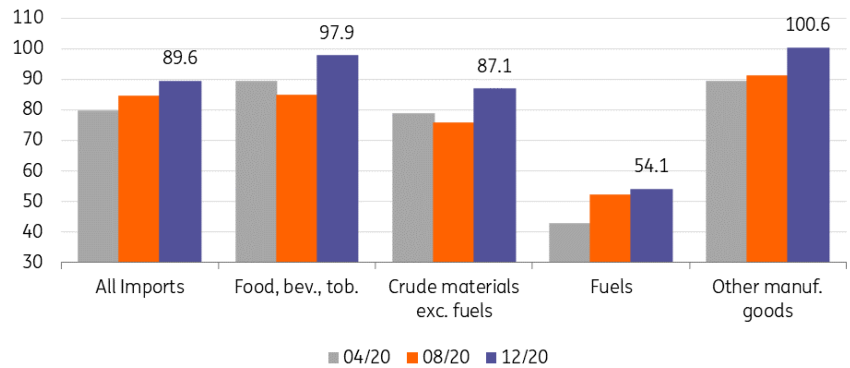
Fiscal policy: For 2021-23, the government's programme envisages a continuation of the supportive fiscal stance, with the primary balance to remain in deficit during the entire forecast period, albeit with an improving trend. However, the signals from the new Minister of Finance suggest more prudence to support the CBT and to restart a disinflation trend. This is in addition to his pledge to de-dollarize domestic debt, given large domestic FX debt issuances in the last few years. While there is a need for supportive policies on the fiscal side, efforts should focus on better management of non-interest spending and contingent liabilities, particularly given the need to reduce Turkey's risk premium.

All in all, the current framework relies more on monetary and credit measures to achieve disinflation and to improve external imbalances. Success on these objectives will be key for a sustainable recovery in capital inflows. Any reduction in external financing risks and de-dollarization of households' assets in return could lead the CBT to launch a rules-based mechanism to replenish reserves.

3 Challenges

Commodity prices: While disinflation and the current account deficit outlook are critical for the current policy framework, the strong uptrend in commodity prices that started in 4Q20 is poised to create challenges. As one of the key import items for Turkey, oil prices have increased by more than 60% since end-3Q20 to above US$60/bbl on the back of not only tight supply but also increasing optimism on the global recovery, with declining Covid-19 cases and the rolling out of vaccines.

Import Price Indices (2010=100)

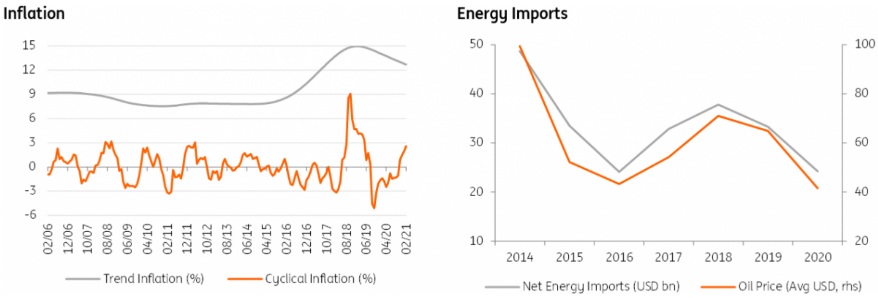


Source: TurkStat, ING

Growing inflation expectations owing to a loose monetary stance of global central banks coupled with large fiscal stimuli support the broader commodities complex. In fact, Turkey's import price index increased by close to 5% in 4Q20, driven primarily by food and non-fuel crude materials. We expect a continuation of this move, given a further rise in food, basic metal and energy prices in early 2021.

While a relatively high inflation trend, sticky services inflation, the possibility of administrative price adjustments and a deterioration in expectations have been factors contributing to concerns on the inflation side, cost-push factors have remained a major determinant and commodity prices are likely to further weigh on input costs, and hence the inflation outlook. Compared to our average oil price forecast for this year of close to US$65/bbl (ICE Brent), the CBT's assumption of US$54.4/bbl in the January inflation report seems to be quite optimistic. We can also make the same assertion about the bank's import price assumption, envisaging an average 6.5% increase in US$ terms this year although the current trend and some expectations imply a somewhat higher level. So, monetary policy should remain tight for even longer - to contain inflationary effects from commodity prices - while a further rate adjustment is also a possibility.

Inflation and energy imports



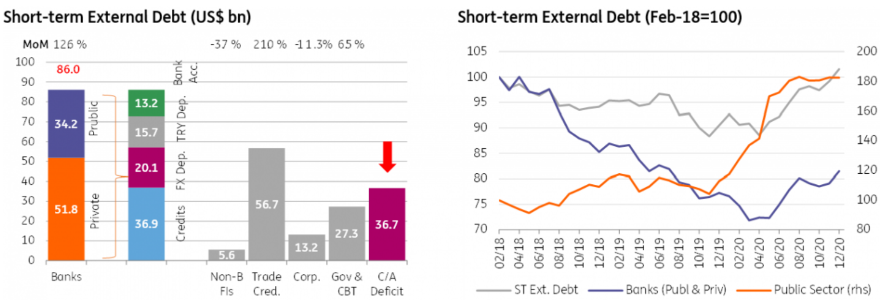
Source: TurkStat, ING

Regarding the external outlook, the current account deficit is expected to narrow in 2021 thanks to normalization efforts, mean reversion in the gold deficit and a recovery in tourism. However, the ongoing rise in import prices can significantly limit the improvement. So, depending on the extent of the commodity prices uptrend, a continuation of tight credit policy and demand control would become even more important for the external outlook.

All in all, commodity prices are a key challenge for the current framework of a tighter-for-longer credit and monetary stance. Any greater than expected deterioration in the growth outlook could impact the sustainability of these policies.

External Borrowing: Despite the volatility in external flows, Turkey was able to rollover much of its external debt last year. This was due to significant deleveraging following the August 2018 financial shock for the private and particularly the banking sector that has since improved sustainability. Accordingly, the external financing requirement for the 12 months ahead dropped from US$185.9bn (roughly 21% of GDP) in early 2018 to US$164.6 bn in April 2020. Public sector leveraging during this period offset some of the decline in the private sector's short-term external debt.

Short-term external debt



Source: CBT, ING

We have since seen a direction change, with external financing requirements reaching US$188.8 bn (c.27% of GDP) at end-2020 due to an increasing reliance on short-term external funding by the public sector (swap deal with Qatar central banks as the major driver) and the private sector (attributable to bank borrowing and to trade credits). While the success of the new policy framework should lengthen the investment horizon of foreign investors in the period ahead, it will take time and current short-term flows will add to overall external vulnerability, raising concerns amid already low reserves. However, all in all, short-term external debt repayment obligations seem manageable currently.

The peak in the lira is behind us

We entered the year with a very bullish TRY view. We were looking for frontloaded TRY gains in 1Q21, targeting an overshoot to USD/TRY 7.00, but a gradual TRY depreciation thereafter. The expected initial overshoot is now behind us (with most of the TRY-specific positive news in the price), and although USD/TRY may return back to the 7.30 level once the sell-off in UST stabilises, we look for a higher USD/TRY by year-end (7.80) though the pace of the lira depreciation should be gradual. USD/TRY at 7.80 still means meaningful lira outperformance vs FX forwards (by around 15%)

In terms of lira positives, the central bank's recent actions and its forward guidance suggest a cautious approach, with a willingness to hike rates further to stem inflationary pressures and keep the current real rate buffer in place. With FX reserves being reduced meaningfully last year, the interest rate is now the key buffer against lira weakness, suggesting a need for caution before reducing the restrictive policy stance. The shift in the CBT monetary policy stance and large rate hikes mean that TRY now benefits from the highest nominal and risk-adjusted carry in the EM FX space, with the margin of its carry advantage being material.

From a fundamental prospective, TRY screens as one of the cheapest EM currencies in real effective exchange rate terms. In contrast to the pre-2013 taper tantrum state of affairs, the lira's vulnerabilities are meaningfully lower in our view, with both valuation and the real rate being in much better shape. The outlook for the current account is also better now, with the deficit set to reduce further in coming quarters. This is a reason why we don't see the lira as one of the EM currencies most vulnerable to the possible repeat of a taper tantrum (see Timing the Tantrum) – as was the case in 2013 when TRY was the worst performing EM currency.

While vulnerabilities have been reduced and we retain a constructive outlook for the risk environment for 2Q, we look for some gentle upside pressure to USD/TRY from late 2Q onwards. First, although the CBT is currently highly committed to the restrictive policy stance, the likely reversal of the current policy stance (via rate cuts) from late 3Q onwards should also take away some support from the currency. While not necessarily our base case, the possible repeat of the 2018 roadmap where the CBT started to reduce tight monetary policy after nine months, and in a quick manner (which in turn led to weaker TRY) remains a risk to the currency. Second, while the Turkey current account position is likely to improve vs 2020 due to the policy normalization efforts, mean reversion in the gold deficit, and the recovery in tourism, it will still remain in deficit and rising commodity prices pose some downside risks for this year. Third, with CPI to remain persistently high and in double digits this year, the lira will experience a meaningful appreciation in real terms via the inflation channel, in turn reducing the pressure on the spot to close the valuation gap more forcefully.

Author

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Disclaimer