NATIONAL BANK OF GREECE

Economic Analysis Division
Emerging Markets Analysis

Special Issue: Turkey

Turkey's recurrent currency crises and its boom-bust growth model

NBG - Economic Analysis Division

Emerging Markets Analysis

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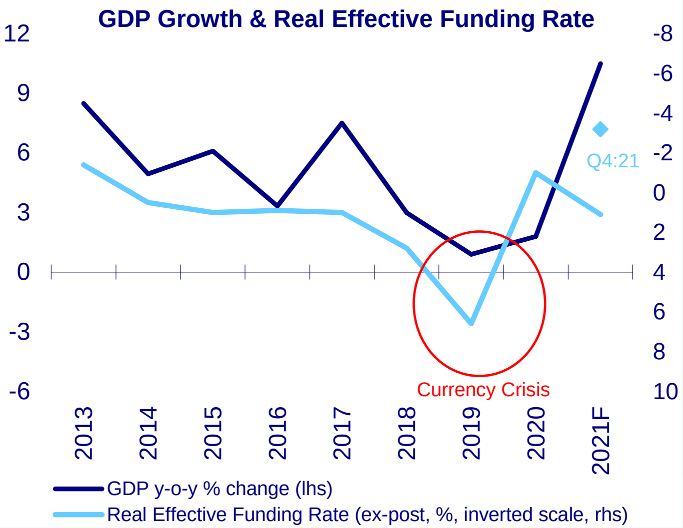
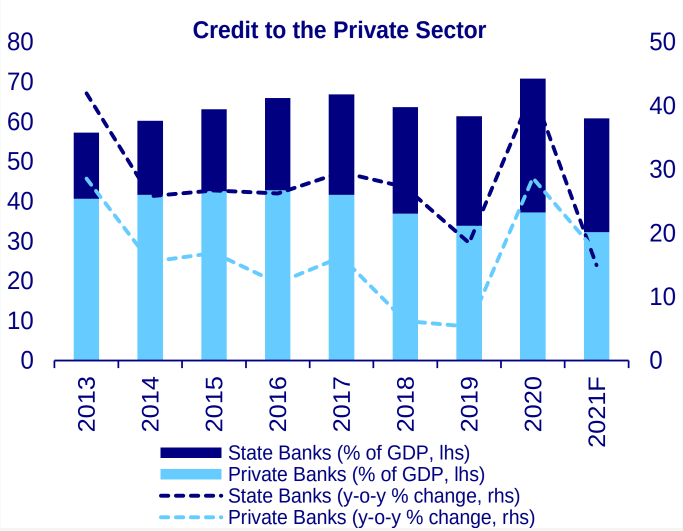
Executive Summary

- ✓ Turkey's **economic overperformance** compared with the Emerging Market average over the past decade has been largely driven by an **accommodative monetary policy** which boosted consumption and investment (especially construction), while prompting **a depreciation of the TRY**, at the same time, fostering export growth
- ✓ However, this seemingly robust performance has come **at the cost of a surge in inflation** to over 20%
- ✓ Meanwhile, **external imbalances persist**, as suggested by recurring current account deficits, keeping Turkey highly dependent on external financing, the quality of which has been progressively deteriorating
- ✓ Overtime, FX financing fell short of covering Turkey's FX needs, keeping the TRY on a steady depreciation path and **eroding external buffers**, with the CBRT's net FX reserves having long turned negative
- ✓ Looming **external debt repayments** cloud the outlook for the TRY, while **rising deposit dollarization**, fueled by stubbornly high inflation and weakening monetary policy credibility, poses an additional risk
- ✓ In view of Turkey's vulnerabilities, the recent easing delivered by the CBRT (including 500 bps in cumulative policy rate cuts since September) has significantly further shaken **confidence**, dealing a fresh blow to the TRY, which has lost more than 55% of its value against the USD y-t-d
- ✓ Although the CBRT has signalled that it would remain on hold for the time being, we believe that Turkey's risk premium and market volatility is unlikely to ease, unless the **vicious cycle of weakening TRY, rising inflation and increasing dollarization** is effectively broken
- ✓ In our view, a **timely tightening in monetary policy** is crucial to restoring confidence and policy credibility, thus preserving macroeconomic and financial stability,
- ✓ Such an adjustment will be difficult to implement, in view of the **unfavourable political backdrop**
- ✓ The establishment of a **stable and predictable policy environment** is a *sine qua non* condition for sustainable economic growth

Turkey's economic overperformance has been largely driven by an accommodative monetary policy…

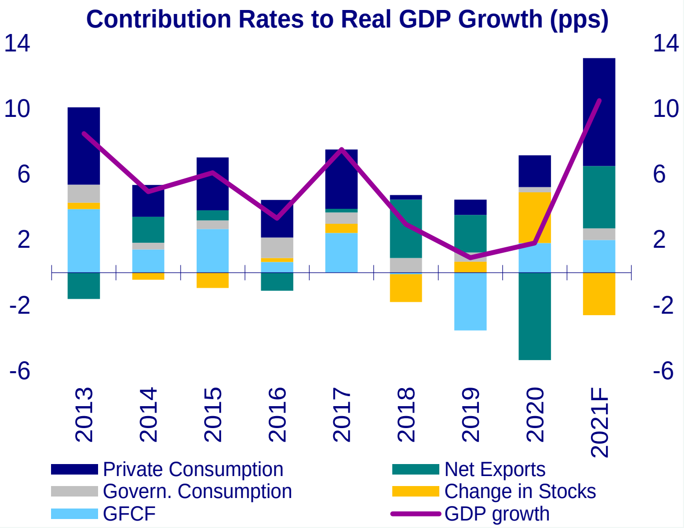
- ✓ Turkey's economic growth model over the past years relied on an **accommodative monetary policy**, as reflected in low (and often strongly negative) real interest rates and a weakening TRY
- ✓ A short-lived deviation from that model was only observed in the wake of the 2018 currency crisis, which prompted an emergency monetary policy tightening
- ✓ The recent massive easing delivered by the CBRT at end-2021 (see below) has shaken confidence significantly and fueled further inflation



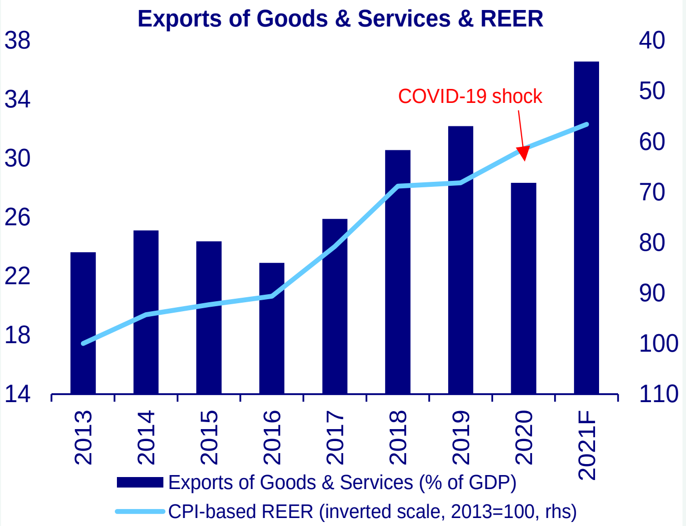


….which boosted domestic demand, while prompting a depreciation of the TRY, at the same time, fostering export growth

- ✓ This model resulted in robust GDP growth rates over most part of the past decade, well above those of Turkey's Emerging Market peers
- ✓ Unsurprisingly, GDP growth has been primarily **consumption-driven**
- ✓ Fixed investment (mostly in **construction**) has also provided a critical contribution, thanks to uninterrupted state support



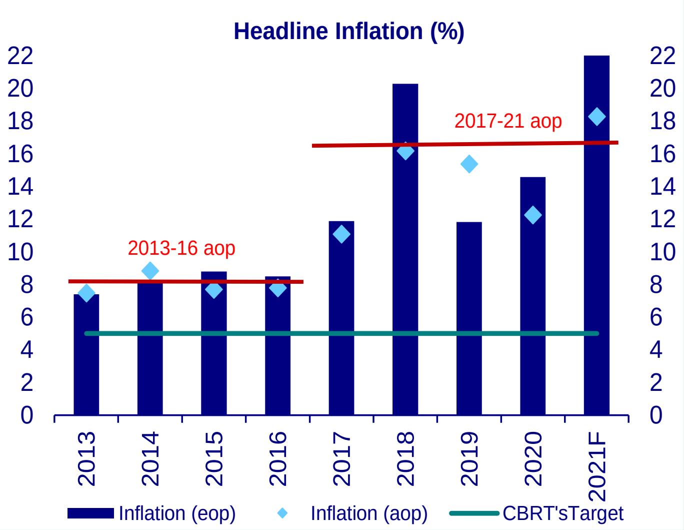
- ✓ At the same time, exports' contribution to overall growth has progressively increased, reflecting **improving price competitiveness**, following the depreciation of the TRY, and **growing export diversification**, especially towards medium and high tech products such as automotive and electronics



Sources: Turkstat, CBRT, BDDK & NBG estimates

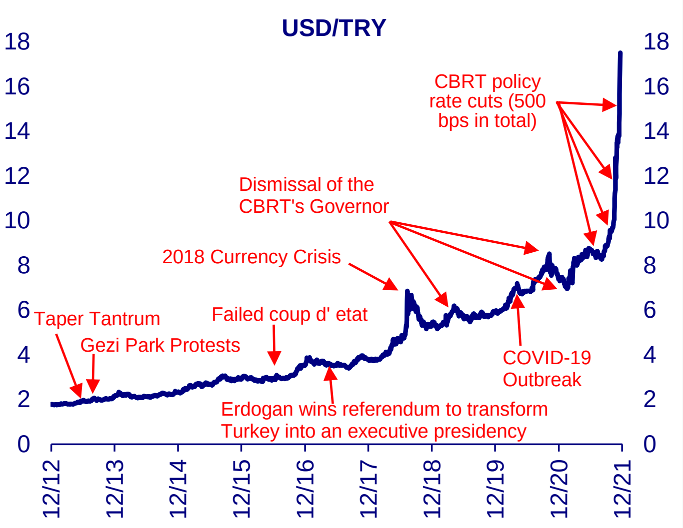
However, Turkey's growth model has come at the cost of a lasting surge in inflation

✓ Headline inflation has jumped to **double-digits** over the past 5 years, well above the CBRT's 5.0% target, reflecting…

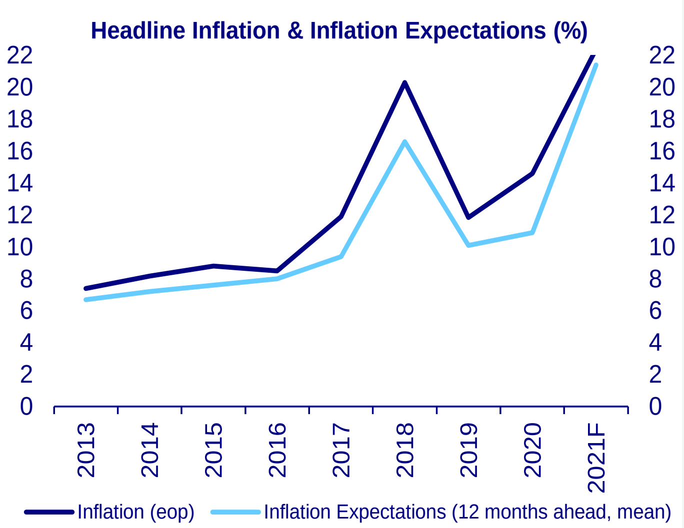


✓ … i) **protracted demand-side pressures**, as suggested by the persistent gap between productivity gains and nominal wage growth (with the latter exceeding underlying inflation, in a clear sign of an escalating wage-price spiral), and …

✓ …ii) the impact of the **sharp depreciation of the TRY**, given the high share of imported goods



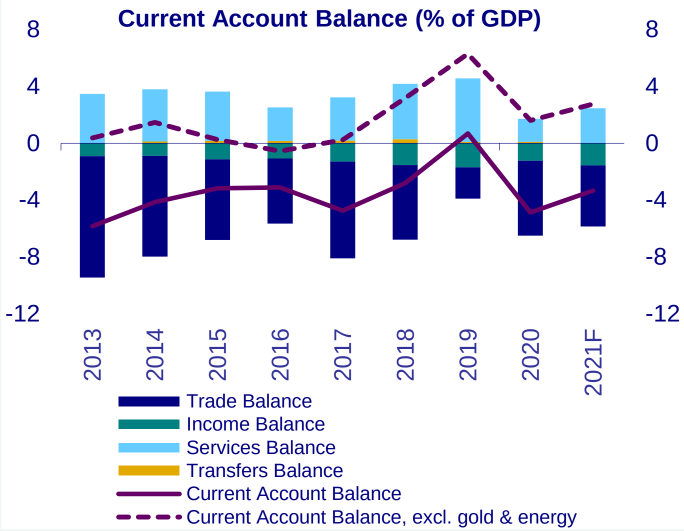
✓ Worryingly, steadily deteriorating inflation expectations undermine disinflation efforts, while suggesting **weakening policy credibility**



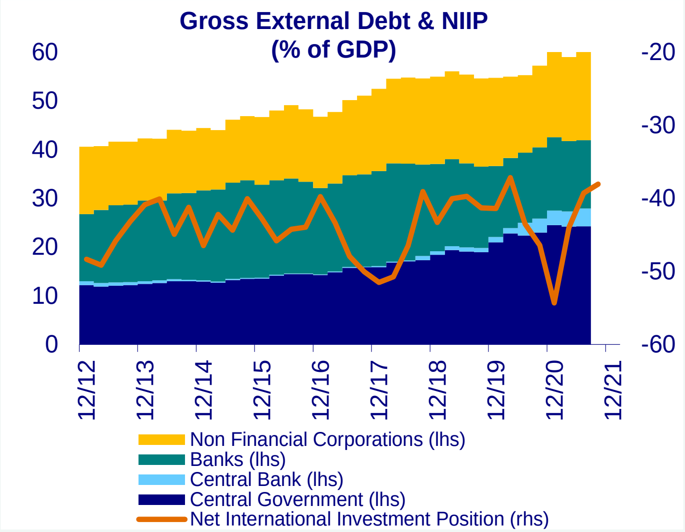
Sources: CBRT, Turkstat, & NBG estimates

Meanwhile, external imbalances persist, as suggested by recurring current account deficits, keeping Turkey dependent on FX financing

- ✓ Despite improving external trade dynamics, in line with the depreciation of the TRY, the **current account balance still remains in deficit**
- ✓ Turkey's almost complete reliance on imports to cover its energy needs has been a key factor behind this structural imbalance
- ✓ The surge in gold imports, reflecting weakening confidence in the TRY, amid stubbornly high inflation, has also taken a toll

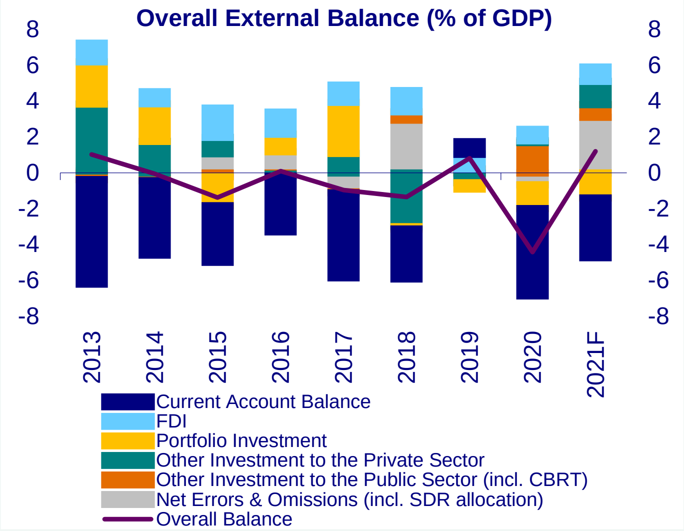


- ✓ On the flipside of persistent current account deficits and the weakening TRY, Turkey's **external debt has been steadily growing**, with the underlying net FX position deteriorating at the same time

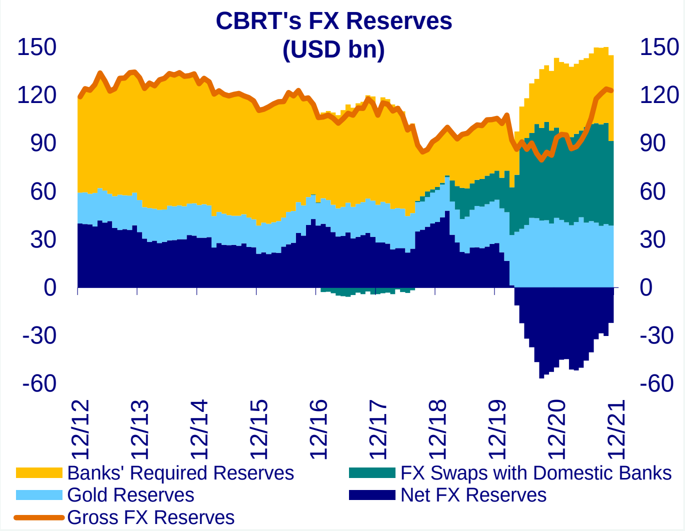


Eventually, FX financing has fallen short of covering FX needs, keeping the TRY on a steady depreciation path and eroding external buffers

- ✓ Worryingly, in light of declining confidence in the Turkish economy, the **quality and quantity of FX financing has deteriorated**, keeping the TRY on a steady depreciation path



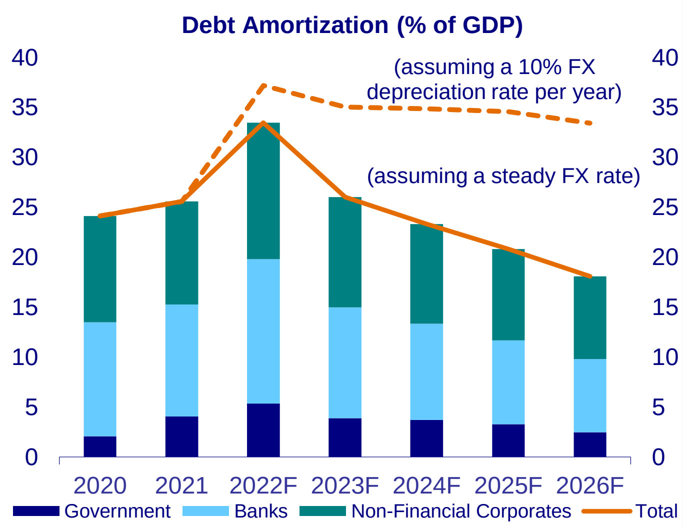
- ✓ Following the CBRT's unsuccessful attempts to brake the weakening of the TRY, **FX reserves have eroded** over the past years
- ✓ The CBRT's FX swap deals with China and South Korea, together with an SDR allocation by the IMF, provided some relief this year
- ✓ The picture gets much worse, when considering the CBRT's **net FX reserves**, which **have long turned negative**



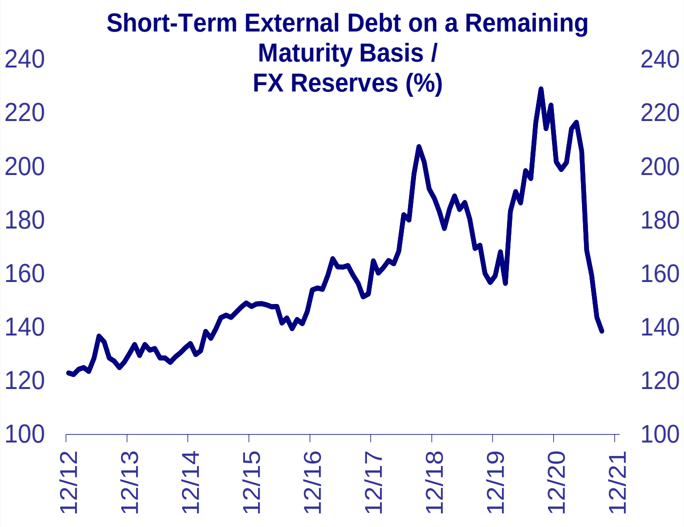
Sources: CBRT & NBG estimates

Looming external debt repayments cloud the outlook for the TRY, given the already weak external buffers, while…

- ✓ **High external financing needs** -- broadly equally split between banks and non-financial corporates -- expose the economy to significant **rollover risks** over the projection horizon
- ✓ The debt burden could increase substantially under a (further) FX depreciation shock

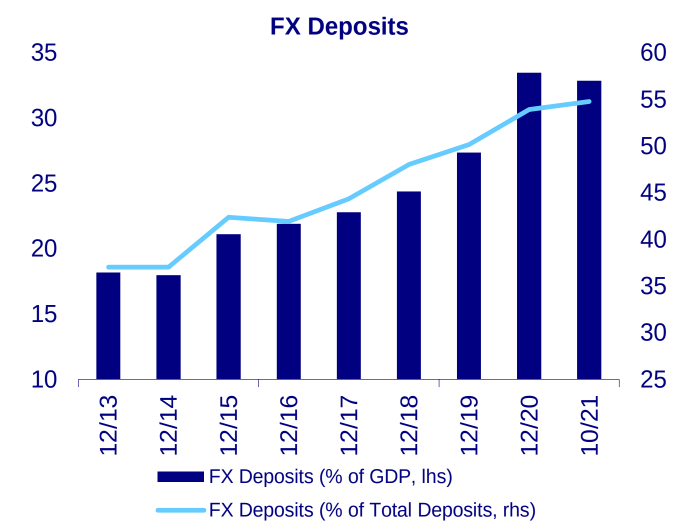


- ✓ Worryingly, despite the recent once-off injections in FX reserves, the latter still remain well below Turkey's short-term FX financing needs



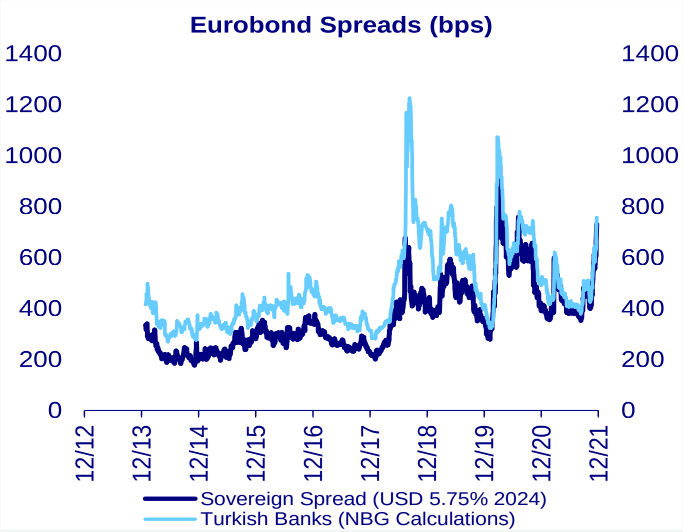
…rising deposit dollarization poses an additional risk

- ✓ Eroding confidence in the TRY, fueled by stubbornly high inflation and weakening monetary policy credibility, has been translated into rapidly **rising deposit dollarization** further exacerbating financial stability risks



Sources: CBRT, BDDK, IMF & NBG estimates

In view of Turkey's vulnerabilities, the recent policy easing delivered by the CBRT has significantly further shaken confidence



- ✓ Given Turkey's external imbalances and surging inflation, the recent easing delivered by the CBRT (including 500 bps in cumulative policy rate cuts -- to 14.0% -- since September) has led to a further sharp deterioration in confidence in the Turkish economy, dealing a fresh blow to Turkish assets and the TRY
- ✓ The latter has lost more than 55% of its value against the USD y-t-d and a whopping 78% over the past 4 years
- ✓ At the same time, the sovereign spread (2025) against the USD benchmark surged to over 700bps, with that of Turkish banks jumping even higher

A timely tightening in monetary policy is crucial to preserving macroeconomic and financial stability

- ✓ Although the CBRT has signalled that it would remain on hold for the time being, we believe that Turkey's risk premium and market volatility is unlikely to ease, unless the vicious cycle of weakening TRY, rising inflation and increasing dollarization is effectively broken
- ✓ In our view, this can be effectively achieved only through a **reversal of the monetary easing** carried out so far rather than through imposing restrictions on FX outflows
- ✓ The picture gets further complicated, when considering the global tightening trend, which increases Turkey's disconnection from the global financial cycle
- ✓ Recall that, in 2018, authorities raised interest rates by 1600 bps to 24.0% (or c. 3.0% in real *ex-post* terms), before the currency stabilised. For illustrative purposes, note that the real *ex-post* policy rate is currently estimated at c. -7.0%, among the lowest worldwide
- ✓ Worryingly, such a policy adjustment will be hard to implement, in view of the unfavourable political backdrop
- ✓ Note that the current CBRT Governor is the 4th to hold that office since 2019, after his predecessors were dismissed by President Erdogan over policy disagreement
- ✓ President Erdogan appears less willing to endorse such an adjustment in monetary policy ahead of the presidential and legislative elections (due by mid-2023), in which he is expected to face a tough fight, as suggested by his all-time low popularity
- ✓ Importantly, although public finances have deteriorated over the past years, they still remain a source of credit strength -- with gross public debt currently standing at just c. 40% of GDP -- and could help mitigate the impact of a tighter monetary policy

Sources: Reuters

The establishment of a stable and predictable policy environment is a *sine qua non* condition for sustainable economic growth

- ✓ Turkey's strengths, including, *inter alia*:
  - its **strategic geographical location**,
  - a young and relatively qualified labour force and **favourable demographic dynamics**,
  - **strong price competitiveness**, and
  - **ease of doing business** (with the country ranking 33^{th} out of total of 198 in the World Bank's relative index),

  suggest that the economy could benefit from: i) the ongoing global supply chain restructuring, in the wake of the COVID-19 shock and the emergence of significant supply-side bottlenecks in China and other low cost producers; and ii) the global Green New Deal to strengthen its export base and gradually close external imbalances
- ✓ To this end, it is important that authorities ensure a **stable and predictable policy environment**
- ✓ On the monetary policy front, efforts should concentrate on:
  - restoring confidence in the independence of the CBRT,
  - maintaining a tight stance until inflation expectations get well anchored, and
  - replenishing FX reserves as soon as conditions allow
- ✓ At the same time, structural policies should focus on:
  - restructuring the labour market, which is marred by high unemployment, low participation and widespread informality,
  - enhancing digitalization,
  - improving governance, especially regulatory predictability, and
  - accelerating green transition (note that Turkey's CO_2 emissions increased at the fastest pace among OECD countries over the past decade), while re-orientating the economy's manufacturing capacity towards green products

Disclosures

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