TURKEY

Highlights

- **Covid-19 has been a major shock to both the demand side (domestic and external) and supply side of the economy.** Before the pandemic, a fiscal and credit stimulus had helped the economy recover from the recession of 2018, and economic growth in 2020 was expected to be robust, but the economy contracted sharply in the second quarter.
- **The authorities have brought in a range of mitigating measures in response to Covid-19.** Several measures were introduced to support vulnerable households, workers and businesses and limit the economic impact of the pandemic, including social assistance programmes, short-time work allowance, a ban on layoffs, loan holidays and low-cost loans through state banks.
- **Expansionary monetary policy has put pressure on the exchange rate and foreign reserves.** A significant easing of monetary policy via policy rate cuts, quantitative easing and other measures to increase liquidity, and the extensive expansion of credit, have put pressure on the exchange rate, and attempts by the authorities to support the lira have resulted in a significant depletion of reserves.

Key priorities for 2021

- **Efforts to help the economic recovery need to be balanced carefully with measures to maintain macroeconomic stability.** The Turkish economy's longstanding reliance on external credit alongside the extensive use of credit stimulus to generate growth in recent years has made it vulnerable to sudden stops of capital inflows. A key priority is preserving the credibility of the central bank in order to increase the effectiveness of monetary policy.
- **There should be tighter rules for the recognition of non-performing loans (NPLs).** The use of asset ratios to encourage credit expansion risks is giving rise to further asset quality issues, at a time when the NPLs hanging over from the 2018 crisis have not been fully addressed.
- **Structural reforms need to be enacted to ensure a genuine rebalancing of the economy.** Reforms are needed to improve workforce skills, promote firm-level innovation and develop domestic capital markets. The recent trend towards shorter supply chains may provide significant opportunities for Turkish companies.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	3.2	7.5	2.8	0.9	-3.5
Inflation (average)	7.8	11.1	16.2	15.5	12.0
Government balance/GDP	-1.3	-1.6	-1.9	-2.9	-5.4
Current account balance/GDP	-3.1	-4.8	-2.7	1.1	-3.7
Net FDI/GDP [neg. sign = inflows]	-1.2	-1.0	-1.2	-0.8	-0.7
External debt/GDP	47.0	52.8	56.4	57.1	n.a.
Gross reserves/GDP	12.3	12.6	12.1	13.8	n.a.
Credit to private sector/GDP	69.8	70.8	68.0	66.0	n.a.

CONTINUES

Covid-19: macroeconomic implications

The Covid-19 pandemic resulted in a shock to both the demand and supply side of the economy. Domestic demand was hit by containment measures, external demand contracted sharply, and the economy has suffered from the collapse in travel and tourism. The partial lockdown in the country had a major impact on domestic consumption, in particular the retail sector, which constitutes 26 per cent of GDP. Production facilities were also hit hard, with many companies shut down for a period due to the containment measures and resulting supply chain disruptions. The economy contracted by 9.9 per cent year-on-year in the second quarter of 2020.

The authorities have responded to the crisis with fiscal and monetary measures. Fiscal measures to address the crisis amounted to around 6.5 per cent of GDP (see below for details). Meanwhile the central bank's policy rate has been slashed from 24 per cent in July 2019 to 10.25 per cent as of September 2020, contributing to an annualised rate of credit growth in 2020 of 25 per cent, principally driven by state banks. The credit stimulus has led to rising inflation and a widening current account deficit (mainly from rising imports), despite the weakening of the exchange rate by around 20 per cent in relation to the US dollar since the start of 2020. This depreciation has arisen despite the authorities spending US$ 60 billion of reserves defending the currency so far in 2020, on top of the US$ 30 billion spent in 2019. In the face of declining reserves, the central bank has engaged in swap agreements, mainly with state banks, to tap the extensive foreign exchange deposits of Turkish residents.

Signs of economic recovery are emerging, but significant risks remain. GDP is projected to contract by 3.5 per cent for the year as a whole, with economic activity recovering in the second half of 2020. This recovery should support growth of around 5.0 per cent next year. If policy tightening addresses the depreciation of the lira, the contraction in domestic demand alongside lower oil prices should keep inflation and the current account deficit relatively contained. However, risks to our forecast are on the downside, especially if there is a second wave of the pandemic, which would likely lead to further containment measures. Other key risks are those associated with a possible further significant depreciation of the lira and withdrawal of foreign exchange deposits from the banking system.

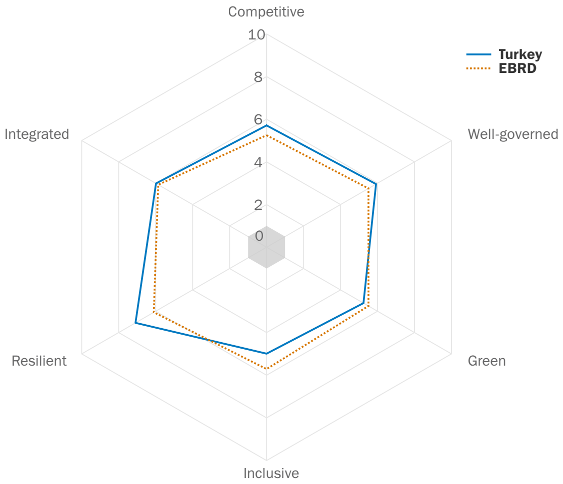
Policy response to Covid-19

The government announced a relief package in mid-March 2020. The package, entitled the Economic Stability Shield, involved tax holidays and value-added tax cuts for hard-hit sectors, and funding for workers. It introduced a mix of financial support, credit support and employment-related measures to help citizens and businesses during the Covid-19 crisis. Measures taken to ease liquidity, particularly for small and medium-sized enterprises, include loan repayment deferrals, credit guarantees and low-cost financings, particularly through public banks. Low-interest loans have been provided for various sectors, from tourism to housing and automotive, in order to revive domestic demand. Social assistance programmes for low-income households and increases in pension payments have also been implemented.

The government unveiled measures to support labour markets. These measures include a temporary working allowance for workers who partially or fully suspend their activities. A temporary nationwide ban on layoffs was imposed to mitigate the impact of the pandemic, while employers were allowed to put employees on unpaid leave with the state providing a daily income subsidy corresponding to half the minimum wage during this period.

CONTINUES

Assessment of transition qualities (1-10)



Structural reform developments

There has been backsliding over the past year in terms of governance and policymaking. Perennial concerns about the concentration of power within the Presidency and consequent lack of independence of key institutions such as the central bank continue. The central bank has cut rates heavily in the past year to the extent that real policy rates are negative, and it seems reluctant to use rate hikes to tighten policy, instead reverting to using the interest rate corridor. This results in less transparent policymaking.

Further capital market controls were introduced during the year, although some have recently been lifted as part of a wider normalisation exercise. Attempts to support the currency in the face of negative real policy rates have involved the introduction of a variety of measures that may be detrimental to investment. These include minor capital controls, including foreign exchange transaction taxes and settlement delays, and bans on shorting and lending certain Borsa Istanbul stocks. Other restrictions include those on offshore swap markets, which have made it difficult for foreign investors to hedge Turkish investments. These measures have resulted in the share of non-resident participation in the Turkish domestic bond market falling to historically low levels. Furthermore, import tariffs and other import restrictions have been introduced or increased on a wide variety of products in the past year. Some of these measures have recently been alleviated as part of a normalisation exercise.

Turkey has joined Euroclear bank. This move, which took place in June 2020, enables international investors to settle trades in Turkish government bonds. It should open up Turkish debt to more cautious investors such as sovereign wealth funds and pension funds, and is potentially important for the development of local debt markets.

The ongoing push to use credit stimulus to engineer a fast recovery has been relaxed in the face of recent lira weakness. Over the first half of 2020 several initiatives were introduced to support increased lending, including a significant increase in the size of the Credit Guarantee Facility to TRY 50 billion (US$ 7.7 billion), differential reserve requirements and remuneration to favour banks meeting certain lending targets, and asset ratios requiring banks to maintain certain levels of loan supply, government bond holdings or swaps with the central bank. Recently, in the face of ongoing weakness of the lira, these measures have been relaxed.