

# TURKEY: HIGH LEVELS OF VULNERABILITY AS A RESULT OF UNORTHODOX MONETARY POLICY AND HEAVY RELIANCE ON EXTERNAL FINANCING



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### Highlights

- > Economic activity supported by expected stimuli measures ahead of parliamentary and presidential elections in June 2023.
- > Huge inflation as a result of unorthodox monetary policy.
- > External vulnerability amid widening current account deficit, low liquidity and heavy reliance on short-term external financing.
- > Attracting new external financing could become more challenging amid sharp tightening global financial conditions.
- > Negative outlook for ST and MLT political risk despite moderate external and public indebtedness.

### Pros

- > Well-diversified economy
- > Geographic location
- > Moderate public debt

### Cons

- > Unorthodox monetary policy
- > Turkish lira under continuous pressure
- > Higher reliance on short-term external financing
- > High corporate debt

## Head of State

- > Recep Tayyip Erdoğan

## Population

- > 85 million

## GDP per capita

- > USD 9,830

## Income group

- > Upper-middle income

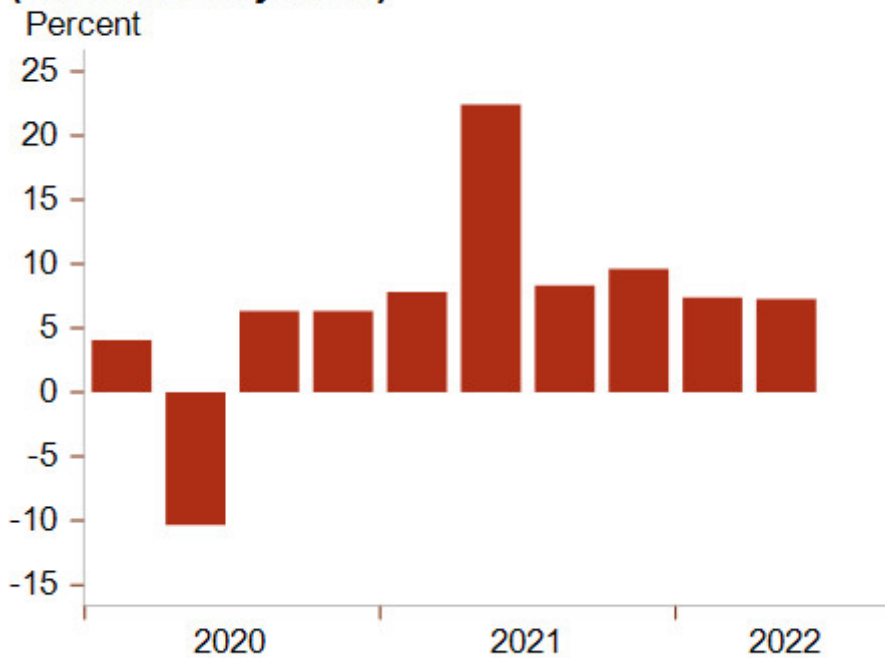
## Main export products

- > Manufactured goods (60% of total current account receipts in 2021), transport (8.6%), food (8.5%), tourism (7.2% in 2021, down from 11.9% in 2019)

## A highly resilient economy, but clouds are accumulating

Real GDP growth has been especially strong and resilient over the past two years (cf. graph representing real GDP growth year on year), despite the multiple external shocks hitting the Turkish economy as a result of the Covid-19 pandemic in 2020 and more recently the war in Ukraine. Looking ahead, global economic activity is again set to face multiple shocks due to the energy crisis in Europe, the zero-Covid policy and property crisis in China and the US slowdown, but despite these heavy headwinds, Turkish economic growth is expected to remain resilient in the short term. Stimuli measures – such as the recently announced housing project – are expected to be implemented to support economic activity ahead of the forthcoming presidential and parliamentary elections scheduled for June 2023, in which President Erdogan is seeking re-election – though some believe that he might face a more united opposition this time around. In this context, it is not unlikely that external tensions, notably in the Mediterranean Sea, will increase and distract voters’ attention away from domestic issues such as the high cost of living driven by huge inflation and the continuous depreciation of the lira.

### Real Gross Domestic Product Growth YOY (Calendar Adjusted)



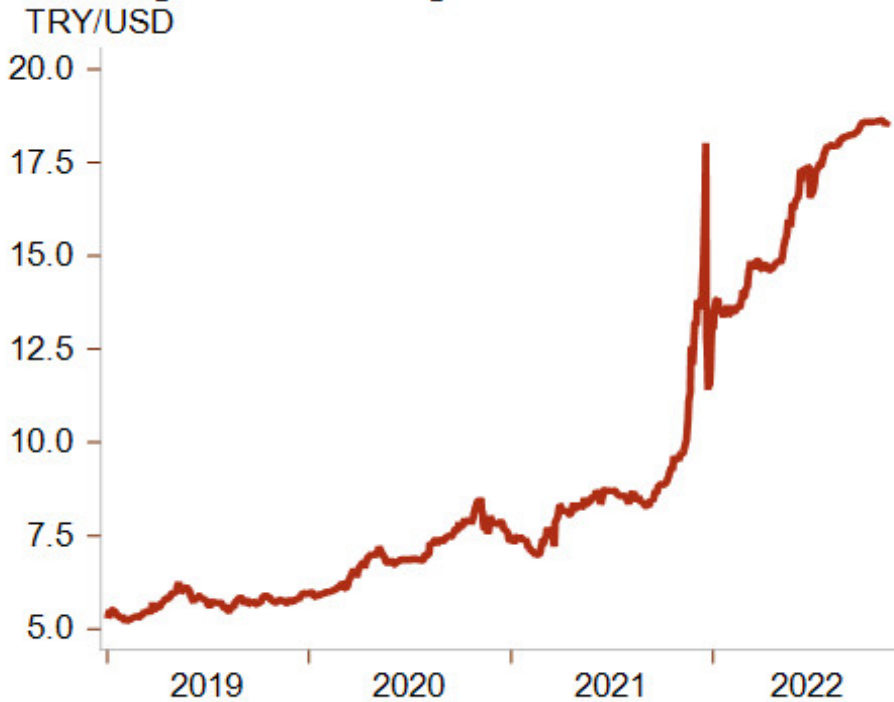
Source: TurkStat

Looking to the future, it appears that a slowdown is on the cards, and the risks that the economy shall face are multiple. Up until now, Turkey (named officially Türkiye) has benefited from supportive external demand, coming notably from the EU and strong demand from the Middle East and North Africa. However, its main trade partner – the EU, which receives about

domestic side, fewer supportive measures are expected after the elections. Moreover, domestic demand is being hampered by the decrease in real income driven by the high cost of living.

### Unorthodox monetary policy

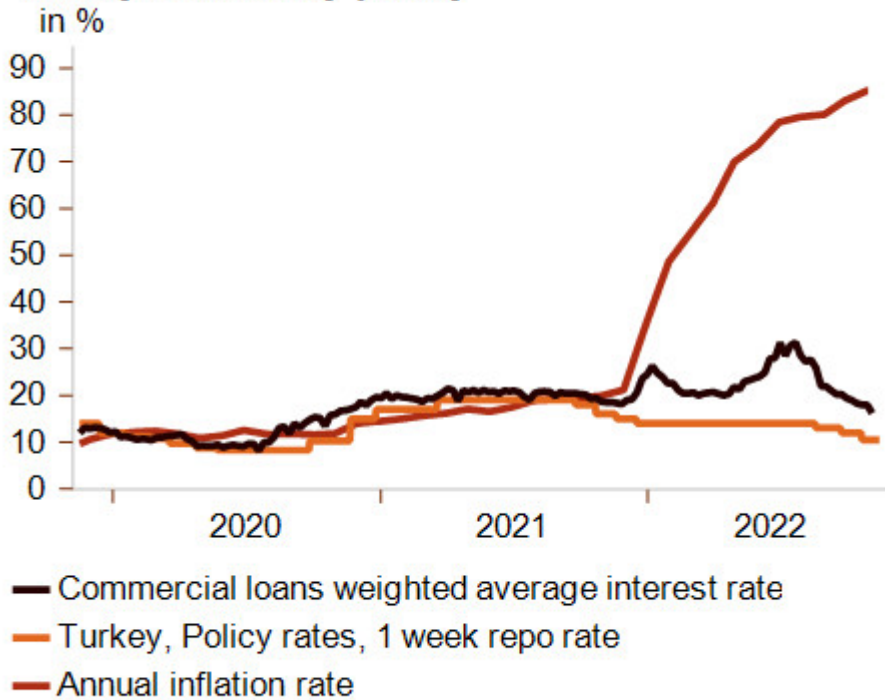
#### Exchange rate: TRY against USD



Source: Macrobond

Although rising inflation amid high food and energy prices and supply chain disruptions are a global trend, inflationary pressures in Turkey are not only explained by these external factors. They are also driven by the continuous depreciation of the lira (cf. graph representing the exchange rate of the Turkish lira against the US dollar, where the rising line represents increasing depreciation) and the unorthodox monetary policy. The central bank has cut its interest rate three times this year while inflation reached more than 80% YoY, a level not seen since the nineties (cf. graph showing policy rate, rate of annual inflation and average commercial loans rate). Moreover, the average interest for commercial loans remains low, as banks are penalised if they lend with high lending rates.

## Turkey: Monetary policy

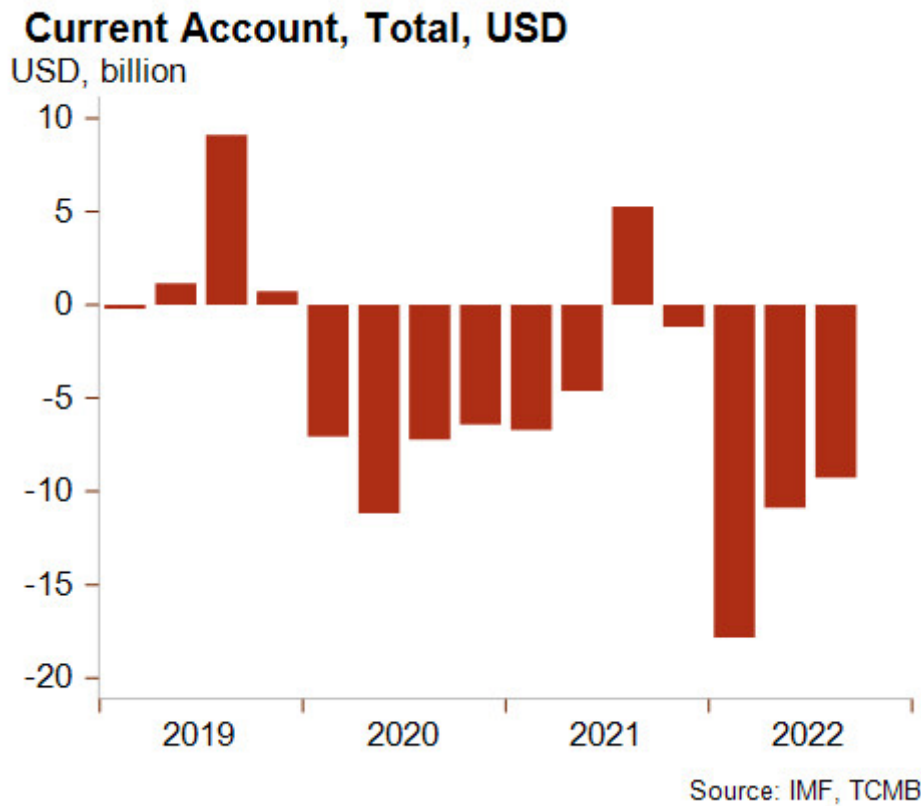


Source: TurkStat, TCMB, Eurostat

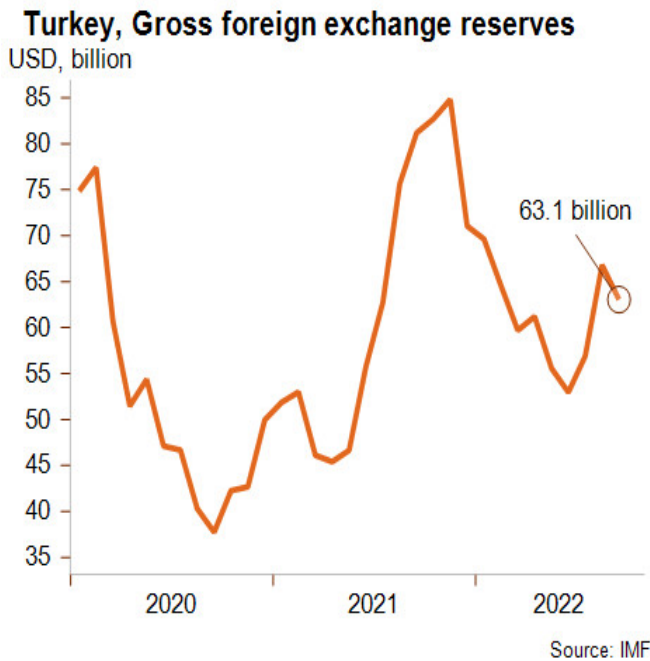
The very high level of inflation is weighing on purchasing power, and therefore also on domestic demand.

### External balances

Despite very strong growth in current account receipts driven by external demand that remains supportive and a rebound in the tourism sector, the current account deficit is widening on the back of high energy prices. This deepening current account deficit is a sign of vulnerability, which is still largely financed by volatile short-term capital inflows, despite Turkey being an attractive destination for foreign investors given its geographic localisation.



This high reliance on short-term external financing has been one of Turkey's key weaknesses for years. So far, the country has successfully been able to attract enough foreign financing (mainly portfolio investments and short-term external loans) to fund its current account deficit. However, the ongoing rapid deterioration of global financial conditions amid synchronised monetary policy tightening could hit the Turkish economy hard if access to external financing becomes too difficult or if capital outflows accelerate. Moreover, negative perceptions – such as fears that Western sanctions will target Turkish entities in view of allegations that they are helping Russia to evade sanctions – might also hamper Turkey's access to external financing from the West. Furthermore, foreign exchange reserves are low, regularly under pressure (cf. graph representing gross foreign exchange reserves) and insufficient to cover the very high short-term external debt, amounting to USD 138 billion in August according to central bank data.



The widening of the current account deficit and capital outflows are putting pressure on the lira, which has been under severe pressure for years (and therefore continues to contribute to inflationary pressure). While in theory the lira's depreciation should support external competition among exporters, in reality this effect is limited as exporters rely on more expensive imports in local currency terms. Moreover, domestic production costs are high and could further increase as minimum wages are also likely to increase before the June elections. In addition, the sharp depreciation of the lira is increasing the cost, in local currency terms, of reimbursing the debt denominated in foreign currency for companies that are not hedged or that have no revenues in foreign currency.

Corporate debt is high – at 72.6% of GDP in Q1 2022 according to the Bank for International Settlements – and mainly owed to the domestic banking sector, which is especially exposed to shifts in global financial conditions given its negative net foreign asset position of about 10% of GDP in June this year.

### Moderate central government debt remains exposed to exchange rate risk

The central government debt remains moderate, at about 40% of GDP in 2022. However, public debt is exposed to exchange rate risk because more than 50% of central government debt is denominated in foreign currency. Furthermore, the currency support scheme – put in place to protect holders of lira-denominated deposits in case of depreciation (under specific conditions) – may represent a high cost for the authorities given the continued pressure in this regard. It is also difficult to have an overview of the state of public finances outside the central government for example the impact of all construction projects and the



## Country risk under pressure

Despite strong real GDP growth, the business environment risk still falls within the most risky category of G/G. This is explained by the challenging macroeconomic conditions stemming from difficult access to credit for the private sector (despite a nominal increase of credit to the private sector of 65% in August this year), sharp depreciation of the Turkish lira and high inflation.

The short-term political risk – representing the liquidity of a country – falls in category 5/7. The rating outlook is negative, as Turkey is heavily exposed to the ongoing tightening of global financial conditions given its reliance on short-term external financing, its low level of gross foreign exchange reserves and its large amount of short-term external liabilities. The MLT political risk – representing the solvency of a country – is also under pressure given the weak liquidity and unorthodox monetary policy. That being said, the MLT political risk classification (5/7) is supported by moderate gross external debt, external debt service, central government debt and the well-diversified economy.

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18/11/2022

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