Middle East Economy Iqtisadi Turkeyscope Insights on Turkish Affairs
Tel Aviv University MDC The Moshe Dayan Center for Middle Eastern and African Studies

Special joint edition of Iqtisadi and Turkeyscope

Editors: Paul Rivlin, Joel D. Parker, Hay E. C. Yanarocak and Ceng Sagnic

Iqtisadi: Vol. 8, No. 6, Turkeyscope Vol. 2 No. 7

June 15, 2017

Turkey's pre-election economic crisis

Paul Rivlin

During April-May 2018, the Turkish lira fell by 24 percent against the dollar. On 23 May, after the lira fell to almost five to the dollar, the Central Bank of Turkey intervened with a sharp increase in one of its primary lending rates, from 13.5 percent to 16 percent. This helped stabilize the exchange rate (see Chart 1). This exchange rate crisis is not Turkey's first: in 2001 there was a massive crisis and devaluation of 30 percent. The 2008 international financial crisis resulted in 15 percent further devaluation. While the economy was hit hard in 2008, it made a quick recovery.[1]

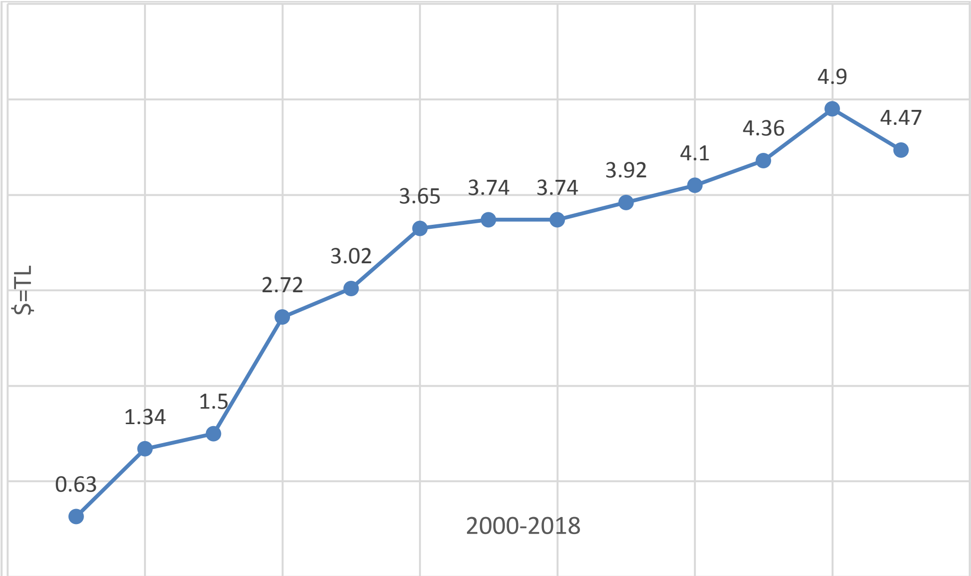
Since then, Turkey's economic performance has been much less impressive. Progress increasingly diverged from the historical record of best-performing economies because the pace of reform that had been designed to move Turkey towards European Union membership flagged and economic decisions became increasingly politicized. Economic growth became more unbalanced, accompanied by increasing debt in both the private sector and the external sphere.

In 2016, when the failed coup took place there was another devaluation. The exchange rate of the Turkish lira fell by a third against the US dollar between March

2016 and March 2017. Much of this occurred during the crisis following the attempted coup, and at the beginning of January 2017. In order to protect the value of the currency, the Central Bank of Turkey raised interest rates. This was done against the government's will and against the background of a weakening economy. The fall in the exchange rate also reflected anxiety about the balance of payments and the level of Turkey's foreign debt.[2]

Chart 1

The Exchange Rate of Turkish Lira and the Dollar, 2000-2018



Source: Central Bank of Turkey

As shown in Table 2, the Turkish economy has both strengths and weaknesses. Although growth was impressive until 2013 - making Turkey the world’s 18th largest economy - it has suffered from a large and chronic deficit on the balance of payments current account. This peaked at over $74 billion in 2011 (almost nine percent of GDP) and has averaged $44.6 billion (almost five percent of GDP) since then. The deficit was financed by inflows of funds from abroad, most of which took the form of borrowing from banks or foreign investments in Turkish financial assets. Had more been financed by direct foreign investment in fixed assets, then the economy would not have been as exposed to such outflows of funds and sudden, sharp pressures on the Turkish lira, which resulted in devaluations. The net effect was an increase in foreign debt and an even faster rise in the share of short term borrowing.

Table 2

Turkey: Main economic indicators, 2000-2017

	GDP ($ billions, current prices)	Consumer prices, annual change (%)	Current account deficit ($ billions)	Current account deficit (% of GDP)	Total external debt ($ billions)	Net credit to the private sector (% of GDP)
2000	273	54.9	3.8	1.9	116.8	17.3
2005	501	10.1	21.0	5.6	173.6	21.4
2010	772	8.6	44.6	5.8	300.9	44.0
2011	832	6.4	74.4	8.9	305.6	49.4
2012	874	8.9	48.0	5.4	338.8	52.2
2013	950	8.9	63.6	6.7	390.4	60.7
2014	934	7.5	43.4	4.7	402.6	63.8
2015	859	8.9	32.1	3.7	396.7	66.8
2016	863	7.7	33.1	3.8	405.7	69.8
2017	858e	7.8	47.4 p	5.5 e		

Sources: Central Bank of Turkey and World Bank (p=provisional, e=estimate)

Since 2002, Turkey's economy has been characterized by a large growth of incomes, a sharp decline in the real interest rate, and a sustained fall in the saving rate. The high rate of inflation has also encouraged consumption and discouraged saving. Consumption has been made possible by borrowing, encouraged by low interest rates. There has been a significant increase in credit taken by Turkish households: the private saving rate fell from 19.6 percent in 2003 to 11.7 percent 2014. In part this was made possible by a fall in real interest rates from 21 percent in 2000 to 1.8 percent in 2015.[3]

Low interest rates on the dollar and other currencies encouraged borrowing abroad. When dollar interest rates rose, the exchange rate of the lira fell. The increased strength of the dollar (against other currencies) intensified this process. The World Bank has shown how both the exchange rate of the lira and the volume of short-term financial inflows have been closely related to US interest rates.[4]

In March 2018, the International Monetary Fund stated that Turkey's economic growth had rebounded sharply in 2017 (reaching 7.4 percent in real terms). This had been made possible by a policy of strong monetary stimulus following the 2016 coup attempt and by favorable external conditions. Although expansionary policies were appropriate at that time, they are no longer needed, as the economy is showing signs of overheating. Monetary policy is too lax, and its credibility is low. (The IMF is referring to interest rates here). Fiscal policies (government spending) have been expansionary and risk undermining the country's hard-earned fiscal credibility. As a result, the economy faces internal and external imbalances: a positive output gap, inflation well above target, and a current account deficit exceeding five percent of the GDP. In addition, political uncertainties and regional instability continue to threaten the economy, while the integration of large numbers of refugees from Syria poses further challenges.[5]

In May 2018, the Organization for Economic Cooperation and Development (OECD) made more critical comments. It noted that Turkey's economic growth had worsened longstanding imbalances that had arisen from excessive reliance on domestic demand. The current account deficit is estimated to have exceeded six percent of GDP in early 2018 and foreign financing needs are projected to reach 25% of GDP in 2018. Rising oil price have increased pressure on the current account and external funding will become scarcer and more expensive as advanced economies in the OECD change their monetary policy. Spending increased dramatically in spring 2018, due to new business incentives and further social transfers. The commitment of the central bank to the official five percent inflation target is in question after several years of overshooting and five consecutive quarters of double-digit inflation. This exacerbated exchange-rate depreciation and volatility, considerably increased the country's risk premia, and heightened risks associated with external debt. Given this problem, the central bank increased its lending rate by a cumulative 375 basis points in April and May 2018. To strengthen monetary policy credibility, the government needs to reinforce its commitment to the central bank's independence and to meet the inflation target. Monetary policy should be simplified, and guidance should be issued based on how the authorities plan to achieve the five percent inflation target in the foreseeable future.[6]

Since the IMF and the OECD issued their reports the crisis has developed and its timing is explained by political developments. When, in April 2018, early elections were announced, following months of bad economic news, the lira and the Istanbul stock market rallied. This was based on the hopes that the anticipated victory of President Erdoğan and the ruling AKP party, would reduce the political pressure to pursue economic growth. This would result in more conventional monetary policy (i.e. higher interest rates) that would encourage domestic saving and reduce pressure on the balance of payments and the exchange rate. It would also discourage lax fiscal policy (high government) that usually precedes elections. Most of all investors hoped that Erdoğan would end his demand that the central bank holds down interest rates. Many in the Turkish financial community hoped the prospect of victory would result in interest rate hikes to combat inflation, strengthen the lira and slow down an economy that has been overheated.

During mid-May, President Erdoğan visited the United Kingdom and these hopes evaporated, as did the feeling that he was a pragmatist. Until then, his theory that high interest rates increase inflation — rather than reduce it, as conventional economic orthodoxy suggests — could be dismissed as political posturing aimed at a domestic audience receptive to the notion (even if they do not entirely subscribe to it) that in Islam interest or usury is a sin. However, in interviews given and at a meeting with institutional investors in the City of London, Erdoğan reaffirmed his opposition to higher interest rates. Furthermore, he declared that after the election, he intended to take control over monetary policy, and if necessary the central bank. The reaction was immediate: within hours, the lira hit a record low, and benchmark 10-year bond yields hit a record high.

After 15 years of growth and easy credit, Turkey has accumulated a great deal of foreign credit that it is now struggling to finance. Corporate foreign currency debt has grown rapidly since 2009, and 80 percent of it is held by Turkish banks. With the fall of the lira, they are struggling. The most dramatic example is that of Yıldız Holdings.

At the beginning of 2018, Yıldız, a holding company that owns Godiva Chocolates and United Biscuits among others, requested the largest loan ever from Turkish banks. It indicated that it was having difficulties with the existing finance structure that requires it to make monthly loan repayments that exceeded $1 billion. Yıldız is one of Turkey's largest conglomerates, with about $12 billion in annual revenue and more than 60,000 employees worldwide.[7]

Foreign direct investment has declined to one-third of previous levels. Credit rating agencies have downgraded Turkey's sovereign debt rating in recent months, citing a lack of economic structural reform and a removal of checks and balances.[8]

Paul Krugman has called this "a classic currency-and-debt crisis", similar to those that Asian and Latin American countries have experienced many times. In it, a country becomes popular with international investors and runs up substantial foreign debt. In Turkey this was largely debt owed by domestic corporations. In the second stage, the country in question, for whatever reason, loses its luster. Emerging markets - such as Turkey and Argentina - are currently suffering from the strengthening of the dollar and rising U.S. interest rates. A self-reinforcing crisis then becomes possible. External lenders cause a loss in confidence resulting in devaluation of the whole economy, leading to a further decline in confidence.

At such a time, the quality of leadership suddenly becomes crucial. Competent officials who understand what's happening are needed. Only they can devise a response and have enough credibility that markets give them the benefit of the doubt. Some emerging markets have competent officials, and they are riding out the turmoil well. According to Krugman (and many others), the Erdoğan regime does not.[9]

[1] Łukasz Rawdanowicz, "The 2008-09 Crisis in Turkey Performance, Policy Responses and Challenges for Sustaining the Recovery," *OECD Working Papers,* December 13, 2010.

[2] Paul Rivlin, "Turkey's Economy is Paying the Price," *Iqtisadi,* Vol. 7, No. 3, March 30, 2017.

[3] Sumru Altug and Melih Can Firat, "Borrowing constraints and saving in Turkey," *Central Bank Review*, Vol. 18, Iss. 1, March 2018.

[4] World Bank Group, "Turkish Economic Monitor: Minding the External Gap," May 2018.

[5] IMF: European Department, "Turkey 2018 Article IV Consultation-Press Release; Staff Report; and Statement by the Executive Director for Turkey," April 30, 2018.

[6] *OECD Economic Forecast*, "Summary: Turkey," May 2018.

[7] Asli Kandemir, Ercan Ersoy, Kerim Karakaya, and Benjamin Harvey, "Yildiz asks banks for biggest ever Turkish loan," *Bloomberg*, February 10, 2018.

[8] Carlotta Gall, "Turkey's Currency Plunges, Potentially Threatening Erdogan's Re-election Bid," *New York Times*, May 23, 2018.

[9] Paul Krugman, "Turmoil for Turkey's Trump," *New York Times*, May 24, 2018.