TURKEY: MACRO-FINANCIAL SITUATION

Juan Carlos Berganza, Paula Sánchez Pastor
and Begoña Lara
ABSTRACT

As in other countries, the effect of the pandemic and the global recession on the Turkish economy was mitigated by the fiscal, financial and monetary support implemented by the country’s authorities. In fact, Turkey was one of the few economies of significant size to record positive GDP growth in 2020 as a whole. However, this policy support also exacerbated the pre-existing macroeconomic imbalances. First, the sharp increase in credit is among the determinants behind the growth in domestic demand. Second, a notable weakening of the lira was observed, leading the already-high inflation rate to rise further. However, in the final stretch of the year the Turkish central bank shifted towards more orthodox monetary policy, helping to restore – at least in part – investor confidence. The banking sector has remained healthy, although overall asset quality has deteriorated as exposure has increased.

**Keywords:** Turkish economy, macroeconomic imbalances, current account balance, capital flows, monetary policy and inflation, Turkish lira, international reserves, bank lending.

**JEL classification:** F31, F32, F34.
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Introduction

Each year, the Banco de España identifies a list of countries from outside the European Union (EU) and the European Economic Area (EEA), known as “third countries”, that are considered material for the Spanish banking system based on the volume and regional distribution of its international credit exposures.\(^1\) In accordance with the guidance\(^2\) provided by the European Systemic Risk Board (ESRB), Turkey has been identified as a material country for the Spanish banking system\(^3\) by virtue of BBVA Group’s ownership interest in the Turkish bank Garanti (49.85% of its capital). Garanti is Turkey’s second largest private bank and the fifth largest if State-owned banks are included. In 2020, Garanti accounted for 8.1% of total BBVA Group assets, while its €563 million contribution to BBVA Group net profit represented 14.3% of total profit generated by the Group’s business areas as a whole (€3.9 billion), excluding the corporate centre.

The Spanish and Turkish economies are also linked by major bilateral trade and financial flows (see Table 1). With regard to foreign trade, 1.5% of total Spanish exports went to Turkey (the 10th non-euro area country behind Hungary) in 2019, while the stock of foreign direct investment (FDI) that same year amounted to 1.1% of total Spanish assets abroad (the 12th non-euro area country behind Uruguay). Turkey is also a material third country for the overall euro area banking system and for the European Union as a whole,\(^4\) and is likewise relevant in terms of trade. The flow of exports from the euro area to Turkey accounted for 1.3% of the total in 2019.

This note first analyses the economic and financial developments in Turkey during the past year, which have been significantly influenced by the course of the coronavirus pandemic but also by pre-existing imbalances. It subsequently examines the economic policies implemented and ends with a review of the state of the banking system.

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1 This identification exercise is based on the Banco de España’s competence to set Countercyclical Capital Buffer rates for Spanish banking institutions according to their credit exposures to material third countries in response to certain financial stability risks. For further details on the operationalisation of the methodology for identification, see Box 3.2 of the Financial Stability Report, November 2017.

2 Recommendation ESRB/2015/1 on recognising and setting Countercyclical Capital Buffer rates for exposures to third countries, and Decision ESRB/2015/3 on the assessment of materiality of third countries for the Union’s banking system in relation to the recognition and setting of countercyclical buffer rate.

3 The list of material third countries can be found at this link.

4 See Table 3.5 of the ESRB report Review of Macroprudential Policy in the EU, 2019, April 2020.
Similarly to the rest of the world, in 2020 the Turkish economy was highly influenced by the course of the COVID-19 pandemic, which reached Turkey slightly later than Europe and the United States, but earlier than other emerging economies. Mindful of the usual limitations when comparing countries, the initial decisions adopted to contain the spread of the virus – restricting people's movement and shutting down a considerable portion of productive activity – can be characterised as in line with those implemented in similar countries, although they were withdrawn more rapidly. In terms of incidence, the number of coronavirus cases and COVID-19-related deaths surged in the last few months of the year, substantially exceeding the figures reported in the first wave and those recorded by other emerging economies (see Chart 1). That prompted the reintroduction of containment measures and a further weakening of the economy.

GDP grew 1.8% in 2020 in Turkey (-2.4% in the aggregate for emerging economies, according to the latest International Monetary Fund (IMF) estimates). This followed

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5 It is important to note that Turkey's figures only began to include asymptomatic cases from late November onwards. See the section on Turkey in OECD Economic Outlook (2020, Issue 2).

6 See World Economic Outlook Update, IMF, January 2021.
growth of 0.9% in 2019,\(^7\) when the Turkish economy was recovering in the wake of the 2018 recession\(^8\) (see Chart 2.1). As in other economies, the effect of the pandemic and the ensuing global recession on the Turkish economy was mitigated by the fiscal, financial and monetary support implemented by the country’s authorities\(^9\) (see the third section). For 2021, the IMF forecasts economic growth of 6%, in line with the 6.3% projected for emerging economies as a whole (see Chart 3.6).

The impact of the crisis and the recovery are influenced by the characteristics of the country’s productive structure. First, the Turkish economy is highly sensitive to external economic developments; although the level of trade openness is not high, it is deeply integrated into global value chains (See Charts 3.1 to 3.3). Likewise, exports of transport and tourism services, two of the sectors hardest hit by the health situation, account for a notably large share of the country’s trade (22% of the total) (see Chart 3.4). Second, Turkey is highly dependent on oil imports. Accordingly, oil price movements (see Chart 3.5) significantly influence the cost of its imports. The notable oil price decline in 2020 therefore acted as a driver of growth. From the financial standpoint, Turkey is dependent on international financing and it is therefore affected by spells of low global appetite for risk (such as that recorded in 2020 H1)

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\(^7\) See Turkey 2019 Article IV Consultation documents, IMF.


and rising sovereign bond yields. Further, Turkish lira exchange rate developments have a very significant impact on the foreign-currency-denominated portion of the debt of financial and non-financial corporations and of the government. Finally, the health crisis has had adverse effects on the supply side of the economy. However, these effects have been moderate since, compared with other countries, few sectors were shut down by administrative decision and only for a relatively brief period of time during the first wave, while the measures introduced to support employment have yielded favourable results (see Chart 2.2).

Inflation stood at 14.6% year-on-year in December 2020 (see Chart 4.1). Underlying this high inflation, and its upward momentum towards the end of the year, are recurring factors in the Turkish economy. These include the weakening of the lira passing through considerably to domestic prices and the high inflation expectations, partly underpinned by concerns over the independence of Turkey’s central bank (CBRT). In 2020, these factors more than offset the deflationary effect of the economic downturn caused by the pandemic and the oil price decline. Thus, inflation remains well above the CBRT target (5%, with an allowable deviation range of +/- 2 pp) and,

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10 See the section on Turkey in OECD Economic Outlook (2020, Issue 1).
11 In July 2018, the president gained the prerogative to directly appoint and dismiss the Governor, Deputy Governor and members of the Monetary Policy Committee. Two CBRT Governors were subsequently dismissed before the end of their tenure, the first in July 2019 and the second in November 2020.
Although the degree of trade openness in Turkey is lower than in other emerging areas, Turkey has close links with the European Union (especially with Germany) both through exports of medium-low technology manufactures and through its high participation in global value chains. In terms of exports of services, tourism accounts for a very significant share of the Turkish economy. As for imports, high dependence on oil leaves the country highly sensitive to price fluctuations; oil prices plunged following the outbreak of the pandemic, but subsequently recovered in part. Finally, on the latest estimates, the Turkish economy was among the few to register positive growth in 2020 as a whole. Growth forecasts for 2021 are in line with the average for the group of emerging economies.

Sources: Thomson Reuters, OECD, World Bank, UNCTAD-Eora GVC Database, WTO and IMF.

a LA: Aggregate of Argentina, Brazil, Chile, Colombia, Mexico and Peru; EE: Eastern Europe (EU-13); ASEAN: Association of Southeast Asian Nations.
b For the euro area, exports and imports between euro area countries are not included.
c Percentage of exports calculated based on the total sum of agriculture, mining and manufacturing. Services, construction and supplies are excluded.
d Upstream: proportion of exports used as an input by industries in other countries that produce goods and services intended for export to third countries (indirect value added exports). Downstream: proportion of exports comprising the value added of foreign goods and services used as inputs to produce goods and services for export.
e LAC: Latin America and Caribbean; EAP: East Asia and Pacific; SEA: South-East Asia.
f IMF January 2021 projections.
The gender gap in financial competences is a significant issue. Looking to the future, various analysts expect the figure to hold at over 10% in 2021 and 2022. The Turkish lira depreciated further in 2020 than the currencies of other emerging economies, only partially recovering as of November (see Charts 4.3 and 6.4). This weakening reflected the lack of confidence among international investors in the economy.
The economic growth model based on strong credit growth and the stimulus measures has led to increasing imbalances in public finances and most notably in the current account balance. The growth in imports was underpinned by robust momentum in lending to the non-financial private sector, which limited the decline in Turkish domestic demand. This came alongside soaring demand for gold (as a reserve asset). The decline in exports came particularly in tourism services.

**Chart 5**

**PUBLIC FINANCES AND BALANCE OF PAYMENTS**

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Turkish financial market indicators weakened in 2020 following the onset of the pandemic, and to a greater extent than other emerging economies (with the exception of the stock market index). However, since November the indicators have shown a gradual improvement.

**FINANCIAL MARKETS**

Chart 6

**SOCCEIRN RATING**

**COUNTRY RISK INDICATORS**

**STOCK MARKET INDEXES**

**EXCHANGE RATES AGAINST USD**

**FINANCIAL STRESS INDEX (b)**

**GOVERNMENT BOND YIELDS**

**SOURCE:** Thomson Reuters.

a  JPM EMBI Global Stripped Spread.

b  An FSI is a combination of daily financial market indicators for different segments that proxy the current state of uncertainty for a specific financial system. An increase in the FSI denotes heightened financial frictions. Values range from 0 (no stress) to 1 (maximum stress).
transparency and suitability of the policies implemented\textsuperscript{12} to address the economic imbalances, the high external financing needs (see Chart 5.6),\textsuperscript{13} the low level of international reserves (see Chart 4.4)\textsuperscript{14} and the geopolitical tensions between Turkey and the European Union, the United States and Russia.\textsuperscript{15} The upshot was that risk indicators (such as the EMBI) also performed comparatively worse than for other emerging economies and Turkey’s sovereign debt credit rating was downgraded.

The Turkish economy’s high external financing needs stem from the long-standing current-account deficit (see Charts 5.3 and 5.4). Underlying the vibrant imports in 2020 was robust momentum in lending to the non-financial private sector, which limited the decline in domestic demand, and the very high demand for gold (traditional reserve asset of Turkish citizens during financial crises) (see Chart 5.4). The negative performance in exports during 2020 was largely on account of the drop in tourism services. Meanwhile, Turkey maintains a significant negative net international investment position (-58.4% of GDP in 2020 Q3) and relatively high foreign-currency-denominated external debt in the private sector, both for financial and non-financial corporations, and more recently in the public sector too (see Chart 5.5). It is worth noting that 60% of foreign currency debt in the non-financial private sector is held with Turkish banks, and around 80% of that is long-term.

**Economic policies**

The fiscal measures introduced in 2020 to ease the pandemic’s adverse economic effects (equivalent to 12.9% of GDP) were similar to those implemented in other emerging economies, although the stimulus size was towards the top end of the scale.\textsuperscript{16} These mainly consisted of measures to provide liquidity support to households and firms, including guarantees, loan servicing payment deferrals, capital injections, additional public spending and forgone revenue, including temporary tax deferrals. The substantial support measures and the reduction in revenue associated with the decline in activity have given rise to notable increases in both the government deficit and in government debt (see Charts 5.1 and 5.2). Thus, the fiscal impairment that began in 2018 has heightened, owing to the successive fiscal and quasi-fiscal stimulus policies introduced since, although government debt as a percentage of GDP, which stood at 40.4% of GDP in 2020,\textsuperscript{17} remains below the average for emerging countries.

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\textsuperscript{12} See, for example, the section on Turkey in *OECD Economic Outlook* (2020, Issue 1).

\textsuperscript{13} These are also covered by more volatile capital flows, such as portfolio investment and bank loans.

\textsuperscript{14} In fact, according to the IMF, if swaps with the CBRT are subtracted the net international reserves would be negative (see *Turkey: Staff Concluding Statement of the 2021 Article IV Mission*).

\textsuperscript{15} See, for example, the section on Turkey in *OECD Economic Outlook* (2020, Issue 2).

\textsuperscript{16} The fiscal stimulus size as a percentage of GDP can be seen in Chart 3.1 of the *Report on the Latin American economy: Second Half of 2020*.

\textsuperscript{17} See *Fiscal Monitor Update*, January 2021.
In their latest reports, institutions such as the OECD\textsuperscript{18} and the IMF\textsuperscript{19} argue that Turkey still has some fiscal space available in 2021. This could be used to address the economic problems generated by the pandemic by implementing temporary fiscal measures. Indeed, some measures introduced in 2020 have been extended into 2021, such as those to support employment (the short-time work allowance scheme - equivalent to 0.4% of GDP - was reopened in December and extended until February 2021) and VAT cuts for certain products (food and some services), which will run until May. However, these international institutions also suggest that the fiscal consolidation process should resume once the economic recovery takes root.

As for monetary policy, the measures initially adopted by the CBRT in response to the pandemic were likewise in line with those introduced by other emerging economies. The CBRT cut the policy interest rate, introduced a programme of direct purchases of sovereign bonds on the secondary market,\textsuperscript{20} and substantially increased liquidity facilities for banks.\textsuperscript{21} With a view to easing depreciation pressures on the lira, the CBRT engaged in foreign exchange interventions through swaps transactions, while State-owned banks conducted sales of foreign currencies to the same end.

However, in contrast with the situation in other emerging and advanced economies, as of August 2020 the CBRT began a phase of substantial increases in policy interest rates, with the dual objective of reducing the high inflation and addressing the depreciation of the lira. Initially it raised the interest rates at which the liquidity injection was made. Subsequently, in November and December, it raised its reference rate. Further, as of November a return to more orthodox monetary policy was announced (injecting liquidity only at the reference rate), while regulatory amendments were introduced vis-à-vis the assets and liabilities of banks with a view to improving the effectiveness of the monetary policy transmission mechanism.\textsuperscript{22} In the initial months of 2021, the CBRT has reiterated its commitment to maintaining tight monetary policy for an extended period of time (and to tighten it further if necessary), until the indicators point to a clear and durable easing of inflation.

The banking sector

The Turkish banking sector comprises State-owned and private domestic banks, along with foreign-owned banks. The ten largest banks account for just over 90% of the banking business, which approximately breaks down (both in terms of assets

\textsuperscript{18} See OECD Economic Surveys, Turkey, Executive Summary, January 2021.
\textsuperscript{19} See Turkey: Staff Concluding Statement of the 2021 Article IV Mission, IMF.
\textsuperscript{20} For a description of the asset purchase programmes run by central banks in emerging economies, see "Asset purchase programmes of Latin American central banks", Box 1 of the Analytical Article Report on the Latin American economy, Second half of 2020, Banco de España.
\textsuperscript{21} See Box 1.I.1 of the CBRT Financial Stability Report, May 2020.
\textsuperscript{22} See Box 1.I.1 of the CBRT Financial Stability Report, November 2020.
The banking system remains healthy, although some indicators have deteriorated in line with the economic situation. Lending grew notably in 2020 (to a greater extent from State-owned banks), underpinned by the deep interest rate cut and temporary measures and regulations, which have already largely been withdrawn. Non-performing loans have held at moderate levels thanks to measures on payment deferrals and loan restructuring. However, asset quality has deteriorated.

**Chart 7**

**BANKING SECTOR**

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**Sources:** Thomsom Reuters, Undersecretariat of the Treasury and Turkish Banking Regulation and Supervision Agency.

a NFIs: Non-Financial Institutions.
**Table 2**

**MAIN ECONOMIC INDICATORS (a)**

<table>
<thead>
<tr>
<th>GDP per capita ($)</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
<th>2020 Q4</th>
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<td>9,127</td>
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<td>GDP per capita (PPP)</td>
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<tr>
<td>Real GDP (Sbn)</td>
<td>761</td>
<td>761</td>
<td>761</td>
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<tr>
<td>Population (m)</td>
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<tr>
<td>Trade openness</td>
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<thead>
<tr>
<th>Banking sector size (assets in $)</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
<th>2020 Q4</th>
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<tr>
<th>Banking sector size (% of GDP)</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
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<tr>
<th>Credit to private sector (% of GDP)</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
<th>2020 Q4</th>
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<td>75</td>
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<tr>
<th>Inflation targeting</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
<th>2020 Q4</th>
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<td>5 %, +/- 2.0 pp</td>
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<tr>
<th>Banking supervision</th>
<th>2019</th>
<th>2020</th>
<th>2020 Q1</th>
<th>2020 Q2</th>
<th>2020 Q3</th>
<th>2020 Q4</th>
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<td>BRSA</td>
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**SOURCES:** Central Bank of the Republic of Turkey and Thomson Reuters.

**Notes:**

- (a) Levels.

... and deposits) into 40% for State-owned domestic banks, 30% for private domestic banks and 20% for foreign-owned banks.

Broadly speaking, the Turkish banking sector remained healthy in 2020, although some indicators deteriorated in line with the economic situation (see Chart 7).
Lending to households and non-financial corporations surged in 2020, underpinned both by the deep interest rate cut and the temporary measures and regulations introduced by the Banking Regulation and Supervision Agency (BRSA) (such as the asset ratio requirement)\(^{23}\) and the CBRT (such as the rule linking reserve requirement ratios and remuneration rates to lending growth). Lending grew notably at both State-owned and private banks; however, the former expanded on a far greater scale (largely through concessional financing or loans at below-market interest rates),\(^{24}\) which led to a significant increase in their market share.\(^{25}\) On the latest available data, corporate sector debt (including bank loans and bond issuance) has risen to 65% of GDP, while the deleveraging of foreign currency debt has continued. However, unlike most emerging economies, the latter remains somewhat larger than local currency debt.\(^{26}\) The debt of households (which cannot borrow in foreign currency) stands at over 15% of GDP (below the average of around 42% for emerging economies). Non-performing loans have remained in check thanks to measures such as loan restructuring, the deferral of loan repayments in 2020 and the extension of loan classification periods. However, overall asset quality has deteriorated owing to the increase in exposure.

The tightening of financial conditions that started in late 2020 has begun to have a dampening effect on credit growth; this effect is expected to continue throughout 2021. Meanwhile, in terms of non-performing loans, the withdrawal of the temporary measures introduced in 2020 (some have been extended until mid-2021) could lead to something of an increase over the coming months, although the economic recovery should act in the opposite direction.

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\(^{23}\) The asset ratio was introduced as a measure to encourage lending and forced banks to extend credit and purchase government debt under threat of fines.

\(^{24}\) With campaigns such as loans to support basic needs – guaranteed by the Treasury-backed Credit Guarantee Fund – or the mortgage incentives of July-August (see the CBRT Financial Stability Reports).

\(^{25}\) See “Turkey: Quasi-fiscal and monetary support is being scaled down” (p. 256) OECD Economic Outlook (2020, Issue 2).

\(^{26}\) At end-2020, local currency debt in the non-financial private sector amounted to approximately 30% of GDP, while foreign currency debt stood at around 35% of GDP.