EXECUTIVE SUMMARY
Supportive external environment and somewhat agile policy responses enable external adjustment

The Turkish economy has experienced major external adjustments over the past 12 months, including declining current account imbalances, reduced external debt of banks, and a recovery in portfolio flows. These have lessened the external vulnerabilities that had accumulated in the run up to the August 2018 currency shock.

These adjustments have reduced the country’s external financing needs and contributed to a more stable Lira, notwithstanding bouts of currency volatility in 2019 Q2 and Q3. The adjustments were aided by somewhat agile policy responses and more favorable (than expected) global monetary conditions.

Even so, foreign exchange reserves have gotten eroded over the past two years, exposing Turkey to external market pressure.

The real sector is deeply affected by shrinking investments and elevated inflation ...

The real sector remains deeply affected by the persistence of macro-financial vulnerabilities. Investment significantly decreased – contracting for four quarters in a row (till 2019 Q2) – whilst industrial production points to a weak turnaround. The gradual recovery from recession in 2018 H2 has been fueled by a pickup in private consumption and net external demand.

The decline in inflation has begun, after exchange rate pass-through and episodes of loss of confidence in the Lira had sharply increased consumer prices, averaging 17 percent in the first three quarters of 2019. A gradual decline in producer prices since October 2018 has helped close the gap between PPI and CPI inflation and reduced pass-through pressures on consumer prices.

...hurting households through rising unemployment and declining purchasing power

Stagnating output levels, rising costs of production, and high consumer prices have led to significant job losses and falling real wages. Turkey's economy lost around 840 thousand jobs from May 2018 to May 2019, amounting to 2.9 percent of total employment. The unemployment rate increased from 10.6 percent to 14 percent between May 2018 and May 2019, with the youth seeing a jump in their unemployment rate from 19.6 to 25.6 percent. Average real wages declined by 2.6 percent between 2017 and 2018. The rise in unemployment and decline in real wages was experienced by workers across the skills and education spectrums.

Poorer households have been the most impacted because many low-income workers are employed in construction and agriculture - the sectors that saw the biggest decline in jobs. Moreover, the long-term impact of a drop in real wages is significantly greater for the poorest households since they have limited coping mechanisms.
The corporate sector remains weighed down by debt burdens, amplifying real sector woes

Corporate debt burden remains high despite gradual deleveraging. Total credit to corporates declined slightly from a peak of 72 percent of GDP (68 percent excluding import payables) to 68 percent (63 percent excluding import payables) between September 2018 and June 2019. Part of the increase in September 2018 was due to currency depreciation, which meant higher TL equivalent of FX debt. The gradual decline was driven by the subsequent appreciation in the currency and reduced domestic borrowing by SMEs. Credit rationing in Turkey affects SMEs more than larger firms, particularly during cyclical downturns.

Credit markets remain tight for much of 2019 (see below), which has impacted the larger corporates, some of which have turned to bond issuances. Capital markets, however, account for a very small share of corporate financing needs.

Elevated corporate debt coupled with high borrowing costs and declining earnings have squeezed corporates’ liquidity position. This is reflected in falling interest coverage ratios, which, for listed companies, have reached critical thresholds. These developments underly the real sector woes noted above, as firms have been forced to cut investments and shed labor.

Corporate vulnerabilities remain high and sensitive to further demand and interest rate shocks. In addition, two thirds of corporate debt is denominated in foreign currency. Fortunately, more than 80 percent of these foreign currency loans belong to larger corporates that are hedged through exports and other mechanisms. Plus, SMEs’ access to FX loans has been tightened and the use of FX indexed loans has been forbidden through regulation. Nevertheless, currency volatility contributes to exchange rate risk through operational and other costs.

Banks too have deleveraged to cope with worsening balance sheets positions

Corporate debt challenges have contributed to a deterioration in asset quality in the banking sector. Non-Performing Loans have risen from 3 percent in September 2018 to 4.7 percent in September 2019. Despite the rise in NPLs, capital adequacy across banks remain within prudential thresholds and profits have only dropped slightly.

An additional indicator of asset quality stress is the rise in the share of Stage 2 loans, which are classified as having elevated credit risk. Stage 2 loans account for around 12 percent of outstanding credit in the system. Part of the increase in Stage 2 loans reflects the introduction of International Financial Reporting Standards accounting norms designed to report more accurately risky assets. An ongoing challenge is the absence of implementation guidelines for this new regulation, which has created inconsistencies in the categorization of distressed assets across banks.

The authorities have committed to addressing the decline in asset quality, though the accumulated effects of last year’s fragilities are projected to sustain pressure on asset quality. According to the statement released by the Banking Regulation and Supervision Agency, NPLs are projected to rise further to over 6 percent after reclassification of loans mandated by the regulator.

Maturity mismatches in bank balance sheets have declined over the past year. The deposit to loan ratio has improved in 2019; loans financed through relatively short-term deposits – which have high rollover ratios – have increased slightly from 80 percent in 2018 to 90 percent in 2019.

Banks continue to close on balance sheet foreign exchange open positions through off balance sheet swap operations. Though banks have been repaying foreign exchange debts, dollar deposits are now just over half
of all deposits; foreign exchange loans on the other hand have been declining. Banks’ long position in FX swap operations help manage currency risk.

Banks have responded rationally by significantly cutting lending activities. The authorities have extended credit guarantees and relaxed macroprudential rules, which provided some credit impulse from state banks. But private banks have been cautious in a weak economic and high-interest-rate environment to avoid further deterioration in asset quality.

**Policies, despite challenges, have helped steady the ship...**

The overall policy response in the past year has fared reasonably well in restoring short-term stability, although given the major reorganization in government there may be room to further strengthen coordination and communication.

While the authorities have maintained a tight monetary policy stance since September 2018, efforts to boost credit through macro-prudential and fiscal channels went in the opposing direction, countering the effects of deleveraging and NPL resolution efforts.

In another example, the Central Bank responded swiftly to Lira liquidity constraints in 2019 H1 through a swap mechanism that helped bolster international reserves. Similar measures were taken in other countries during the Taper Tantrum episode of 2013. The Central Bank has consistently published comprehensive information on foreign exchange reserves; though an unclear drop in net reserves in 2019 Q1 created market anxieties and subsequent currency volatility.

There has been some progress in supporting corporates and banks to repair their balance sheets, although more is needed. The authorities have adopted both in- and out-of-court corporate debt restructuring frameworks in the past year and a half. These have been used mostly by larger corporates; SMEs seem to be relying on refinancing through credit guarantees. The debt restructuring measures could be usefully preceded by an independent Asset Quality Review in the banking sector, drawing on international expertise, which could further build market confidence.

Fiscal policy has responded countercyclically to help moderate the economic downturn. Transfers to households have increased rapidly, which will have played some role in cushioning the job losses among low-income workers. Ad hoc tax cuts were implemented to spur consumption, but at the likely loss of tax revenue. Authorities also cut capital spending to make fiscal space for public transfers.

**...but there is still room for improvement**

There has been an increase in the number of changes in the overall policy framework in Turkey in recent years. This could be in part due to the ongoing reorganization in government; new roles and responsibilities take time to settle. In addition, responding to a crisis requires firefighting, with effective communication and consultation on policy decisions.

Using big data techniques, the TEM finds that these may have contributed to increased economic policy uncertainty. The analysis shows that: (i) the number of changes to rules and regulations affecting businesses increased significantly each year peaking in 2018, reflecting greater volatility in the business environment; (ii) a growing share of the changes has been introduced through more discretionary legal instruments (i.e. not requiring formal consultation), which will have contributed to uncertainty; (iii) the most frequent changes were made in the areas of labor market, finance, the environment, quality infrastructure, trade and tax; (iv) most recently, the focus has shifted from tax and labor market issues towards quality infrastructure, environmental issues.
The above is not to say that the policy and institutional changes were not positive for businesses or that all changes were relevant for all businesses – but that businesses had to contend with more changes than before, which can be detrimental for operational and investment decisions. Strengthening policy transparency and predictability now that the dust is beginning to settle on major administrative changes will be central to building investor confidence and reducing risk premia on investment.

**LOOKING AHEAD**

**Pace and sustainability of recovery subject to reducing uncertainty and restoring investor confidence**

The TEM projects no change in GDP in 2019 and gradual medium-term recovery with risks tilted to the downside. Medium-term growth is projected to be driven largely by a continued recovery in consumption. Inflation is projected to fall to high single digits in the medium term. Poverty is projected to increase in 2019, before declining gradually over the forecast period.

The degree of uncertainty over the medium-term remains high relative to peer countries, as reflected in the broad range of forecasts across different institutions. The pace and sustainability of the current incipient recovery will depend in great part on reducing economic uncertainty and restoring investor confidence. A sudden loss of confidence in the currency will heighten the balance sheet pressures on banks and corporates and further damage the real sector.

**Turkey needs to strengthen external buffers to reduce market pressures**

Key to restoring confidence and reducing Turkey’s risk premia is strengthening external buffers. Though Turkey’s reserves are adequate compared to possible short-term calls, it nevertheless remains vulnerable to external market pressures (EMP).

Empirical analysis suggests that the two important leading indicators of EMP are: a sharp increase in the US Federal funds rate, which predicts a crisis around one year ahead, and a spike in the ratio of short-term financial flows to reserves, which predicts a crisis within a few months. Though the former seems less likely now, Turkey remains vulnerable to the latter, particularly if foreign flows remain speculative rather than geared to long-term investments. This raises the importance of strengthening external buffers, and, through that, building investor confidence and reducing risk premia.

**Which can be supported by tight monetary policy**

Monetary policy going forward will be critical to reducing risk premia and strengthening external buffers, but monetary authorities have a complex balance to strike. An overly expansionary monetary policy could fuel currency pressures and further stress corporate and bank balance sheets. Market interventions to accelerate credit expansion could delay recovery (given existing leverage, short-term finance and low demand) and exacerbate financial instability. Corporate debt overhang in Turkey is likely to be an important drag on private investment over the medium-term.

Addressing this challenge will require a holistic approach to dealing with distressed assets in the banking sector, which the authorities are working on. It will also require efforts to increase access to long-term finance including through the development of capital markets, which is a long-term endeavor. In East Asia for example, policy reforms after the Asian Financial Crisis helped to significantly increase firms’, including SMEs’, access to domestic equity and bond markets. This helped reduce financial vulnerabilities emanating...
from foreign currency borrowing, high debt rollover risks, and access to limited markets, which are all challenges in Turkey.

In addition to using available fiscal space effectively by focusing on the composition of the fiscal stimulus

Effective use of available fiscal space can play a useful role in supporting Turkey’s economic recovery. Turkey entered recession in 2018 H2 with more fiscal space compared to selected peer countries in comparable recessions in recent years.

One difference with those peer countries is the elevated risk premium and borrowing cost in Turkey, which constrains fiscal space and the multiplier. An analysis of how fiscal space evolves under different macroeconomic scenarios suggests that Turkey can absorb limited shocks.

Starting from the assumption that Turkey has some fiscal space, it is important to assess the effectiveness of the countercyclical response based not just on the level but also the composition of the fiscal stimulus. Econometric analysis of the impact of transfers on growth point to a positive and significant relationship.

Since workers at the bottom end of the welfare distribution are likely to have been affected more badly (i.e. because of lack of alternative sources of income, higher share of job losses in relatively low skill industries such as construction), automatic stabilizers through public transfers to those workers could help to at least partially offset the drop in private consumption.

But these transfers need to be timely, targeted, and timebound. They should not turn into long-term entitlements that create budget rigidities and negative labor market impacts. They need to be designed to clearly provide temporary relief.