4 July 2023

Research Turkey

Fixing the economy with only bad options on the table

- **President Erdoğan's new economic team has started monetary policy normalisation. However, reversing the course without causing more pain is all but easy, as imbalances in the economy have been building up for a while.**
- **We expect the CBRT to gradually hike the policy rate to 25%, but at a pace insufficient to bring the real rate into the positive territory, particularly as recent lira depreciation is expected to fuel inflation going forward. Credit demand is expected to remain elevated, maintaining pressure on current account and lira.**

President Erdoğan's personal preference for low interest rates has caused severe damage to the Turkish economy. Inflation has skyrocketed, external imbalances have grown, and the central bank's credibility and FX buffers have been eroded. As a result, an average Turk is poorer due to the loss of purchasing power; refinancing risks are on the rise particularly for those reliant on foreign borrowing; and the risk of an acute currency crisis remains as long as foreign reserves are very low.

How did Turkey end up in such a vicious circle? Obviously, low interest rates fuel inflation because a negative real rate encourages consumption and discourages savings. In Turkey, a low real rate has also led to net capital outflows and a rising demand for credit, which in turn, has boosted imports. Imports growth (where high energy prices are partially to blame) has topped exports growth, leading to a record-wide current account deficit. This implies that the country as a whole, all sectors included, is borrowing abroad. However, as capital outflows have same time been negative, the rising FX demand has led to a constant drain on foreign reserves – a factor that has further eroded the CBRT's credibility.

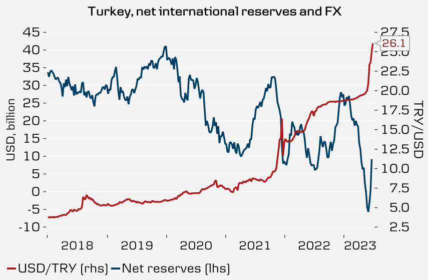
After the run-off presidential election on May 28, President Erdoğan decided to appoint Mehmet Şimşek as the finance minister, and a few days later, Hafize Gaye Erkan as the new central bank governor. Both have background in banking and enjoy a good reputation. Yet, breaking free from Turkey's vicious circle is all but easy. In our *Research Turkey – Time to fasten seatbelts as Erdogan secures another term*, 29 May, we highlighted the risk of lira depreciation in the absence of a policy turnaround. Thereafter, USD has gained more than 25% against lira despite the policy reversal. Why is that?

We think the recent fall in lira only underlines how the adjustment will be painful, particularly if you cannot go all in. We would have initially expected lira to appreciate once monetary policy is reversed but that would have necessitated that the CBRT would have hiked rates by so much the real rate would have been brought into the positive territory. In June, Turkish consumers still expected annual inflation at 39% end-of-year, so a 650bp hike by the CBRT, which brought the policy rate from 8.5% to 15%, was hardly sufficient. Hence, pressure on lira remains. Same time, lira depreciation in itself is also a reflection of policy normalisation: after the election, interventions in the FX market by state banks have been much more infrequent. Lira has been artificially strong, and now, in the absence of interventions, it is seeking a new equilibrium (although, in July, interventions seem to have resumed).

Previous publications

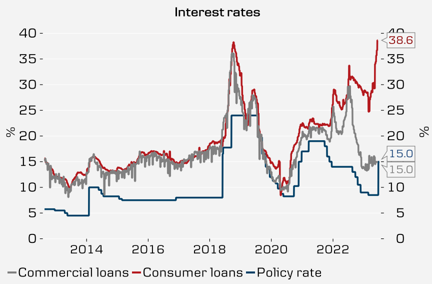
- *Research Turkey – Time to fasten seatbelts as Erdogan secures another term*, 29 May
- *Research Turkey – Erdogan's final countdown?* 8 May
- *Outlook Turkey – Erdogan faces his biggest test as May election approaches*, 23 February

Lira has weakened substantially post-election but also reserves have recovered



Source: CBRT, Macrobond Financial

Interest rates on commercial loans follow policy rate while consumers currently pay a higher rate



Source: CBRT, Macrobond Financial

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Lira depreciation has both good and bad implications for the economy. An artificially strong lira was one of the main reasons for criticism towards Erdoğan in the run-up to the election. According to media reports, even Erdoğan's son-in-law and the manufacturer of Bayraktar armed drones, Berat Albayrak, encouraged his father-in-law to reverse policy. Recent lira depreciation should boost exports, and hence, help a positive current account adjustment. Seasonal factors, lower energy prices and rising tourist income, will further lift FX inflows, which should also help FX reserves (the net figure stood at USD 9bn in June) recover. In longer term, an improvement in CA balance and a recovery in reserves would be positive for lira but the story is not that simple.

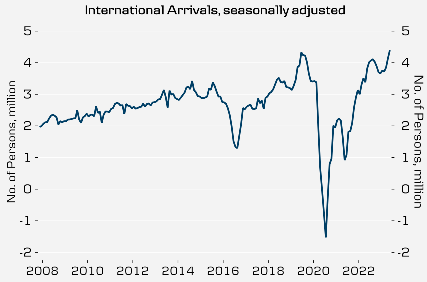
While boosting exports, massive lira depreciation is also a headache for the central bank as it will likely fuel inflation expectations. Rising inflation expectations will complicate the much-needed adjustment in real rate, and there is a risk demand for credit remains high, which in turn, could boost imports and demand for FX, sustaining the negative CA dynamics. Also, lira depreciation could again increase demand for FX-protected deposits, a special scheme introduced in December 2021, where the government compensates the depositor for any FX loss. FX-protected deposits are becoming a significant contingent liability, and a source of vulnerability for Turkey's public finances.

The CBRT, under its new leadership, could have decided to hike rates more aggressively and avoided a limbo, where, in the absence of interventions (that correctly aims at protecting the country's reserves), lira just continues to fall. Yet, it seems the new economic team does not have such a mandate. Probably, as in the short term such action would hurt economic growth. In a press conference after the appointments, Erdoğan presented a rhetorical question of whether the president is going to make a serious change in interest policy, and responded himself: '*I am the same'*. Indeed, it is likely that Erdoğan will closely monitor how the economy reacts to interest rate hikes in the run-up to next year's municipal election. If economic growth (that topped expectations in the first quarter) starts to falter, Şimşek and Erkan's days could soon be numbered.

Balancing between what one knows is necessary and how far one can go without provoking Erdoğan means that Şimşek and Erkan are walking on a tightrope. Unfortunately, we think this means the upcoming rate hikes will be insufficient in pace and scale to rapidly restore the health of the Turkey's economy. Meanwhile, imported inflation, particularly, is likely to rise due to weaker lira. We think the CBRT will hike rates by 250bp in the three upcoming meetings, bringing the policy rate to 22.5% by end of Q3. We think they will end the hiking cycle in the fourth quarter after having raised the policy rate to 25%. However, we stress that in the absence of forward guidance, visibility is poor, and Erdoğan could suddenly change his mind, which could again lead to a policy reversal. Remember, in March 2021, Erdoğan fired CBRT governor Naci Agbal after only five months in charge, once he had gone against Erdoğan's wish and hiked interest rates.

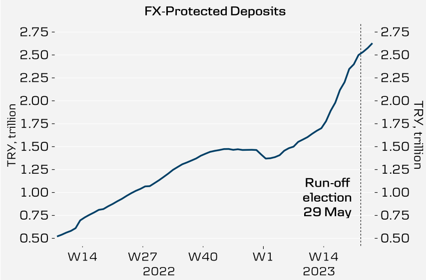
As the limbo continues, imbalances will continue to build up, and in the absence of (costly) interventions, lira will continue to fall. We highlight that one key risk to follow is Turkey's growing reliance on United Arab Emirates. Emirati banks have increased lending to Turkish banks since the two governments, previously locked in rivalry, reached a rapprochement in November 2021. According to Bloomberg, two of the Gulf state's largest lenders arranged 61% of all syndicated loans to Turkish banks during H1-2023, compared with about 15% the year earlier. Turkey also signed a USD 5bn swap deal with the UAE in 2022. Finance minister Şimşek has already paid a visit after his appointment and Erdoğan is planning to travel to UAE in July. Admittedly, despite having diverging positions in the past on several issues, the countries also have a long history of economic ties. Yet, too much reliance on one country is always a risk that warrants monitoring.

Tourism in Turkey is back to pre-pandemic levels



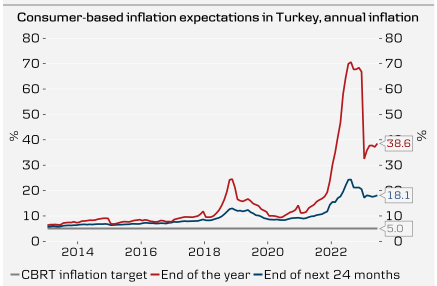
Source: CBRT, Macrobond Financial

Lira depreciation has increased demand for FX-protected deposits



Source: CBRT, Macrobond Financial

Consumers do not foresee a swift return to central bank's inflation target



Source: CBRT, Macrobond Financial

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Date of first publication

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