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Turkey: macro-financial situation

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Rationale

Turkey is identified annually as a material country for the Spanish and euro area banking systems. Moreover, Turkey and Spain are linked by major trade and financial flows. It is therefore important to monitor the country's macro-financial situation and main weaknesses.

Takeaways

- The Turkish economy continued to post very high inflation rates at end-2022, while economic activity began to slow in Q3, following its strong previous momentum. All of this in the context of sizeable external financing needs, foreign currency debt and low international reserves.
- Fiscal policy performed better than expected, and the country's accounts remain healthy. In terms of monetary policy, in August the Turkish central bank resumed the process of reducing the policy interest rate initiated a year earlier, with the real interest rate standing at -75.5% in November.
- Nonetheless, macroprudential and regulatory measures were implemented to keep credit growth in check and encourage only lending to certain productive sectors. Meanwhile, the banking sector's balance sheets remain relatively healthy, although some indicators have worsened.

Keywords

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

JEL codes

F31, F32, F34

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Introduction

In accordance with the guidance provided by the European Systemic Risk Board (ESRB),[1] Turkey has been identified annually by the Banco de España as a material country for the Spanish banking system,[2] largely due to the BBVA Group's credit exposures to this country through its subsidiary bank Garanti. BBVA's stake in Garanti's capital increased to 85.97% in 2022, compared to 49.85% prior to the voluntary takeover completed in May.

Garanti is Turkey's second largest private bank and the fifth largest if state-owned banks are also included. As at 30 September 2022, Garanti's assets accounted for 9% of total BBVA Group assets, and its contribution to the BBVA Group's net profit was 6.2% (€336 million), compared with 8.5% and 13.1%, respectively, as at 31 December 2021. The lower net profit in 2022 can be explained by the fact that hyperinflationary accounting[3] has been applied since 30 June 2022 (with effect as from 1 January of that same year), with a negative -€1,319 million impact on the net attributable profit in the first nine months of the year, mainly due to the revaluation of the net monetary position.

The Spanish and Turkish economies are also linked by major bilateral trade and financial flows. With regard to foreign trade, in 2021 1.7% of total Spanish exports went to Turkey (the 7th non-euro area country in terms of its share in such exports), while the stock of foreign direct investment (FDI) in Turkey amounted to 0.9% of the total in 2020 (the 12th non-euro area country). Turkey is also a material country for the banking systems of both the overall euro area and the European Union, and is likewise relevant in terms of trade. The flow of exports from the euro area to Turkey accounted for 1.4% of the total in 2021 (see Table 1).

This article first analyses economic and financial developments in Turkey in 2022, which were shaped, on the domestic front, by the application of an economic policy framework that seeks to use a weaker exchange rate to reduce the current account deficit and, externally, by the fallout from the war in Ukraine. It goes on to examine the economic policies implemented over this period and ends with a review of the state of the banking system.

Economic and financial developments

Very high, accelerating inflation was the most notable feature of the Turkish economy in 2022. Although inflation already exceeded 35% at end-2021 (more than double the figure at end-2020),

1 European Systemic Risk Bank (2015).

2 This identification exercise is based on the Banco de España's competence to set countercyclical capital buffer rates for domestic banking institutions according to their credit exposures to material third countries in response to certain financial stability risks. The operationalisation of the methodology for identifying material third countries is detailed in Banco de España (2017).

3 In line with IAS 29 (International Financial Reporting Standards: Financial Reporting in Hyperinflationary Economies), the audit firms publicly declared that hyperinflation accounting should be applied in Turkey as from 30 June 2022, with effect as from 1 January 2022.

Table 1
Exposure to Turkey of Spain and the euro area (a)

	€bn		% of GDP		% of total		Ranking	
Relevance of Turkey for:	Euro area	Spain	Euro area	Spain	Euro area	Spain	Euro area	Spain
Exports of goods	77.0	6.5	0.53	0.45	1.41	1.69	17	13
Imports of goods	72.7	9.5	0.50	0.67	1.37	2.27	18	11
Exports of services	13.2	0.5	0.10	0.04	0.59	0.59	33	26
Imports of services	15.9	0.5	0.12	0.04	0.74	0.77	26	18
International investment position FDI: assets	56.9	5.3	0.44	0.42	0.34	0.91	38	18
International investment position FDI: liabilities	19.1	0.1	0.15	0.01	0.14	0.01	47	52
International investment position portfolio investment: assets	34.2	0.3	0.26	0.02	0.12	0.03	42	44
International investment position portfolio investment: liabilities	0.2	0.0	0.00	0.00	0.00	0.00	73	56
Credit exposure to Turkey of banks reporting to the BIS (b)	112.8	64.4	0.78	4.52	0.96	3.28	23	10
Turkish banks' claims on euro area and Spanish residents	6.4	0.0	0.04	0.00	0.07	0.00	21	24
Turkish residents' debt with euro area and Spanish banks (c)	112.8	64.4	13.98	7.99	64.42	36.80	---	1

SOURCES: BIS, IMF, World Bank, Ministerio de Industria, Comercio y Turismo, OECD and Banco de España.

a Data for 2021 (trade balance), 2020 (services balance and IIP in FDI) and June 2021 (IIP in portfolio investment).
b Euro area and Spanish data for 2021 Q3.
c Turkish data for 2021 Q3.

prices continued to accelerate in 2022, with the year-on-year rate reaching a 24-year high of over 85% in October. Moreover, core inflation continued to rise, exceeding 70% in the same month (see Chart 1.a).

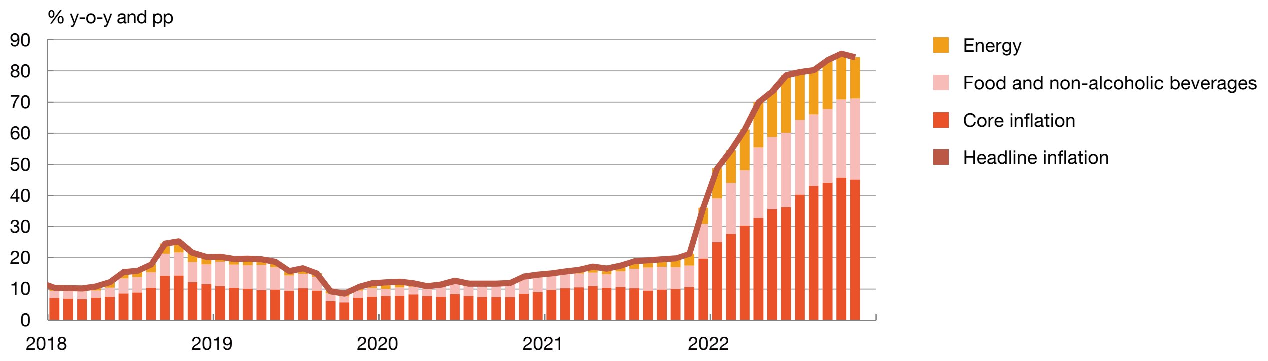
Meanwhile, there was a progressive deanchoring of inflation expectations.[4] While such expectations are now easing gradually, they still stand at very high levels: 34.6% 12 months ahead and 20.6% 24 months ahead. Even the five-years-ahead rate (with a projection of 9.1%) falls outside the 5% ± 2 pp target rate set by the Central Bank of the Republic of Turkey (CBRT).

The domestic causes of this very high inflation notably include the strength of domestic demand, buoyed by low interest rates and robust nominal credit growth. The 30% increase to the minimum wage in July (affecting around two-thirds of overall formal employment), which came on top of the 50% hike in January, has also played its part. It is worth noting that a further 55% rise has been announced for January 2023.

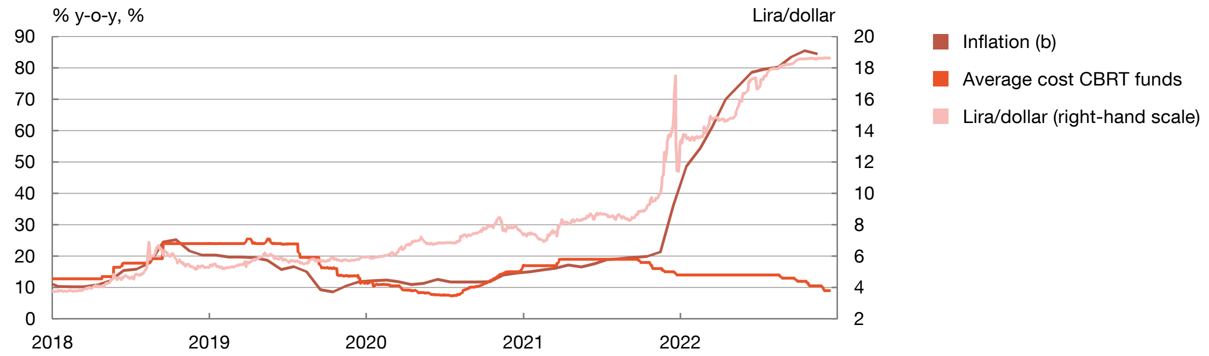
4 CBRT (2022e).

Chart 1
Inflation continued to rise sharply in 2022 H2

1.a Contributions to year-on-year inflation (a)



1.b Inflation, interest rate and exchange rate



SOURCES: Thomson Reuters, CBRT and Turkish Statistical Institute.

a The contribution of the components is measured as the rate of change of each component multiplied by its weight in the CPI.
b CPI.

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The external factors include those deriving from global supply chain difficulties, which have gradually been remedied, alongside those caused by the invasion of Ukraine, such as the sharp rise in commodity prices, particularly energy (Turkey imports more than 90% of the gas and petrol it consumes). The depreciation of the Turkish lira has also contributed to the increase in imported inflation (see Chart 1.b).

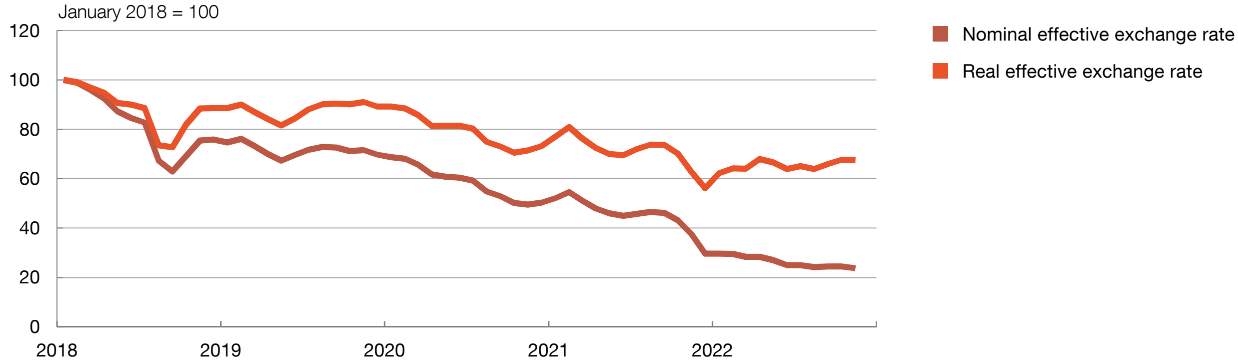
The Turkish lira exchange rate continued to decline in 2022. It fell 29% against the dollar (the main currency of the country's international trade positions), four times the average for emerging market economies. This despite the Turkish authorities' currency market interventions to prop up the lira and their "liraisation" strategy.[5] Nonetheless, the real effective exchange rate appreciated by 6% in 2022 H2, since the surge in inflation more than offset nominal effective depreciation (see Chart 2.a).

5 CBRT (2022b and 2022c).

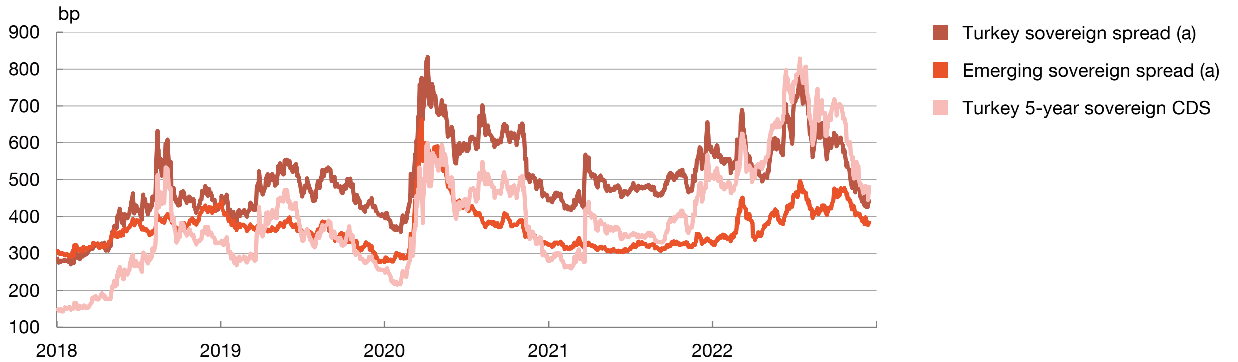
Chart 2

Deepening financial tensions and a rising risk premium

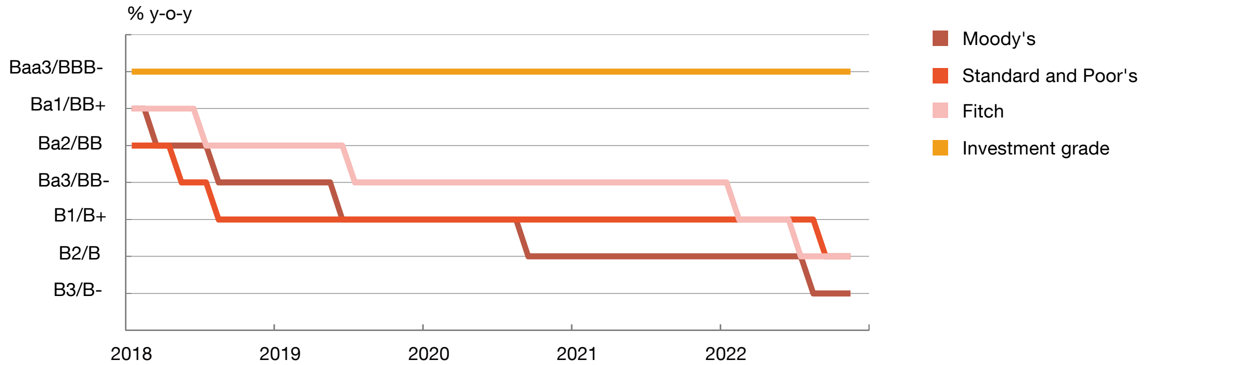
2.a Turkish lira effective exchange rates



2.b Country risk indicators



2.c Sovereign rating



SOURCE: Thomson Reuters.

a JPM EMBI Global-Stripped Spread.

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Introduced in December 2021, the liraisation strategy essentially seeks to stabilise the Turkish currency by reducing the country's dependence on international currencies. It aims to do so by creating new financial instruments (such as the foreign exchange-protected deposits, the centrepiece of this strategy[6]), diversifying collateral and regulating liquidity management practices.

6 Sánchez Pastor (2022).

In addition to the pressures on the lira, the increased tensions on the Turkish financial markets were also reflected in higher sovereign risk premia and the downgrade of Turkish government debt between July and October by the leading credit rating agencies (see Charts 2.b and 2.c).

Moreover, against this background of high inflation and a weak lira, the demand for and price of certain safe-haven assets have risen. Housing is a case in point, with prices fast outpacing inflation since 2021 (188% year-on-year in October 2022), driven also by higher demand (mainly purchases without a mortgage, albeit in part owing to foreign demand) and other factors such as rising construction costs and the moderation of the housing supply.

Similarly, gold imports have increased and the main stock market index has risen considerably (see Chart 3.a). In terms of deposit dollarisation (another way of protecting savers), the introduction of foreign exchange-protected deposits has helped reverse the rising trend in bank deposits in foreign currency. Thus, such deposits have fallen from 65% of total deposits at the start of the year to 53% in October. Nonetheless, if protected deposits are also included when calculating deposit dollarisation, this figure exceeds 70% (see Chart 3.b).

Turing to economic activity, the Turkish economy continued to grow at a rapid pace in 2022 H1, with 7.5% year-on-year growth, thanks in large part to the buoyancy of private consumption (fuelled by loose credit conditions and the positive performance of the labour market) and of exports (see Table 2). However, 2022 Q3 saw a 0.1% quarter-on-quarter drop in GDP, recording a negative growth rate for the first time since 2020 Q2 (see Chart 5.a), due to a fall in investment and exports.

Looking ahead, activity is expected to continue slowing in the near-to-medium term. Private consumption is likely to decelerate due to the fall in real disposable income brought about by very high inflation and to the expected moderation in lending as a result of the macroprudential measures set in place in mid-2022. Moreover, exports are expected to make a smaller contribution to GDP growth, given the loss of competitiveness associated with the appreciation of the lira in real effective terms.

Additionally, the Turkish economy will continue to be affected by the adverse effects of the Russian invasion of Ukraine, as it has close trade ties with both these countries,[7] and by lower external demand. In this setting, the International Monetary Fund (IMF) expects GDP growth to slow down to 3% in 2023 from 5% in 2022 (see Chart 4.b).

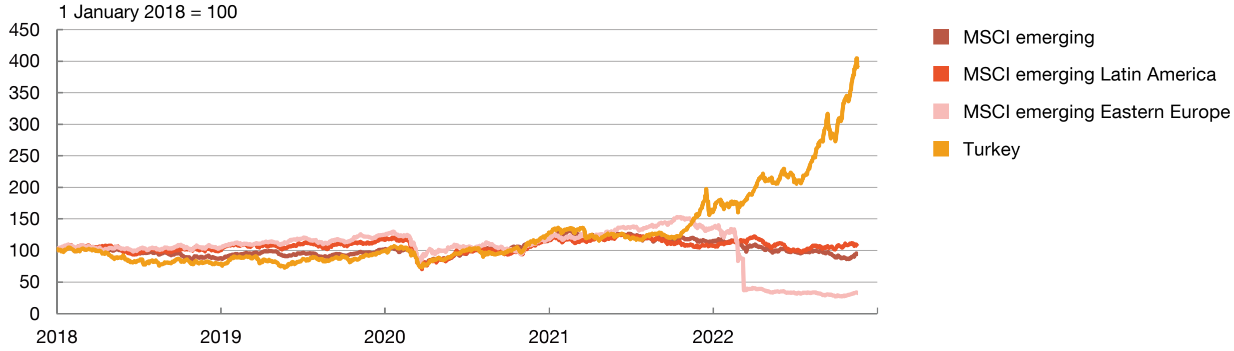
The current account deficit, another vulnerability for the Turkish economy, widened further to 5.5% of GDP in October, in 12-month cumulative terms. This represents a substantial worsening from the average for the period 2015-2021 (2.7% of GDP) (see Chart 5.a). The deterioration in 2022 is explained by the notable increase in the energy trade deficit (given the sharp rise in the cost of the energy that Turkey needs to import) and higher imports of gold (as a safe-haven asset) and of other goods overall (due to the buoyancy of consumption).

7 Sánchez Pastor (2022).

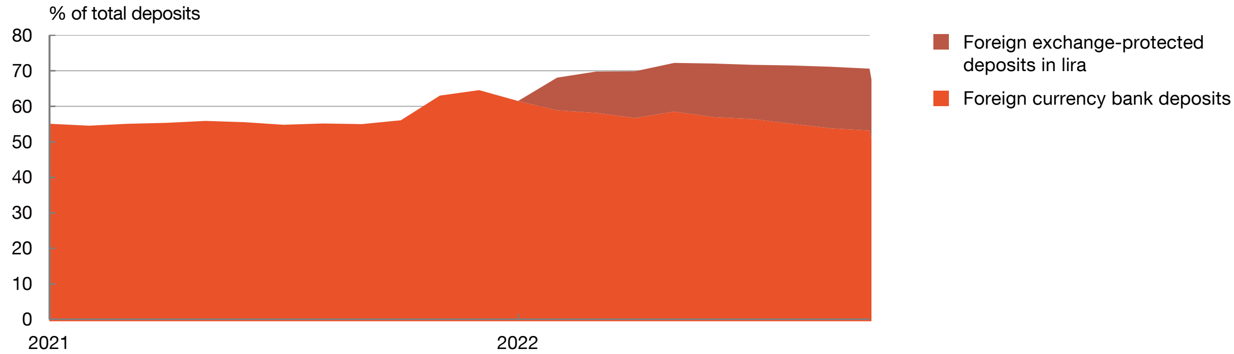
Chart 3

Rising prices and demand for certain safe-haven assets

3.a Stock market indices



3.b Dollarisation of deposits



SOURCES: Thomson Reuters and Turkish Banking Regulation and Supervision Agency.

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This deterioration took place despite the notable increase in tourism receipts and the beneficial effects on Turkish exports of the higher demand from some of its neighbouring countries and from Russia. In the case of the former, exporters harnessed the opportunities arising from the disruptions in Asian supply chains[8] (due to the closure of Chinese ports because of the zero-COVID policy, higher freight costs, etc.). In the case of Russia, as Turkey did not join the sanctions imposed by developed countries, there was a notable increase in Turkish exports of technological products.

The external deficit was largely financed by inflows of foreign direct investment and other investments (loans) and a reduction in reserves. Also of note were the portfolio capital outflows and the sharp increase in errors and omissions (see Chart 5.b).

The country continues to depend heavily on external financing, although its net negative international investment position improved in the first three quarters of 2022 (-29.6% of GDP),

8 See the section on Turkey in OECD (2022).

Table 2
Main economic indicators (a)

	2019	2020	2021	2021 Q4	2022 Q1	2022 Q2	2022 Q3
GDP	0.8	1.9	11.4	9.6	7.5	7.7	3.9
GDP (q-o-q)				1.6	0.6	1.9	-0.1
Domestic demand	-1.4	7.3	6.5	5.3	4.7	5.2	3.3
Private consumption	1.5	3.2	15.3	20.5	21.1	22.5	19.9
Government consumption	3.8	2.5	2.6	1.4	4.7	2.0	8.5
Fixed capital investment	-12.5	7.4	7.4	2.1	4.1	5.0	-1.3
Exports	4.2	-14.4	24.9	21.6	14.8	16.4	12.6
Imports	-5.0	6.7	2.4	3.1	2.2	5.8	12.2
Consumer prices	15.2	12.3	19.6	25.8	54.8	74.1	81.1
Core inflation	13.5	11.2	18.3	22.2	44.0	55.3	65.3
Retail sales (IBGE)	-0.5	3.1	16.4	13.2	7.7	12.6	7.6
Consumer confidence index (b)	79.7	81.0	79.0	72.3	72.3	66.1	70.9
Total credit	4.0	29.0	21.7	24.1	38.3	52.2	64.8
Industrial production	-0.6	2.2	16.5	11.5	10.3	10.7	2.5
Total employment	-2.2	-4.7	7.6	9.9	7.9	8.0	5.8
Unemployment rate (% of labour force)	13.7	13.1	12.0	11.2	11.0	10.7	10.0
Wages	18.2	7.0	39.7	48.6	68.4	76.0	97.8
Current account balance (% of GDP)	1.4	-4.4	-0.9	-0.9	-2.3	-3.0	-7.0
Trade balance (% of GDP)	-2.2	-5.3	-3.6	-3.6	-5.5	-6.9	-13.6
International reserves ($bn)	144.9	128.0	156.7	156.7	152.1	143.4	152.8
Central government primary balance (% of GDP)	-0.6	-0.8	-0.2	-0.2	0.4	1.6	0.8
Central government total balance (% of GDP)	-2.9	-3.4	-2.7	-3.6	-3.1	-1.3	-1.4
Public sector gross debt (% of GDP)	30.8	35.9	37.9	37.9	37.2	33.7	44.5
Sovereign spread (bp)	467.4	574.2	487.6	532.5	568.5	578.2	657.6
Exchange rate against $ (period average)	5.7	7.0	8.8	11.1	13.9	15.8	17.9
Exchange rate against € (period average)	6.4	8.0	10.4	12.6	15.6	16.8	18.1
Policy interest rate (1-week repo auction)	12.0	17.0	14.0	14.0	14.0	14.0	12.0

SOURCES: CBRT and Thomson Reuters.

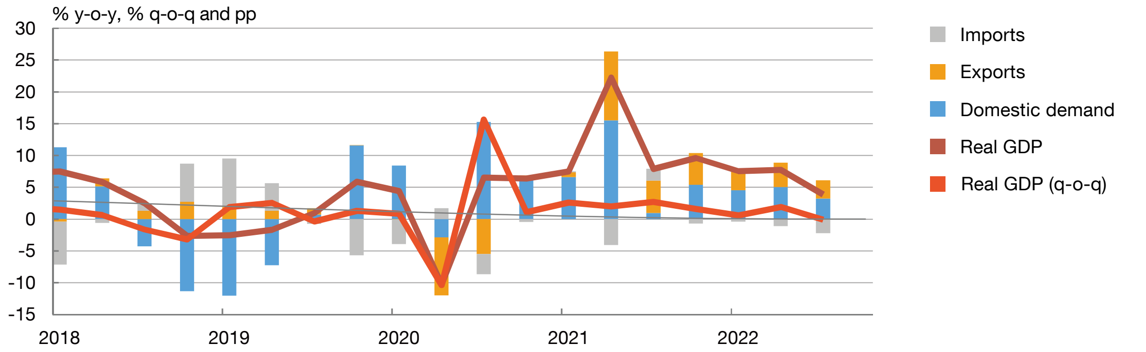
a Year on year change, unless otherwise indicated.
b Levels.

owing to a reduction in liabilities, both in direct investment and in portfolio investment (see Chart 6.a). The first half of the year saw a rise in gross external debt (to 60.1% of GDP), primarily that of the public sector, which now accounts for almost half of total external debt.

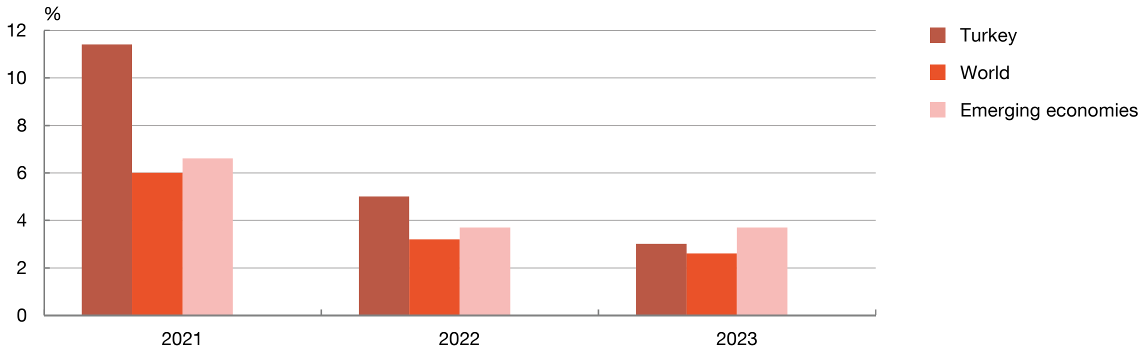
Within non-financial corporations' foreign currency-denominated debt, the difference between long-term financial liabilities and assets has narrowed. Indebtedness to domestic banks has decreased and has fallen below the debt owed to external lenders for the first time in more than ten years. In the short term, although assets exceed financial liabilities, the vulnerability arising from the relative mismatch across firms remains (for example, many construction companies have foreign currency debt but their income is in Turkish lira), compounded by the exchange rate depreciation, which poses a risk for Turkish banks (their main lenders) (see Charts 6.b and 6.c).

Chart 4
The Turkish economy has sustained a strong pace of growth, but the outlook is for moderation

4.a GDP growth rate and contributions



4.b GDP growth forecasts (a)



SOURCES: Ministry of Treasury and Finance, Turkish Statistical Institute and IMF.

a October 2022 IMF forecasts.

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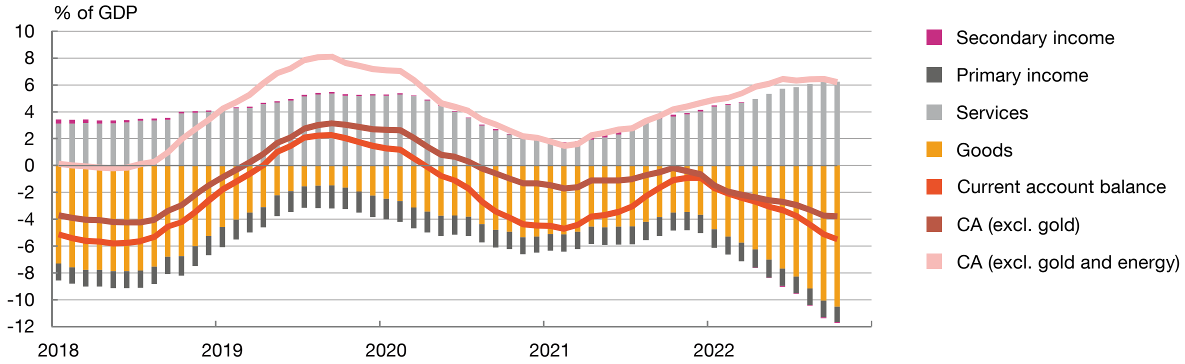
Economic policies

Turkey's fiscal accounts remain relatively healthy and have performed better than expected in 2022, as the economic buoyancy and inflation have driven up revenues, while some expenditure items, such as compensation of employees or social transfers, take longer to adjust to inflation (see Chart 7.a).

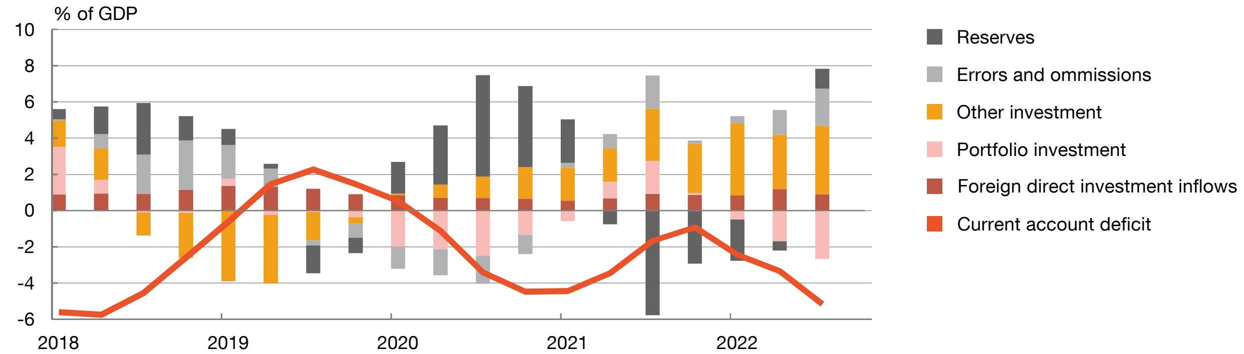
That said, although the central government deficit had narrowed to 0.6% of GDP by mid-year (in four-quarter cumulative terms), it is projected to deteriorate substantially in 2022 and 2023 to 3.4% and 3.5%, respectively, according to the Turkish Government's Medium-Term Plan 2023-2025 estimates. This worsening will come on the back of lower tax revenue (due to more subdued economic growth), and an increase in expenditure (due to the measures taken to tackle inflation and, possibly, to the measures that may be adopted to energise the economy, given the proximity of the June 2023 elections).

Chart 5
The current account deficit is widening

5.a Current account
12-month cumulative



5.b Current account balance and financing
4-quarter cumulative



SOURCES: Thomson Reuters, CBRT, Ministry of Treasury and Finance and Turkish Statistical Institute.

Further, the introduction of foreign exchange-protected deposits, which shift exchange rate risk to the public sector, is creating a potentially large contingent liability.[9] Public debt has declined in 2022 to stand at 29.3% of GDP in Q3, while its average maturity has lengthened, although the proportion of foreign currency-denominated debt has increased (see Chart 7.b).

With regard to monetary policy, and in line with the Government's New Economic Model,[10] based on low interest rates, the CBRT resumed the path of rate cuts it had embarked on in 2021 Q4, lowering its benchmark interest rate by a cumulative total of 500 basis points (bp) between August and November 2022, to 9%. Thus, the policy interest rate in real terms, both ex ante (calculated using 12-months-ahead inflation expectations) and ex post (using current inflation)

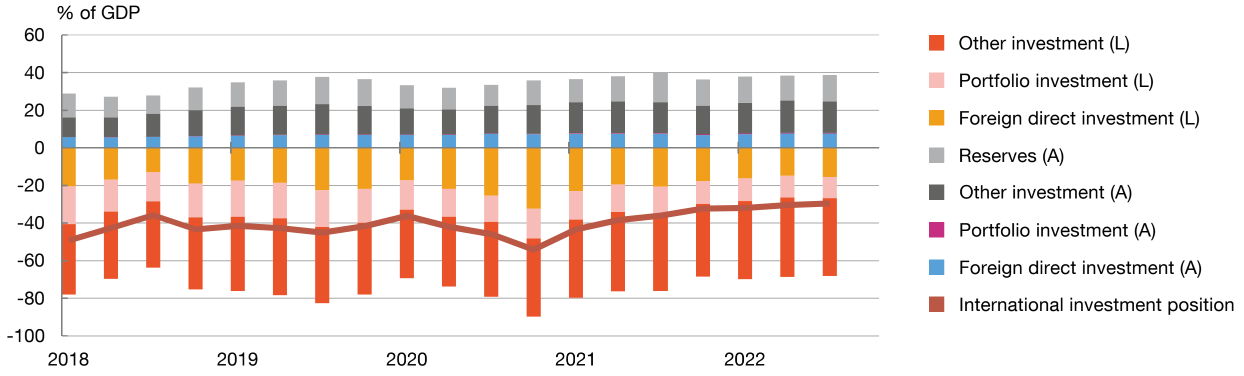
9 With an estimated cost that could exceed 5% of GDP in a scenario of extreme depreciation of the lira, according to Barclays.

10 The so-called "New Economic Model" seeks to encourage private investment and improve export competitiveness via low interest rates and a weak exchange rate, in order to reduce the current account deficit. See the section on Turkey in European Bank for Reconstruction and Development (2022).

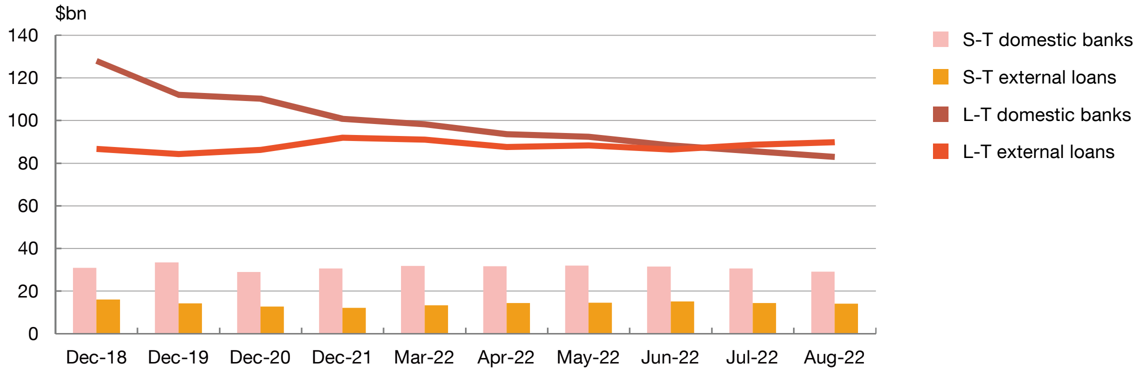
Chart 6

The country remains highly dependent on external financing, although the situation of non-financial firms is improving

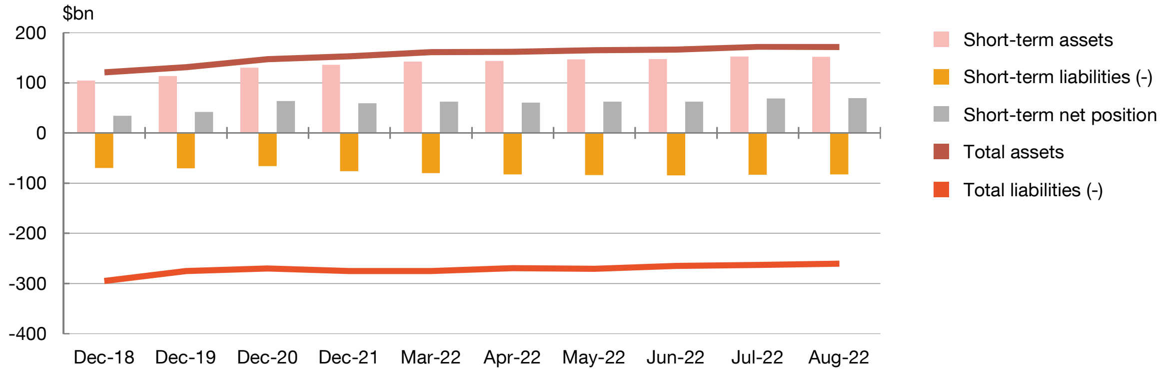
6.a External position (a)



6.b Non-financial firms' foreign currency liabilities by maturity (b)



6.c Non-financial firms' foreign currency assets and liabilities



SOURCES: Thomson Reuters, CBRT, Ministry of Treasury and Finance and Turkish Statistical Institute.

a (A) assets; (L) liabilities.
b Short-term external loans include long-term external loans falling due within a year. However, short-term domestic loans do not include long-term bank loans falling due within a year.

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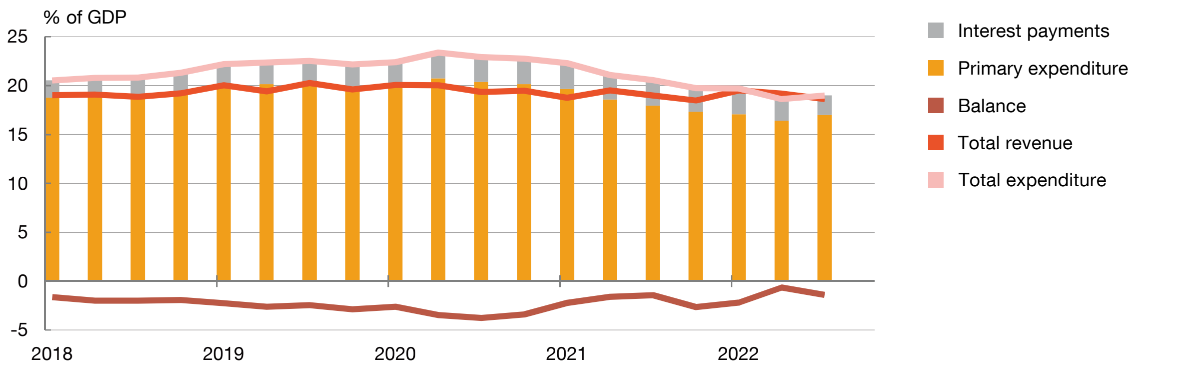
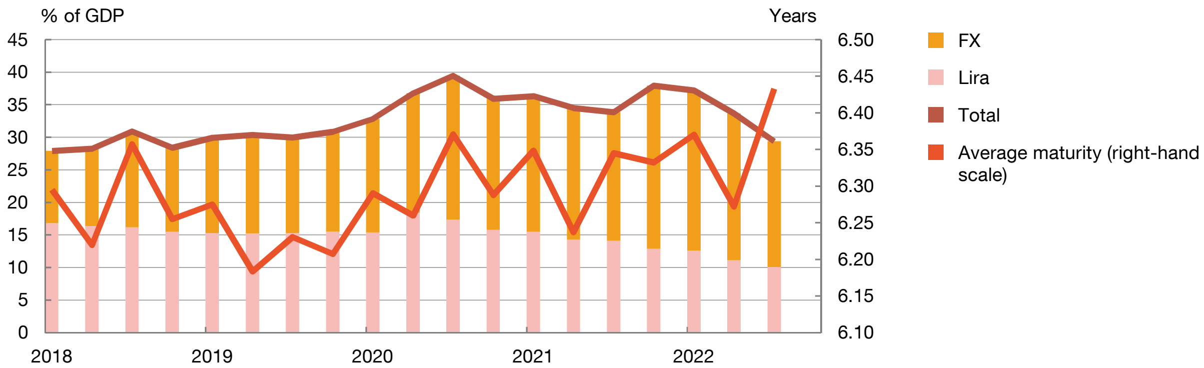
Chart 7
A healthy starting position for public finances

7.a Central government balance
4-quarter cumulative



7.b Gross central government debt



SOURCES: Thomson Reuters and Ministry of Treasury and Finance.

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would stand in deeply negative territory (-28.5% and -75.5%, respectively, in November). This gives an idea of the remarkable looseness of monetary policy.

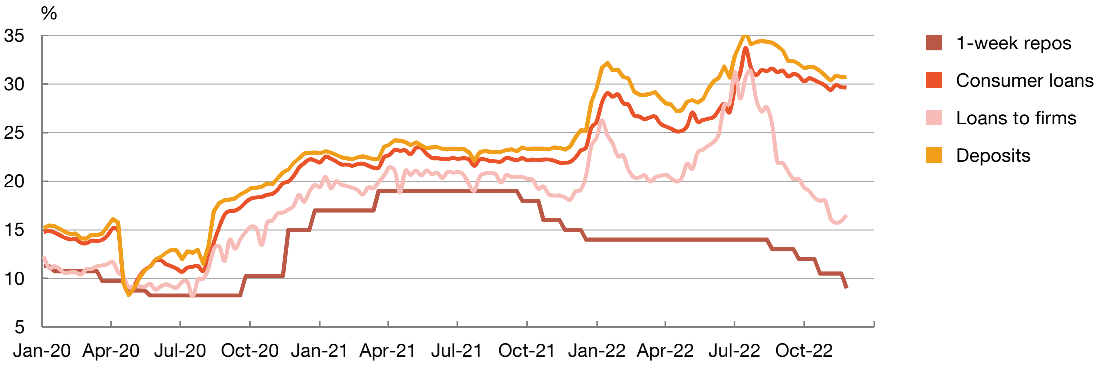
However, given the diverging course of policy and market interest rates since end-2021 (see Chart 8.a), the CBRT introduced a measure in August 2022 to narrow the widening gap between the policy interest rate and corporate lending rates, by forcing credit institutions to hold a certain percentage of the amount lent in lira-denominated bonds, which varies according to the difference between these two interest rates.[11]

Net international reserves have remained very low (and in negative territory if swaps with commercial banks are excluded) (see Chart 8.b). This has been so despite (i) the foreign exchange transfers received from Russia since the summer relating to the construction of a nuclear power plant in Turkey by a Russian firm, (ii) the measures aimed at increasing reserves, as part of the

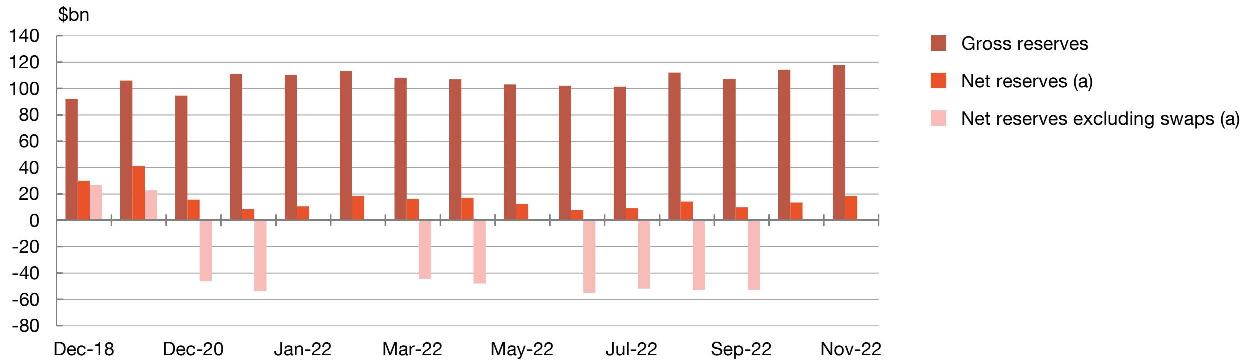
11 They must hold 20% of the amount lent when the compound annual interest rate is more than 1.4 times the benchmark rate. If the rate applied is more than 1.8 times the benchmark rate, they must hold 90% of the amount lent.

Chart 8
The CBRT has lowered its policy interest rate, against a backdrop of soaring inflation and scarce international reserves

8.a Interest rates in Turkish lira



8.b CBRT reserves



SOURCES: Thomson Reuters, CBRT and Turkish Statistical Institute.

a Gross reserves = gold and foreign currency. Net reserves = gross reserves - reserve requirements (gold and foreign currency) - public sector foreign currency deposits. Net reserves excluding swaps = net reserves - gold swaps and foreign currency swaps. The information on net reserves and net reserves excluding swaps is from Barclays, with no data available for January, February, May, October and November 2022.

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liraisation strategy (such as the requirement for exporters to convert 40% of their foreign currency income into Turkish lira),[12] and (iii) the strong performance of tourism.

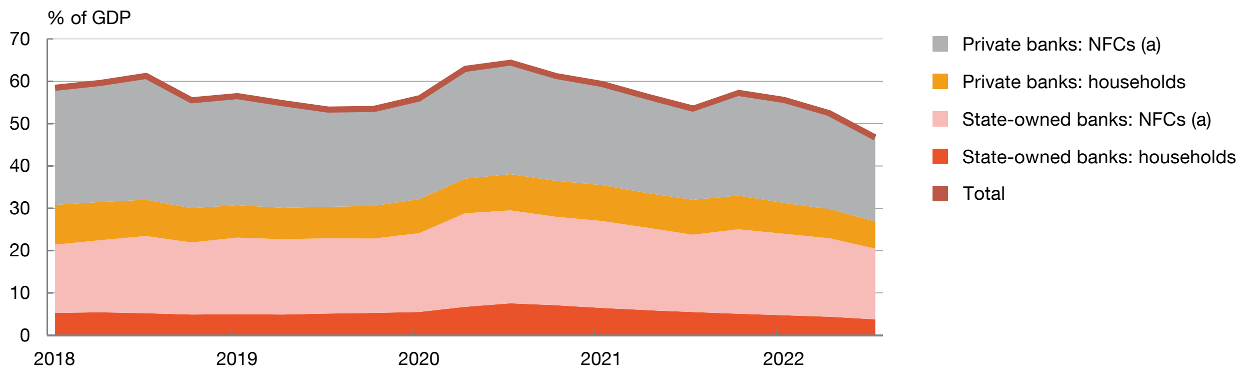
The banking sector

The banking sector has remained healthy in 2022, although indicators have performed unevenly. With regard to credit developments, lending to the corporate sector has fallen in real terms, albeit to a lesser extent than lending to households (see Charts 9.a and 9.b). The introduction of a series of measures by the CBRT and the Banking Regulation and Supervision Agency (BRSA) have influenced these developments.

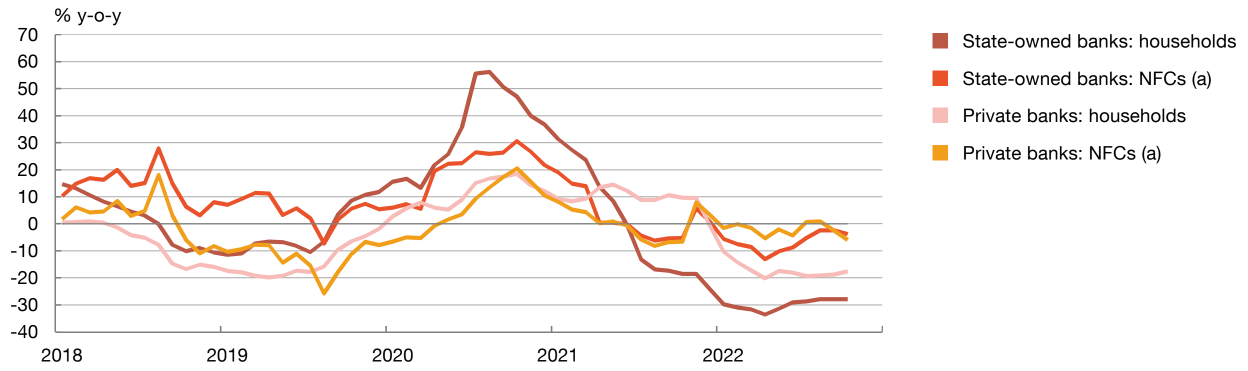
12 See press releases of 23 April, 10 June and 18 October in CBRT (2022a).

Chart 9
Measures have been introduced to control credit growth

9.a Stock of bank credit



9.b Change in real bank credit



SOURCES: Thomson Reuters and Ministry of Treasury and Finance.

a Non-financial corporations.

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Thus, in tandem with the easing of monetary policy, macroprudential and regulatory measures were implemented with the aim of keeping credit growth in check and boosting only lending to the productive sectors most related with investment, exports and potential growth. With respect to lending to the corporate sector, the new measures in force (mainly the imposition of reserve requirements on loans to certain business activities considered to be of less interest) have led to a rise in the cost of such lending.

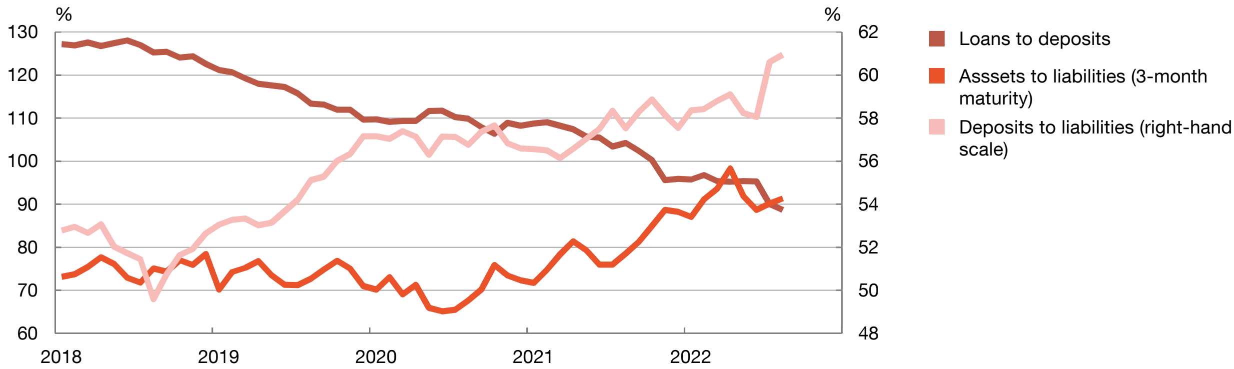
As for consumer credit[13] (which in Turkish statistics includes mortgage lending and credit cards), measures were introduced in June[14] reducing the maturity of consumer loans from 24 months to 12 months, increasing the minimum repayment rate for credit cards and reducing the loan-to-value ratio for mortgages.

13 Mortgages account for 25% of total consumer credit, credit cards for 28%, general-purpose loans for 44% and auto loans for 3%.

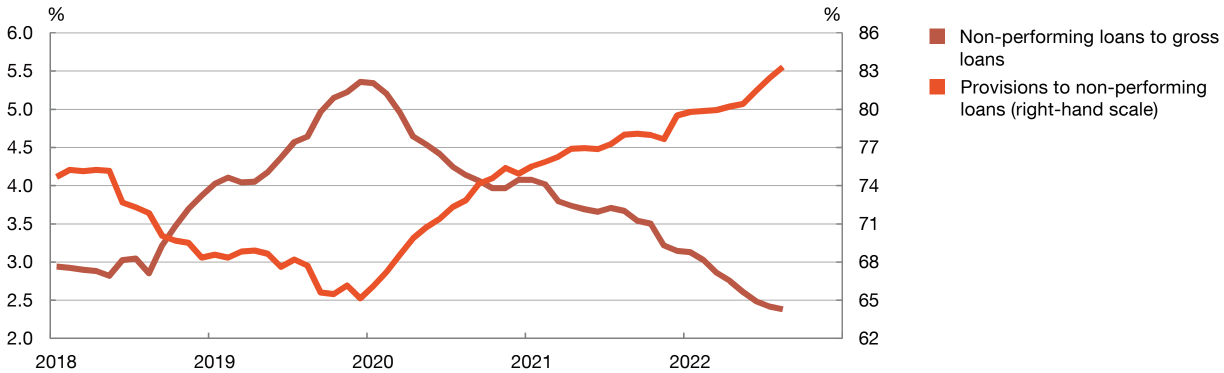
14 CBRT (2022d).

Chart 10
The banking system remains healthy

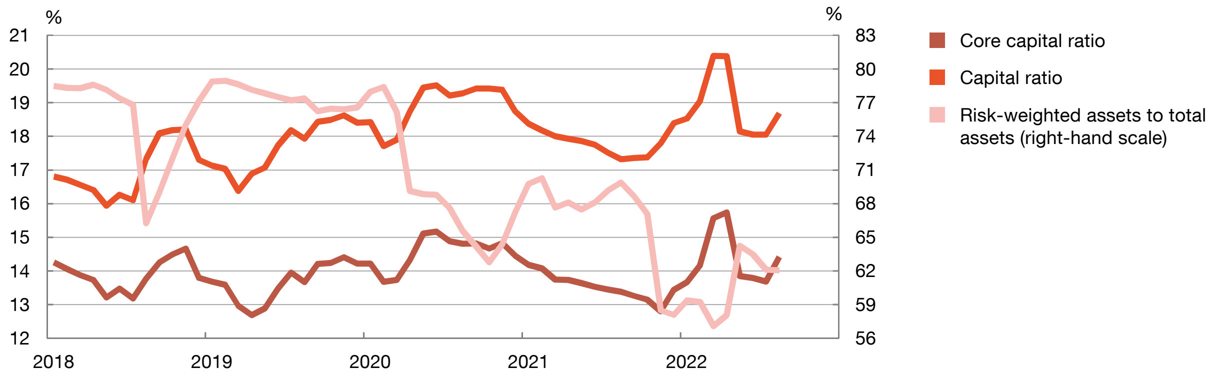
10.a Liquidity and leverage



10.b Non-performing loans



10.c Solvency



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SOURCES: Turkish Banking Regulation and Supervision Agency.

The liquidity position of the banking sector remains comfortable, although lately lending has been growing more than deposits and the rising trend in the percentage of short-term assets relative to short-term liabilities has reversed (see Chart 10.a). Additionally, 100% of syndicated loans have been rolled over, although at a higher cost. The non-performing loan (NPL) ratio has continued to decrease (to 2.4%) and provisions have continued to increase (see Chart 10.b). The solvency ratio's upward trend reversed from April, although it remains above the regulatory limits (the capital adequacy ratio (CAR) stood at 18.7% in August 2022) (see Chart 10.c).

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