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Turkey: caught in emerging markets turbulence

The most striking news over the past few weeks was the nearly 20% devaluation of the Turkish lira combined with a strong increase of the minimum lending rate by 175 basis points to 15% by the Central Bank on 7th June.[1] Turkey is thus one of the most pronounced examples of the recent adjustment processes taking place in international financial markets which have seen increases in interest rates worldwide (guided by the actions of the US Federal Reserve Bank) and a major rearrangement of international portfolios away from emerging markets and towards more home-biased portfolios in both the US and Europe. The reasons for such a rearrangement are explained in the introductory section of this report.

However, there are also reasons why the reaction to this change in the global environment was particularly strong in Turkey. Amongst the economic developments were deteriorating inflation rates as well as the consistent current account imbalances. On the political front there were a number of signs that tensions were rising within Turkey between the current government and various opposition forces in preparation of a long-drawn out pre-election period (elections are to be held in 2007). On top of that is the problematic situation with respect to Turkey's EU accession process.

Year-on-year inflation rates, which had come down from 45% (CPI) and 48% (PPI) in 2002 to 8.2% and 5.9% respectively in 2005, nudged upwards to 8.8% in April and 9.9% in May 2006 (both CPI figures). Some of this increase is due to higher petroleum and imported commodity prices, but commentators found this turnaround nonetheless surprising. The inflation targeting strategy by the Central Bank to bring the yearly inflation rate down to 5% in 2006 now seems unattainable. Particularly high were the price increases of clothing and footwear, food and beverages and household equipment for the CPI, as well as agriculture and the metal industries for the PPI.

The trade accounts were seriously affected by the rise in fuel prices, as import growth amounted to 13.2% in the first quarter of 2006 and export growth to 4.3%. However, 7.6 percentage points of the increase in imports can be accounted for by growth in mineral fuels, mineral oils and other oil-related items. The exports/imports ratio in goods trade amounted to 61.8% in the first quarter of 2006 as compared to 62.3% in the first quarter of 2005. The current account deficit reached USD 8.6 billion in the first quarter of 2006 as compared to USD 6.2 billion in the corresponding quarter of 2005. The current account

[1] On 25th June the Central Bank increased the rate by another 225 basis points to counteract the continuing pressure on the Turkish currency, so that the minimum lending rate stands now at 17.25%.

deficit amounted to 6.4% of GDP in 2005 and the expectation – before the recent turbulence – was that it would remain roughly at that level or increase slightly to 6.5% in 2006. Taking the short-run, terms-of-trade, effects of the recent devaluation into account, it might deteriorate to 7.0% in 2007, which would further support a cautious stance by international investors and lenders in the short/medium term.

In the last wiiw forecast report[2] we discussed at length the international financial accounts and pointed to the high inflows of foreign credits to the private sector. This fuelled both consumption and investment expenditure. Looking at the first quarter of 2006, the financial accounts showed a net inflow of USD 16.5 billion (i.e. almost double the current account's deficit of USD 8.6 billion). Of this amount, 1.2 billion was foreign direct investment, 3.6 billion portfolio investment, 9.2 billion were trade and financing loans to the corporate sector, and 2.8 billion credits to banks. In the first quarter of 2006, therefore, corporate and bank loans accounted for 67% of total net inflows of capital (currency reserves increased by over USD 7 billion). The picture was thus one of a high inflow of liquidity into the Turkish economy built on an expectation of continued high rates of economic growth (of about 6% per annum both in 2006 and 2007). This was on the foundations of impressive achievements over the 2002-2005 period in terms of conquering fiscal problems (public debt had declined from 93% of GDP in 2002 to 68% in 2005; interest payments on public debt had come down from 19% of GDP in 2002 to 9.4% in 2005; the consolidated budget balance from -16.2% of GDP in 2002 to -4.4% in 2005 with a primary surplus of 5%) and a sharp fall in inflation rates.

There were, therefore, a number of factors which made international investors react even more in the case of Turkey than in the case of other emerging markets when a reshuffling of international portfolios started to take place in May 2006 in the wake of rising interest rates in the US and in Europe and an expectation of a slowdown of the US economy (and specifically of its importing capacity). Turkey had managed to massively reduce inflation rates, but they still hovered around 8% per annum and there was a very sizeable current accounts deficit. While there were important changes going on in the export structure, which was upgrading from more traditional labour-intensive commodities to more sophisticated industrial products, the overall export-import ratio (around 62%) did not indicate a turnaround and hence the situation could be interpreted as one where a devaluation was required to correct an 'over-valued' currency. Amongst emerging markets which had experienced a massive inflow of liquidity, Turkey was a prime candidate where such a correction could take place and such a situation easily initiates a self-fulfilling process. In the wake of general outflows from emerging markets to reduce the degree of risk in international portfolios,

[2] L. Podkaminer, V. Gligorov et al., 'Strong Growth, Driven by Exports in the NMS and by Consumption in the Future EU Members', *wiiw Research Reports* No. 325, February 2006.

Turkey therefore experienced a particularly strong pressure on its currency and on stock market values.

Furthermore, developments inside Turkey and in Turkey's relationship to the EU did not help to instil a picture of stability and trust. There was a tussle over the (rather late) appointment of a new Governor of the Central Bank and an assassination of a judge which was seen as reflecting a sharpening of conflict between secularist and Islamic forces, and growing criticism in the business community and the military over government policies. At the same time, the EU embarked towards very hesitant accession negotiations with Turkey and the increasing perception of a tough stance being taken by a number of EU member states (and the Commission itself) at each stage of the negotiation process combined with a very uncertain final outcome, increased the feeling that the longer-run Turkish position in international economic relations was rather uncertain. The perception is thus different compared with even half a year earlier when the decision regarding the start of negotiations was highly welcomed by the international financial community.

What to expect next? One could take both an optimistic and a pessimistic stance as regards future developments. On the optimistic side, one could interpret recent developments as a healthy shock leading to an adjustment in an over-valued exchange rate and, at the same time, giving the monetary authorities (the new Governor of the Central Bank) the opportunity to show their determination in insisting on the continuation of a downward path of inflation and in fiscal prudence, as a deviating policy would lead to further punishment by international financial markets. The devaluation combined with a watchful control of domestic inflationary pressures could indeed tackle the rather vulnerable current account situation and thus add stability in external accounts to the already achieved stability in internal fiscal accounts. The pessimistic picture emerges from an uncertainty to which extent and with what time horizon an international adjustment of portfolio positions might continue to take place. In the case of a more protracted process, the pressure on the Turkish currency will persist, the fear of induced, imported inflationary pressures might lead to even stronger interest rate hikes and this could severely affect growth. Growth and restructuring was (and will continue to be) characterized by a high demand for imported capital equipment and other necessary inputs which can be badly affected by devaluation. Furthermore, the hard earned trust in the value of the domestic currency by domestic savers might be endangered, reducing the effectiveness by which domestic policy-makers can influence monetary developments. Finally, international investors will continue to be affected by monetary developments (in inflation and exchange rate expectations) and perceptions of Turkey's longer-run position with respect to the European Union.

Our own forecasts over the next two years reflect the uncertainty with regard to the bets regarding the optimistic and pessimistic outcomes, and we adjust modestly downwards our growth forecasts for the Turkish economy.

Table TR

Republic of Turkey: Selected economic indicators

	2001	2002	2003	2004	2005 [1]	2005	2006 [1]	2006	2007
						1st quarter		forecast	
Population, th pers., mid-year [2]	68365	69302	70231	71152	72065	.	.	.	.
Gross domestic product, YTL mn, nom.	178412	277574	359763	430511	487202	94675	.	560000	626000
annual change in % (real)	-7.5	7.9	5.8	8.9	7.4	6.6	.	5.5	5.5
GDP/capita (EUR at exchange rate)	2386	2799	3028	3416	4040	.	.	.	.
GDP/capita (EUR at PPP - wiiw)	5370	5650	5810	6520	7210	.	.	.	.
Gross industrial production									
annual change in % (real)	-8.7	9.5	8.7	9.8	5.3	6.1	3.1	6	6
Gross agricultural production									
annual change in % (real)	-6.5	6.9	-2.5	2.0	5.6	.	.	.	.
Construction industry									
annual change in % (real)	-10.6	-5.6	-9.0	4.6	21.5	.	.	.	.
Consumption of households,YTL mn, nom.	128513	184420	239586	284631	328561	.	.	.	.
annual change in % (real)	-9	2.1	6.6	10.1	8.8	4.1	.	.	.
Gross fixed capital form., YTL mn, nom.	32409	46043	55618	76722	95307	.	.	.	.
annual change in % (real)	-31.5	-1.1	10.0	32.4	24.0	10.3	.	10	15
LFS - employed persons, th, avg.	21524	21354	21147	21791	22046	20838	20604	.	.
LFS - employed pers. in agricult. th, avg.	8089	7458	7165	7400	6493	.	.	.	.
LFS - employed pers. in industry th, avg. [3]	4884	4912	4811	5017	5452	.	.		
LFS - employed pers. in services th, avg.	8551	8984	9171	9374	10101	.	.		
LFS - unemployed, th pers. average [4]	1967	2464	2493	2498	2519	2750	2796	.	.
LFS - unemployment rate in %, average	8.4	10.3	10.5	10.3	10.3	11.7	11.9	11.5	11.0
Reg. unemployment rate in %, average	3.2	1.9	2.5	.	.	.	.	.	.
Average gross wages in manuf.industry (YTL/Hour)	1.95	2.68	3.30	3.74	4.20	.	.	.	.
annual change in % (real)	-14.6	-5.4	-1.9	2.5	2.0	3.2	.	.	.
Consumer prices, % p.a. [5]	54.4	45.0	25.3	8.6	8.2	8.4	8.1	9.0	6.0
Wholesale prices in manufacturing, % p.a. [5]	66.7	48.3	23.8	14.6	5.9	15.0	4.5	6.0	4.0
General governm. budget, EU-def., % GDP [6]									
Revenues	.	32.3	26.8	26.6	30.7	.	.	26.0	25.4
Expenditures	.	45.2	38.2	32.3	31.8	.	.	27.4	26.4
Deficit (-) / surplus (+)	.	-12.9	-11.3	-5.7	-1.2	.	.	-1.4	-1.0
Public debt, EU-def., in % of GDP [6]	105.2	93.0	85.1	76.9	69.6	.	.	64.5	60.8
Discount rate % p.a., end of period	60.0	55.0	38.0	38.0	23.0	32.0	17.0 [7]	18.0	.
Current account, EUR mn [8]	3787	-1613	-7106	-12550	-18553	-4725	-7173	-20500	-21500
Current account in % of GDP	2.3	-0.8	-3.3	-5.2	-6.4	.	.	-7.0	-6.5
Gross reserves of CB, excl. gold, EUR mn	20975	28370	29725	28962	40581	29001	48487	.	.
Gross external debt, EUR mn	126876	138026	128953	130217	136618	121984	.	.	.
FDI inflow, EUR mn [8]	3742	1203	1549	2282	7782	561	879	.	.
FDI outflow, EUR mn [8]	555	185	441	691	842	96	-149	.	.
Exports of goods, BOP, EUR mn [8]	38376	42464	45279	53927	61801	13694	15753	73000	89000
annual change in %	15.4	10.7	6.6	19.1	14.6	18.9	15.0	18	22
Imports of goods, BOP, EUR mn [8]	42543	50171	57667	73132	88142	18449	22994	106000	125000
annual change in %	-25.4	17.9	14.9	26.8	20.5	18.5	24.6	20	18
Exports of services, BOP, EUR mn [8]	16969	14843	15868	18441	20776	2881	2997	.	.
annual growth rate in %	-19.4	-12.5	6.9	16.2	12.7	20.1	4.0	.	.
Imports of services, BOP, EUR mn [8]	6773	6504	6580	8159	9551	1969	2039	.	.
annual growth rate in %	-22.6	-4.0	1.2	24.0	17.1	20.2	3.6	.	.
Average exchange rate YTL/USD	1.2253	1.5077	1.5003	1.4253	1.3440	1.3236	1.3289	1.60	1.60
Average exchange rate YTL/EUR (ECU)	1.0940	1.4307	1.6918	1.7714	1.6736	1.7377	1.5974	1.90	1.90
Purchasing power parity YTL/USD	0.4240	0.6115	0.7524	0.7930	0.7799	.	.	.	.
Purchasing power parity YTL/EUR	0.4859	0.7084	0.8817	0.9277	0.9379	.	.	.	.

Notes: 1) Preliminary. - 2) 2004 and 2005 SIS projections. - 3) Mining and quarrying; manufacturing; electricity, gas and water supply; construction. - 4) Civilian Labour Force: unemployed . - 5) From 2004 new methodology. - 6) According to ESA'95, excessive deficit procedure. - 7) CBRT lending interest rate. - 8) Converted from USD.

Source: CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury), Eurostat.