KONRAD ADENAUER STIFTUNG

# Unsustainable or Unorthodox?

# MACRO-ECONOMIC POLICY OPTIONS IN TURKEY

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## Introduction

As President Recep Tayyip Erdoğan enters the third decade of his rule in Turkey, he faces numerous challenges on the economic front. Whether praised or criticized for his 'unorthodox' policies in the face of a multi-year decline in the local currency and a severe cost of living crisis, his narrow re-election as President of the Republic offers a blueprint of contrasting economic policy options. Defying "domestic doomsayers" and London-based "loan sharks", Erdoğan has pledged to continue his policy of low interest rates.[1] Various economic indicators are flashing warning signs. It remains to be seen if the new finance minister and central bank governor can execute a policy U-turn. The change in personnel must now be followed by a change in substance, which must be significant enough in order to be effective, but which is politically risky since it involves costs for broad sections of Turkish society.

## Fiscal policy stocktaking

The new government will immediately have its work cut out, starting with a review of the fiscal situation in the central budget. Pre-election spending rose sharply as repeated minimum wage increases, early retirement schemes, public sector wage hikes and government subsidies for first-time mortgages will leave their mark on budgetary expenditure short- and medium-term. The U.S. American investment bank JPMorgan forecasts that the government's budget deficit, which reached 0.9 percent in 2022, could reach 4.5 percent in 2023.

The new finance minister will have to deal with a complex fiscal issue that could have a major impact on private and state-controlled commercial banks, retail savers and corporate account holders. The depreciation of the local currency over the past years had reached such levels that many citizens sought financial refuge in dollar-denominated bank accounts. In December 2021, at the behest of President Erdoğan, the government introduced a scheme that compensates holders of lira-denominated savings accounts for declines in the lira-US dollar exchange rate.[2] This scheme has two main consequences:

- It shifted the institutional burden of responsibility (for the domestic currency) from the central bank to the treasury, i.e. ultimately to the tax payer. According to data from Turkey's banking sector regulator, total deposits from this compensation scheme exceeded USD 121 billion by mid-May 2023. Former finance Minister Nureddin Nebati (in office until 4th June 2023) put the cost to the Treasury at TL 95.3 billion (USD 4.7 billion) between the end of 2021 and May 2023.
- The modus operandi of the compensation scheme is such that it increases the dollar-denominated liabilities of the public sector. Put otherwise, the scheme increases Turkey's sovereign debt in foreign currency the more the lira depreciates and the longer the Treasury has to activate the compensation mechanism for the holders of such special savings accounts.

## Central bank policy making

Since February 2023, the benchmark interest rate of the Turkish central bank (CBRT) is set at 8.5 percent, after having been cut four times by a total of 500 basis points during the second half of 2022. With consumer price inflation (CPI) reaching 39,6 percent in May 2023, inflation-adjusted (real) interest rates are deeply negative.[3] Any upward adjustment of interest rates involves risks that have to be taken into

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[1] Two days after his re-election, in a speech to Turkey's Union of Chambers and Commodity Exchanges Erdoğan criticized domestic opposition officials. "They were supposed to present this Turkish economy to the loan sharks in London but they couldn't panic our business world" Erdogan said. "Every time they open their mouths they present a dark future for the Turkish economy. Please pay no attention to these doomsayers." Source: The Wall Street Journal, 30. Mai 2023, "Turkey's Lira Hits New Low After Erdogan's Re-Election".
[2] The precondition was that owners of dollar-denominated accounts had to convert these into Turkish lira and hold these accounts for at least a year.
[3] The Mai inflation data is misleading. The Erdoğan government provided private households during the past (election) month with free natural gas. Its share in the basket of goods and services that calculates monthly price inflation was reduced to zero.

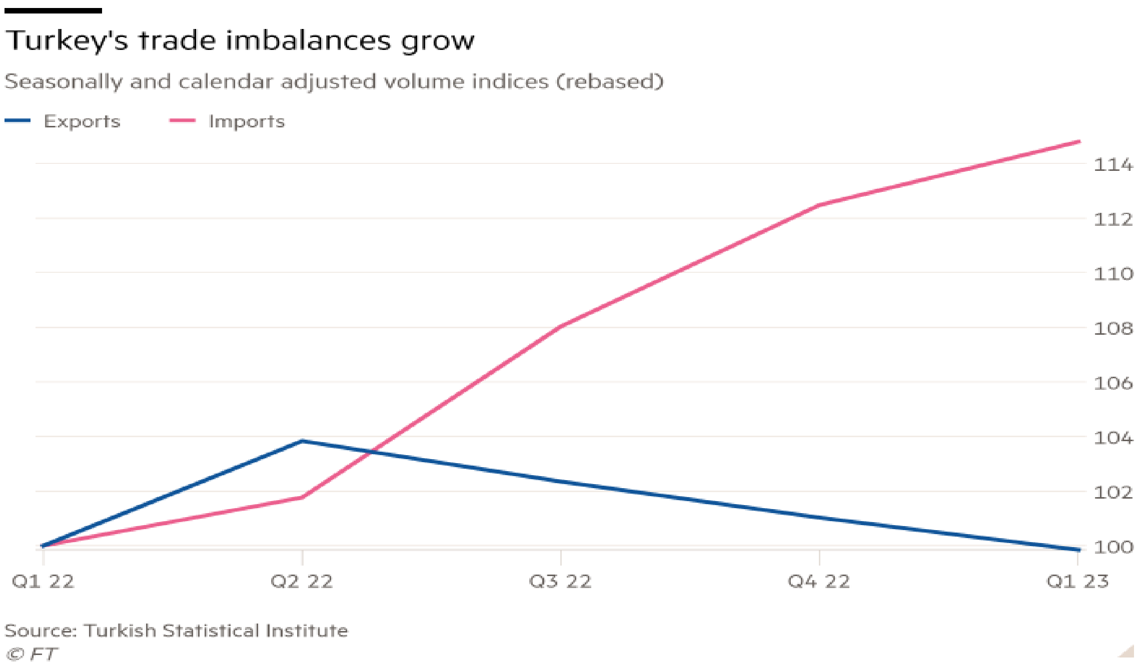
account. These risks increase if the necessary course corrections are delayed or watered-down. These include, inter alia:

- Depending on the size and timing of the CBRT's policy rate hikes, the impact on the Turkish economy will be felt for at least two quarters. Instead of the (consumer) credit expansion that has driven GDP growth in 2022 and early 2023, higher interest rates will lead to lower credit demand, an increase in non-performing loans (NPLs) on banks' balance sheets and a recalibration of price inflation in the real estate sector.
- The Central Bank of Turkey has an urgent need to replenish its foreign exchange reserves. Over the past three years, it has mainly used currency swap agreements with local banks and foreign governments (e.g. Saudi Arabia, Qatar, UAE, China and South Korea). Such agreements involve the sale of dollars and other currencies in exchange for lira for a fixed period of time (usually three to five years). The swap agreements on the balance sheet of the CBRT currently exceed USD 33 billion. Without such swap arrangements, the CBRT's net foreign reserves are in negative territory, thereby currently limiting its operational capacity.

## Options for stabilizing the macroeconomic situation

According to the Turkish Statistical Institute (TÜIK), gross domestic product (GDP) increased by four percent in the first quarter of 2023 compared to the same period in 2022. The key drivers of GDP growth in Q1-2023 were fiscal expansion ahead of the May elections, consumer demand fuelled by the availability of cheap credit and the government's initial reconstruction spending in the eleven south-eastern provinces affected by the earthquake in early February.

Despite this better-than-expected macro-economic performance, there are looming micro-economic challenges to confront. One of these is the urgent need to address Turkey's growing trade imbalances. Already in 2022, spending on imports, especially those related to energy imports, grew exponentially, despite Turkey receiving price discounts and payment deferrals from Russia. The trade gap is a major source of Turkey's widening current account deficit, which reached over six percent of GDP in Q1-2023 (Goldman Sachs data and chart below).




*Financial Times, 31. May 2023.*

Turkey's main export destinations remain the countries in the EU. So far, its export capacity has benefited from its proximity to these markets and the openings provided by the customs union (for manufacturing goods). The trade regime with the EU is an important stabilizing factor for Turkey's economic performance. But an overvalued local currency, double-digit price inflation and domestic consumption fuelled by cheap credit work in the opposite direction of competitive export capacity. Put otherwise, the unorthodox course of action taken by the government and the central bank produce collateral damage which are partially mitigated through trade with the EU.

The new government would be well advised to reconsider the delicacy of this balance. Declining or stagnating Turkish exports to the EU would be a red flag in urgent need of corrections. Demands for policy revisions can come from different quarters. Either Turkish exporters make their voices heard or the central bank abandons supporting the lira, be it by policy choice or by default as it runs out of foreign exchange reserves to execute such interventions.

## Forecasts in view of economic and fiscal policy to date

Given the economic challenges facing Turkey, the outcome of the dual elections and the acceptance of the results by all parties removes a key element of uncertainty: political risk factors due to turbulence in a transitional period. President Erdoğan's new five-year mandate gives him unprecedented leverage. Either to continue the divisive politics or by introducing a course correction which would have to include elements of inclusiveness and dialogue. Various statements by Erdoğan prior to the second round of voting and during his inauguration on 3rd June 2023 hinted at such a course correction.[4]

It remains to be seen if the new cabinet can introduce a substantial policy reversal. The appointment of Mehmet Şimşek[5] as the new finance minister could be a positive signal in this regard. His professional reputation is unquestionable and he enjoys high regard abroad due to his international career. What room for manoeuvre he can define vis-à-vis Erdoğan in the coming months, however, is an entirely different matter? His first comments emphasized "transparency, consistency and predictability" in economic policy making, based on "rationality".

In the absence of substantial policy reforms existing risk factors can be expected to multiply, as reflected in recurring currency volatility, an intensifying balance of payment crisis and a financial sector that faces increasing difficulties to access foreign currency in a highly dollarized economy.

Foreign portfolio investors adopted a wait-and-see attitude during the past months. They have reduced their financial exposure to the Turkish stock market and in their bond portfolios. They will need to be convinced to again commit resources to Turkey beyond the appointment of new finance and economy ministers and a change at the helm of the central bank. Portfolio managers in London and on Wall Street are looking for substantial, not cosmetic changes in critical policy areas such as:

- Abandoning institutional support for the Turkish lira would imply a free-floating domestic currency, with potentially short-term systemic consequences for the economy's declining growth prospects. Between the first and second rounds of the presidential election, the lira depreciated (against the US dollar) for eight consecutive days. Having breached the critical level of 23 liras to the dollar, the downward trend represents a historic low. Turkish exporters continue to claim

[4] „Germany and the USA are taking in Syrian refugees. Are we such a conventional country that we cannot open our doors for such refugees as the USA and France are doing? We all have a huge responsibility." (translated by J.B., source: https://www.hurriyet.com.tr/amp/gundem/cumhurbaskani-erdogandan-onemli-aciklamalar-42273890 / „We have the honor to serve Turkey and the Turkish people for a another five years. We will do so for all 85 million citizens, irrespective of their political views, their origin, their affiliation and their communities." (translated by J.B., source: https://www.tccb.gov.tr/haberler/410/147380/-milletimiz-cumhuriyet-in-ikinci-asrini-turkiye-yuzyili-ile-taclandiracaktir-).

[5] Mehmet Şimşek (56) was already Finance Minister and Deputy Prime Minister between 2008 and 2018. He left the government bench when President Erdoğan appointed his son-in-law Berat Albayrak as Finance Minister. The appointment of Cevdet Yilmaz, who is considered an economic reformer, as deputy president can also be seen as an attempt by Erdoğan to realign the economic policy competence of the cabinet.

that the local currency is overvalued[6] and that any market intervention by the CBRT hurts their price competitiveness.

- How to implement a controlled depreciation of the lira is a key policy challenge for both the central bank and the finance ministry. Recent history is instructive. In late 2021, a sharp depreciation of the lira caused short-term panic among retail investors and triggered a run on local banks. While exporters would welcome a devaluation, importers would face rising costs for foreign goods and services.
- International investors will be watching to see where Turkey's borrowing needs are coming from. Financing from Russia, China and the Gulf States has bridged foreign exchange gaps in the run-up to the elections. A continuation of access to this group of financing providers would not be a reassuring message to 'Western' portfolio managers.
- Turkey's public debt is relatively low and mostly domestically financed. At 27 per cent of GDP at the end of 2022, the government has the fiscal space to finance part of the earthquake reconstruction costs with higher debt. But the question remains: where will the debt financing come from? Local banks lack the necessary resources. Western banks are reluctant to commit resources while the broad outlines of future policy are unclear or remain tied to President Erdoğan's "unorthodox" prerogatives. He refuses into negotiations with 'Western' multilateral lenders such as the IMF.[7]

## Outlook

Given the adherence to current fiscal and monetary policy making it is likely that the new government will emphasise a mix of continuity and gradual policy adjustment in the short term. The latter will be determined by President Erdoğan's willingness to accept the need for U-turns in selected policy areas. The appointment of Şimşek as finance minister is a first indication of moving in that direction. The change at the helm of the central bank complements this pivot. Hafize Gaye Erkan, a former finance executive in the United States replaced Şahap Kavcıoğlu[8] who implemented Erdoğan's advocacy to reduce interest rates. It remains to be seen if the return of Simsek and the appointment of Erkan has set the stage for interest rate increases. The next meeting of the central bank's rate setting committee is scheduled for 22nd June.

Changing course in areas such as restoring the de facto, not just de jure, independence of the Central Bank and the Statistical Office and allowing market forces to determine the true value of the Turkish lira is a tall order. In combination they are politically risk prone. Averting a post-election currency crisis and replenishing foreign exchange reserves[9] is the order of the day for the new finance minister and central bank governor. Their political leverage to introduce adjustments will depend on Erdoğan's willingness to relinquish presidential prerogatives and instead listen to scientific expertise. This would involve the acceptance of pragmatism not seen in Turkish economic policymaking in recent years.

Turkish fiscal and monetary policy making faces a fork in the road: either in the direction of a '*whatever it takes*' moment or an increasing confrontation with the consequences of ignoring economic reality. The lira's depreciation since Erdoğan's re-election and the personnel changes in fiscal and monetary policy

[6] Even after falling 60 percent against the US Dollar during the past two years, the Turkish lira is overvalued due to repeated market interventions by the central bank and state-owned commercial banks to support its declining value.
[7] It is instructive to recall Turkey's recent history of economic policy adjustments. Kemal Derviş, Turkey's former economy minister, died at the age of 74 just before the first round of the presidential election. In 2001, he left the World Bank in Washington to initiate a major economic adjustment programme with the IMF in Turkey. Recep Tayyip Erdoğan, who became prime minister in 2003, immensely benefited from the results of these reforms.
[8] Erkan is the fifth central bank governor in four years. Şahap Kavcıoğlu switched to the position as Turkey's banking watchdog (BDDK). It is noteworthy that Erdoğan recruited Simsek and appointed Erkan who both have extensive international experience and outreach to the private sector.
[9] Turkey's gross foreign exchange and gold reserves declined by a staggering 15 percent in the six weeks before the first round of voting on 14th May 2023.

may signal the initial steps towards a new economic agenda emerging in Turkey. But abandoning the artificial support for the lira through a controlled devaluation and in parallel reversing a policy of low interest rates will require deft policy management and institutional independence of the involved participants.

Despite the rationale for policy adjustments in the Turkish economy we should keep in mind a lesson learned from the recent elections. Erdoğan was re-elected against the backdrop of a severe cost-of-living crisis and major economic challenges. The notion of "*it's the economy, stupid*" has its limits, particularly among AKP voters and adherents of the president.[10] They have not ignored the economic and financial challenges they face on a daily basis. But they were not the decisive factor in their voting preferences.

This experience could embolden the president in the near future to continue holding on to his economic assumptions. If this were to be the case during the coming months, the consequences for the Turkish economy could be far-reaching. Calls for pragmatism and advocacy of policy corrections are coming from Brussels, Berlin and Washington. Some members of the new government and parliament could pay more attention to these suggestions and put them into practice. But a re-elected President Erdoğan may interpret his victory as a mandate to ignore 'Western' siren calls and continue to challenge economic orthodoxy of London-based financial speculators, whatever the cost.

There are many countries, mostly in the Global South, that are closely watching the economic policy experiment unfolding in Turkey in real time. It should be noted that not all of them are autocratic governments. Erdoğan's ability to continue 'squaring the circle' will be tested repeatedly during his third presidential term. But he will also test our assumptions about the economy in general and the Turkish political economy in particular.

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[10] Former Democratic U.S. President Bill Clinton's claim, made in 1992, that the economic situation decides the election in a country was disproved in Turkey in May 2023.

# Imprint

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*This publication reflects the views of the author only.*

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