Global Macro Views – Credit-Dependent Growth in Turkey

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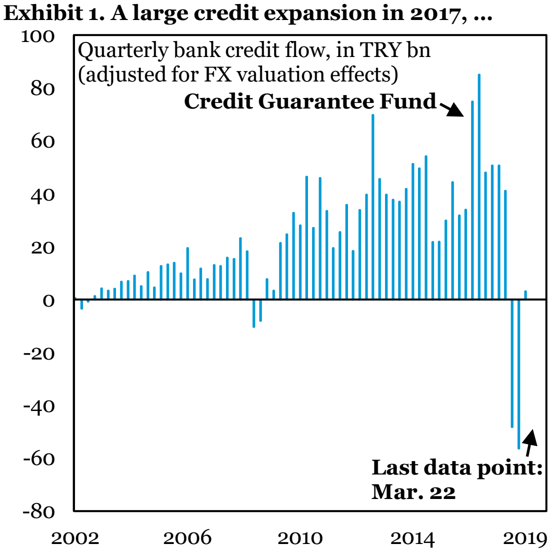
- Turkey's recent growth path reflects a series of credit expansions.
- A credit boom in 2017 widened the current account deficit sharply, ...
- which made Turkey very vulnerable to last year's BoP *"sudden stop."*
- Another credit expansion has been underway during Q1 of this year, ...
- and again coincided with rising volatility in the $/TRY exchange rate.
- Volatile markets necessitate a shift away from credit-driven growth, ...
- to a new growth model with an emphasis on structural reforms.

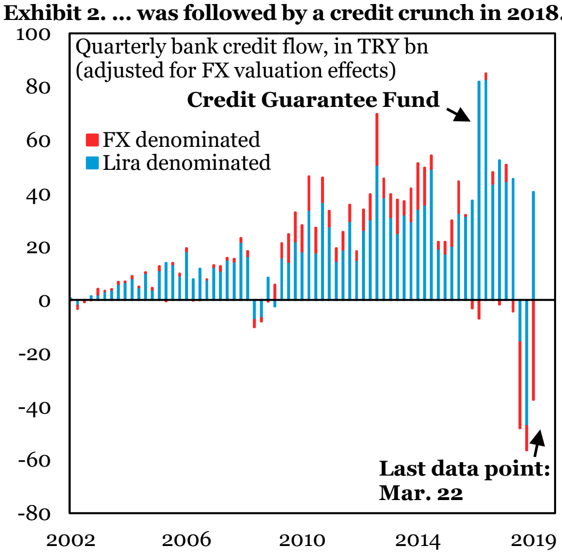
Turkey's recent growth path is heavily influenced by a series of credit expansions. A large credit boom two years ago, in part due to government incentives via the *Credit Guarantee Fund*, set the stage for very rapid growth in 2017, with Turkey outperforming essentially all its emerging market peers. However, that credit boom came at a cost. It widened the current account deficit sharply, increasing Turkey's dependence on foreign capital inflows, which left the country vulnerable to last year's *"sudden stop"* in the balance of payments. That *"sudden stop"* transformed the external picture, with the current account registering large surpluses in the second half of 2018, the result of a big decline in domestic demand. Understandably, the sharp drop in GDP – even as it reduced external vulnerability – has been a challenge for the country, and state banks stepped up lending in Q1 of 2019 to buffer activity. Unfortunately, this latest credit expansion again coincided with rising volatility in the exchange rate. The underlying reality is that increasingly volatile global capital markets are unwilling to fund heavily credit-dependent growth models. A shift to less credit-dependent growth, including via structural reforms, is needed.

Exhibit 1. A large credit expansion in 2017, ...



Source: Haver, IIF

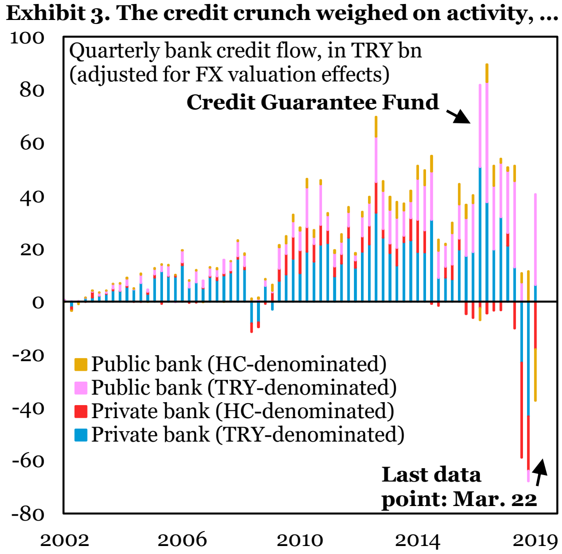
Exhibit 2. ... was followed by a credit crunch in 2018.



Source: Haver, IIF

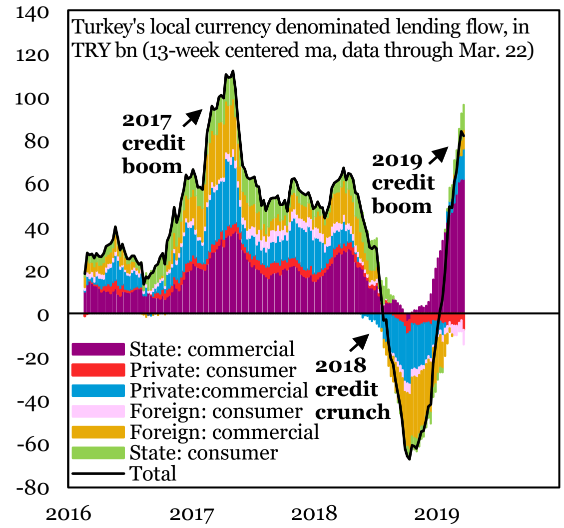
Turkey saw a large credit boom in 2017 (Exhibit 1), driven in part by the government's *Credit Guarantee Fund*. That boom boosted growth, which surpassed that in essentially all of Turkey's peers that year, but came at the cost of widening the current account deficit sharply, increasing the country's dependence on foreign capital inflows. Last year's *"sudden stop"* in the balance of payments consequently resulted in a dramatic credit crunch (Exhibit 2), which in turn caused domestic demand to fall sharply. The resulting drop in GDP reduced Turkey's external vulnerability, but also posed large challenges for the country. State banks stepped in to fill the void, boosting Lira-denominated lending in Q1 of this year (Exhibit 3), especially to firms that have been suffering from the effects of last year's *"sudden stop"* (Exhibit 4).

Exhibit 3. The credit crunch weighed on activity, …



Source: Haver, IIF

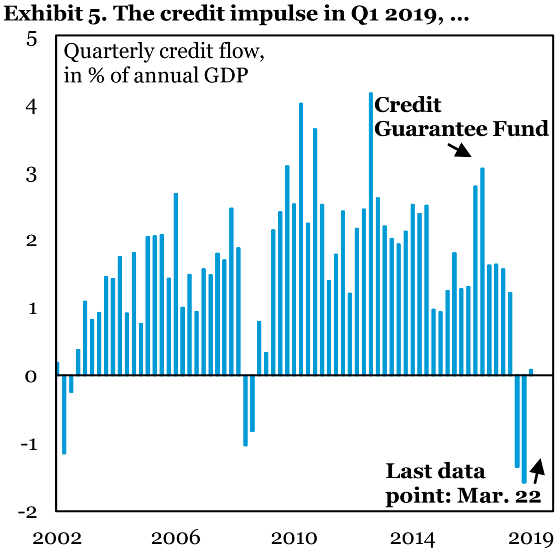
Exhibit 4. … and state banks recently stepped in.



Source: Haver, IIF

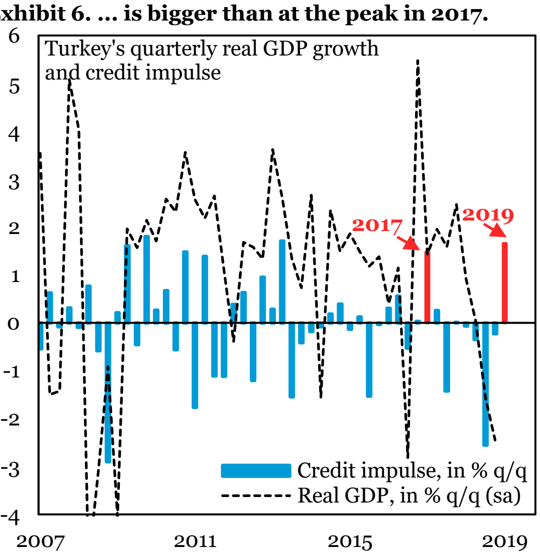
We have previously examined how credit-dependent growth is across EM, with Turkey consistently near the top of the list in this dimension. The underlying reality is that global capital markets are more volatile and less willing to fund credit-dependent growth, which is – we believe – why the recent credit expansion has again coincided with rising Lira volatility. Indeed, if we scale the quarterly flow of credit by nominal GDP (Exhibit 5), the quarter-on-quarter change in this measure – the credit impulse to GDP – is larger this year than at the peak in 2017 (Exhibit 6), underscoring just how credit-dependent the growth model remains. A shift to less credit-dependent growth, including via structural reforms, is needed.

Exhibit 5. The credit impulse in Q1 2019, …



Source: Haver, IIF

Exhibit 6. … is bigger than at the peak in 2017.



Source: Haver, IIF