Global Macro Views – Turkey's External Vulnerability and Credit-Led Growth

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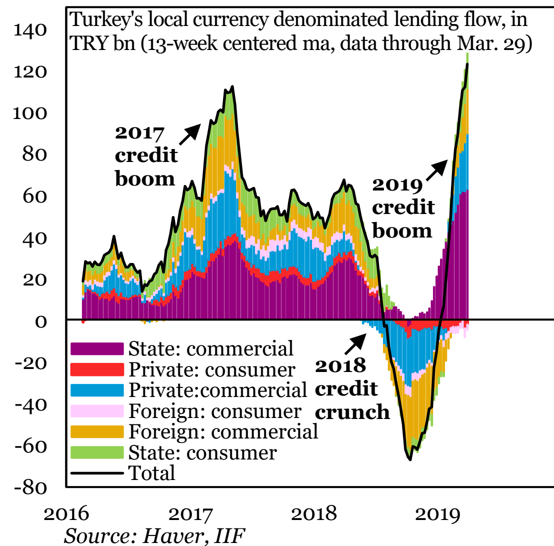
- Turkey's growth model has been heavily credit-based in recent years.
- That credit-based growth has come at the cost of external vulnerability, ...
- which has risen with a growing dependence on external capital inflows.
- Last year's sudden stop in the BoP gave rise to a severe credit crunch, ...
- cutting the current account deficit and reducing external vulnerability.
- But the credit expansion in Q1 of this year undid a lot of that progress.
- We see much of recent Lira weakness through this credit-focused lens.
- The way forward lies in shifting Turkey away from credit-led growth.

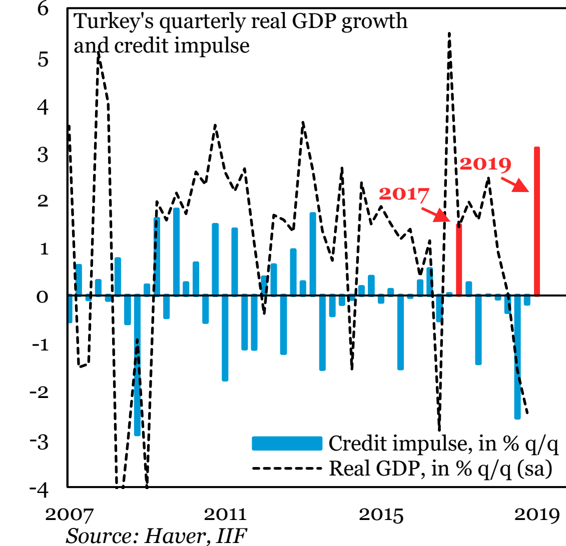
Turkey's recent growth path is heavily influenced by a series of credit expansions. A large credit boom two years ago, in part due to government incentives via the *Credit Guarantee Fund*, set the stage for very rapid growth in 2017, with Turkey outperforming essentially all its emerging market peers. 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. Q1 saw a large lending boom, ...



Source: Haver, IIF

Exhibit 2. ... with a GDP impact bigger than 2017.



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 all of Turkey's peers, but 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 caused a credit crunch, which meant domestic demand fell sharply. The resulting drop in GDP reduced Turkey's external vulnerability, but also posed challenges. State banks stepped in to fill the void, boosting Lira-denominated lending in Q1 of 2019, such that the positive credit impulse to the economy exceeded that in 2017 (Exhibit 2). As in 2017, that focus on growth has had negative repercussions for the external picture, with import demand rising (Exhibit 3), which in turn pushed adjustment of the trade balance into reverse (Exhibit 4).

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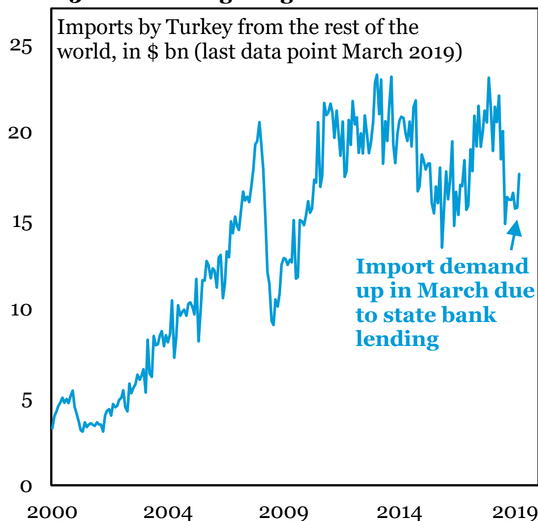
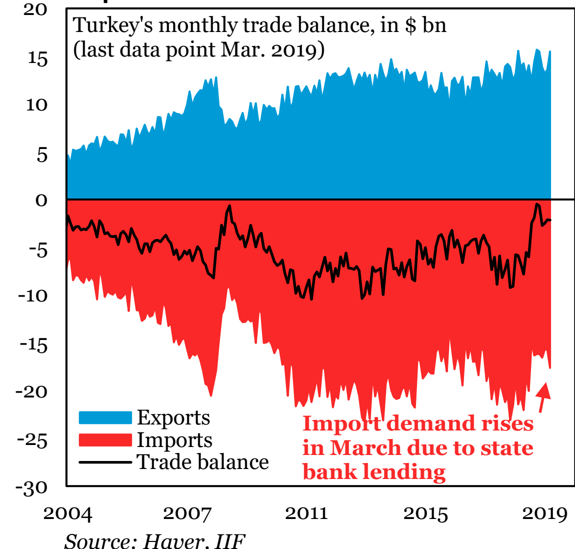
Exhibit 3. Rebalancing has gone into reverse.



Source: Haver, IIF

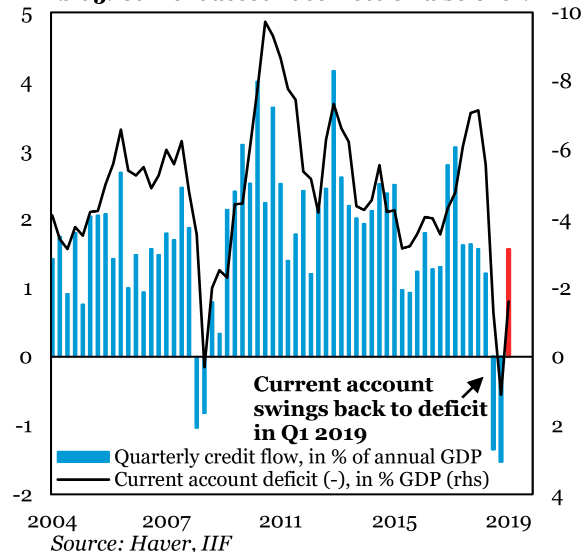
Exhibit 4. Trade balance correction is over.



Source: Haver, IIF

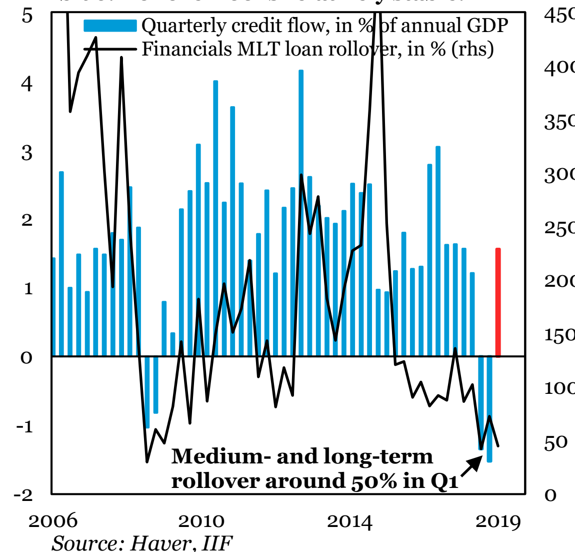
We estimate that the credit expansion is likely to have pushed the current account back into deficit in Q1, to the tune of -1.6% of GDP (Exhibit 5). We see this shift, which in turn reflects the Q1 lending boom, as the underlying driver for recent Lira volatility, even as rollover rates on external debt remain relatively stable, albeit low (Exhibit 6). This means that the recent rise in external vulnerability is the direct result of a renewed emphasis on credit-led growth, which volatile global capital markets are unwilling to fund. The way forward is to shift away from credit-based growth, including via structural reforms.

Exhibit 5. Current account correction also over.



Source: Haver, IIF

Exhibit 6. Rollover looks relatively stable.



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