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An Evaluation of the Turkish Economy during COVID-19

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Contents

Introduction

In this report, we provide an evaluation of the Turkish economy during the COVID-19 pandemic. We note that the structural reforms that were implemented after the 2001 crisis allowed the banking system to remain on solid ground despite all the challenges brought about by COVID-19. The accommodative policy measures that were adopted by Turkey during the pandemic did generate certain vulnerabilities as a side effect, such as dollarisation of the economy, the erosion of central bank reserves, and excessive credit growth. Nevertheless, the switch to orthodox policy making in November 2020 is a step in the right direction. We argue that the depreciation of the Lira is an opportunity for foreign investors to take advantage of cheap Turkish assets, once investor confidence is re-established through more conservative policies.

Unlike a global contraction that is expected for 2020, Turkish growth in 2020 will likely be close to a positive number. However, the side effects of the accommodative policies which brought an inevitable tightening in financial conditions will likely limit the rebound in 2021.

The remainder of this report is structured as follows. The first section provides a background of the Turkish economy before the pandemic. The next section evaluates the risks and opportunities that are present in the Turkish economy following the pandemic. The third section discusses the policy measures that were adopted during the pandemic, and the fourth section concludes.

Background

The 2001 crisis was a turning point for the Turkish economy. The impact of the crisis on the banking sector and financial markets was rather drastic, resulting in significant capital outflows. The Lira depreciated more than 50 percent, and the GDP declined by 6 percent at that time.

Turkey already had a standby agreement with the International Monetary Fund (IMF) when the 2001 crisis hit. Following the crisis, a new programme was put into action that emphasised long-term stability and structural reforms. Accordingly, the sizable budget deficits would be reduced. A floating exchange rate regime was adopted together with an independent central bank. An amendment to the Central Bank Law (no: 1211) granted operational independence. In 2003, implicit inflation targeting was adopted, which was replaced by explicit inflation targeting in 2006 where the inflation target was publicly announced.

In the aftermath of the 2001 crisis, independent regulatory institutions were founded to increase transparency and improve efficiency, such as the Banking Regulation and Supervision Agency (BRSA), Telecommunications Agency, Competition Agency, and State Auction Agency. The new programme aimed at restructuring the banking system. To that end, insolvent banks were liquidated; state bank debt was counted towards long-term public debt and restructured; the BRSA was given the authority to closely monitor the banking system; a deposit insurance system was established; and banks were recapitalised. Bank capital is the difference between a bank's assets and liabilities. By increasing their capital, banks can absorb any losses that they incur on the value of their assets. At that time, capital adequacy ratios reached 15 percent after the regulatory changes.[1]

One of the priorities of the Justice and Development Party (Adalet ve Kalkınma Partisi, AKP) government, which came to power after the 2001 crisis, was fiscal discipline. Increased taxes on gasoline and consumption goods as well as privatisation played a key role in establishing budgetary discipline. In turn, fiscal discipline helped with lowering inflation from 30 percent in 2002 to 9 percent in 2004.

Until the onset of the Global Financial Crisis (GFC) in 2007, tight monetary and fiscal policy together with privatisation and EU membership negotiations led to a sharp increase in foreign direct investment, which reached close to 20 billion USD by 2007. Nevertheless, because the majority of these investments took the form of purchasing existing firms, the impact on employment was limited. [2]

Turkey registered a 7 percent growth rate from the period after 2001 until the GFC, thanks to the reestablishment of macroeconomic stability, strong export demand and improved EU relations. The restoration of macroeconomic fundamentals and the consequent high growth rates gave the government the financial means necessary for a more active role in foreign policy. Nevertheless, a long-term perspective on industrialisation, sustainable growth and employment could not be achieved. [3]

[1] Çalışma Tebliği, *Turkish Experience from the Crisis to Stability [Krizden İstikrara Türkiye Tecrübesi],* BRSA Working Paper, 2010, https://www.bddk.org.tr/ContentBddk/dokuman/duyuru_0395_02.pdf (accessed 8 January 2021).

[2] Pamuk, p.289

[3] Taymaz, E. and Voyvoda, E., 2012, Marching to the Beat of a Late Drummer: Turkey's Experience of Neoliberal Industrialization since 1980, New Perspectives on Turkey, 47, 83-111.

The immediate impact of the GFC was a decline in exports and investment. Because the banking sector had been restructured with strict regulations after 2001, the impact of the crisis on the banking sector remained limited. Furthermore, the monetary and fiscal discipline in the period before the GFC paid off during this time by allowing for accommodative policies without increasing economic vulnerabilities.

In the period after the GFC, Turkey's relations with the EU deteriorated as Germany and France explicitly objected to Turkey's membership, besides other domestic political factors. As the EU anchor weakened, the motivation to undertake structural reforms to address the low savings rate, current account deficit or low employment also faded. At this time, Turkey prioritised demand-driven policies to stimulate growth, particularly through the construction sector. The abundant global liquidity in the aftermath of the GFC made it easier to fund these demand-driven policies by allowing the private sector to tap into foreign borrowing. Thus, the decline in public sector debt after 2001 was gradually replaced by an increase in private sector debt.

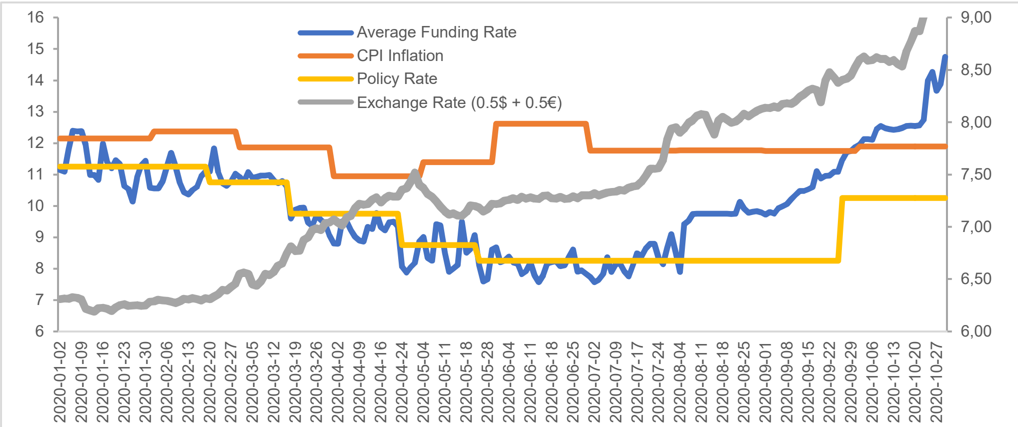
The expansion in external borrowing accumulated the vulnerabilities of the Turkish economy by increasing the dependence on capital inflows. Coupled with the Turkish government's deliberate attempt to stimulate the economy with low interest rate policies, pressures on the Lira accumulated, particularly in the period after 2017. The tension with the US regarding Pastor Branson, who was arrested and formally indicted on alleged charges of espionage and having links to outlawed organisations, led to the currency crisis in August 2018. At this time, the Lira depreciated about 20 percent. The central bank responded to the crisis with a rate hike of 625 basis points. About a year later, Central Bank governor Murat Çetinkaya was replaced by Murat Uysal on the grounds that Çetinkaya was not willing to ease policy as requested by President Erdoğan and the government. The new governor slashed interest rates by 15.75 percentage points in 14 months from July 2019 to September 2020. In order to prevent these easings from weakening the Lira, foreign currency reserves of the central bank were tapped.

When the pandemic hit in March 2020, the Turkish economy had already been suffering from high inflation for some time, as well as widening fiscal and current account deficits. Unlike the GFC of 2007–2009 however, there was limited room for accommodative policies.

The effects of COVID-19 shock on the Turkish economy

COVID-19 shock affected the Turkish economy through regular supply and demand channels. The decline in supply reflected the lockdown decisions at the early stages of the pandemic as well as those workers who caught the virus and could not report to work. On the demand side, the negative impact mostly came from the 'fear factor' that reflected new consumption habits of households constrained in social interaction. Furthermore, those industries that are more closely connected to the rest of the world through trade linkages or external borrowing were further affected due to disruptions in supply chains and the depreciation in Turkish Lira (TL) that increased the cost of borrowing. Cakmaklı et al. (2020)[4] quantify the overall impact of these channels and find the economic cost of COVID-19 to be about 17 percent of GDP (compared to the previous quarter) in the best-case scenario where the pandemic is contained in the most effective way.
Turkey adopted an aggressive monetary easing coupled with moderate fiscal accommodation when the COVID crisis hit. At the beginning of 2020, the policy rate set by the Central Bank of the Republic of Turkey (CBRT) was at 11.25 percent, while the headline inflation rate was 12.15 percent. With the easings that came after the COVID-19 outbreak, the policy rate was soon lowered significantly below the inflation rate (see Figure 1). As the real policy rate moved deeper into the negative territory, 'dollarisation' was triggered. The adverse effects of dollarisation on the exchange rate were offset by selling central bank reserves. Such policies were not sustainable, however, and increased the vulnerabilities as reflected in the risk premium (see Figure 2).

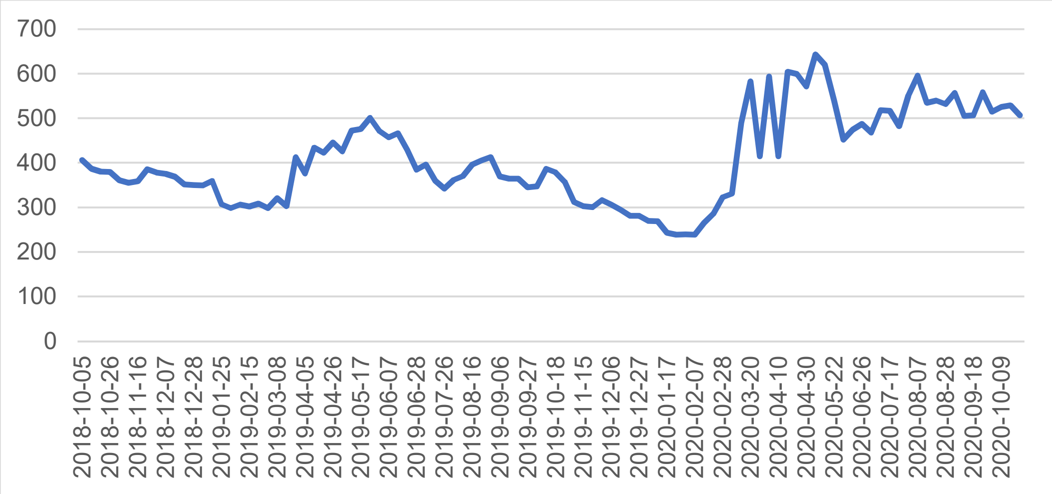
Figure 1: Average Funding Rate, CPI Inflation, Exchange Rate and Policy Rate



Source: Central Bank of the Republic of Turkey (CBRT)

[4] Cakmaklı, C., Demiralp, S., Kalemli, Ozcan, S., Yesiltas, S., and Yıldırım, M., 2020, COVID-19 and Emerging Markets: An Epidemiological Model with International Production Networks and Capital Flows, NBER Working Paper No. 27191, https://www.nber.org/papers/w27191

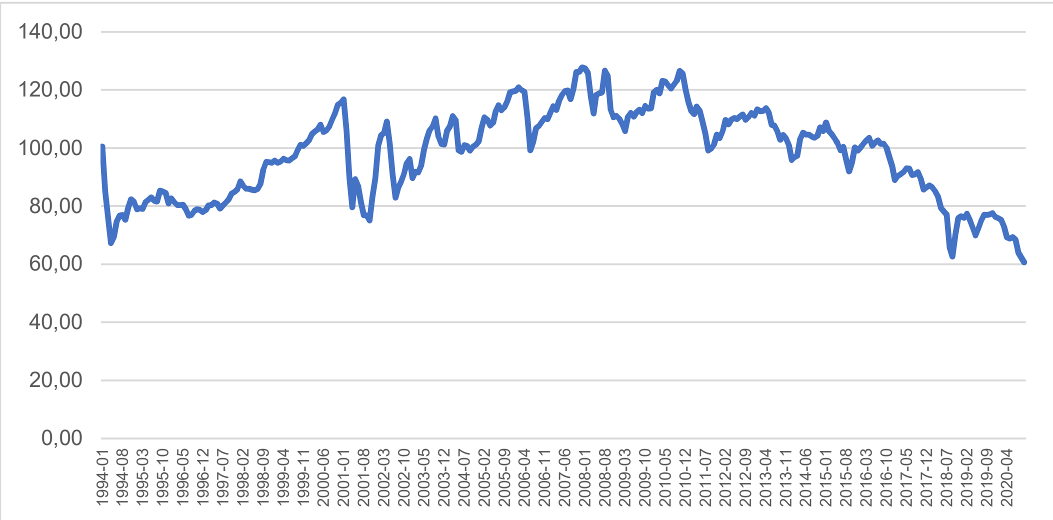
Figure 2: CDS Premium



Source: Turkey Data Monitor

August 2020 marked a turning point for the policy stance. The exchange rate was allowed to adjust to market conditions, and it was expressed by the government that a competitive TL was preferred moving forward (see Figure 3).[5] Furthermore, the macroprudential measures to encourage credit expansion were reversed. Accordingly, the BRSA lowered banks' asset ratio to 95 percent from 100 percent and eased the conditions that pushed banks to lend more.[6] In late November the BRSA announced that the asset ratio would be abandoned altogether in January 2021.

Figure 3: Real Exchange Rate (CPI based)



Source: CBRT

On September 22, the CBRT raised the policy rate by 200 basis points, which was interpreted as the first mark of orthodox tightening policies. The market response was rather favourable. The favourable mood did not last long, however, when the CBRT returned

[5] https://www.reuters.com/article/turkey-economy-albayrak/update-2-turkish-minister-shrugs-off-lira-volatility-sees-economic-contraction-possible-idUSL8N2FE64B
[6] https://www.reuters.com/article/us-turkey-banks-idUSKCN2560EW

to implicit rate hikes at its October meeting. As shown by the blue line in Figure 1, the average funding rate was allowed to exceed the policy rate (solid black line) at that time. The Lira depreciation accelerated afterwards.

November 2020 was an eventful month. On 6 November, CBRT governor Murat Uysal was replaced by Naci Ağbal. On 10 November, Minister of Treasury Berat Albayak was replaced by Lütfi Elvan. On 11 November, President Erdoğan commented on the new economic policy and highlighted that inflation targeting would be a priority, which was followed by a rate hike of 475 basis points on 19 November.

The combination of expansionary monetary and fiscal policy that was implemented during the pandemic yielded a 6.7 percent growth rate in the third quarter of 2020, following a 9.8 percent decline in the second quarter. The question at this point is whether the growth momentum is sustainable. The accommodative policies that were adopted at the early stages of the pandemic were not sustainable as they increased certain vulnerabilities of the Turkish economy by increasing the costs of production through a weaker Lira, enlarging the budget and current account deficits and depleting CBRT reserves. Thus, the steps that reversed these accommodative policies after August 2020 were unavoidable. As Turkey adopts a tighter policy stance, the growth rate is expected to slow. Nevertheless, to the extent that the policy reversal is perceived to be consistent with Turkey's macroeconomic fundamentals, the longer-term impact should be favourable.

The initial response of financial markets to the tighter policy stance are favourable. The Lira is currently stable below 8 TL/USD and capital inflows through equity and bond holdings registered a 6 billion USD increase in the second half of November. It is rather challenging to make longer term predictions when the financial markets are so volatile, and pandemic-related news is uncertain. Nevertheless, in order to provide a clearer assessment of the impact of the pandemic and the related policy measures, we will go over the main risks and opportunities for the Turkish economy in the post-COVID world, in order to better evaluate Turkey's prospects going forward.

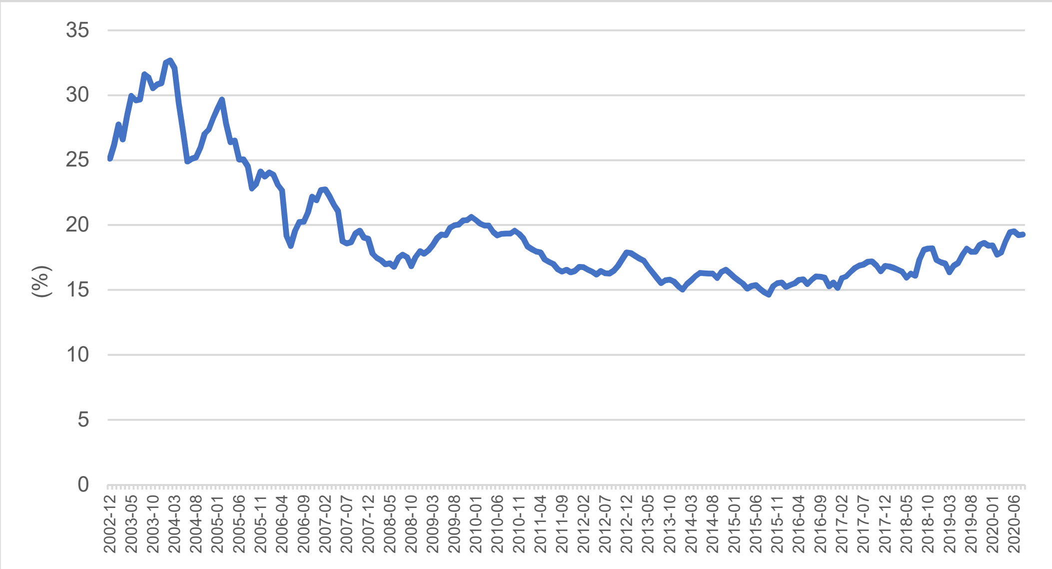
Risks Associated with Non-performing Loans

The banking sector is prone to widespread loan defaults, and the primary risks exposing the sector could be assessed by non-performing loans (NPL), which captures loans where the borrower is under default and has not made payments during a certain time window (often 90 days). COVID-19 was expected to increase NPL ratios worldwide, given the easing of lending standards coupled with the economic slowdown. In this environment, economies with strong capital adequacy ratios are expected to be less affected.

A bank's capacity to absorb losses before becoming insolvent is measured by its capital adequacy ratio, which is the ratio of the bank's available capital with respect to its credit exposures. After the 2001 crisis, the government set high standards for the capital adequacy ratio for Turkish banks. Figure 4 shows the capital adequacy ratio in Turkey. The figure illustrates that even though the average capital adequacy ratio followed a downwards trend after 2001, it was still around 20 percent when the pandemic hit, which is significantly higher than European counterparts. Compared to NPL ratios, which hovered around 5 percent (Figure 5),[7] the capital adequacy ratios indicate that there is enough room to absorb the negative shock to NPL ratio caused by the COVID-19 pandemic.

[7] In comparison, NPL ratios across euro-area countries ranged from 0.3 percent to 17.1 percent in 2019.

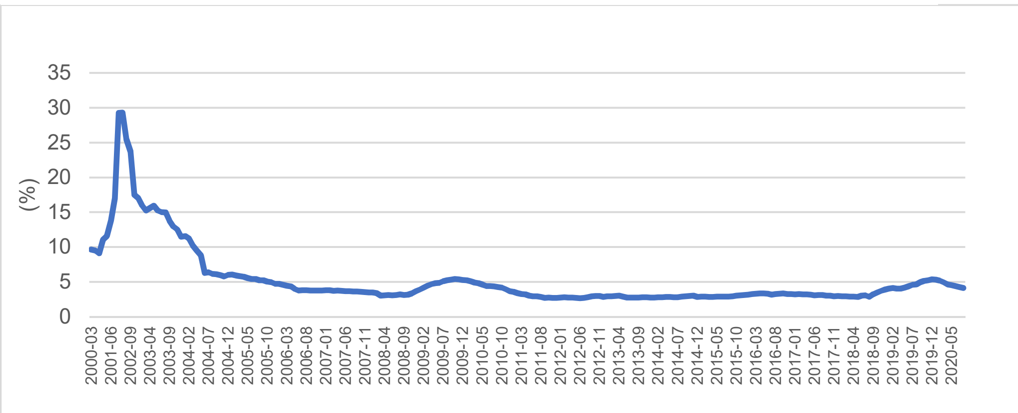
Figure 4: Capital Adequacy Ratios



Source: Turkey Data Monitor

After the exchange rate crisis in August 2018, the NPL ratio followed an increasing trend, given the large share (about 35 percent of GDP) of foreign debt owned by the private sector. COVID-19 shock led to further deterioration in the exchange rate despite sizable foreign exchange (FX) sales through central bank reserves. The Turkish Lira depreciated about 40 percent since the beginning of the year, making it one of the hardest hit currencies during the pandemic. Nevertheless, Figure 5 shows that there is not an alarming increase in the NPL ratios. Two factors likely contributed to low NPL ratios: (i) the credit expansion in a low interest rate environment made it easier for firms to rollover their debt; and (ii) depreciation in the TL in a low interest rate environment was prevented with sizable sales of foreign exchange reserves. Hence, the external debt burden of the private sector was less affected by the low interest rate policies.

Figure 5: NPL Ratios



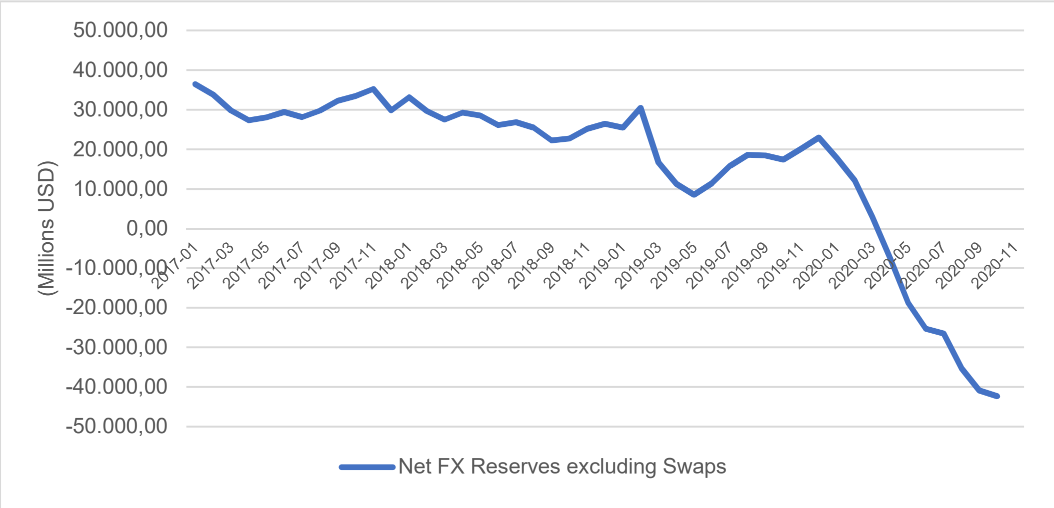
Source: Turkey Data Monitor

In the period after August 2020, Turkey changed its policy stance and allowed the exchange rate to depreciate, as noted earlier. This may increase the pressures on NPL moving forward. Nevertheless, even if the NPL numbers double, they would be manageable, particularly given the high capital asset ratios.

Financial Risks Associated with the Exchange Rate

Since the beginning of 2020, the TL has depreciated more than 40 percent. The grey line in Figure 1 shows the nominal exchange rate. Interestingly, more than 10 percent of that depreciation took place in the period after August. Although the government claimed that a more competitive exchange rate would decrease the costs of production for the export sectors, the main challenge of a weaker TL is on financial stability. By the end of 2019, the external debt stood at 56 percent of GDP. Consequently, the depreciation of the TL increases the debt burden of the corporate sector. As of August 2020, short-term debt that is due in 2020 stood at 132.8 billion USD, of which 65 billion USD is held by non-financial corporations. The 10 percent depreciation increases the debt burden of the non-financial corporate sector given that most of the income of these firms is in Turkish Lira. This is a challenge that puts downwards pressures on the economy and increases the potential for NPL. Furthermore, recent CBRT studies reflect that a 10 percent depreciation in TL increases the inflation rate by approximately 1.5 percentage points.[8] Thus, the depreciation of the TL since the beginning of the year is expected to increase the inflation rate by about 5 percent or more.
Orthodox economic policies would have dictated that the CBRT intervene against the inflationary pressures with a rate hike. However, to keep the interest rates low, the CBRT decided to use its reserves to fight against the depreciation of the Lira. Figure 6 shows the net foreign reserves of the CBRT since 2018. The use of central bank reserves to defend the value of the Lira increased the vulnerabilities of the Turkish economy to foreign exchange shocks. However, the return to orthodox policies as of October 2020 is perceived favourably.

Figure 6: CBRT´s Net FX Reserves



Source: CBRT

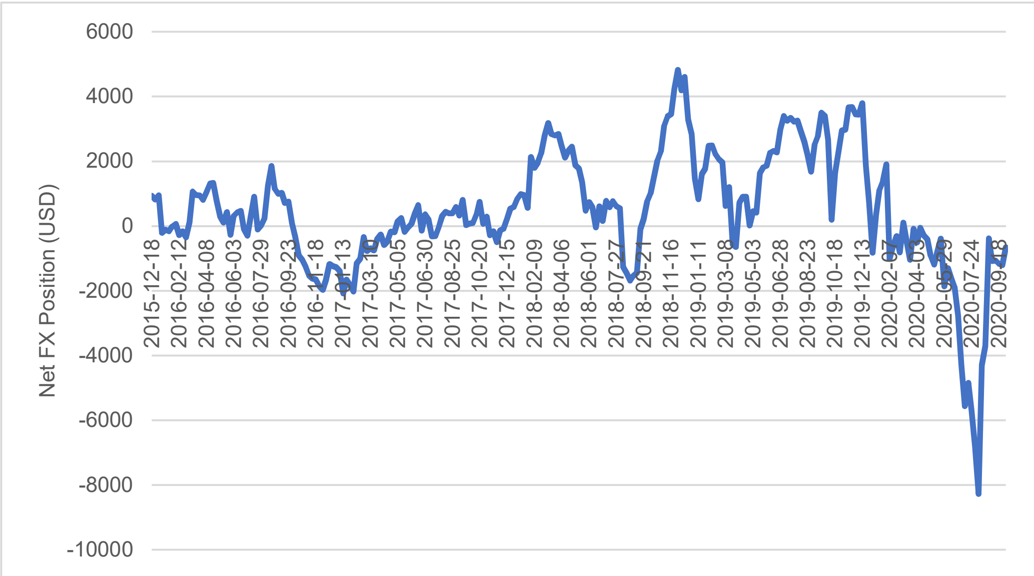
Effects of Credit Growth on the Economy

The Turkish stimulus package to offset the COVID-related recession relied on sizable credit growth. The government had already adopted a credit-driven growth model in order to offset the slowdown after the August 2018 exchange rate crisis. We have seen a substantial increase in credit growth during COVID-19, partly because firms' need for cash increased and partly because the government encouraged lending through the Credit Guarantee Fund

[8] https://www.tcmb.gov.tr/wps/wcm/connect/blog/en/main+menu/analyses/exchange+rate+pass-through

and low interest rate policies. Rapid credit growth can be a sign of stress and could be a potential trigger for financial crisis. [9]
Unlike advanced economies where bank deposits increased during the pandemic (as a result of increased demand for safe haven assets), in Turkey the increase in TL loans was not matched by a proportional increase in TL deposits. Instead, the low interest rate environment triggered dollarisation and increased FX deposits and demand for gold instead.[10] Consequently, loan-to-deposit ratios on TL-denominated assets and liabilities exceeded 140 percent. There has also been a net outflow from the banking system such that the decrease in TL deposits was not exactly matched by an increase in FX deposits, increasing the net borrowing needs of the banking system. While banks could swap these FX deposits for TL at the CBRT, micro-prudential measures such as the active ratio made it more expensive to accept FX deposits and put additional strains on bank balance sheets. The active ratio also penalized banks if they did not lend. Figure 7 shows that the net FX position of the banking sector followed a V-shaped pattern and is at pre-COVID levels, eliminating concerns on that front.

Figure 7: Banking Sector Net FX Position

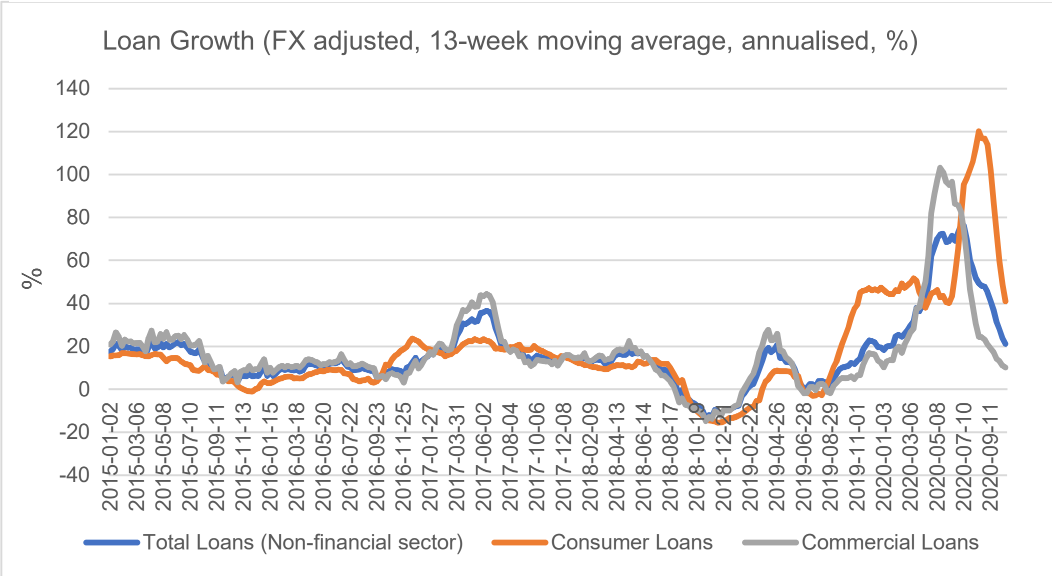


Source: Turkey Data Monitor

In the aftermath of the pandemic, the 13-week moving average credit growth reached a peak of 100 percent for commercial loans by mid-May, and 120 percent in mid-August for consumer loans (see Figure 8). Excessive credit growth increases the funding needs of the banking sector and puts pressure on the TL, particularly given the fact that the average loan-to-deposit ratio is around 140 percent. Figure 9 shows that the composition of the banking sector's FX debt moved towards short-term loans during the pandemic season where banks were net payers of long-term loans, but were able to roll over short-term loans.

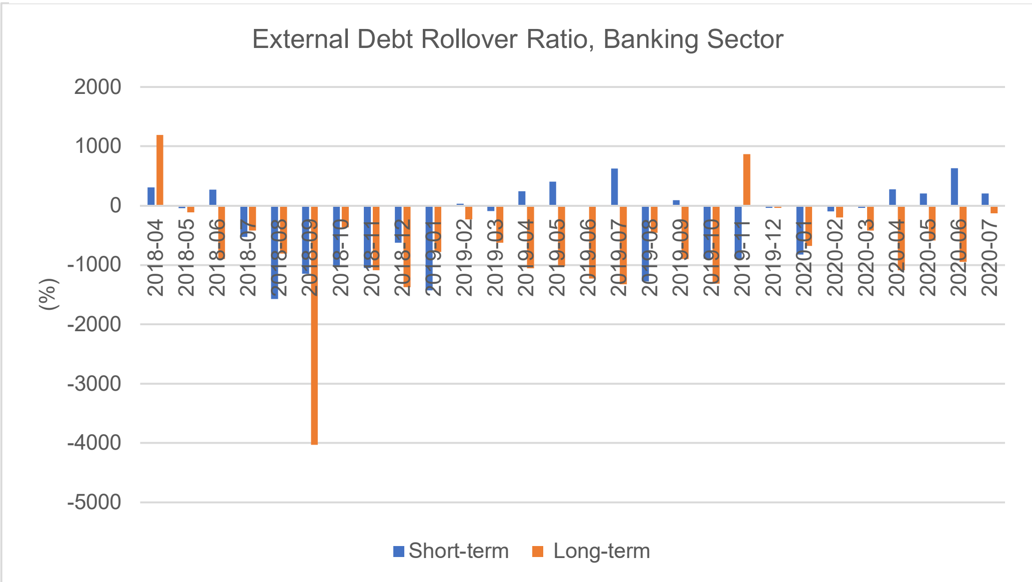
[9] Jorda, O., Schularick, M., and Taylor, A., 2013, When Credit Bites Back, Journal of Money, Cred-it and Banking 45, 3-28.
[10] https://uk.reuters.com/article/uk-turkey-currency-gold/gold-rush-at-turkish-bazaar-a-test-of-trust-for-lowly-lira-idUKKCN25A0H8?il=0

Figure 8: Credit Growth Rates for Commercial and Consumer Loans



Source: Turkey Data Monitor

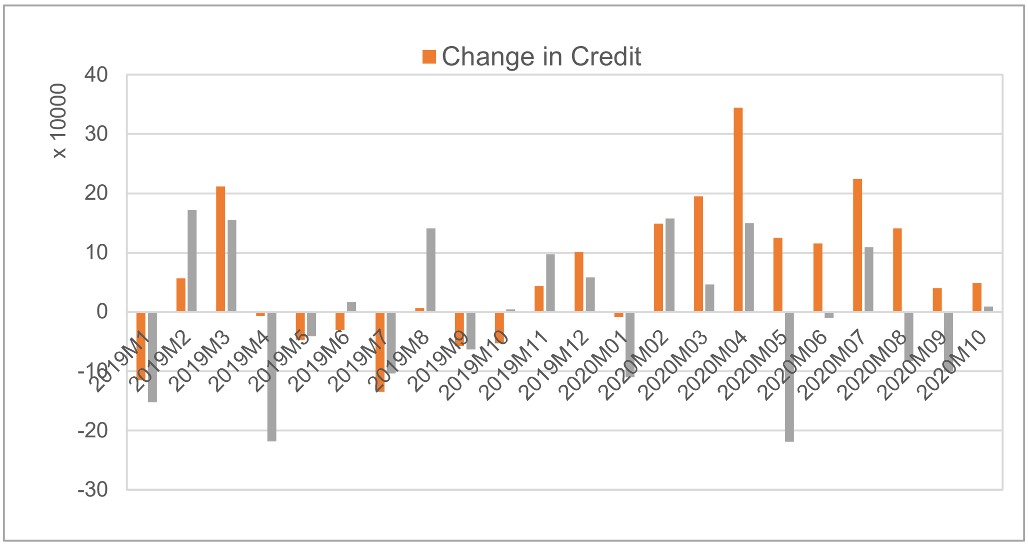
Figure 9: Banking Sector Rollover Ratios of Cross-Border Loans



Source: CBRT

Credit growth has slowed since August 2020, as shown in Figure 10, which displays the change in credit in real terms (orange bars) and the credit impulse (grey bars). With tightening measures in place, loan growth declined to 40 percent for consumer loans and 10 percent for commercial loans. This is also reflected in credit impulse, which shows the change in credit growth. While the slowdown in credit growth is bad news for the growth rate, it is good news for the exchange rate and macroeconomic balances. The slowdown in credit growth reduces the probability of hard landing moving forward and makes it possible to ease exchange rate pressures as well as the inflation rate. Looking forward however, the rollover needs of the corporate sector might limit the decline in credit growth.

Figure 10: Credit Conditions

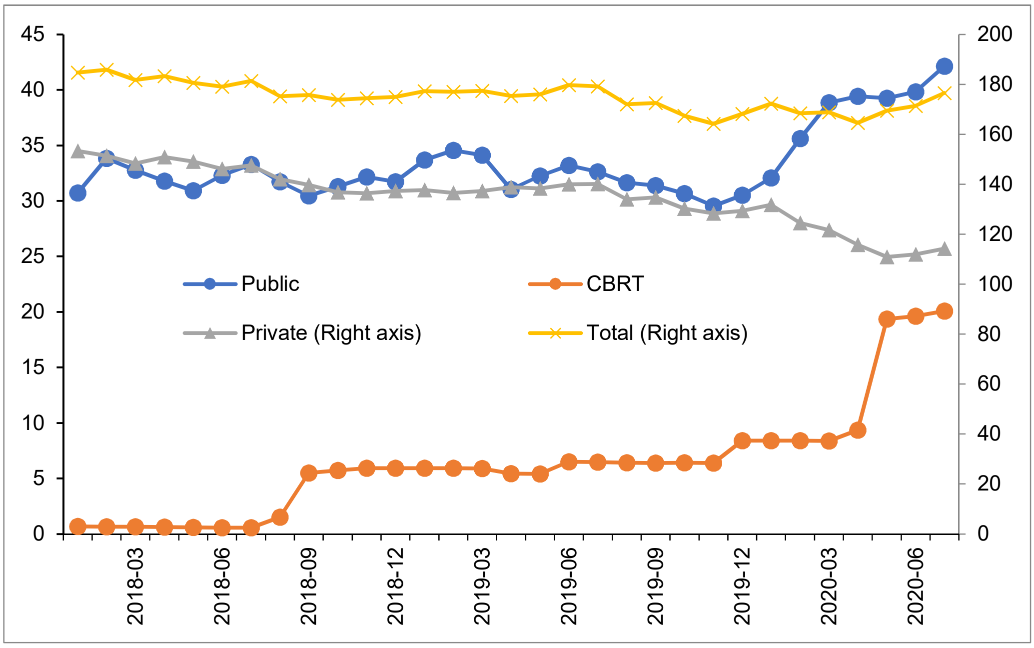


Source: CBRT

Change in the Composition of Short-Term Funding

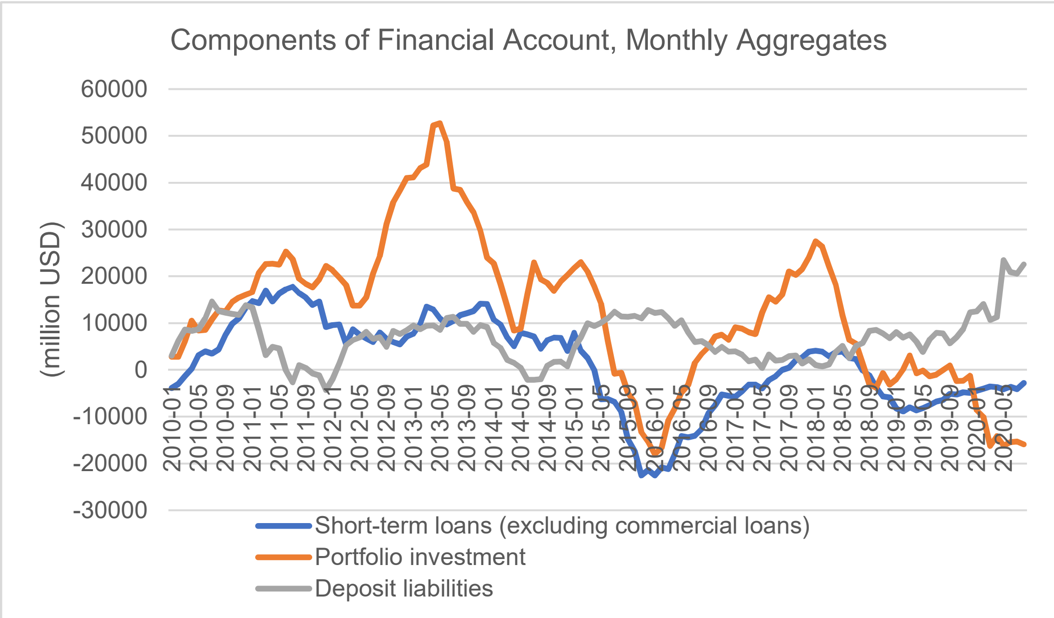
Net FX reserves of the CBRT declined significantly in 2020. Gross reserves amounted to 42.3 billion USD as of the end of October. Just to provide perspective, gross reserves were as high as 89 billion USD on average over the years between 2008 and 2018. While gross and net reserves declined at a fast pace, part of the decline in FX stock was offset by the increase in short-term debt by the CBRT and the public sector.
Looking at the short-term funding of the private sector, we observe a decline in the short-term external debt of the private sector which offsets the increase in the short-term external funding of the public sector and the CBRT. Figure 11 displays the evolution of the short-term debt structure for these three sectors in the last two years. Turkey has been experiencing a decline in capital inflows for a while. The volatility in the exchange rate and the consequent restrictive measures that were adopted during the pandemic accelerated outflows of short-term funding. As shown in Figure 12, portfolio flows declined by 15 billion USD over the course of last year while short-term loans (excluding commercial loans) declined by 2 billion USD. While the decline in short-term funding puts pressure on the exchange rate, low levels of funding reduce the scope for further volatility in financial markets and the exchange rate.

Figure 11: Short-Term Debt Structure (Debt with 1 year or shorter maturity, billion $)



Source: TurkStat

Figure 12: Financial Borrowing: Short-term loans, portfolio investment, currency and deposit liabilities

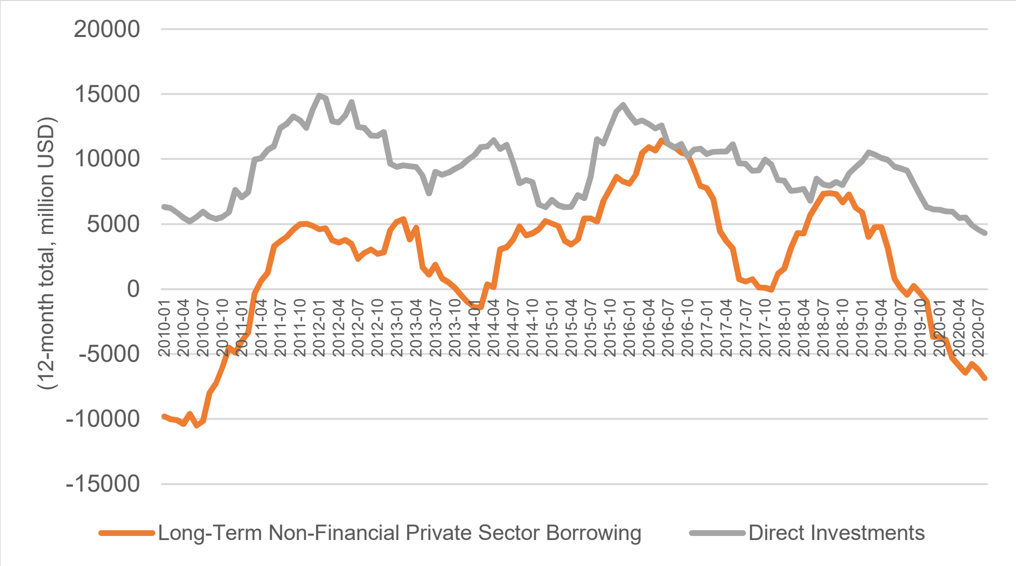


Source: Turkey Data Monitor

Decline in Long-Term Funding

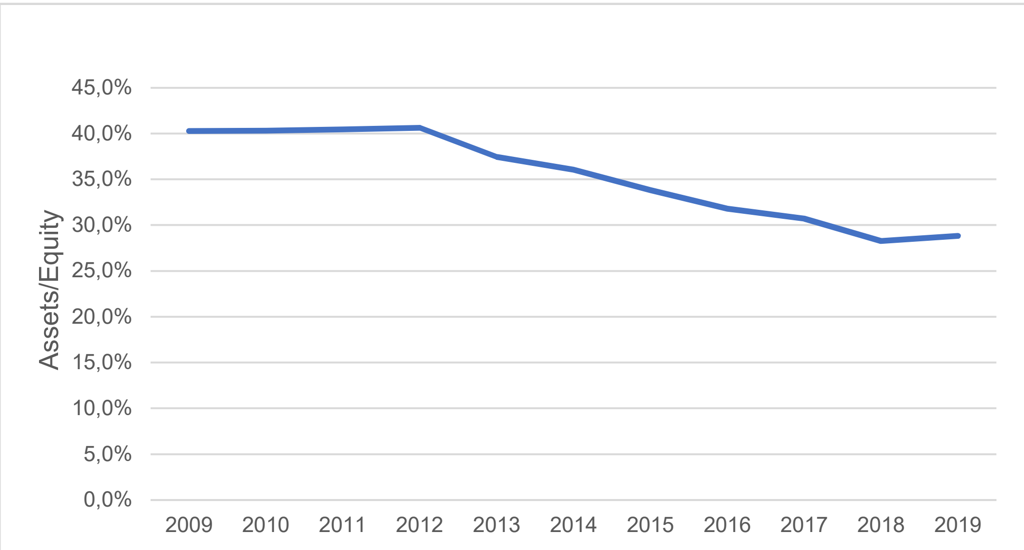
Long-term funding of the non-financial corporate sector has been declining in the last 12 months (see Figure 13). Combined with the weaker TL, some Turkish firms are struggling to repay foreign currency debt, resulting in loan restructurings. On the bright side, depreciation in the TL makes Turkish assets more attractive, which may explain the stable pattern of foreign direct investment. Since the exchange rate crisis in August 2018, the focus for Turkish companies has been on deleveraging, which is the process whereby businesses pay their debt by accumulating cash, often by selling their assets. Deleveraging is an advantage for the heavily indebted private sector to strengthen its balance sheets. Furthermore, Figure 14 suggests a similar picture as firms in the non-financial sector have been deleveraging in recent years. This can be indeed explained by the fact that firms' cash holdings display a significant time variation.

Figure 13: Corporate Borrowing and FDI



Source: Turkey Data Monitor

Figure 14: Leverage in Non-financial Corporate Sector

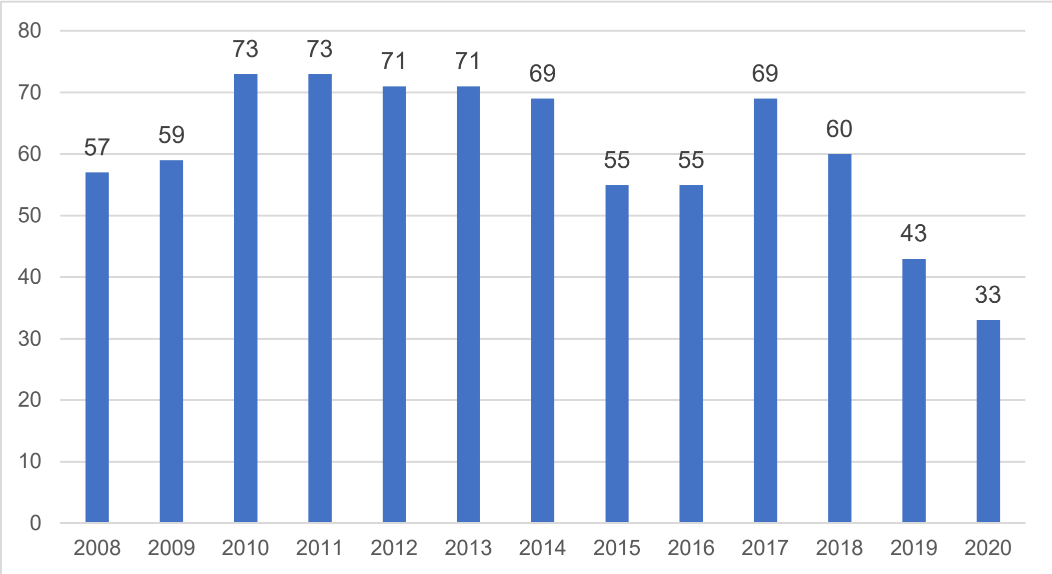


Source: CBRT

Business Conditions

Turkey has been introducing business-friendly regulations to create an environment fostering business startups and growth. Based on the World Bank's ease of doing business index, Turkey moved up from a rank of 43 in 2019 to a rank of 33 in 2020 (Figure 15).

Figure 15: Ease of Doing Business



Source: World Bank, Doing Business Database

Nevertheless, the quick 'patches' that were adopted to fight the August 2018 crisis limited foreseeability of the business environment and received protests from the business community. The Turkish Industry and Business Association (TUSIAD), one of the largest NGOs representing the Turkish business community, expressed in February 2020 that 'we must be aware of the negative effects on the investment environment caused by changes in legislation concerning the real sector and money markets, unanticipated laws that impact the business world, tax policies that undermine the confidence of economic actors and measures that generate concerns over property rights'.[11]
While this warning came prior to the onset of the pandemic, further restrictions were imposed in due course. In April 2020, banks were required to inform the Ministry of Treasury and Finance before making any money transfers from Turkey of 100,000 TL (close to 12,750 USD as of 1 December 2020) or more (or the equivalent in any other currency). In the same month, the 'asset ratio' was introduced by the BRSA, which designed a mechanism to punish banks that do not lend or buy government bonds or engage in swaps with the central bank. Another regulation was issued in May 2020 regarding manipulation and misleading transactions in financial markets.[12]
Gradual removal of the above-mentioned restrictions or regulations in the second half of 2020 signals a more market-friendly approach and allows greater access to international debt markets. For example, the Treasury sold $2.5 billion Eurobonds in October 2020, following the rate hike by the CBRT that signalled a return to more orthodox policies.

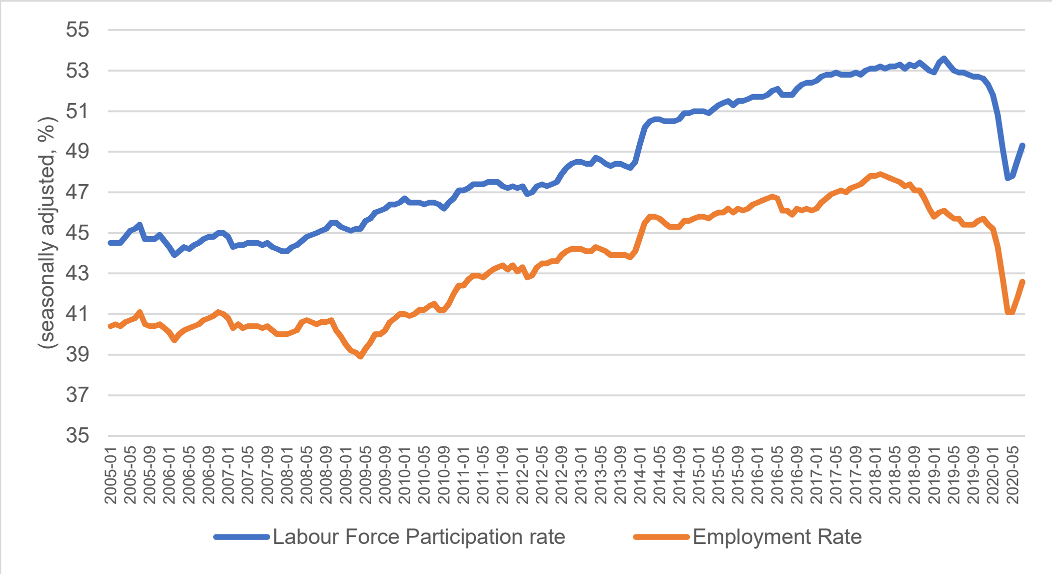
[11] https://tusiad.org/en/press-releases/item/10531-general-assembly-meeting-of-tusiad

[12] A nice summary of these restrictions can be found here: Hakan Yazici, "Will Turkey Attract Foreign Investments after Covid-19?", *Yetkin Report*, 14 May 2020, https://yetkinreport.com/en/2020/05/14/will-turkey-attract-foreign-investments-after-covid-19/

Labour Force and Productivity

Economic growth can be decomposed into capital accumulation, labour and Total Factor Productivity (TFP). In terms of labour, Turkey has a dynamic and flexible population. A young, qualified labour force supported by a strong infrastructure has always been one of the strengths of the Turkish economy. On the other hand, the unemployment rate had been on the rise for some time even before the pandemic started. The duration of the pandemic will be critical because long spells of unemployment may cause permanent damage to the labour force by increasing discouraged workers who drop out of the labour force. The labour force participation rate has been declining since the onset of the August 2018 crisis. Nevertheless, the recent increase in labour force participation likely reflects the stimulus measures that were put into effect during the pandemic (Figure 16).

Figure 16: Labour Force Participation and Employment Rate



Source: Turkey Data Monitor

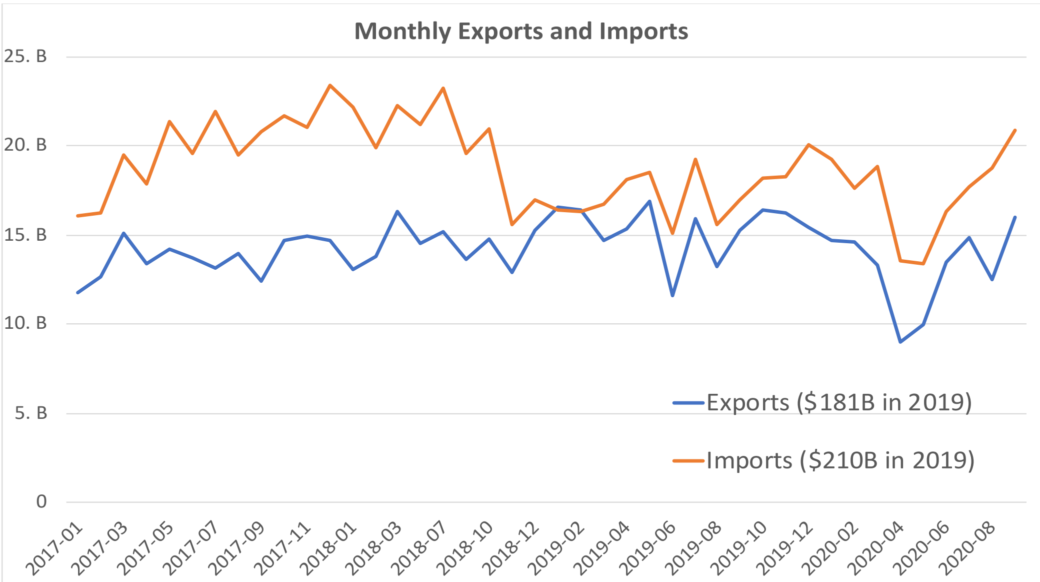
Of course, a dynamic labour force does not translate into per capita income growth. For Turkey to enrich its population, it needs to increase its TFP. Yet, Turkey experienced a significant decline in TFP in the period after 2010. The contribution of TFP to total growth was nil after 2014 where growth was driven by capital accumulation.[13] While the decline in the contribution of TFP is clearly negative for growth prospects, post-COVID transformation and support for new technologies by the Turkish government, such as solar and wind energy, electric vehicles and unmanned air vehicles, provides an opportunity for Turkey. Due to the redistribution of global supply chains after the pandemic and thanks to its geographical advantages, Turkey might attract more foreign direct investment, which might result in technology transfer that could in turn translate into higher TFP levels.

[13] Bakış, O. and Acar, 2020, Evolution of Total Factor Productivity in Turkish Economy: A Sec-toral Outlook, 1980-2018 ("Türkiye Ekonomisinde Toplam Faktör Verimliliğinin Seyri: Sektörel Bakış, 1980-2018"). BETAM Working Paper Series No: 19.

Trade Conditions

Çakmaklı et al.[14] note that those sectors that are more closely connected to the rest of the world through trade relations as well as external borrowing links are more severely affected by the pandemic. One important caveat associated with international trade is the chronic trade deficit run by Turkey. In 2019, the trade deficit was close to 30 billion USD with 210 billion USD in imports and 181 billion USD in exports. The only trade surplus was observed right after the August 2018 crisis, in the first two months of 2019 (Figure 17: Monthly Exports and Imports). In the first nine months of 2020, exports were 118 billion USD and imports were 156 billion USD compared to 133 billion USD of exports and 154 billion USD of imports in the same months of 2019. Interestingly, exports drastically declined during the pandemic, but imports increased, resulting in a higher trade deficit. The increase in imports is related to the credit expansion in Turkey. After a slump between March and May, exports rebounded starting in June (Figure 18: Monthly Export Changes). Imports, on the other hand, were affected less during the pandemic, with import levels exceeding the average of the previous three years in July (Figure 19: Monthly Import Changes). In both imports and exports, intermediate goods were the least affected by the pandemic (Figures 20 and 21 monthly export/import changes in various categories). Consumption goods and capital goods declined significantly but have rebounded to pre-pandemic levels in recent months. This rebound is also related to the credit growth, which facilitated access to these types of goods. The global recovery that is expected in 2021 should support Turkish exports and ease borrowing conditions. With a weaker TL, the trade deficit is expected to decline.

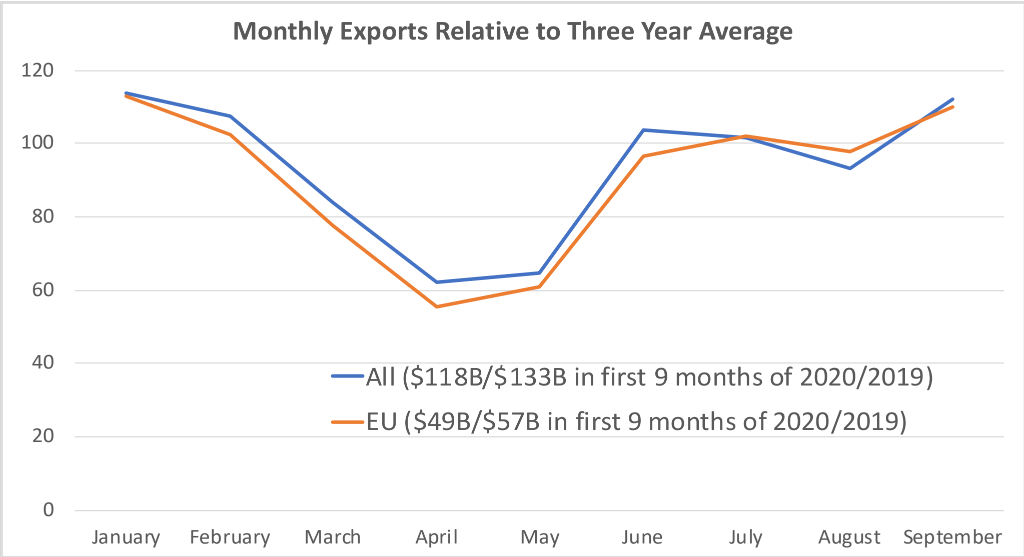
Figure 17: Total Imports and Exports (billions USD)



Source: TurkStat

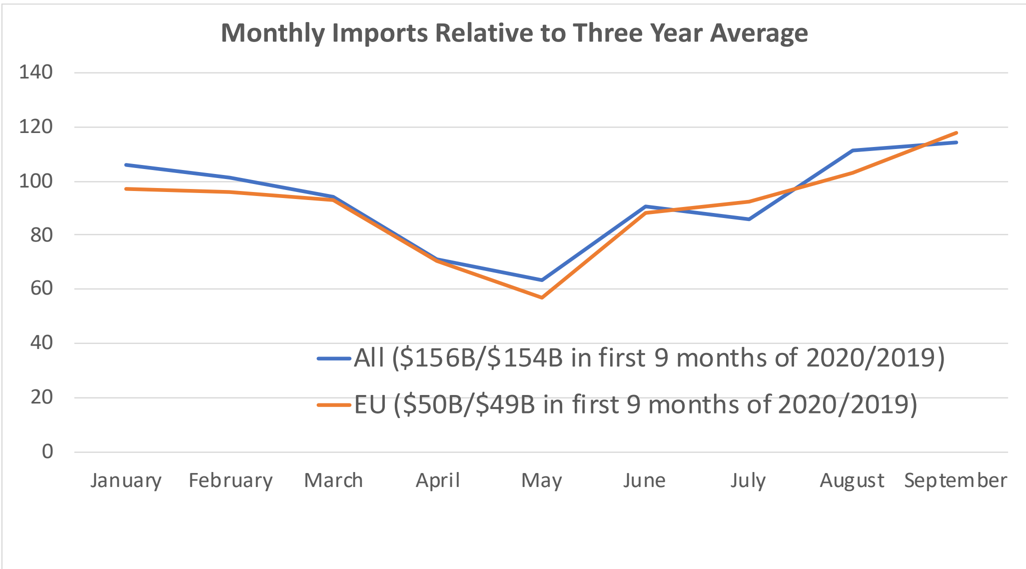
[14] Cakmaklı, C., Demiralp, S., Kalemli, Ozcan, S., Yesiltas, S., and Yıldırım, M., 2020, COVID-19 and Emerging Markets: An Epidemiological Model with International Production Networks and Capital Flows, NBER Working Paper No. 27191, https://www.nber.org/papers/w27191

Figure 18: Changes in Exports (percent change compared to previous three years)



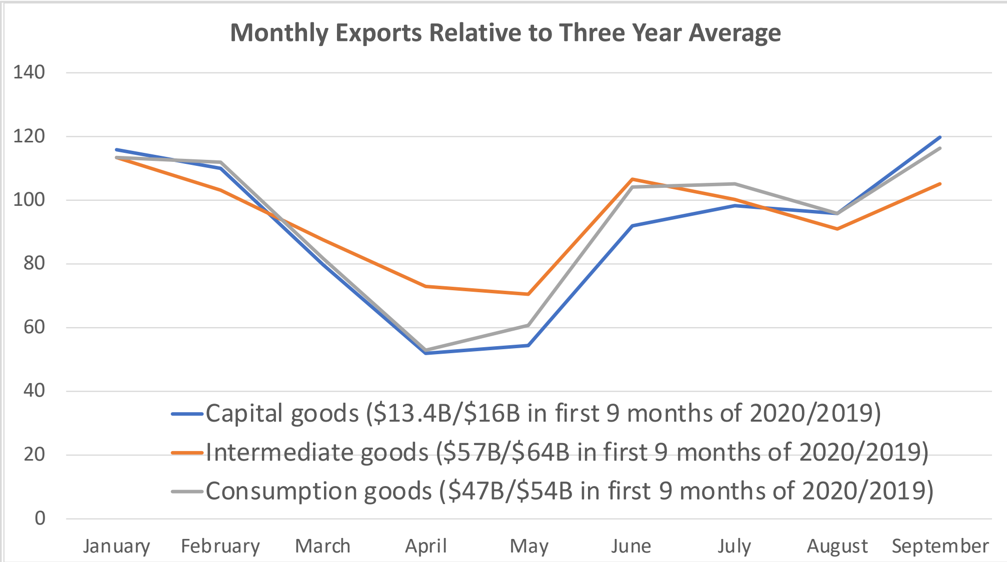
Source: TurkStat

Figure 19: Changes in Imports (percent change compared to previous three years)



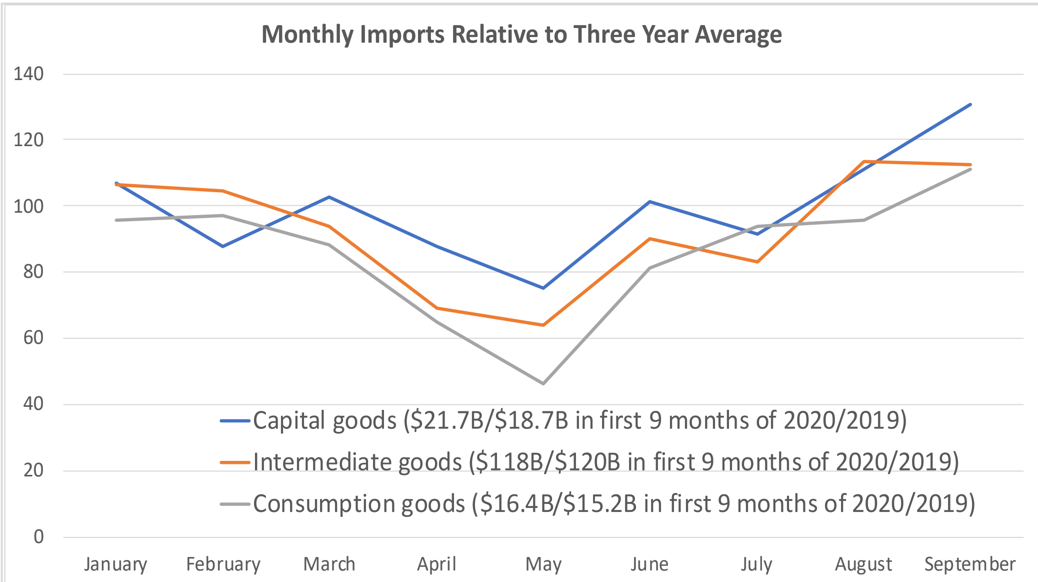
Source: TurkStat

Figure 20: Changes in Exports in Various Categories (percent change compared to previous three years)



Source: TurkStat

Figure 21: Changes in Imports in Various Categories (percent change compared to previous three years)



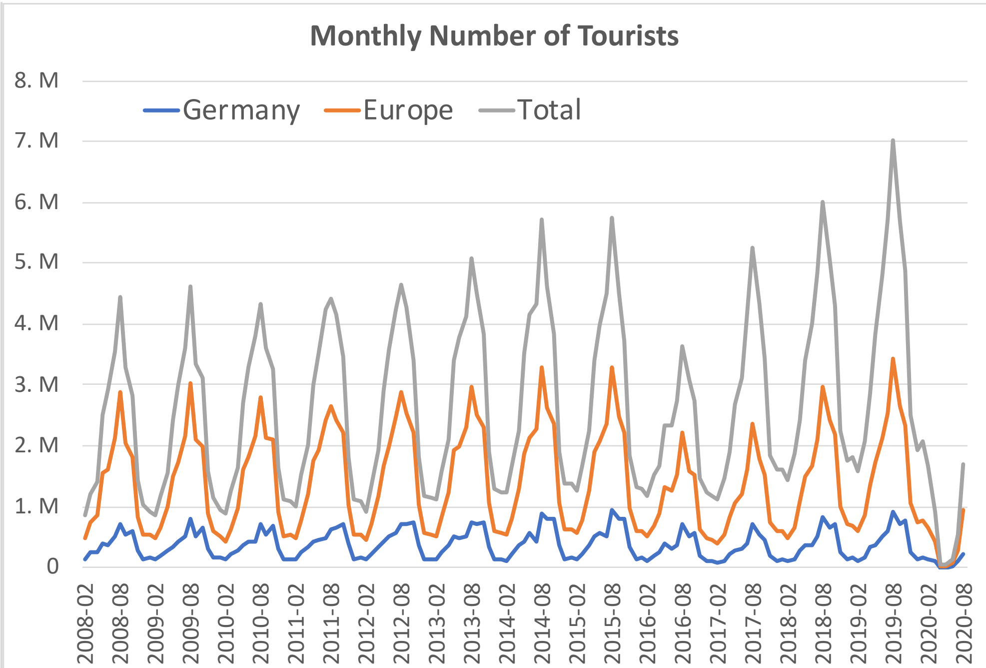
Source: TurkStat

One of the major drivers of the trade deficit, and therefore the current account deficit, is energy imports. In 2019, Turkey's energy import bill was close to 42 billion USD, which would account for the trade deficit observed that year. The decline in oil prices during the pandemic is a major advantage for an oil-importing country like Turkey, contributing extensively to the narrowing of the current account deficit per year. Nevertheless, the depreciation in the TL limits the decline in the price of imported oil. Furthermore, the decline in oil prices is expected to be temporary and bounce back once economies recover from the COVID shock.

Tourism

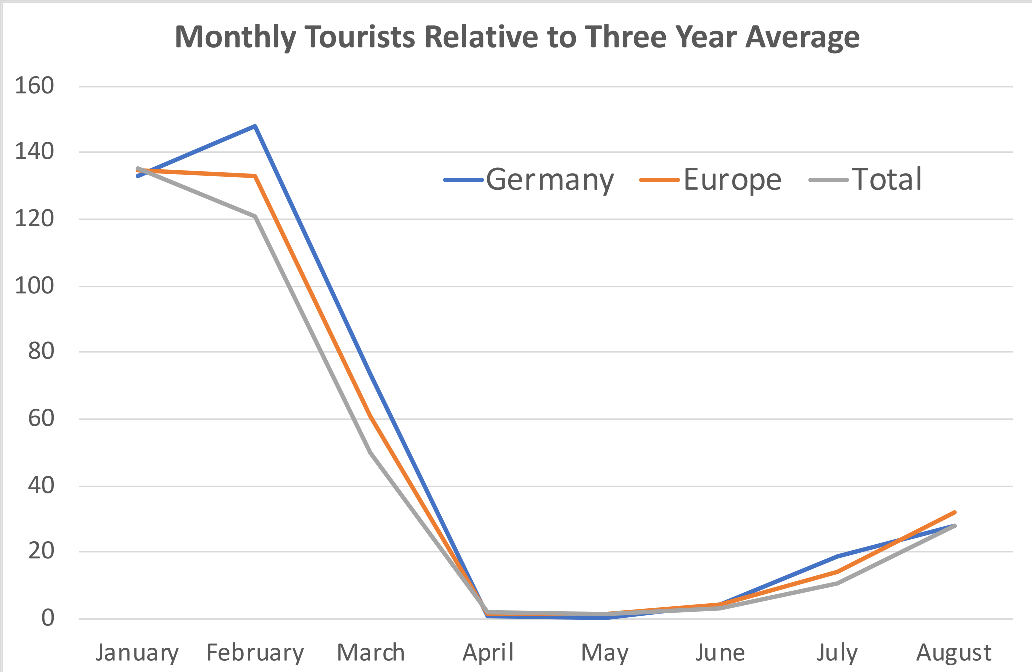
The tourism sector is instrumental in reducing the current account deficit. During the pandemic, the sector was hit drastically. In total, 44.7 million tourists, of whom 22 million were from the EU and 5 million from Germany, visited Turkey in 2019 (Figure 22: Monthly Tourist Numbers) with the bulk of the tourists coming during the summer months. As a comparison, Turkey attracted close to 30 million tourists during the first eight months of 2019, but only 7 million tourists visited in 2020 during the same months. With the pandemic, total tourist numbers declined close to null in April and May of 2020, and the numbers gradually increased during the summer months of June, July and August. But even at the peak in August, the number of tourists relative to the average of the last three years is only 28 percent (Figure 23: Changes in Tourist Numbers). According to Turk Stat, in 2019 tourism revenue was 34.5 billion USD, with 26.6 billion USD earned during the first three quarters. In 2020, the first three quarters yielded 8.1 billion USD. In total, we can expect more than 20 billion USD decline for 2020 in terms of direct tourism revenue. Furthermore, the industries that supply input to the tourism industry are not considered in this tally, which could bring the total damage of the COVID-19 pandemic via the tourism channel to much higher levels. In fact, according to an estimate by Atan and Arslanturk (2012) the multiplier effect of the tourism industry is found to be close to 1.9, bringing the adverse impact of tourism to an output loss of 38 billion USD in various industries. Altogether, the analysis in this section suggests that the negative impact of tourism on Turkey's GDP will likely be between 3 and 5 percent in 2020. We expect tourism to bounce back once the pandemic is taken under control. With a weaker TL, Turkey might attract even more tourists in the post-pandemic period, supporting a faster recovery.

Figure 22: Monthly Tourists (in millions of people)



Source: TurkStat

Figure 23: Changes in Monthly Tourist Numbers (percent change compared to previous three years)



Source: TurkStat

Table 1: Summary of Weaknesses and Strengths of the Turkish Economy during COVID-19

		Weaknesses	Strengths
1.	**Non-performing loans**	NPL ratio is increasing.	Capital and liquidity ratios are still strong compared to European standards. NPL ratio is not alarming.
2.	**Financial risks associated with the exchange rate**	Weaker TL is a burden for the FX debt and inflation spillovers.	Weaker TL makes Turkish assets rather competitive.
3.	**Credit growth**	Banking sector extended loans to achieve government targets. Excessive credit growth was part of the stimulation package. It increased risk exposure and pressured the exchange rate.	Slowdown in credit growth has started. Reduces the probability of hard landing and allows easing of exchange rate pressures. The rollover needs may limit the decline in credit growth.
4.	**Short-term funding**	There have been significant outflows during the crisis (about 15 billion USD decline in portfolio flows as a 12-month cumulative value).	Low levels of short-term funding reduce the scope for further volatility in financial markets and exchange rate. Interest in Turkey's debt market is expected to come back as the investors see more stability in the economy.
5.	**Long-term funding**	Long-term funding has been declining for a while. Some Turkish firms are struggling to pay back foreign currency debt, resulting in loan restructurings.	Depreciation in TL makes Turkish assets more attractive. Recent signs of increase in FDI. Since August 2018, Turkish companies have been deleveraging. Deleveraging is an advantage for the heavily indebted private sector.
6.	**Business environment**	Frequent changes in regulations reduced foreseeable business conditions.	Ease of doing business improved.
7.	**Labour force and productivity**	Turkey has experienced significant decline in TFP in the period after 2010. The contribution of TFP to total growth was null after 2014 where	Dynamism and flexibility of the private sector. Young, qualified and yet unemployed labour force can be integrated into

		growth was driven by capital accumulation. In recent years Turkey has suffered brain drain of highly educated young people, particularly after the experience of the recurrent economic crises and political tensions.	production rather quickly. Strong infrastructure is an advantage. Post-COVID transformation in global supply chains and technology transfers creates an opportunity for Turkey to increase its productivity.
8.	**Trade conditions**	Pandemic limits Turkish exports. Current account deficit continued to increase even during the pandemic due to fast credit growth. Depreciation in TL limits the decline in price of oil that Turkey imports. Improvements in global growth may cause oil prices to increase in 2021.	Positive growth is expected with the trade partners in 2021. Weaker Turkish Lira might help with the trade deficit. Decline in oil prices is an advantage for an oil importer like Turkey.
9.	**Tourism**	Pandemic affected tourism drastically. More than 30billion USD shock to the current account.	Positive growth and higher tourist appetite expected when the pandemic is over.

An evaluation of counter-cyclical policies developed to offset the pandemic. Were they successful? What will be the long-run impact?

Turkey was already in the middle of an accommodative policy cycle, i.e., with low interest rates to stimulate growth, when the COVID-19 shock hit. When the pandemic hit Turkey in March 2020, the policy rate was at 10.75 with the inflation rate at 12 percent, already suggesting a negative real policy rate. Meanwhile the IMF-defined primary budget deficit was at 3.4 percent as of the end of 2019. Hence, both monetary and fiscal space was limited when the pandemic hit.

In terms of the policy measures adopted during the pandemic, an aggressive easing policy based on sizable bond purchases and credit growth was implemented during the first half of the year. The CBRT immediately cut rates by 100 basis points during their emergency meeting in March and again in April 2020. The announcement that came in late March eased collateral requirements to borrow from the CBRT and allowed unlimited bond purchases with the provision that 'limits might be revised depending on market conditions'. The CBRT and the Banking Regulation and Supervision Agency introduced several financial repression measures in the following days that increased the risk exposure of the banking system, encouraging banks to lend at low rates or buy government bonds. They also introduced certain capital flow management measures that reduced domestic banks' reserve requirements for foreign currency deposits and put limits on the daily amounts of domestic banks' swap transactions. Notice that although it was important to react early to the pandemic, especially for an emerging market (EM) such as Turkey, market perception of such measures is just as important. This is because potential risks and hence the costs of foreign borrowing are priced by global investors. Thus, effective and transparent communication of policy actions is as critical as the actions themselves.

The idea of money printing through bond purchases to offset the contractionary impact of the pandemic was unavoidable and in line with monetary policy practices in the rest of the world. Nevertheless, an EM that faces a double-digit inflation rate and a chronic current account deficit soon hits the boundaries of low interest rate policies in terms of a weaker local currency. Turkey tried to offset the impact of low interest rates policies adopted by the central bank by selling FX reserves. However, such policies were not sustainable and caused depletion of valuable FX reserves. In August 2020, signals of a policy change appeared with the announcement that a competitive exchange rate would be preferable. Following this statement, the CBRT increased its policy rate explicitly by 200 basis points on 24 September. While the rate hike was not sufficient to defend the TL, an explicit rate hike after almost two years was still perceived to be a positive change towards orthodox monetary policy. However, the CBRT disappointed markets once more when it reverted to unorthodox policies a month later, preferring another implicit rate hike on 22 October instead of a more orthodox policy of increasing the policy rate. The TL was on a free slide, reinforced by the global strengthening of the USD against EM currencies due to the pricing of US elections as well as the second wave of the pandemic. Nevertheless, the TL diverged negatively from the rest of the EMs at this time due to policy choices and geopolitical tensions.

In November 2020, following the replacement of the central bank governor and appointment of a new Treasury minister, the CBRT returned to orthodox policies and hiked rates by 475 basis points. At this time, the BRSA announced that it would remove the 'asset ratio' in an attempt to continue 'normalising' policy. This was a critical move because the asset ratio led banks that had been unwilling to provide credit to risky businesses to reduce their deposit rates. The exchange tax on foreign currency trade was reduced from 1 percent to 0.2 percent to effectively restore the freely operating market. Furthermore, the international funding channels of currency trade with certain maturities, i.e., swap markets, were restored by relaxing the limits of trade as well as the related rates to normal levels for the market to operate. These limits include swap contracts with various maturities.[15] This had been subject to fierce discussion in 2019 and 2020, as Turkish authorities shortened the supply of TL to foreign investors to prevent an increase in the demand for the foreign currency in swap markets. As a result of these measures that all signalled a return to conventional policies, inflation expectations and the risk premium declined. This led to an easing of financial conditions which reduced benchmark interest rates by more than 200 basis points in the month of November, despite the sizable rate hike by the CBRT.

In terms of fiscal policy, the first stimulus package announced by the government in March was consistent with the general framework adopted by other countries as well. While the original package announced in mid-March was 2 percent of GDP, the scope of the package was later expanded gradually to around 12.8 percent of GDP, comparable to the average size of the fiscal stimulus among G20 countries. According to the IMF Policy Tracker, the estimated fiscal support increased to close to 570 billion Turkish Liras (close to 80 billion USD) as of early October 2020.[16] Primary areas of spending were loan guarantees to firms and households (6.8 percent of GDP), loan service deferrals by the state-owned banks (1.5 percent of GDP), tax deferrals for businesses (1.5 percent of GDP), equity injections into public banks (0.5 percent of GDP) and a short-term work scheme (0.4 percent of GDP). The limits of the Credit Guarantee Fund were increased to make bank loans more accessible. Temporary income support was provided to those workers whose companies had ceased production due to the pandemic. According to the New Economic Programme announced on 29 September 2020,[17] direct transfer payments included 4.4 billion TL (560 million USD) as cash transfers to needy families, 6.2 billion TL (close to 800 million USD) as social support programs, 18.7 billion TL as short-term work allowance (2.4 billion USD), 3.6 billion TL (460 million USD) for unemployment. In addition, another 2 billion TL (256 million USD) was raised as a part of the 'We are self-sufficient donation campaign by the government, bringing the total to close to 35 billion TL (close to 4.5 billion USD), 0.8 percent of GDP. Additionally, employee layoffs were banned until January 2021. In comparison, direct payments in the United States as a part of the Coronavirus Aid, Relief and Economy Security Act were close to 2.6 percent of GDP.

[15] See decision number 9169 of the BRSA for details.

[16] IMF Policy Tracker, https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19.

[17] https://ms.hmb.gov.tr/uploads/2020/09/YEN%C4%B0-EKONOM%C4%B0-PROGRAMI-SUNUM.pdf

Conclusion

Looking forward, while the expansionary monetary policy that was adopted at the onset of the pandemic was the proper policy to support the economy, the risks of excessive credit growth should have been better evaluated and a larger portion of the money that was injected into the economy could have been used in the form of direct transfer payments to society. We should note that monetary policy operates through monetary injections with no distributive power. It is the fiscal policy that is responsible for the allocation of the stimulus package to the most needy agents.

Given the asymmetric nature of the crisis that hit the lower income groups the hardest, transfer payments were critical to provide much-needed income relief and revive demand. Should the transfer payments have covered only those who lost their income, or should they have been in the form of 'helicopter money' in the Turkish context, which has a sizeable informal economy? The answer depends on the extent of funding that was available to support the economy. Hypothetically, a generous programme that did not trigger longer term macroeconomic imbalances could minimise the economic damage and prevent long-term risks. A less comprehensive programme, on the other hand, would delay the speed of recovery. Looking back, the fiscal policy could have focused more on the informal sector and take more effective measures to reduce poverty due to the pandemic.

FX sales to defend the value of the TL were rather risky and should have never been considered a policy option. Instead, a more sustainable and orthodox policy package would likely have provided a more balanced growth path, accumulating less vulnerabilities. The Turkish growth rate for 2020 will likely be close to a positive number thanks to early restrictive measures adopted during the first wave, monetary and fiscal stimulus, and injection of FX reserves. However, the vulnerabilities due to FX sales and excessive credit growth that led to an unavoidable tightening of financial conditions will likely limit the rebound in 2021.

The major success in the policy measures that were put into practice during the pandemic was the lockdown measures implemented during the first wave. Thanks to a delayed start, Turkey had the opportunity to observe the measures that were taken by other countries and put similar measures into practice quite rapidly. The measures were not very restrictive but rather focused on school closings, travel restrictions, age-dependent curfews to limit the exposure of most susceptible and most active age groups, and restrictions in public areas, leaving most businesses open.

With a peak in infections observed within only one month, Turkish performance was significantly better than a typical partially restrictive lockdown scenario. In terms of the number of patients, the peak was observed in mid-April 2020, about one month after the lockdown measures were put into practice. In order to gauge the performance of the measures adopted by Turkey, Cakmaklı et al. [18]provide a baseline to evaluate these numbers. Using the statistics reported by World Health Organization regarding the infection rate and the recovery rate to determine the key parameters, Cakmaklı et al.[19] find that in a partial lockdown the peak is observed in about 200 days. The duration of the lockdown is rather

[18] Cakmaklı, C., Demiralp, S., Kalemli, Ozcan, S., Yesiltas, S., and Yıldırım, M., 2020, COVID-19 and Emerging Markets: An Epidemiological Model with International Production Networks and Capital Flows, NBER Working Paper No. 27191, https://www.nber.org/papers/w27191

[19] Ibid.

long because the infection spreads among the working population. In a full lockdown, however, the peak is observed immediately after the lockdown because the infection rate declines immediately once most people are kept at home. Hence, the Turkish experience in first three months of the pandemic was superior to the partial lockdown scenario Cakmaklı et al..[20]

What could be the factors that underlie this superior performance in controlling the first wave of the pandemic? Let us reemphasise that the restrictions were put into practice quite early, before the pandemic spread to the population. Furthermore, the health sector worked rather effectively. Health care has been undergoing significant changes in Turkey with remarkable intensive care unit capacity, which contributes to a higher recovery rate.[21]A third factor is the role played by the COVID-19 scientific committee which worked as an effective bridge between the government, the media and the public. The committee was quite successful in their communication regarding the course of the pandemic and the necessary measures. The government and the media were receptive to the warnings of the committee. The media pushed for more restrictions and encouraged social distancing rules. Meanwhile, the government gradually increased the restrictions and moved towards a full lockdown scenario. Other factors that explain the superior performance of the lockdown are related to the success in lowering the infection rate. There are sociological, demographic as well as leadership factors that play a role. In term of demographics, there are fewer nursing homes in Turkey because elderly are typically taken care of by their families. This limits the infection rate among the most vulnerable group. In addition, the population is relatively young with the elderly constituting less than 10 percent of total population. A similar lockdown strategy was proposed by Acemoglu et al.[22], showing that lockdowns based on age structure to protect the most vulnerable groups would be optimal.

Our research in Cakmakli et al.[23] indicates that while a lockdown would eventually contain the pandemic, prematurely releasing the restrictions before the number of cases decline to sufficiently low levels might bring a second wave for any country. Ironically, this is particularly true for a more successful lockdown during the first wave, which limits herd immunity and leaves most of the society susceptible to the virus.

As the second wave hit Turkey in November 2020, the authorities reintroduced lockdown measures to contain the health risks. As for the economic risks, they need to contain the growing geopolitical risks and deliver the right policy mix that signals that the double-digit inflation will be restrained, and macroeconomic balances will be improved. The replacement of the economic team, the switch to orthodox policies with explicit rate hikes, as well as the reversal of the measures that were introduced by the previous management are steps in the right direction to restore the credibility of the CBRT, institutional independence, free market mechanisms and meritocracy, and to improve the investment environment.

Turkey has the potential to bounce back quickly from financial crises when the right policies are adopted. The recent history proves this remarkable performance, where recessions are followed by rapid expansions. As the eighth largest economy in Europe with its strong infrastructure, dynamic market base, strong export performance and attractiveness to tourists, it can once again offer an appealing investment environment to European investors with the proper structural reforms and policy choices in the post-COVID era. The period after the 2001 crisis provides the perfect example as Turkey quickly bounced back from a severe crisis. At that time, the reforms that were put into place emphasised institutional transparency, central bank independence, fiscal prudence and adherence to European

[20] Ibid.

[21] https://www.institutmontaigne.org/en/blog/battle-over-numbers-turkeys-low-case-fatality-rate

[22] Acemoglu, D., Chernozhukov, V., Werning, I. and Michael D. Whinston, M.D., 2020, A multi-risk SIR model with optimally targeted lockdown. NBER Working Paper No. 27102

[23] Cakmaklı, C., Demiralp, S., Kalemli, Ozcan, S., Yesiltas, S., and Yıldırım, M., 2020, COVID-19 and Emerging Markets: An Epidemiological Model with International Production Networks and Capital Flows, NBER Working Paper No. 27191, https://www.nber.org/papers/w27191

business law and regulations. A solid reform calendar with concrete actions established confidence in the policies and supported economic growth. Looking forward, Turkey should address similar weaknesses regarding institutional independence, transparency and rule of law to re-establish investor confidence.

Table 2: Summary of Weaknesses and Strengths of Economic Policy Measures

	Weaknesses	**Strengths**
Fiscal Policy	Less room left for fiscal expansion.	Budget deficit is still strong compared to European standards.
Monetary Policy	Negative real interest rate and FX sales were not sustainable. Credibility weakened.	A return to traditional policies with rate hikes has started, reducing risk premiums. Looking forward, however, the fiscal needs may necessitate further quantitative easing.

Abbreviations

AKP	Justice and Development Party (Adalet ve Kalkınma Partisi)
BRSA	Banking Regulation and Supervision Agency
CDS	Credit Default Swap
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Price Index
EM	Emerging Market
FDI	Foreign Direct Investment
FX	Foreign Exchange
GFC	Global Financial Crisis
IMF	International Monetary Fund
NPL	Non-performing loans
TFP	Total Factor Productivity
TurkStat	Turkey Statistical Institute
TUSIAD	Turkish Industry and Business Association

List of Figures and Tables

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