

Turkey's Unorthodox Monetary Policy

The Liraziation Experiment

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Outline

The State of Play in the Turkish Economy

External Funding Requirement

The Lirization Strategy

Headwinds

Financial Dollarization

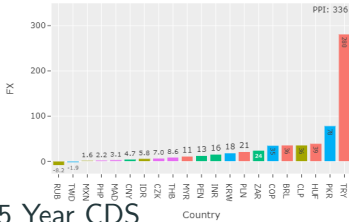
Loan Growth and FX Depreciation

Policies Needed

The State of Play in the Turkish Economy

The State of Play in the Turkish Economy

FX depreciation since mid-2018



5 Year CDS



CPI and PPI Inflation Rates



CA Balances



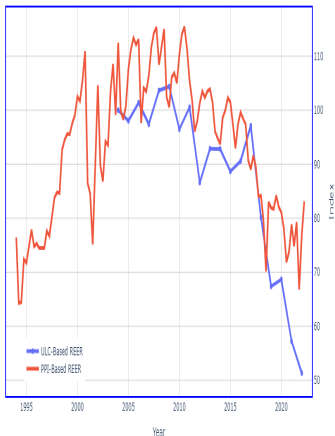
The State of Play in the Turkish Economy

- Since mid-2018 lira has depreciated by 280%.
- Moderate improvement in Turkey's BOP problem
 - ✓ Average CAD/GDP in period 2013-19: 3.3%.
- Instead, it has led to inflation

The realized PPI inflation of 336% since mid 2018 has likely wiped out the competitiveness gain from the ongoing nominal depreciation.

Real Effective Exchange Rates (REER)

PPI & ULC-Based REER



Mixed Outcomes

- No recent improvement in PPI-based REER
- Significant depreciation in unite labor cost based REER
- Depreciated euro worsens **integrated** REER
- Inflation uncertainty impedes production and trade activities

Competitiveness of the Turkish Economy

- Productivity-led growth (pre-2013 era) has gone
- First demographic dividend ended in 2017
- Exports' import-dependency is still too high
- Currency depreciation's **expenditure declining** (not shifting) channel improves trade balances

Recent Swings in External Funding Costs

- Credit risk spread has substantially increased:
 - ✓ 5 Year CDS in September 2021: 360
 - ✓ 5 Year CDS in June 2022: 835
- Sovereign borrowing cost has substantially increased accordingly and because of rising interest rates:
 - ✓ 5 Year eurobond yield in September 2021: 4.4%
 - ✓ 5 Year eurobond yield in June 2022: 10.1%

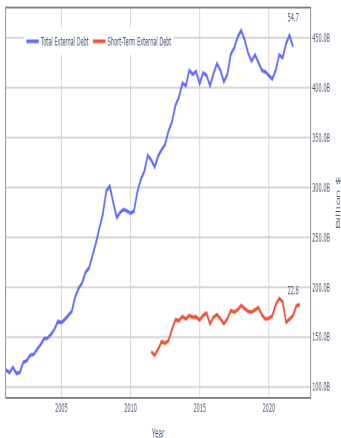
External Funding Requirement

Elevated External Funding Requirement

- Short-term external debt to GDP ratio is 22.6%
- Current account deficit to GDP ratio: 3%-4%
- Significant recent declines in net international investment position

External Debt

Figure: External Debt

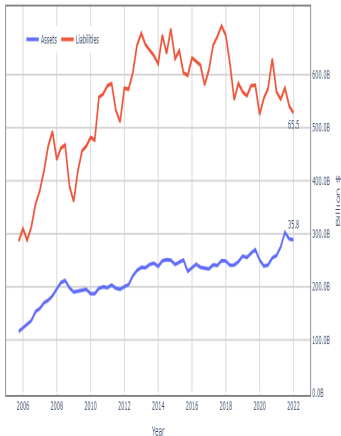


Rising External Debt

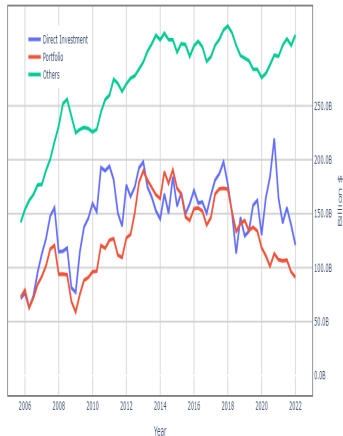
- Total foreign debt to GDP ratio is 54.6%
- Nearly half of it (41.4%) is to be refinanced

International Investment Position

Assets and Liabilities of IIP

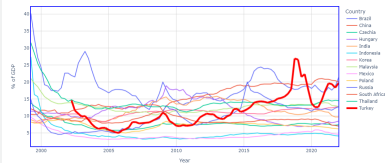
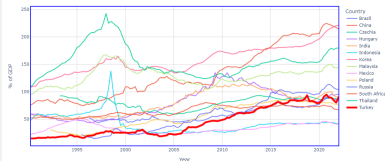


Liability Composition of IIP



Elevated Debt Services

Credit and Debt Services to GDP



- Moderate level of loan to GDP
- Elevated debt services to GDP
- Lira depreciation and increasing internal and external funding cost will likely to increase debt services

The Liraziation Strategy

The Liraziation Strategy

- declining potential growth

- weakened institutional quality and policy credibility

- strong headwinds

Monetary Stimulus

Monetary and related stimuli ...

- regulatory policies boosting bank loans

- loan credit risk guaranties

- FX reserve sale policy

... deteriorated stock and flow balances

Stock Balances

- external balances
- private debt/GDP
- public debt/GDP

Flow Balances

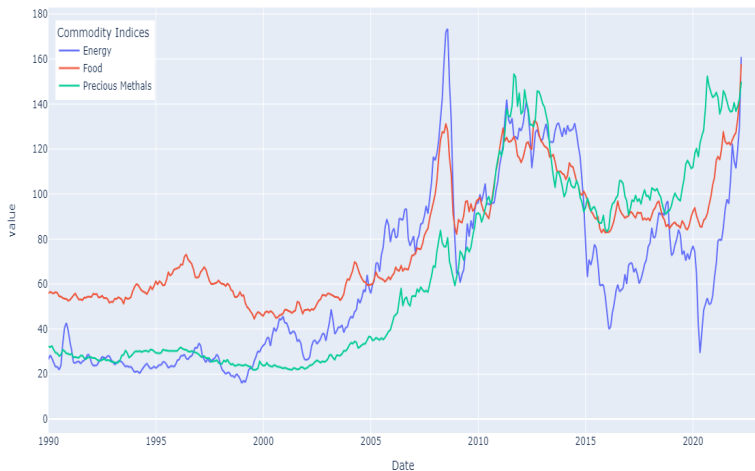
- galloping inflation
- unsustainable loan growth
- resurgent CA deficit
- substantially depreciated lira

The Most Recent Policy Responses

- Orthodox policies
 - ✓ Hiking deposit reserve ratios
 - ✓ New investment instruments
- Heterodox policies.
 - ✓ FX-linked deposits
 - ✓ FX sales
 - ✓ Policies to increase the cost of ₪ short positions
 - ✓ Required reserve ratios with composition objectives
 - ✓ Micro-management of financial sector decisions

Headwinds

Headwinds: Elevated Commodity Prices



Headwinds: Rising Interest Rates

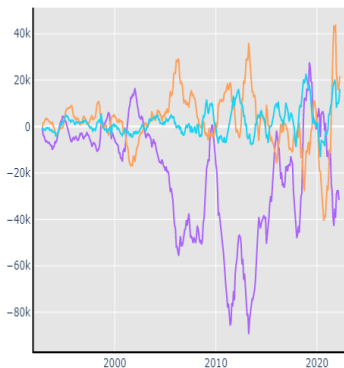
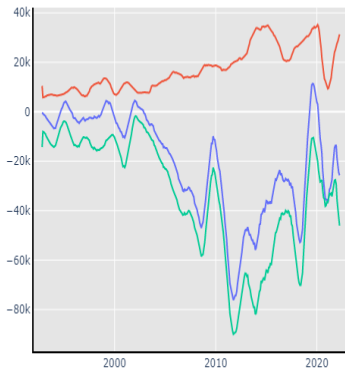
- Major and EM CBs to raise policy rates
- Market rates have already significantly increased
- Sovereign risk premium has increased

Headwinds: Weakened External Financial Safety

- Loss of investment grade status
- Increased geopolitical risks
- Heavily depleted foreign currency reserves

BOP - Financial Accounts

— Current Account Balance — Services Balance — Trade Balance — Financial Accounts Balance
— Reserves — Net Errors & Omissions



- Reserves: most active account

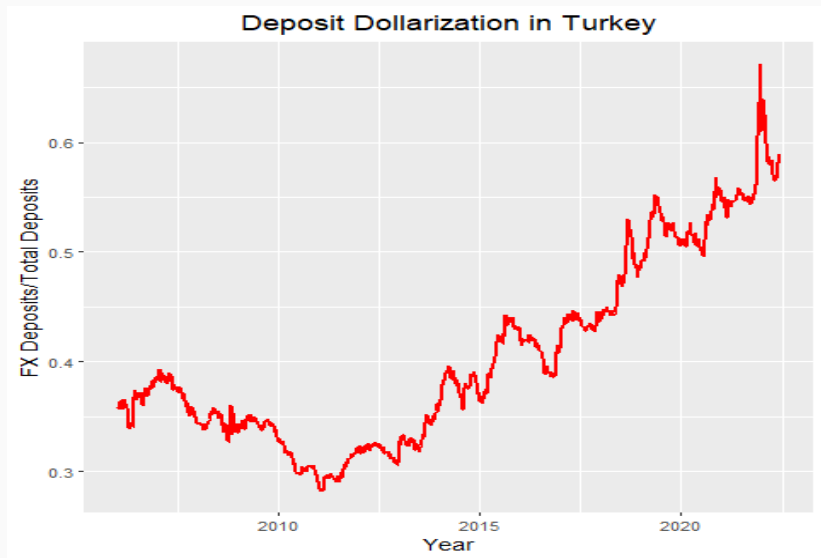
Headwinds: Weakened FX Reserves Position



- CBRT has sold a great deal of reserves
- CBRT has also accumulated reserves

Financial Dollarization

Financial Dollarization in Turkey



History of Dolarization in Turkey

- High inflation/negative real interest rates
- Volatile economy
- Lack of inflation hedging domestic investment vehicles

..., in general, led to dolarization

Volatile Growth Rates

Variable	DM	EM	LCN	Turkey	Peru	USA
Growth Rate						
Mean	2.24	3.25	2.65	4.72	4.32	2.47
SD	1.03	2.11	2.11	4.59	3.50	1.57
Per Capita Growth Rate						
Mean	1.51	2.56	1.27	3.14	2.92	1.47
SD	0.78	1.89	2.07	4.51	3.67	1.51
Sharpe Ratio						
Total	2.16	1.54	1.26	1.03	1.23	1.57
Per Capita	1.94	1.35	0.62	0.70	0.80	0.98

Source: World Bank. Observation Period: 1990 - 2018

Volatile Growth Rates - Quartile of Growth Rates

Country	%5	%10	%15
DM	1.12	1.57	1.66
EM	0.80	1.25	2.07
LCN	-0.18	0.12	0.30
Turkey	-4.69	-3.65	0.75
Peru	-0.48	0.42	1.18
USA	-0.13	0.78	1.55

Source: World Bank. Observation Period: 1990 - 2018

Inflation Rates

Variable	DM	EM	LCN	Turkey	Peru	USA
Inflation Rate	1.73	9.24	4.50	29.82	3.91	2.23
SD(Inflation Rate)	0.36	17.83	2.26	30.60	2.93	1.00

Source: World Bank. Observation Period: 1995 - 2018

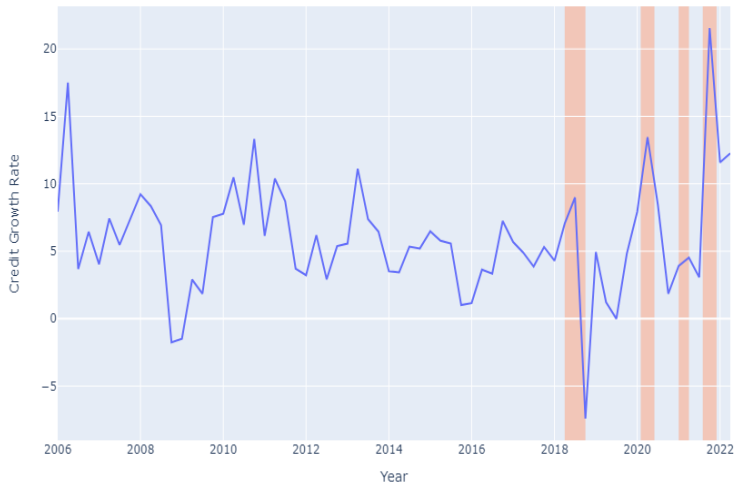
Recent Redolarization in Turkey

- Very high inflation/negative real interest rates
- Depreciated central bank independency and credibility
- Heightened economic policy uncertainty

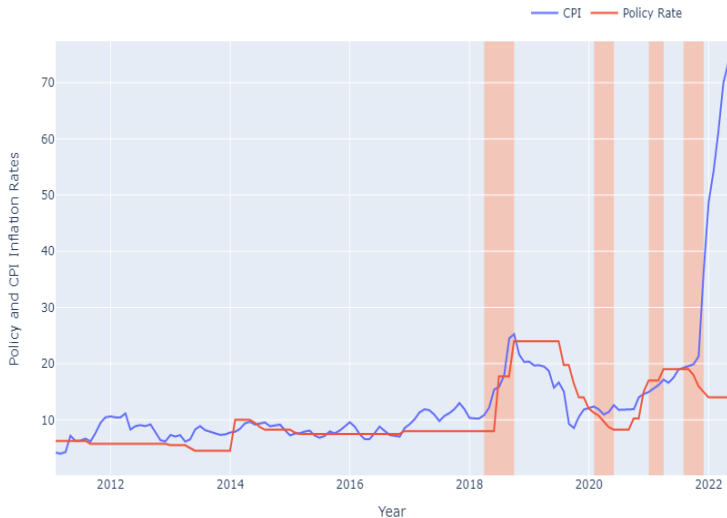
Loan Growth and FX Depreciation

High Correlation bt. Loan Growth and FX Depreciation

Quarterly Credit Growth Rates

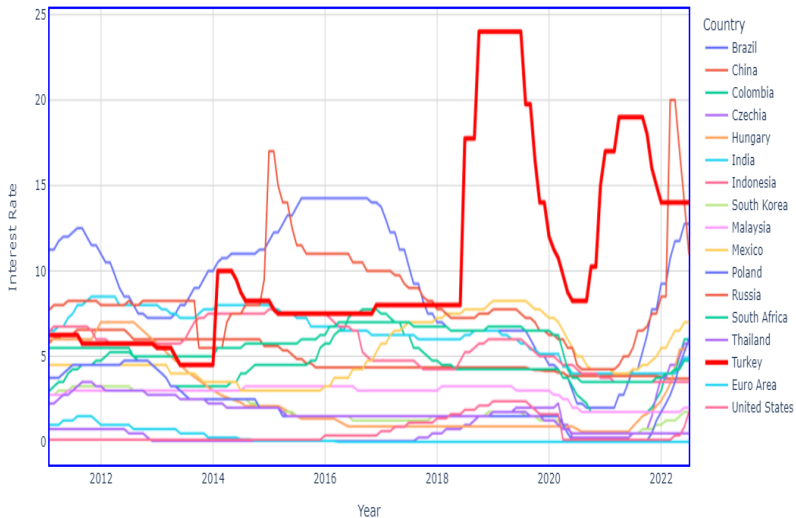


High Correlation bt. Real Interest and FX Depreciation



Policies Needed

Inflation Expectation Anchoring Policy Rates



Structural Reforms

Redoing First Generation Reforms

- Rule-based policies
- Market economy
- Independency of economic and financial institutions
- Institutional quality

Second Generation Reforms

- Productivity and microeconomic reforms
- Business sector governance reform
- Deregulation
- Financial deepening and saving incentives

broad-based consensus

Pulses of Ordinary Citizens

- 75% of ordinary Turks think the most important issue is the economy and unemployment. [Metropoll, Turkey's Pulse, May 2022].
- Since mid-2018, the share has been almost entirely above 50%