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Murat Üçer, reputed macroeconomist, former advisor to the Ministry of Economy, Global Source Partners' consultant in Turkey, co-founder of Turkey Data Monitor, and senior lecturer at Koç University, dissects the dynamics driving the Turkish economy as well as the main risks that lie ahead.

With a GDP growth of 7.4 percent in 2017 and Q1 2018, the Turkish economy has beaten growth expectations. How do you explain this?

The government applied a lot of fiscal and monetary stimulus. An embellished credit guarantee fund enabled banks to extend credit that carried a guarantee from the government. This was a very good business for banks, enabling them to lend about TRY 200-250bn *[around USD 50 billion*] in 2017, which is a sizeable magnitude, at over five percent of GDP. The government also eased up on fiscal policy, stepping up spending and cutting taxes to give a boost to economic activity and consumption.

Furthermore, the first part of 2017 saw exports grow rapidly, mainly due to Europe's economic recovery, which always helps Turkey. In addition, there was a strong base effect related to the 2016 Q3 contraction – the quarter of the coup attempt.

So the main reason behind this unexpected performance was the stimulus: Turkey does have the potential to grow between three and four percent already irrespective of stimulus, so with the additional help these figures can double easily.

But this high growth rate came with problems, with inflation recently hitting double digits (while it was high single digit for the past ten years) and current account deficit amounting to almost six percent of GDP. This means growth was overly stimulated and the economy became badly overheated.

How does Turkey's economy fare now?

The weakest link in Turkey's economy relates to the external accounts, which is typically about three things. First is the current account deficit: at around five to six percent of GDP. Currently, Turkey has the widest current account deficit among advanced and large developing countries. Second, we also look at the country's external financing requirement and how much money is needed in the short term to rollover debt – and this number is around another USD 180bn. Together with the current account deficit, this makes up a financing requirement of over 25 percent of GDP.

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Lastly, in order to manage this number, we need to have very strong external reserves, which unfortunately is not the case. Turkey's reserves are not particularly strong in comparison to the country's peers, with around USD 100 billion gross reserves. This also falls quite short of the USD 180 billion short-term external debt, whereas economists typically want at least a full coverage of short-term debt, so we are talking of inadequacy of our reserves. Therefore, from an external point of view, we are quite vulnerable considering that the global liquidity environment is changing. Last year's exceptional growth aggravated these pressures or imbalances, not just through inflation but also by increasing the current account deficit.

If Turkey continues proceeding in the same manner, what are the risks?

Fortunately, we are not in an overheating phase anymore, as the economy is currently slowing down quite sharply as far as I can see. Interest rates have recently increased and currency has weakened very sharply. There has been some stimulus from the government but with interest rates so high, I am not sure it will be enough to boost growth. Credit can no longer grow as fast either, mainly because there is no demand for it, nor do private banks have the funding base to support strong credit growth (while loan-to-deposit ratios are well over one). All these aspects mean that

we might see negative growth in the second part of the year – not year on year, but quarter on quarter terms.

The question is how much of that slowdown will help to tame the current imbalances. The government probably thinks that thanks to a slower economy over the next two quarters, the problems will be solved whereas most economists think Turkey should take a comprehensive look at where things are. In this regard, there are even some talks regarding the need to approach the IMF, but the latter has only been requested back in 2001, and the current government is very proud of not needing it since taking power in 2002-2003. Like most places, there is a stigma attached to resorting to the IMF; however, having a fresh look at where the problems are and what next steps should be taken has become absolutely crucial.

Finally, as I noted earlier, the global environment has changed now, while the latter was very supportive over the past several years. This can no longer help Turkey, as rates are normalizing globally for the first time. Put differently, there is not going to be much support for countries like Turkey, which lived very well off this global central bank support all these years. In the meantime, it makes no doubt that the country underwent a lot of positive achievements after the 2001 crisis also, and Turkey today holds relatively strong banks and low public debt. All these reforms helped Turkey, in addition to its dynamism, demographics and a good location, and combined with global liquidity, we had a very strong and relatively easy period of growth. However, investors are now getting more cautious about the prospects of emerging markets, and due to its imbalances, Turkey is seen as an exceptional risk.

Moving forward, many economists are expecting growth to slow down to four percent, and unless we start doing things right it will start slowing further down. Again, in the past we achieved significant growth, but we know how unsustainable this growth has been, and how it came with imbalances which created a sustainability problem.

What alternatives can the government turn to if they do not want to use the IMF for funding?

The risk is that the government may continue to push growth but without enough funding coming from abroad, this could create problems. This means that the central bank might be pressured to ease rates, or fiscal policy may stay loose, and ultimately investors may lose confidence in Turkey’s outlook. We have to somehow take the right measures to cool off the economy, press ahead with reforms and restructure some of the bad credit in the system. The private sector is heavily trying to restructure its credit with the banking sector, and although banks are strong they cannot remain so

forever. Also, the country has not undertaken much structural reform in recent times. More broadly, we need to face up to the problem and do a frank analysis of how we got here and where we go from here.

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Turkey will no longer be receiving as much private capital flows from abroad, so we need to improve the investment environment and make sure FDI picks up somehow. The day of reckoning and that of coming to terms with the situation is now. In the short term, we have to accept the slow growth and put the policies in place in a timely fashion. There is a large polarization between those who understand and acknowledge the problem, to those who think that we can just continue doing what we have been doing.

Remember, Turkey’s Achilles heel is the funding requirement. Unlike other countries, we do not have large reserves of assets and therefore less economic fighting power, in addition to a lot of external debt to unload.

Finally, what advice would you give to our readers and potential investors keeping a close eye on the country’s economy?

We all need to watch how all this dynamic will play out, how Turkey will formulate a new plan and place itself on a sustainable growth path. We need to watch politics of course, and what sort of economic program Ankara comes up with. Turkey is at a critical juncture, there is no one single indicator or two to watch, the whole economy needs close monitoring. But Turkey has great potential, let’s hope that we will do the right things and that potential will be realized.

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