EXECUTIVE BOARD MEETING

SM/20/104
Correction 3

July 29, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **2020 External Sector Report—Chapter 3**

Board Action:	The attached corrections to SM/20/104 (7/8/20) have been provided by the staff:
Evident Ambiguity	**Page 34 (row 6)**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Page 34 (rows 2, 3, 7)**
Questions:	Mr. Leigh, RES (ext. 34747) Mr. Adler, RES (ext. 35648) Mr. Rabanal, RES (ext. 36784)

Table 3.28. Turkey: Economy Assessment

Overall Assessment: *The external position in 2019 was moderately stronger than the level implied by medium-term fundamentals and desirable policies, although uncertainties are high.* This assessment reflects the lagged adjustment of external balances following the sharp depreciation of the real exchange rate in 2018, which is projected to unwind over time. Large external financing needs and relatively low reserves leave Turkey vulnerable to shocks.

Potential Policy Responses: In the near term, policies need to cushion the impact of the COVID-19 crisis and protect the most vulnerable through temporary and targeted fiscal support, preferably within a policy package that would help secure greater external stability. If imbalances that existed prior to the COVID-19 outbreak persist in the medium term, policies should aim to strengthen external resilience and support a sustainable rebalancing of the economy. Monetary policy, supported by efforts to rein in rapid credit growth, would aim to reduce inflation durably and strengthen central bank credibility while rebuilding reserves. Focused structural reforms would be necessary to enhance productivity, increase resilience to shocks, and strengthen the broader public sector balance sheet and improve transparency in general. These could include efforts to bolster the business climate, including by further strengthening Turkey's insolvency and corporate restructuring frameworks.

Foreign Asset and Liability Position and Trajectory	**Background.** After reaching –54 percent of GDP at end-2017, Turkey's NIIP rose to –48 percent at end-2018 and –46~~7~~ percent at end-2019. The large change in 2018 mostly reflected valuation effects from the lira's sharp depreciation that year, as a higher share of external assets relative to external liabilities are denominated in FX (a portion of the liabilities are in the form of Turkish equities and lira-denominated debt securities).[1] After a large increase in 2017, total foreign liabilities remained broadly stable at about 79~~80~~ percent of GDP at end-2019. Based on 2020 first quarter data, the NIIP rose to –41~~2~~ percent of GDP, largely due to a decline in equity liabilities. Foreign liabilities are dominated by debt, which, at 54 percent of GDP, remains sustainable over the medium term. Private external debt service is vulnerable to global and domestic financial conditions because most of the debt is in FX, a significant portion of which is short term (about 20 percent of GDP, on a remaining maturity basis), with about 40 percent of long-term debt at variable rates. **Assessment.** The size and composition of external liabilities, coupled with relatively low reserves, continue exposing Turkey to liquidity shocks, sudden shifts in investor sentiment, and increases in global interest rates. The FX exposure of nonfinancial companies is high, with the potential to undermine bank asset quality. Turkey's NIIP is projected to gradually increase to about –32 percent of GDP by 2025, driven by a decline in liabilities, mainly loans, as the economy rebalances in a post-COVID environment.				
2019 (% GDP)	NIIP: –45~~6~~.8	Gross Assets: 33.7~~5~~	Res. Assets: 14.0~~3.8~~	Gross Liab.: 79.5~~80.3~~	Debt Liab.: 53.9
Current Account	**Background.** The CA deficit, after averaging 3.5 percent of GDP during 2014–16, widened to 4.8 percent in 2017 as policy stimulus resulted in overheating, before narrowing in 2018 to 2.7 percent as domestic demand contracted and the lira depreciated sharply. The CA registered a surplus of 1.2 percent of GDP in 2019, reflecting continued import compression and strong tourism receipts. In the first quarter of 2020, the CA registered a deficit, which led to a decline in the 12-month CA surplus to 0.2 percent of GDP. Import tariffs of up to 30 percent have been imposed on a large number of items. The IMF staff projects a broadly balanced CA in 2020 with a rise in the goods balance (driven by import compression) offset by a fall in services (due to a fall in travel services). **Assessment.** The EBA CA model estimates a norm of –1.7 percent of GDP, with a particularly large standard error of 1.8 percentage points of GDP. The cyclically adjusted CA surplus in 2019 is estimated at 0.8 percent of GDP. After taking into account the temporarily large receipts from travel services (0.9 percent of GDP higher than normal in 2019), the IMF staff assesses the CA gap to be about 1.6 percent of GDP, subject to considerable uncertainty (with a range between –0.2 and 3.4 percent of GDP).				
2019 (% GDP)	Actual CA: 1.2	Cycl. Adj. CA: 0.8	EBA CA Norm: –1.7	EBA CA Gap: 2.5	Staff Adj.: 0.9	Staff CA Gap: 1.6
Real Exchange Rate	**Background.** After depreciating sharply in 2018, the average REER depreciated by 2.2 percent in 2019 and a further 7.8 percent through May 2020 driven by nominal depreciation of the lira. **Assessment.** The EBA REER level and index approaches suggest the REER remained undervalued in 2019 by 21 to 23 percent, albeit with large uncertainties. The IMF staff CA gap suggests the REER was undervalued by 7 percent (based on an elasticity of 0.22). The staff assesses the REER to be undervalued by 7 to 23 percent in 2019 (with a midpoint of 15 percent).				
Capital and Financial Accounts: Flows and Policy Measures	**Background.** Net capital flows registered modest inflows of US$0.5 billion in 2018 and US$5.6~~4.5~~ billion in 2019 (0.7~~6~~ percent of GDP and excluding reserves and E&O). E&O were positive in 2018, likely reflecting repatriation of foreign assets and unrecorded capital inflows before switching to outflows in 2019. In the first quarter of 2020, net capital outflows were US$6 billion due to portfolio and other investment outflows. To help address currency volatility in August 2018, Turkey introduced limits on bank swaps and other derivatives transactions with foreign counterparties as well as export surrender and repatriation requirements (both CFMs). These measures were partially unwound as volatility receded, but limits on bank swaps and other derivatives transactions with foreign counterparties were reintroduced and tightened in December 2019 and February–April 2020 in response to new bouts of volatility. **Assessment.** The quality of financing remained weak in 2019. Turkey remains vulnerable to adverse shifts in global and domestic investor sentiment, with annual gross external financing needs of about 23 percent of GDP on average during 2020–21. CFMs should be phased out as macroeconomic and financial conditions improve.				
FX Intervention and Reserves Level	**Background.** The de jure exchange rate is classified as floating. With pressure on the lira in early 2020, including from the COVID shock, gross reserves had declined by US$22 billion as of mid-May 2020, and net international reserves have dropped by US$15 billion to US$26 billion since the beginning of the year.[2] **Assessment.** Gross reserves increased to 85 percent of the IMF's ARA metric at end-2019, from 74 percent at end-2018, but dipped to 67 percent in mid-May 2020. Similarly, reserve coverage of external financing requirements rose to 64 percent in 2019, from 46 percent the year prior, and then dropped to 49 percent in mid-May. Significant accumulation of reserves over the medium term is needed given sizable external liabilities and dependence on short-term and portfolio funding.				