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Turkey's economy during the Covid-19 Pandemic: Light at the end of the tunnel?

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As of the end of May 2020, the impact of the novel coronavirus pandemic (Covid-19) on the Turkish economy is hardly visible to the naked eye of the ordinary citizen. Despite continuing measures of social distancing and curfews, she can do her groceries in supermarkets with fully stocked shelves; shopping centers have opened their doors again; hairdressers are back in business; dining in restaurants will soon be possible subject to certain prerequisites. During more than two months of lockdown, she has also made purchases online, which actually worked very well, given the fact that delivery personnel were exempted even from total curfews. From her point of view, if this has been the worst it could get, things will be back to normal very soon.

The "Economic Stability Shield"

Turkey's economy has indeed avoided the worst-case scenario of an economic collapse in the face of the Covid-19 pandemic, yet the damage done is real and significant, although it might not be realized at once by our ordinary citizen. As has been the case with the entire world, Turkey has also experienced the shutting down of factories; both domestic and foreign trade have slowed down not only in merchandise goods but also and perhaps more importantly in services; bankruptcy filings and unemployment soared.

As a major component of its efforts for combating the adverse effects of Covid-19 on the economy, the Turkish government initiated the "Economic Stability Shield" covering a series of measures including deferrals of tax payments, special arrangements for rent payments, incentives related to loans companies are obtaining from banks, flexible and remote working schedules for both the public and the private sector, and various kinds of wage support. When initiated first in March, this package was said to provide 100 billion liras worth (equivalent of 13.45 billion euros at the time of writing) of a support for the economy, and in the coming weeks it was reinforced by other measures such as new incentives for small businesses, while the Turkish Wealth Fund, which owns majority stakes in two public banks has announced a total liquidity of 21 billion liras (2.83 billion euros) will be injected to the public banking sector in order to strengthen the capital structure, and as an continuing attempt to stimulate stalling economic activity, the Central Bank of Turkey resumed its easing cycle with the eighth interest rate cut in a row, by a full 1 percent on 22 April, bringing the policy rate to 8.75 percent, down from its mid-2019 level of 24.0 percent. More interest cuts are apparently on the pipeline.

Economic shock on both demand and supply side

These measures have helped to dampen the negative effects of the pandemic on the economy, however the situation that Turkey is facing, together with the rest of the world, is unprecedented, hence bringing about unique difficulties. The pandemic has not only caused a simultaneous shock on both the demand and supply side, it has also led to a paradoxical situation wherein measures taken to protect the public health, such as lockdowns and curfews, are causing economic harm. Producers have scaled back their output, employment and purchasing activity, while buyers, whether corporate or individual, are reducing their purchases given the uncertainty of the economic situation in the near to medium term. To add to these, Turkey's case is perhaps even more complicated than most countries, because it was already facing structural challenges before the virus, especially so after the collapse of the currency in the summer of 2018.

Macroeconomic data reveal the extent of the problems faced by the Turkish economy. In March 2020, industrial production in Turkey decreased 7.1 percent over the previous month, resulting in a 2.0 percent slump on a year-on-year basis, and following an 8.5 percent growth in the previous month concluding six consecutive months of growth in this area. Since lockdowns in Turkey started in the second half of March, these figures might not fully reflect the real extent of the

Covid-19 impact on production, which will be evident when figures for April, which were not available at the time of writing, are released.

A more detailed picture on how production is affected is provided by capacity utilization data, for which April figures are available. Capacity utilization rate in Turkish industry dropped from 72.6 percent to 61.9 percent in one single month, and this drop was most significant in investment goods, which have seen their rate going down by a massive 22.8 percent to 51.4 percent, followed by durable consumer goods and consumer goods in general. Sector-wise, it was wearing apparel, textiles and leather, which were most affected, followed by machinery, electrical equipment, transportation vehicles and chemicals. On a positive note, capacity utilization has actually increased for food products and pharmaceuticals, which makes sense, as the Turkish government has prioritized these vitally essential sectors and actively supported them. In the meantime, the Purchasing Managers' Index (PMI) compiled by Istanbul Chamber of Industry has gone down from 48.1 in March to 33.4 in April pointing to the most significant contraction in factory activity since the global financial crisis in 2008.[1] It is true, that since March 2018, the PMI has gone above the 50 point mark line only twice, yet these two instances were in January and February this year, meaning that Covid-19 has broken a trend that was only recently beginning to recover after a long hiatus.

The situation is no different on the domestic demand side. Retail sales in Turkey decreased by 8.1 percent in March over the previous month, corresponding to a 0.2 percent decline compared with the same month of the previous year. April figures are expected, for similar reasons with production, to show a deeper effect of Covid-19 on sales. In the meantime, the consumer confidence index dropped from 58.2 in March to 54.9 in April, its lowest level since 2004 when the index was first created. It has to be noted that there are also some early signs of recovery; for instance sales of real estate has increased by 3.0 percent in March 2020, and although this is mostly attributed to the sharp fall in interest rates, it is nevertheless a positive development.

Turkey has a deficit economy, and the deficit becomes only wider because of the economic impacts of the Covid-19 pandemic weighing on the country's budget, such as a steep rise in public expenditures caused by combatting the virus and a reduction in revenues due to incentives provided to economic actors such as tax deferrals. In April, the central government budget posted a deficit of 43.2 billion liras (5.8 billion euros), corresponding to a massive 136 percent increase in the budget deficit compared with the same month in 2019. Over this one-year period, expenditures increased by 42.7 percent, while he increase in revenues was limited with 13.1 percent.

A light at the end of the tunnel?

What about the light at the end of the tunnel? How likely and how soon is Turkey to recover economically? According to the projections by the International Monetary Fund (IMF), Turkey will enter a recession, its economy will shrink by 5.0 percent in 2020, however this will be followed by growth at the same scale in 2021, by 5.0 percent.[2] It is of course questionable to what extent such projections can mean anything given the unprecedented scale of uncertainty that not only Turkey but the entire world is facing. Forecasts are based on assumptions, and they do vary. For instance, Standard & Poor's rating agency has a less gloomy view for Turkey's economy in 2020, expecting a contraction by 3.1 percent, and also a less optimistic view for

[1] PMI is an index of the current direction of economic trends in the manufacturing sector, summarizing whether market conditions are expanding, staying the same, or contracting. It is based on opinions of senior managers in various industries as stated through a monthly survey. A PMI above 50 represents an expected expansion compared with the previous month, and a reading under 50 represents a contraction.

[2] "World Economic Outlook, April 2020: The Great Lockdown", International Monetary Fund. https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020.

2021, forecasting growth by 4.2 percent.[3] On the other hand, Oxford Economics expects the Turkish economy to shrink by 5.1 percent in 2020, and then grow by 7.1 percent in 2021.[4]

Numbers vary, but the consensus is that Turkey's economy is on the track for a "U" shaped recovery. However, this recovery cannot be taken for granted. There are two vital prerequisites for such recovery to materialize: first, a well-planned and carefully implemented plan for normalization in the short term, and second, structural improvements in the medium to long term.

Normalization of life in general, and economic activities in particular, is crucial, but also extremely difficult to formulate because of the unprecedented nature of the situation. The Turkish government expects the economy to normalize in the second half of the year, however normalization will come gradually and needs to be carried out accordingly. Reopenings will have to be undertaken without compromising the measures taken against the spread of the Covid-19 virus, always keeping in mind that second large wave of the virus cannot be ruled out. Different provinces have different conditions and there also differences between cities and rural areas; all these differences will require different approaches to normalization in different localities. Confidence will have to be restored for all economic actors; normalization won't be of any use if producers hesitate to resume production, and consumers hesitate to buy because of uncertainties and lack of confidence in how well the process is managed. So far, Turkey's government has maintained a certain level of confidence among the public, mainly thanks to the success of the health infrastructure in coping with the pandemic, however the task will be more difficult when it comes to reopening the economy with similar success. Premature reopenings can complicate the situation and lead to a loss of confidence. The whole thing is a delicate task.

Past and present challenges

As mentioned above, Turkey's economy had structural shortcomings before the pandemic, which only exacerbated them. Some "big topic issues" remain as crucial as ever, such as the need to increase productivity, improve the capability to generate value added, reduce inequalities in income distribution, and so on. However, when it comes to dealing with structural problems in order to reach the light at the end of the tunnel, the priority will be on fixing the country's external finances.

In March 2020, Turkey's current account deficit widened sharply to 4.92 billion dollars, from 1.15 billion dollars in the previous month, and compared with only 0.12 billion dollars in March 2019. In the same period exports contracted by 17.8 percent, again compared to the same month of the previous year, while imports increased by 3.1 percent. April figures, when they are announced, are likely to show a steeper decline in Turkey's foreign trade, not only because of lower demand and supply, but also because of closed borders and cancelled transportation routes. There is also a similar picture in Turkey's services trade. The country's major revenue item in this field is tourism, which has been one of the first casualties of Covid-19. Flights have been cancelled, and an already declining rate of hotel occupancy, which had gone down from 67.4 percent to 53.8 percent in Istanbul over the first quarter of the year, has come to a complete shutdown with hotels closing their doors and/or converting into dormitories for health personnel working on the frontline. In the first quarter of the year, Turkey's tourism revenues had decreased by 11.4 percent from a year earlier to 4.10 billion dollars, and in the second quarter of the year, is likely to experience a meltdown. As captured ironically yet accurately in a headline used by a Turkish business journal, "*Turizme yaz, bu yaz gelmeyecek*" (This summer, there won't

[3] "S&P affirms Turkey's credit rating", Anadolu Agency, May 7, 2020. https://www.aa.com.tr/en/economy/sp-affirms-turkeys-credit-rating/1831921.

[4] "Country Economic Forecast Turkey", Oxford Economics, April 27, 2020. https://www.emis.com/php/search/docpdf?pc=TR&sv=EMIS&doc_id=677775581.

be summer for tourism).[5]

For sure, measures are being taken to cushion the negative effects in the short term. For instance, the Ministry of Trade has launched the “contact-free export” initiative, a set of measures aimed at conducting the entire process of cross-border shipment of goods with minimal human-to-human contact. The tourism community has come up with new efforts to diversify the product portfolio. The Central Bank is opening up bilateral currency swap lines with other countries in order to generate foreign exchange liquidity in the market.

Such measures are useful, however the challenge is structural. Turkey has a current account deficit, and a low domestic savings rate. This situation requires a surplus in the capital account, in other words more foreign capital flowing into the country is needed. When this is not the case, foreign exchange reserves are used, but they are not infinite. On the other hand, while foreign direct investment can add value to the economy in the form of employment and revenue generation, portfolio investment can only help to save the day, at the expense of increasing the indebtedness of the country. There had been an improvement in Turkey’s external balance after mid-2018 all the way up to mid-2019, which had reduced the country’s external borrowing requirement. However, things have changed afterwards, and the Covid-19 situation has exacerbated the situation. Both foreign direct investment and portfolio investment are slowing down; deficits are mostly financed through reserves. In March 2020 alone, Turkey’s official reserves went down by 16.6 billion dollars.

In a video conference with major foreign investors, Turkey’s Minister of Finance, Berat Albayrak, assured that the central bank’s reserves were more than enough at present, banks and companies had no problem in rolling over external debt, and the Treasury needed to roll over only 4.7 billion dollars of external debt in 2020.[6] A balance of payments crisis is indeed not likely for Turkey at the moment, but the situation has to improve. Surviving the pandemic is a must, but what matters in the long term is to build a more resilient economic structure. This is why Turkey needs to improve its export potential in both quantity and quality, improve its business environment in order to draw more productive and value-generating foreign direct investment, build trust with both domestic actors and international investors, and ensure the efficient allocation of credit to productive areas of the economy.

Our average Turkish citizen is happy because she will be soon allowed to do shopping while at the same time sipping her Turkish coffee at a cafe and taking a stroll along the Bosphorus. Many Turks, especially small business owners and workers who were laid off, will require more time than her to come to terms with the economic effects of the pandemic. However, if the normalization process is formulated and implemented carefully and concrete and determined steps are taken to address the structural challenges that the economy is facing, not only will the light at the tunnel can be reached soon, but also all the Turks will be able to live in an economy that is more resilient compared to its pre-pandemic conditions.

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[5] H. Bader Arslan, “Turizme yaz, bu yaz gelmeyecek”, Dünya, May 4, 2020. https://www.dunya.com/kose-yazisi/turizme-yaz-bu-yaz-gelemeyecek/469371.

[6] “Turkey - Economic activity to normalise in H2 in worst-case scenario - FinMin Albayrak”, CEEMarketWatch - Daily News, May 7, 2020. https://www.emis.com/php/search/doc?pc=TR&dcid=678435405.