Current Account Deficit Dynamics: Different This Time?

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Current Account Deficit Dynamics

Along with the rapid economic recovery, current account deficit problem immediately became the top item on Turkey's agenda. Current account deficit reached a historic record at US$48.5 billion as of the end of 2010. As a ratio to the gross domestic product (GDP) the deficit guaranteed to exceed record-high 6.1% witnessed in 2006 (Figure 1). Meanwhile, the International Monetary Fund (IMF) issued the second post-program monitoring note on Turkey.[1] The note praised on Turkey's growth performance while emphasizing the risks originating from the current account deficit. The most serious warning stated in the note read: "Turkey's main challenge is determining the right policy mix in the face of vulnerabilities arising from excessive domestic demand and volatile short-term capital flows."

Figure 1. The ratio of current account balance to GDP, 2000-2010

Source: CBRT and TURKSTAT, *estimate

As also underlined in the IMF note, the rise in domestic consumption above expectations and the repercussions on import demand were highly effective in the substantial increase in the current account deficit. Nevertheless, the laggard recovery in exports due to the global crisis also contributed to the intensification of current account deficit problem. Many European economies have still been struggling with challenges in the process fueled with Greece's debt crisis implying that exports of Turkey will not likely recover in the short term. This is another factor that reiterates the risk of high current account deficit in the next years.

What are the factors that make the recent current account deficit debates disparate and more dangerous? We can talk about two new developments. First, current account deficit became to be financed increasingly via short-term funds. Second, the ratio of

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[1] The note issued on February 16, 2011 is accessible at the below link: http://www.imf.org/external/np/sec/pn/2011/pn1124.htm

current account deficit to FX (foreign exchange) earning capacity reached to record-high levels.

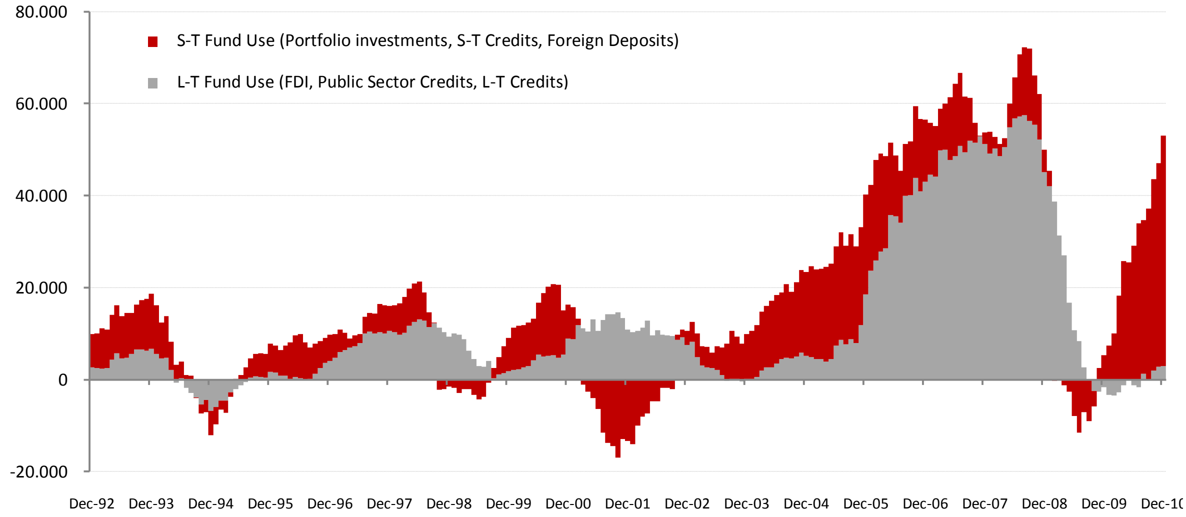
By 2010 net amount of foreign capital inflows reached US$53 billion. This represents the strongest fund inflow performance since 2006 in which US$56.6 billion of fund inflow took place. Nevertheless, when the maturity structure of the fund inflow is examined, the current outlook becomes quite disparate compared to that in 2006. Figure 2 shows the fund inflows in the last two decades and the maturities. According to this, portfolio inflows (hot money), trade credits, short term corporate credits and foreign deposits constitute the short-term funds denoted with the red area. Foreign direct investments (FDI), institutional government loans and long term corporate credits constitute the long-term funds denoted with gray area.

In the light of Figure 2, three points can be stressed. First, foreign fund use in Turkey, which was historically below US$20 billion, has increased steeply after 2005 reaching above US$50 billion per year. In the said period the majority of the funds used were long term. Out of the total amount of foreign funds used, 76 percent in 2006 and 95 percent in 2007 were long term funds.

However, with the crisis, foreign fund inflows diminished sharply and fell to US$3.7 billion by the end of 2009. In 2010 fund inflows recovered rapidly and reached above US$50 billion again.

Although foreign fund use recovered in quantitative terms, there appears a striking qualitative deterioration. 94% of the foreign funds used in 2010 were short term indicating this severe qualitative deterioration.

Figure 2. Composition of foreign fund inflows by maturity, 12-month cumulative fund use, 1992-2010

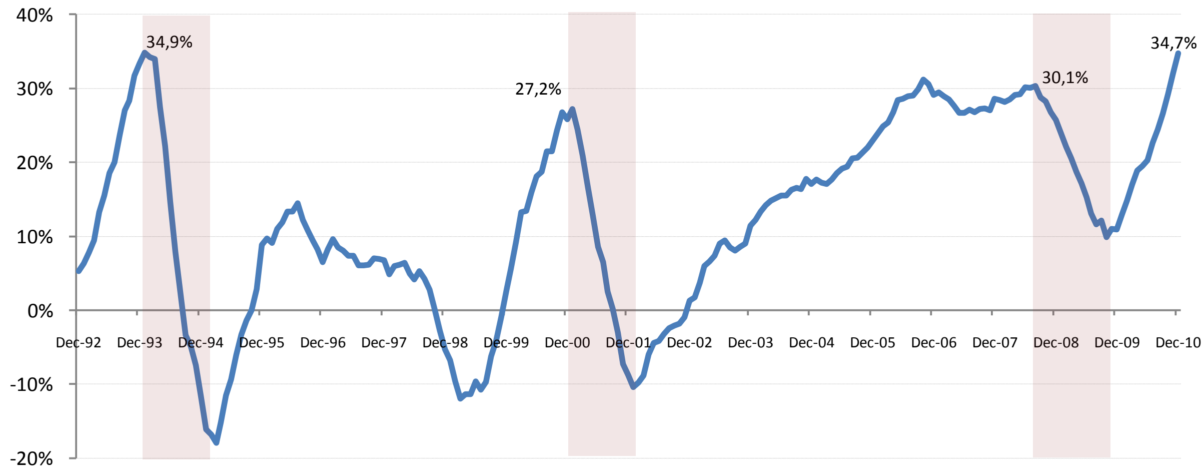


Source: CBRT, TEPAV Calculations

Composition of the short term fund inflows reveal that portfolio inflows called as hot money constitute an important share. US$19.6 billion out of the total short-term fund inflows came from the 'hot money' inflows. However, upon the trough examination of the data, it can be concluded that the accumulation of risks in the banking sector is more remarkable. Short term foreign credits used by banks in 2010 elevated by US$12.2 billion. Moreover, the deposits foreign banks held in Turkish banks increased by US$15.6 billion. This implies deterioration in the liability structure of the banking industry, which reaches approximately 5% of the banking assets.

Besides the deterioration in the quality of deficit financing, repayment capacity is an important indicator with respect to the sustainability of the deficit. The most significant determinant of the repayment capacity is the ability to generate FX. Figure 3 shows the current account deficit as a ratio of FX generating transactions (earning capacity), i.e. export and tourism revenues.

Figure 3. Ratio of current account deficit to FX generating transactions (export + tourism revenues), 1992-2010



Source: CBRT, TEPAV Calculations

It is possible to comment on the sustainability of Turkey's current account deficit on the basis of the above figure, as well. The change in the ratio of the current account deficit to FX generating transactions over the last two decades reveals vulnerabilities during the crises following rapid hikes in 1993 and 2000. The ratio stood around 30% at the outburst of both of the crises which might imply that the said is a critical threshold for Turkey. With the impact of the relative macroeconomic stability and rapid export growth in the aftermaths of the 2001 crisis, it took five years for the ratio to reach 30%. Although the ratio dropped to 10% along with the global crisis, it then reached to a historic level in only one year. Here, weak recovery in export performance is as important as the rapid increase in the current account deficit. To put it differently, the problems regarding Turkey's export markets reiterate the severity of the current account deficit problem.

What do these figures imply? The figures imply that the characteristics of the current account deficit problem of Turkey have changed considerably. Turkey’s main challenge in 2011 is implementing the measures necessary to slowdown domestic demand that intensifies current account deficit. The rapid deterioration in the current account deficit resulted from the buoyant economic growth driven by domestic demand in the absence of export recovery. The economy heated up excessively in 2010. The main challenge for the economy management in 2011 seems to be cooling down the economy. It, however, is a matter of debate whether this will be attempted on the eve of the general elections and a possible cabinet change.