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BUDGET PERFORMANCE PAVES THE WAY FOR THE CURRENT ACCOUNT DEFICIT

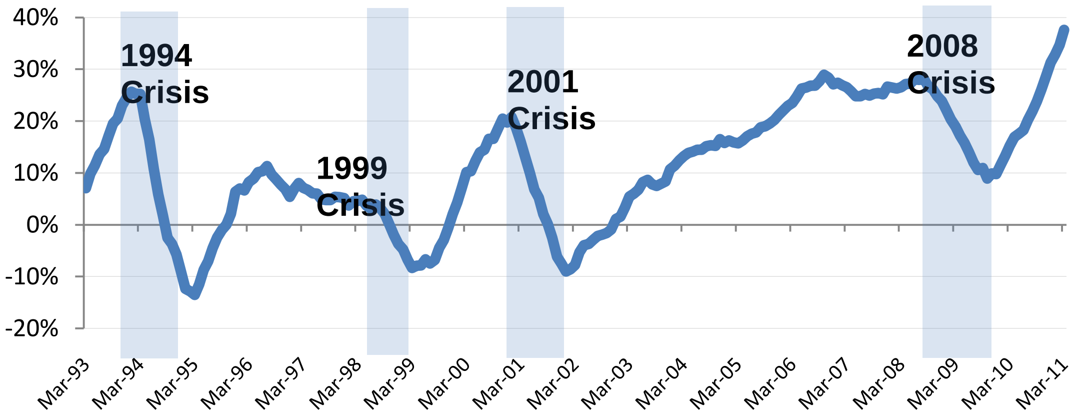
Current account deficit has been a major source of vulnerability for Turkey for years. The sustainability of the current account deficit, a chronic challenge for Turkey, is closely related to the foreign exchange (FX) generating capacity of a country. With this perspective, the ratio of the current account deficit to FX generating transactions, that is exports of goods and services (tourism, construction, transportation etc.), is an important indicator.

Figure 1that shows the current account deficit of Turkey as a ratio to FX generating transactions merely maps the financial crises Turkey, or the boom-bust cycles underwent. It is seen that whenever this ratio reached 25-30% particularly during the 1994, 2001 and 2008 crises and dropped steeply after the crises. In this regard, it is important to note that 30% is a critical threshold for the ratio of the current account deficit to FX generating transactions.

During the recovery period in the aftermaths of the 2008 crisis, this ratio increased rapidly and exceeded 30% as of the end of 2010. As of the first quarter of 2011, current account deficit (cumulative figure for twelve months) reached a record high US$ 60.5 billion, 37.6% as a ratio to the FX generating transactions.

[1] http://www.tepav.org.tr/en/ekibimiz/s/1034/Sarp+Kalkan

Figure 1. Ratio of the current account deficit to FX generating transactions (export and services income), 12 months, cumulative



Source: CBRT Balance of Payments and TEPAV's Calculations

Different crisis dynamics

In fact, current account deficit escalated rapidly also during the recovery period after the 2001 crisis. Nevertheless, then the hike in the current account deficit did not surpass that in the FX generating transactions. In other words, exports of goods and services surged more rapidly compared to the hike in the current account deficit. Therefore, the ratio did not attain a dangerous level for almost five years.

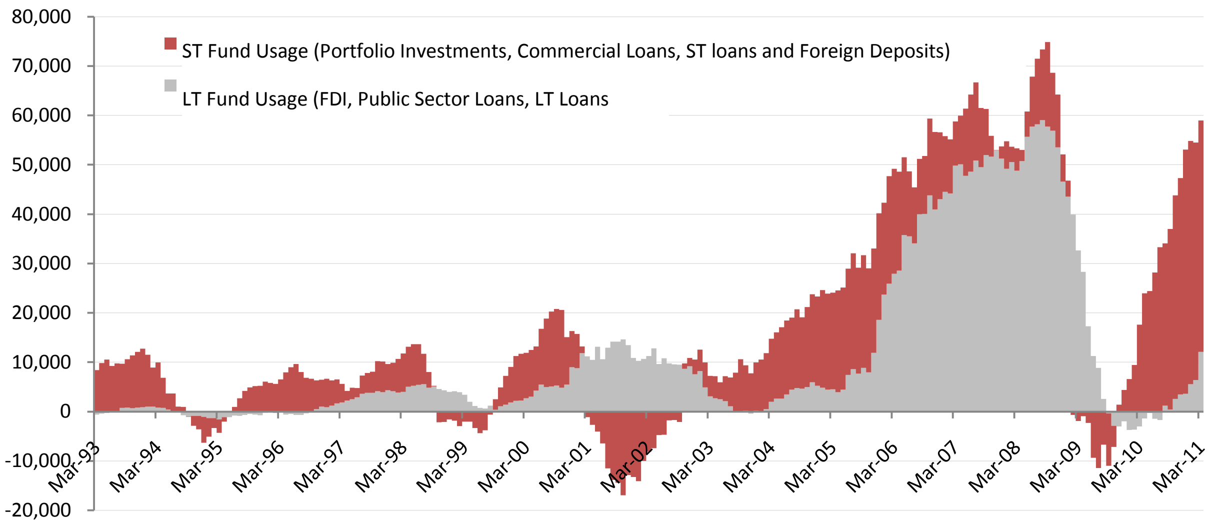
After the 2008 crisis, exports of goods and services as well as the current account deficit decreased steeply. During the first phase of the crisis, namely between September 2008 and September 2009, exports of goods and services and current account deficit dropped by US$38.7 billion and US$35.3 billion, respectively. This outlook signifies the primary difference between the 2008 crisis and the previous crises: in the aftermaths of the former, export revenues decreased along with the current account deficit.

The second distinguishing feature is observed in the recovery period. Unlike previous crises after the 2008 crisis, current account deficit increased rapidly while the recovery in the exports of goods and services was not sufficient to offset this. Between October 2009 and March 2011, current account deficit increased by US$48 billion whereas exports of goods and services increased only by US$20.4 billion. In other words, weak recovery in exports due to sluggish foreign demand reinforces the current account deficit problem.

80% of the deficit is financed via short term funds

The method of financing the current account deficit also is an important indicator of riskiness. Figure 2 presents the fund inflows and their maturity structure for the last 20 years. According to this, short term funds are composed of portfolio investments (hot money), commercial loans, short term loans and foreign deposits, as denoted with the red area. Foreign direct investments (FDI), loans used by the public sector and long term loans used by the private sector constitute the long term funds, denoted with the grey area.

Figure 2. Maturity of Foreign Borrowing, 12 months, cumulative, million $



Source: CBRT Balance of Payments and TEPAV's Calculations

Figure 2 reveals three findings. First, after 2005, foreign fund usage boosted significantly and attained a long term character. Long term funds constituted 76% of total fund usage in 2006, and 95% in 2007.

However, together with the 2008 crisis, a sharp fall was observed in foreign fund inflows, which deteriorated to US$3.7 billion as of the end of 2009. Fund inflows recovered in 2010 and reached US$58.9 (twelve months cumulative) as of the end of 2011's first quarter.

Nevertheless, the quantitative recovery in foreign fund inflows was not accompanied with a qualitative recovery. By the first quarter of 2011, 80 percent of the foreign funds are short term, implying a severe qualitative deterioration in the financing mode of the current account deficit.

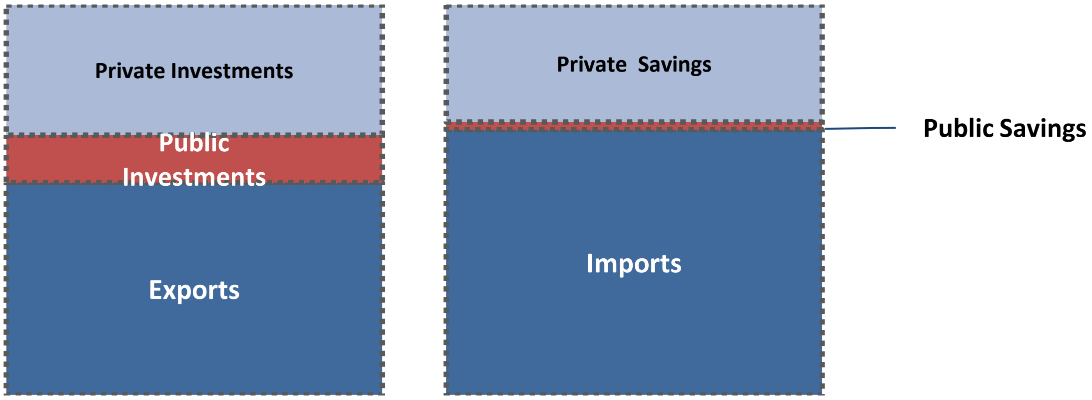
Current account deficit is an outcome: Budget deficit is the usual suspect

As summarized in the previous sections, there exists a severe deterioration in both the level and the finance quality of the current account deficit. The common public opinion is that current account deficit is not a problem as long as it can be financed. Nevertheless, in order to take precautions against current account deficit, the driving factors shall be identified and well understood.

Trade balance, budget balance and private sector savings-investment balance (S-I Balance) represent an equilibrium. The sum of the budget balance and savings-investment balance (S-I Balance) must be equal to the foreign trade balance. This relationship is shown in Figure 3. The left column shows the injections to the income stream and the right column shows the leakages from the income stream. Leakages take place through three channels: private sector savings, tax and other revenues of the public sector, and payments for imports. At the injections column, there are private investments, public expenditures and investment and exports.

According to this model, if private savings and public savings are insufficient to finance private investments and public investments, the economy will inevitably have a current account deficit the magnitude of which corresponds to the budget deficit and the private sector S-I deficit. That is to say, if your economy already is faced with private savings gap as in the case with Turkey; a rise in budget deficit will bring an equal rise in the current account deficit.

Figure 3. Macro Equilibrium in Turkey, 2010



Source: 2010 estimates in SPO 2011 Annual Program and 2010 National Income Calculations

Three fourths of Turkey's current account deficit is caused by the budget deficit

Figure 3 and Table 1 shows Turkey's outlook with respect to foreign trade balance, budget (public S-I) balance[2] and private savings (S-I) balance in 2010. Although the final savings-investment balance figures are not yet announced, the estimates declared by the State Planning Organization (SPO) give approximate results.

Current account deficit of Turkey at 61 billion TL is approximate to the sum of the budget deficit (or public S-I gap) at 43.6 billion TL and private savings gap at 13 billion TL. This indicates that the driving factor for high current account deficit is not the private savings gap as commonly argued, but the public budget deficit. More clearly, approximately three fourths of the current account deficit is caused by the budget deficit.

[2] The note uses the central government budget balance and public sector C-I balance interchangeably as 96% correlation was calculated for the two concepts in the 2003-2010 period. However, in definition, budget balance and public C-I balance are different due to several transactions including capital transfers, tax on wealth, other transfers, and borrowing and lending.

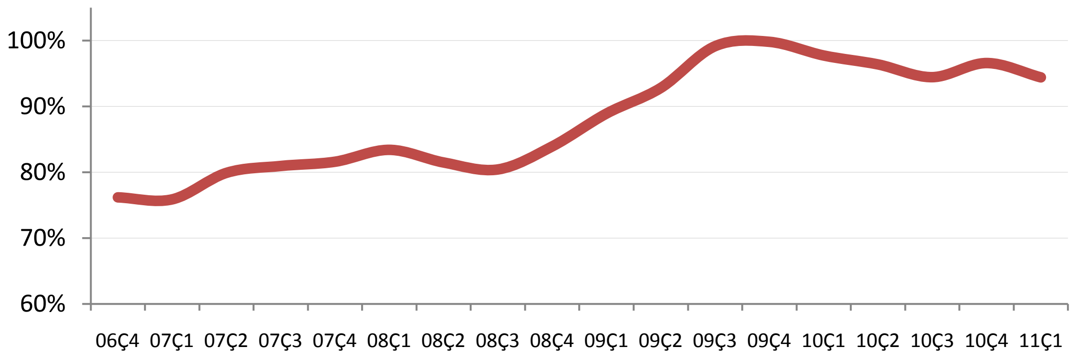
Table 1. Foreign trade balance, budget balance and private C-I balance, 2010, million TL

Export of Goods and Services	233,077
Import of Goods and Services	294,032
Foreign Trade Balance	**-60,955**
Public Disposable Income	131,595
Public Consumption	122,886
Public Savings	***8,709***
Public Investments	52,336
Public C-I (Budget) Balance	**-43,627**
Private Disposable Income	958,584
Private Consumption	828,909
Private Savings	***129,675***
Private Investments	142,872
Private C-I Balance	**-13,197**

Source: 2010 estimates in SPO 2011 Annual Program and 2010 National Income Calculations

In the light of this correlation between the current account deficit and budget deficit, one must ask the following critical question: Does Turkey sufficiently tighten the fiscal policy in order to manage the current account deficit? Budget figures reveal that in the recent period fiscal policy was not tightened but loosened.

Figure 4. The ratio of primary expenditures to budget revenues, 12 month, cumulative



Source: Ministry of Finance

Figure 4 reveals the indication of the loosening of fiscal policy. The ratio of primary budget expenditures to budget revenues, which moved around 80% before the crisis, reached 100% along with the real decrease in budget revenues during the crisis. On the other hand, the hike in primary expenditures could not be prevented, as a result of which the share of primary expenditures in budget revenues attained a permanent position around 95%. In other words, Turkey failed to take the advantage of the drop in the interest expenditures that could have eased the budget deficit and therefore the current account deficit.

TEPAV Fiscal Monitoring Report that assesses 2010 budget implementation results also addresses the "extremely" expansionary fiscal policy practice. The report stresses that fiscal stance, measured on the basis of the change in structural primary budget balance, has been deteriorating, giving way to distortions in the long term fiscal policy dynamics.[3]

Budget deficit must be cut to ease the current account deficit

Turkey has introduced a few measures to struggle with current account deficit. What is more, these measures predominantly targeted to reduce the private sector savings gap. Among these are the measures implemented by the Central Bank to prevent rapid credit expansion, for instance. Even if these attempts prove completely successful and the savings and investments of the private sector attain the balance, this can solve only one fourth of the current account deficit problem.

Current account deficit must immediately be reduced down to manageable levels. To this end, it is needed to tighten the fiscal policy. A balanced budget, private savings gap close to the 2010 level and a correspondent trade balance seems to be the ideal and sustainable outlook for Turkey.

[3] For the mentioned Fiscal Monitoring Report (in Turkish) please see the below link: http://www.tepav.org.tr/tr/haberler/s/2100