

How Relevant Is Turkey's Current Account Deficit?

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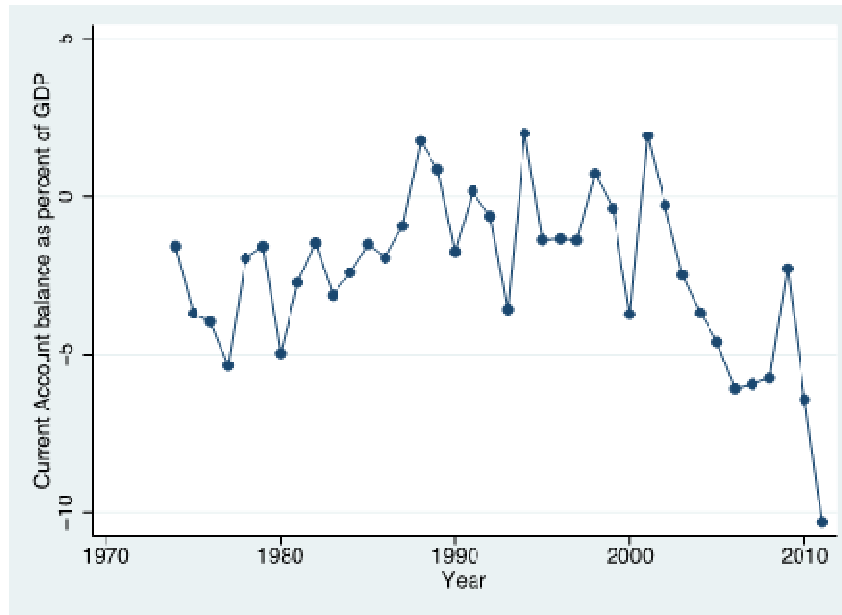
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Abstract

In recent months Turkey's current account deficit went above 10% level. It is possible to view current account deficits as welfare enhancing in the long run especially if the country is borrowing to finance its investment projects that cannot be met through its national savings. On the other hand if the current account deficit is a reflection of domestic market distortions such as consumer credit booms current account deficits cannot be welfare enhancing as it was observed during the recent European financial crisis that involved, among other countries, Spain and Portugal, which had similar current account deficits. Current account deficits that are born as a result of domestic market distortions cannot be sustained in the long run. In this paper we are analyzing the causes of Turkey's current deficits and assessing the consequences. Our results show that although there is no imminent danger from the present level of current account deficit that can be sustained as long as Turkey can keep up its stellar growth rate, however over a protracted amount of time this has the potential to cause a serious investor confidence problem.

1. Introduction

At the end of 2011 Turkey's current account deficit stood at 10% of its GDP, the closest current account deficit in Europe or elsewhere was Greece's current account deficit which was 9.6% of its GDP – 5% is usually the threshold level that markets start paying attention to it. Although, current account deficits is nothing new for Turkey, in the past 40 years only five times the current account was in black (Figure 1), 10% was unseen before. Even if 10% is twice the acceptable level of current account deficit, it is by no means an unsustainable level: Norway in 1970s ran a current account deficit of 14% in order to finance its oil explorations and investments in the North Sea. It is possible to view current account deficits as welfare enhancing in the long run especially if the country is borrowing to finance its investment projects that cannot be met through its national savings. On the other hand if the current account deficit is a reflection of domestic market distortions such as consumer credit booms current account deficits cannot be welfare enhancing as it was observed during the recent European financial crisis that involved, among other countries, Spain and Portugal, which had similar current account deficits. Current account deficits that are born as a result of domestic market distortions cannot be sustained in the long run simply because distortions in a market cannot persist for a long time.

Figure 1: Turkey's Current Account – Source: World Development Indicators

Hence, depending on the nature of the current account it is possible to distinguish between “good” current account deficits, which are sustainable even in the medium run and “bad” current account deficits, which are not sustainable in the medium run. Following Blanchard and Milesi-Ferreti (Blanchard and Milesi-Ferreti (2009)), we will call a current account deficit good if it is arising out of intertemporal decision making and bad if it is arising out of market distortions as a result of current account financing consumption rather than investment; feeding into fixed investment in residential housing rather than more productive investments; leading to consumer credit booms; official transactions financing the deficit rather than private investments as well as portfolio investments rather than greenfield direct investments, which are rather long-term investments.

Yet, it is still possible to ask the question whether the current account is still relevant after the integration of financial markets as a result of globalization of the world economy (Obstfeld (2012), Johnson (2009)). The issue arises because the current account gives us the net flow, which may not be indicative of the gross flows and it was the gross capital flows as Karen Johnson (Johnson (2009)) shows that increased the severity of the 2007-2008 financial meltdown worldwide. However, the importance of large current account imbalances lies in the fact that markets usually treated it as a symptom (Gourinchas and Obstfeld (2012)).

Another dimension in which current account plays a role is its effect on the international investment position of the country, which is basically the accumulated current account balances. Even though in the short run as a result of changes in asset values and exchange rates investment position might fluctuate quite a bit, in the long run it reflects the accumulated current account balances. According to the Turkish Central Bank data, at the beginning of 2012 external assets of Turkey was 182.2 billion dollars and its external liabilities was 561.7 billion dollars, its net foreign liabilities is about 40% of GDP – clearly a sustained current account imbalance create long-term liabilities! The large magnitude of net external liabilities is causing a big drag on the current account deficit: in 2012 net income payments to foreign investors were about 7 billion dollars. Obviously, this is not a sustainable position and at some point Turkey will have to start exporting more than it is importing in order to meet its foreign liabilities, which will require a drastic change in the composition of its output increasing production of tradables and decrease the production of non-tradables, which should make its tradables more competitive by reducing their relative price.

A clear implication of current account imbalance is not microeconomic, such as how competitive is the export industry compared to the rest of the world but rather it is macroeconomic as a

current account deficit indicates shortcoming of savings over investment. Hence, elimination of current account deficit in the first place require that a country should increase savings relative to investment, in other words reduce consumption with respect to investment or vice versa. Because savings mean national savings, reducing government budget deficit would also help to eliminate current account deficits.

One can take a dynamic view and consider productivity increases in the tradables sector so that the relative price of tradables will be competitive increasing exports relative to imports, which also means increasing income and increasing savings with respect to investment. In our conclusion we point out the necessary reforms to attain this kind of productivity increase in the overall economy.

In this paper we explore the causes and consequences of the recent deterioration in Turkey's current account. In order to do that we organize the paper as follows: section 2 focuses on the literature of current account deficit in general and Turkish current account deficit in particular; section 3 looks at the causes of the current account deficit and tries to decide whether it is a "bad" or "good" deficit; section 4 examines the sustainability of the current account; section 5 looks at the possible consequences of the deficit in terms of composition of output; and section 6 concludes.

2. The Background

How current account is viewed depends on the epoch in which it is viewed. Until the mid-1970s, discussion on current account was based on its flow behavior and the method of analysis was relative prices – so called "elasticities pessimism" was the dominant view. Yet after that the current account deficits were viewed as structural and hence the dominance of import substitution policies (Edwards (2002)). However, following Sachs (1981) argument, current account is now viewed as an intertemporal decision, which is more appropriate because current account being the difference between national savings and investment both of which are themselves the result of intertemporal optimization activity of rational decision makers. The "Lawson Doctrine" (Lawson (2011)) takes view to the extreme views current account not a problem as long as it is between consenting adults – i.e., as long as it is a private debt. However, in light of recent events in Europe indicated that even though the Spanish government deficit small compared to its current account deficit, debt among consenting private parties are still very important.

Obstfeld and Rogoff (Obstfeld Rogoff (1996)) provides the necessary frame work, yet it is Milesi-Ferretti and Razin who gave it a framework to analyze whether a current account is sustainable or not. They distinguish between willingness-to-lend and ability-to-pay, any confidence issue generated by the perceptions of which will endanger the sustainability of the current account deficit. Right after the recent global financial crisis, Blanchard and Milesi-Ferretti of the IMF were arguing for the reduction of world imbalances. (Blanchard and Milesi-Ferretti (2009)).

Although, Turkey has consistently incurred current account deficits there are not many studies examining causes, sustainability, and consequences of its long-term current account deficit. Using the framework provided by Milesi-Ferretti and Razin, Binatli and Sohrabji (2008) examines Turkish current account sustainability. Their results imply that as a result of favorable international conditions, Turkey could sustain its current account deficit. Because, their paper preceeded the financial crisis of 2007-08, they could not foresee the fall out from the last financial crisis.

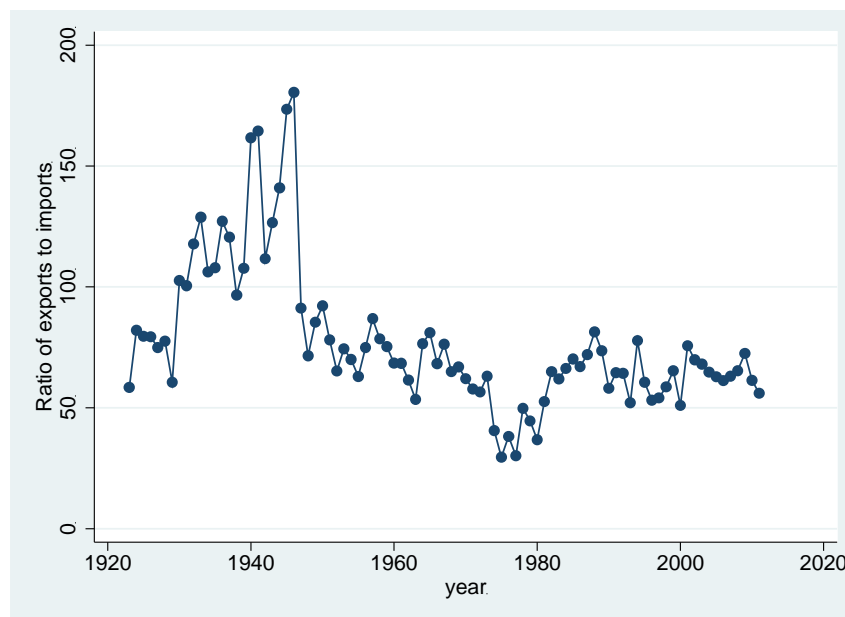
Another study that examines the sustainability of the Turkish current account is Kalyoncu (2005). He examines whether there is a cointegrating relationship between Turkish exports and imports and he finds out that there is one. Therefore, his conclusion is that Turkey's current account deficit is sustainable. Guncavdi and Ulengin (2008) looks at the effect of capital flows on the tradable and non-tradable expenditures. They find that non-tradable expenditure has a big impact determining demand for imports and paying for them using the capital inflows.

3. Sustainability of the Current Account Deficit

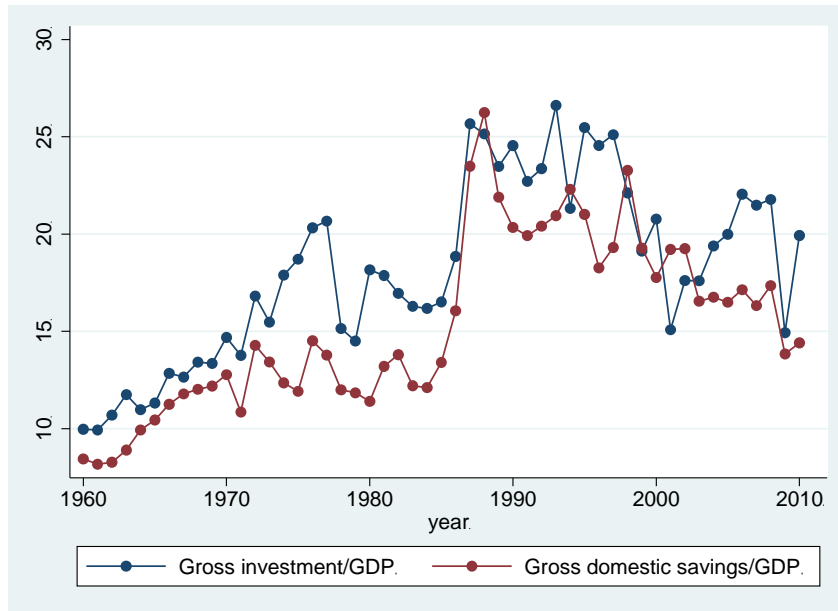
Following Olivier Blanchard and Jean Maria Milesi-Ferretti assessment of current account deficit, we will also examine Turkey's current account deficit whether it was borne out of market distortions ("bad") or it was born out of utility maximizing intertemporal decisions ("good"). Especially, we will look for market distortions in six dimensions such as the duration of current account deficits; whether the current account deficit is financing consumption or investment; whether fixed investments is done in residential housing or in more productive investments; if there are any recent consumer credit booms; whether official transactions are financing the deficit rather than private investments; and finally if the foreign net income is decreasing or not.

- Turkey's current account was consistently in red since the mid-1970s – see Figure 1. Very clearly, a country cannot have current account deficit forever; at some point it needs to start paying the debt incurred by the current account deficits. What has also been happening is that to pay for the extra borrowings Turkey has been selling its home assets such as real estate, mines, and government companies. This is the only way the current account deficit can be sustained for this magnitude and duration as long as there are willing buyers, of course. Geographical position of the country has been the driving force behind the demand for these home assets. Another way to see that is the export-import ratio which has been consistently less than one since 1947 (Figure 2). Sale of home assets is the only way to sustain the difference in the value of exports to the value of imports.

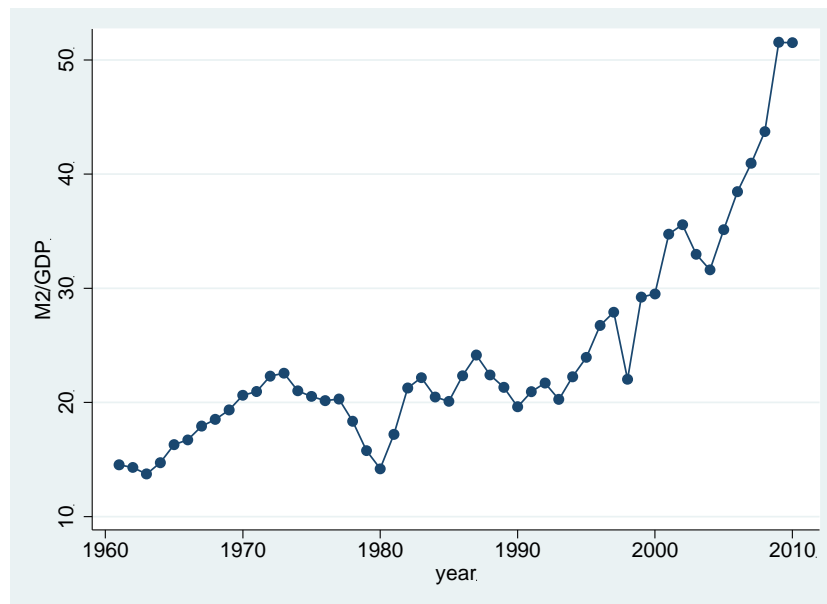
Figure 2: Turkey's Export-Import Ratio. Source: TurkStat



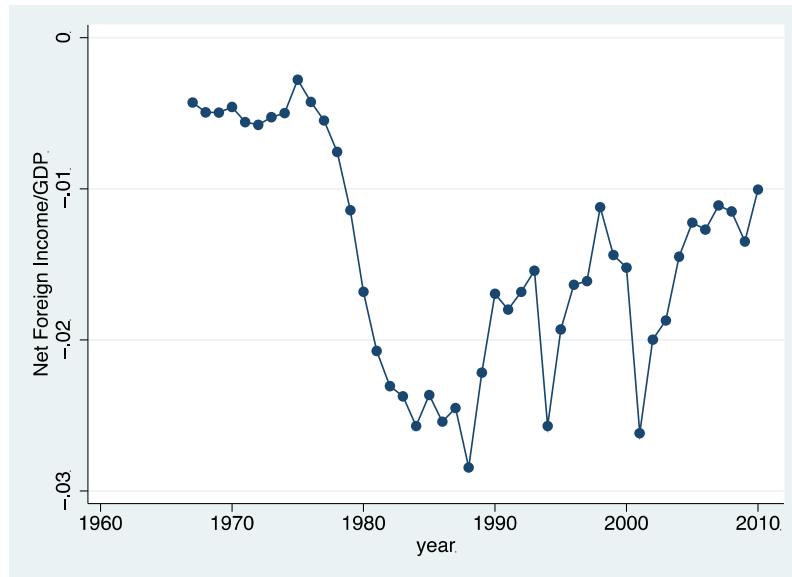
- National income identity gives us current account as the difference between national savings and investment: if an open economy is saving less than its investment requirements it borrows the difference from the international markets, which will show up as the current account deficit. As Figure 3 shows both savings and investment has been decreasing since the late 1980s and yet the current account has been consistently in the deficit area despite rigorous economic growth after 2001. Therefore the only possible explanation of this long-standing current deficit must be that it is financing consumption rather than investment, which should be concerning in terms of sustainability of the current account deficit.

Figure 3: Domestic Savings and Investment. Source: World Development Indicators

- Another indicator to see if there is recently an increase in consumer credits. Figure 4 shows that especially after 2000 growth of consumer credit has accelerated, again raising concerns about the sustainability of the deficit.

Figure 4: Credit Boom. Source: World Development Indicators.

- As a result of persistent current account, the country's net international asset position should be worsening that puts a drag on the net international income flows. As the figure 5 indicates there has been improvement on that front however the international investment has been worsening approaching 40% of the GDP.

Figure 5: Net Foreign Income. Source: World Development Indicators.

- Moreover, as the data from the Turkish Central Banks shows, most of the capital flows into Turkey are short term portfolio investments that is subject to investor sentiment and can reverse the course very quickly.

Overall our conclusion from the six criteria that we have been discussing is that long-term sustainability of the Turkey's current account is very questionable. Yet, it looks as if it is not all economics that are on foreign investors mind in determining to willingness-to-lend – otherwise long time ago current account deficit would have caused financial crises. Yet, as Ozatay (2000) shows in none of the previous crises current account deficit did not play a leading role. In sustaining its current account deficit, Turkey's geopolitical position as well as its economy plays a very important role.

There is also another way to look at the sustainability of the current account due to Mussa (2005). According to this criterion, the current account deficit is sustainable as long as economic growth is strong. We can do this exercise as follows:

Let,

c =currentaccount

n =thedebttoGNPratio

g =nominalGNPgrowthrate

Then the external debt will stabilize if $ng=c$; It is rising if $ng<c$; or it is decreasing if $ng>c$. For Turkey: $g \approx .18$ and $n \approx 1/3$. Hence, $ng \approx 6\%$. According to the Mussa's exercise, Turkey's sustainable level of current account is around 6% given its current economic growth potential and its debt to GDP ratio. Considering that in recent years the current account deficit has been well above this level, it cannot be sustained for much longer period of time. As a result of sustainability criteria and the criterion proposed by Michael Mussa, our conclusion is that the unsustainability of the current account if we leave out the geopolitical consideration of Turkey.

What are the possible scenarios for winding down the current account deficit. In this paper we will examine one possible scenario derived from the TNT model of international economics.

4. TNT Model

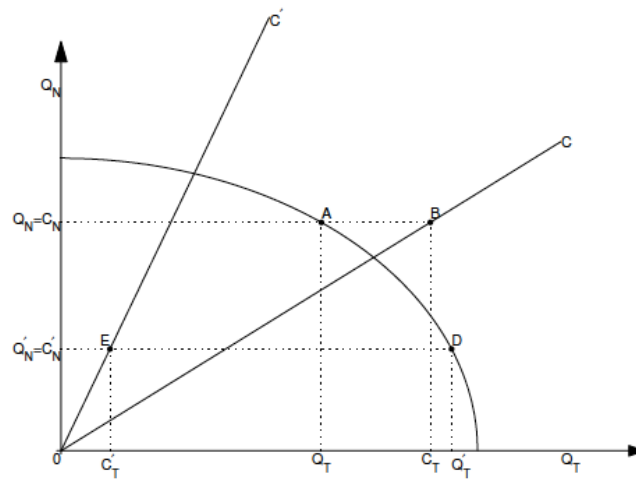
In this paper we have been arguing that, geopolitical conditions aside, Turkey's current account deficit is not sustainable and eventually there should be a correction, that is at some point, hopefully sooner than later, the Turkish economy should readjust its output mix producing more tradables and less non-tradables. The unsustainability of the current account deficit or perceived relative riskiness of the

economy may cause a change in the foreign investor sentiment reversing the flow of capital into the country and leading to currency depreciation. Although, the amount of depreciation will depend on the prevailing conditions, a rough approximation can be obtained using the Marshall-Lerner condition:

$$\frac{\Delta D}{X} = [\eta_{IM} - \eta_X - 1] \frac{\Delta \epsilon}{\epsilon}$$

We can conservatively assume that the term in the brackets is about 1/2, and Turkey exports about 20% of its GDP. Also, with the Turkish growth it can sustain a current account deficit of about 5%. These numbers require that the real depreciation should be about 30%. This is a substantial amount of depreciation yet Turkey has also a substantial current account deficit.

Figure 6: Partial Equilibrium: a real exchange rate depreciation.



The consequences of a currency depreciation of this amount can be scripted following one of the standard models of the international economics, i.e., the TNT model which predicts expenditure switching and production of more tradables – for a textbook treatment of which see Schmitt-Grohe and Uribe (2011). Figure 6 displays a typical country running trade deficit. Suppose, the economy is producing at A , Q_T amount of tradables and Q_N amount of non-tradables, and consuming at B . By definition, non-tradables are not exportable hence their domestic consumption is equal to the domestic production. As it is shown in the figure the country is running a trade deficit. According to the TNT model the slope of the production possibilities frontier, $\frac{P_T}{P_N}$, gives the real exchange rate. A currency depreciation, i.e., an increase in $\frac{P_T}{P_N}$, moves the production to D , at which point production of tradables increases relative to the non-tradables. Income expansion path (OC') rotates to the left so that the new consumption of non-tradables is equal to C'_N and the new consumption of tradables is equal to C'_T . As it is shown in the figure, the economy is now running a trade surplus. Also, note that how the composition of output changed from less tradables to more tradables. The transition of the economy from non-tradables to tradables require reallocation of resources, such as labor, investments, intermediate goods, to their new uses, which is of course costly in the short run.

How likely is that scenario? Data from Guncavdi and Ulengin (2008) shows that in recent years relative share of expenditures on non-tradables with respect to tradables has been increasing, Figure 7. As it is shown in Figure 8, the same source also gives that relative price of non-tradables has been increasing, meaning that the real exchange rate is overvalued and needs to be adjusted, i.e., a depreciation.

Figure 7: Tradables vs Non-tradables. Source: Guncavdi-Ulengin.

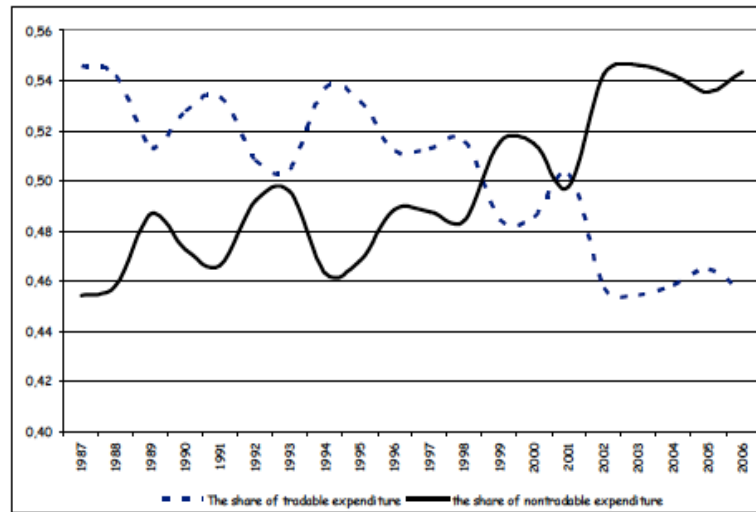
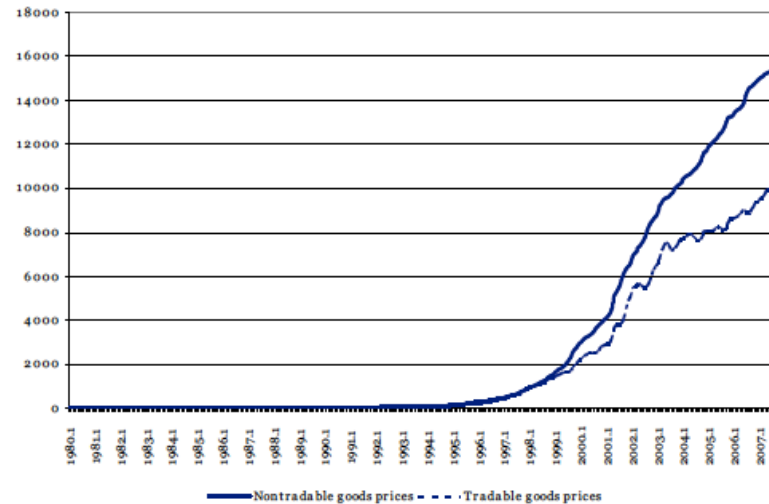


Figure 8: Relative Price of Tradables. Source: Guncavdi-Ulengin.



In the short run a depreciation will make the tradables more competitive and increase the exports. However, for tradables to stay competitive the economy requires that productivity increases in the long run. A McKinsey Global Institute Report (McKinsey (2003)) gives various sources to increase the productivity in the following areas: reduce the level of informality, liberalize the utility sector, and finally macroeconomic stability following a macroeconomic discipline.

5. Conclusion

Since World War II, Turkey’s ability to meet its imports by exports were quite limited. Available data suggests that since the mid-1970s for only five years Turkey had current account surplus. This perennial issue of current account deficit led to the worsening of the net international liabilities, currently about 40% of the Turkish GDP. Unfortunately, globalization did not help this problem but rather exacerbated it: after the late 1980s, when Turkey opened up its financial account and its financial markets started integrating with the world financial markets, the size of the current account deficit started swelling as well. Especially after the 2001 crisis, globalization softened the borrowing constraints and let to consumer credit booms, mostly financing consumption rather than investment. It seems Turkey does not have a problem of financing this kind of deficit, perhaps owing to its geopolitical position, by

borrowing from abroad. Unfortunately, the capital comes in the form of portfolio investment, whose flow can easily be reversed at the slightest changes in the risk perception. However, the downside of this kind of capital flows is the stronger lira that is hurting the Turkish exports.

Our analysis suggests that Turkish Lira is overvalued and the Lira needs to lose some of its value, which will ultimately help with the exports. But this means production of more tradables and less consumption of both tradables and non-tradables. Yet, such a transition is not easy, at least politically and socially, and very costly. For Turkey, One way to ease transition is to invest in its infrastructure and increase productivity by reducing the informality in its economy, liberalizing its utility sector, and providing more macroeconomic stability. Yet, all these call for a higher saving rate both private and public. Turkey needs to make these choices now: procrastination will only make things worse.

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