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Current account balance and external adjustment in Turkiye

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KOÇ UNIVERSITY-TÜSİAD ECONOMIC RESEARCH FORUM
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CURRENT ACCOUNT BALANCE AND EXTERNAL ADJUSTMENT IN TURKIYE

Hakan Kara
Çağrı Sarıkaya

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August 2023

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Current Account Balance and External Adjustment in Türkiye*

Hakan Kara¹, Çağrı Sarıkaya²

August 2023

Abstract

This paper identifies the cyclical drivers of the current account balance (CAB) in Türkiye and assesses the relevant macro policy implications. We employ the notion of “underlying current account”, which corrects for cyclical factors such as global and domestic growth, terms of trade, as well as other exogenous factors including data revisions and idiosyncratic shocks to balance on services. We show that excessive fluctuations in the headline external deficit in recent years can be largely attributed to a combination of unusually large external shocks such as the pandemic and the war, in conjunction with a record-low domestic real interest rates. Special emphasis is put on the role of gold trade and its relation to domestic macro policies. Accounting for the impact of all factors, we estimate that the underlying CAB has shrunk from -6.4% in 2010 to a range of -0.9% to -1.6% in 2023, suggesting a substantial improvement in the external balance during the past decade. However, the underlying balance has significantly deteriorated after 2022, as the jump in inflation coupled with the quasi-fixed exchange rate regime implemented through active use of central bank reserves quickly eroded the competitiveness gains of past years. Besides, as the domestic agents have increased their demand for physical goods/assets to hedge against high inflation under ultra-low real rates, the upward shift in the demand for gold and other imported goods started to feed through the structural component of the CAB. These observations imply that, it may be challenging to lock in the recent gains in the external balance unless the authorities eventually deliver the necessary cyclical adjustment and restore the credibility of the macroeconomic policy framework by re-establishing a nominal anchor.

Key words: Underlying current account, Turkish economy.

JEL codes: E32, E65, F32

* The views expressed herein are those of the authors and do not necessarily reflect the views of the corresponding institutions.

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1. Introduction

Historically, external balance has been an integral part of the macroeconomic sustainability discussions in Türkiye. With the accumulation of sizeable external debt during the past decade, this issue has become even more significant for macroeconomic policy design. Despite the massive adjustment in the real exchange rate since 2016 and the stagnation in the financial deepening after 2018, current account (CA) deficit has climbed to around 5.5% of GDP by June-2023. Weakened policy credibility, portfolio outflows, and lower visibility associated with high and volatile inflation has further raised doubts on the sustainability of existing macroeconomic policies. Accordingly, much of the recent debate on economic policy has concentrated on the high CA deficit and low levels of central bank reserves under limited access to sustainable sources of external financing.

This study takes a closer look at the external balance dynamics in Türkiye by identifying the cyclical drivers of the current account balance. To this end, we make use of the updated estimates for the “underlying current account” *à la* Kara and Sarikaya (2013) and evaluate its implications for the policies in the near future. Our results suggest that several idiosyncratic shocks and excessive domestic demand fueled by unusual monetary policy implementation have been driving the volatility of the CAB, making it difficult to assess the extent of the external adjustment just by looking at the raw data. When we correct for temporary or policy-induced cyclical factors, and calculate the underlying current account, we find that the external deficit has narrowed substantially since 2011, despite the significant reversal in 2023. We argue that the improvement in the external balance should not be taken for granted as it came at the cost of higher inflation. Using this background, we discuss the outlook for external balance under different scenarios by conditioning on the macro policy approach.

2. Historical evolution of external balances

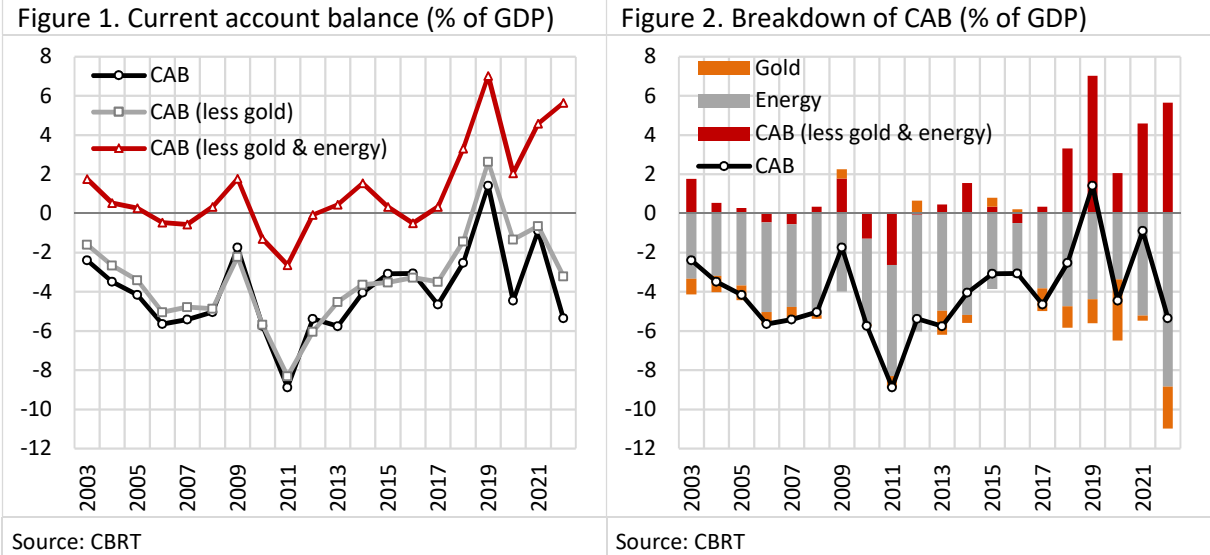
Türkiye has been running large and persistent external deficits over the last decades. One exception is 2019, which was a year marked by a significant import compression following the deep GDP contraction in 2018H2.³ Subdued domestic demand and credit slowdown led the headline CAB to reach a surplus of 1.4% of GDP in 2019. However, the CAB moved back to negative territory as the economy recovered in the subsequent years (Figure 1).

Several factors can be cited as usual suspects in driving the recent volatility and deterioration in the CA deficit. External balance has been under significant pressure due to not only adverse shocks originated from the Covid-19 pandemic in 2020 and the war in Ukraine in 2022, but also the pro-growth domestic policies relying on massive monetary and credit expansion. Regarding the pandemic-related shock to tourism and transportation sectors, the number of foreign visitors has completely recovered by reaching its pre-pandemic trend by early-2023. On the other hand, the lagged effects of the surge in commodity prices continued to inflate the import bill in energy front as of the first half of 2023. In the next section, we will attempt to quantify the contribution of each of these factors in order to gauge the underlying drivers of the CAB.

The distortionary impact of large and persistent shocks associated with the pandemic and the war calls for a deeper look at the components of the external balance. Before delving into the technical decomposition, it may be insightful to have a cursory look at the recent course of the external balance. Especially the energy and the gold components need special attention. For instance, energy trade balance worsened to record low levels, to almost -9% of GDP in 2022, reflecting the adverse

³ GDP contracted by -1.6% and -3.2% on quarterly basis, respectively in the third and fourth quarters of 2018.

terms of trade shock.⁴ Gold imports have also shown substantial volatility during the past decade. Decomposing CAB into its three main components, namely gold, energy and the remaining items (hereafter CABX: current account balance excluding gold and energy), one can easily notice the increased volatility in the headline CAB and the remarkable upside shift in the CABX after 2017, an episode characterized by capital outflows and sustained real depreciation (Figure 2).



Hence, the last two decades exhibit two distinct episodes in terms of the shifts in the composition of external balance, as summarized in Table 1. The headline CAB/GDP was -4.6% during 2003-2017, while it improved to -2.4% during 2018-2022. External adjustment appears even more striking when gold balance is excluded (from -4.2% to -0.8%). Further stripping out the energy item, and hence the large part of the negative terms of trade shock, the improvement in CABX has been remarkable, from 0.1% to 4.5%. Note that this improvement was driven by not only goods but also services.

	CAB	Breakdown of CAB			Breakdown of CABX		
		Gold	Energy	CABX	Goods	Services	Income
2003-17	-4.6	-0.4	-4.3	0.1	-1.9	2.9	-0.8
2018-22	-2.4	-1.6	-5.3	4.5	1.7	4.1	-1.2

Several conclusions can be drawn from these observations. First, there seems to be a notable improvement in the CAB through time. Nevertheless, from a policymaking standpoint, this adjustment should not be solely attributed to the sustained real depreciation. The flattening of credit/GDP as well as the post-pandemic opportunities from the relocation of supply-chains can also be considered as important drivers. This point will be discussed in more detail in the next section. Second, during the high inflation period after 2017, the gold trade balance has deteriorated substantially from -0.4% to -1.6%, suggesting that rising gold demand is partly driven by the hedge motive to be protected against inflation and financial repression. Therefore, treating the gold imports as a completely exogenous shock may be misleading; it might be a precautionary response to the inflationary environment driven by excessive monetary expansion. In the next section, we provide a

⁴ Although fully excluding energy from the external balance does not make much sense from an economic point of view, it provides some useful insight to strip the contribution of the fluctuations in oil prices in the short-term, given the inelasticity of energy demand to prices.

detailed discussion by decomposing the cyclical drivers of the external balance, which will be used to construct our measure of the underlying current account.

3. Cyclical adjustment to current account balance

3.1. The notion of underlying current account

Underlying current account (UCA) is the level of the CAB that would have prevailed had the cyclical drivers been at their trend levels. By cyclical movements, we mean fluctuations in aggregate demand in domestic and foreign economies, and relative prices. These determinants are subject to different type of shocks (to demand, supply, terms of trade, etc.). When these disturbances are large in magnitude, exports and imports may deviate significantly from their trends, blurring the underlying trend of the CAB.

For instance, a fall in domestic output below its trend (negative output gap) may lead to a temporary improvement in the external balance by compressing import demand, as in 2009 and 2019. Large and persistent falls in the oil price may have a similar impact, as in 2015. As the effects of shocks dissipate and main drivers revert back to their normal courses, external balance becomes more aligned with its trend levels. Hence, accounting for transitory (cyclical) movements in aggregate demand and international prices allows for better understanding of the underlying trend of CAB.

UCA is a widely used tool in external balance assessments (EBAs) of the IMF to identify policy-induced imbalances and draw recommendations accordingly.⁵ The rationale behind EBAs is the pursuit of maintaining the consistency between the actual CAB and a *norm* (sustainable) level implied by economic fundamentals. In doing so, the policy adjustment is built on two main pillars: (i) implementing cyclical policies to bring supply and demand into balance by steering the economy toward its trend level of output, (ii) for any remaining misalignment, making the additional adjustment through exchange rates. Basically, if the external deficit is a result of an expansionary domestic policy stance causing overheating, a policy tightening may facilitate the necessary adjustment in the external balance.

The measures of UCA are basically constructed by removing the impact of cyclical factors (output gaps) on imports and exports of goods and services, while the components of terms of trade can also be adjusted for global cycles. After stripping out the cyclical components of external balance, any misalignment between the UCA and *norm* current account can be addressed by an appropriate adjustment in exchange rates. In this paper, we focus on the cyclical movements and calculate the UCA to provide some guidance on the dynamics of the CAB in the medium term. Computation of the *norm* current account, which is rather driven by structural factors, is beyond the scope of our study.

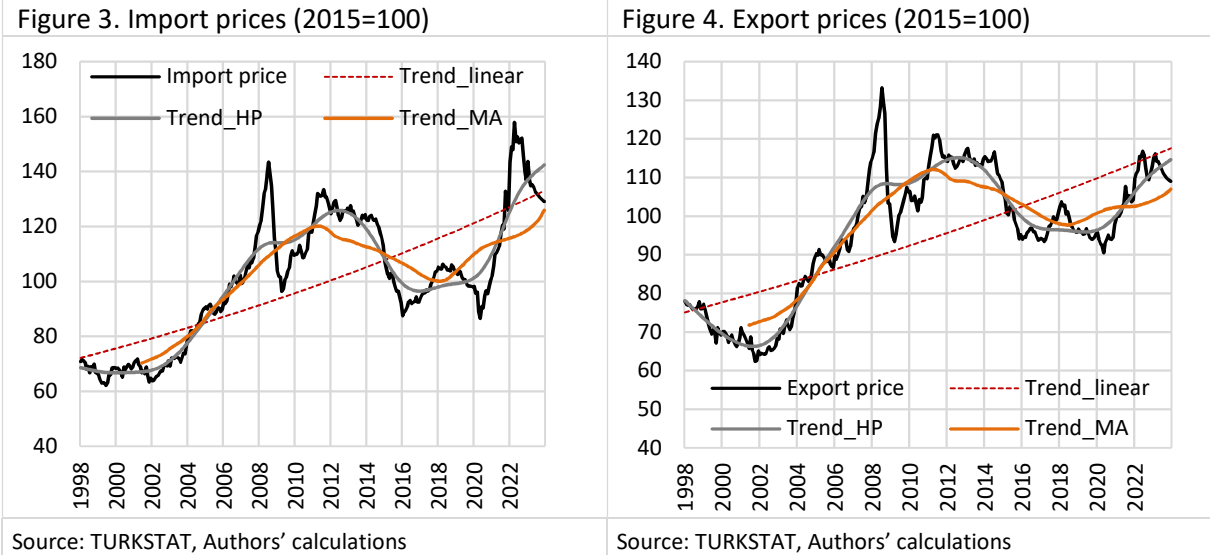
3.2. Adjustment for terms of trade

International prices are affected by global financial and business cycles. Expansion and overheating phases in the global economy are associated with increases in commodity prices, whereas cool down and contraction periods, such as the GFC in 2009 and Covid-19 in 2020, have the opposite effect.

Türkiye is highly dependent on imported energy, whose demand is rather inelastic to the international prices. Therefore, removing the impact of “temporary” changes in terms of trade is crucial to measure the UCA, which necessitates the estimation of the deviation of import and export prices from their trends. This procedure is typically conducted by using statistical filters. Although the

⁵ External balance assessments by countries are regularly made by the IMF. See IMF (2023a) for the latest report. See Obstfeld (2017) and IMF (2022a) for methodological details.

filters employed in this process are fairly standard (linear, Hodrick-Prescott, moving average, etc.), judgement may need to be incorporated in the choice of specific filter(s) to be used. Taking a look at the data, commodity price cycles appear to be highly persistent during the last twenty-five years, as the reversals in short-to medium-term trends take quite a long time. In this case, using variable-trend filters such as Hodrick-Prescott (HP) or moving averages (MA) may provide a better characterization of long and persistent cycles.



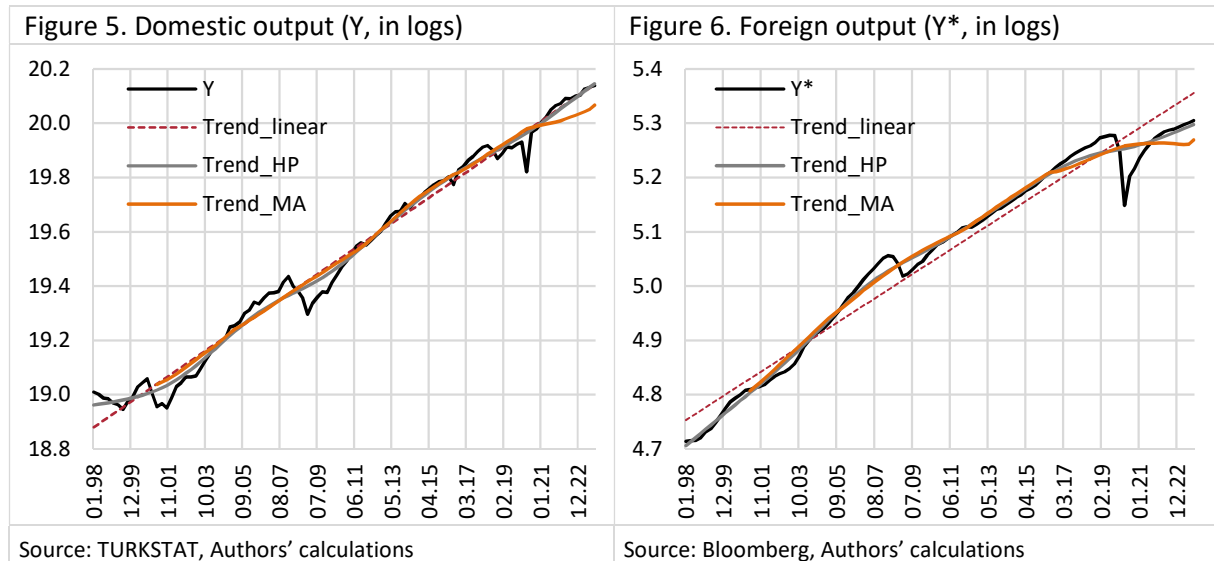
Another concern is the end-sample problem inherently ingrained in these filters. For instance, both the Covid-19 pandemic and Russia-Ukraine war have had still-lingering effects on global inflation, but controversially, linear and HP trends signal that import and export prices have already fallen below their trends. A more persistent trend measure, MA filter, seems to be more consistent with our judgment of the recent gaps in commodity prices, especially regarding the energy component. With this view, we opt to use seven-year centered MA trend in cyclically adjusting the components of terms of trade (Figure 3 and 4).

3.3. Adjustment for business cycles

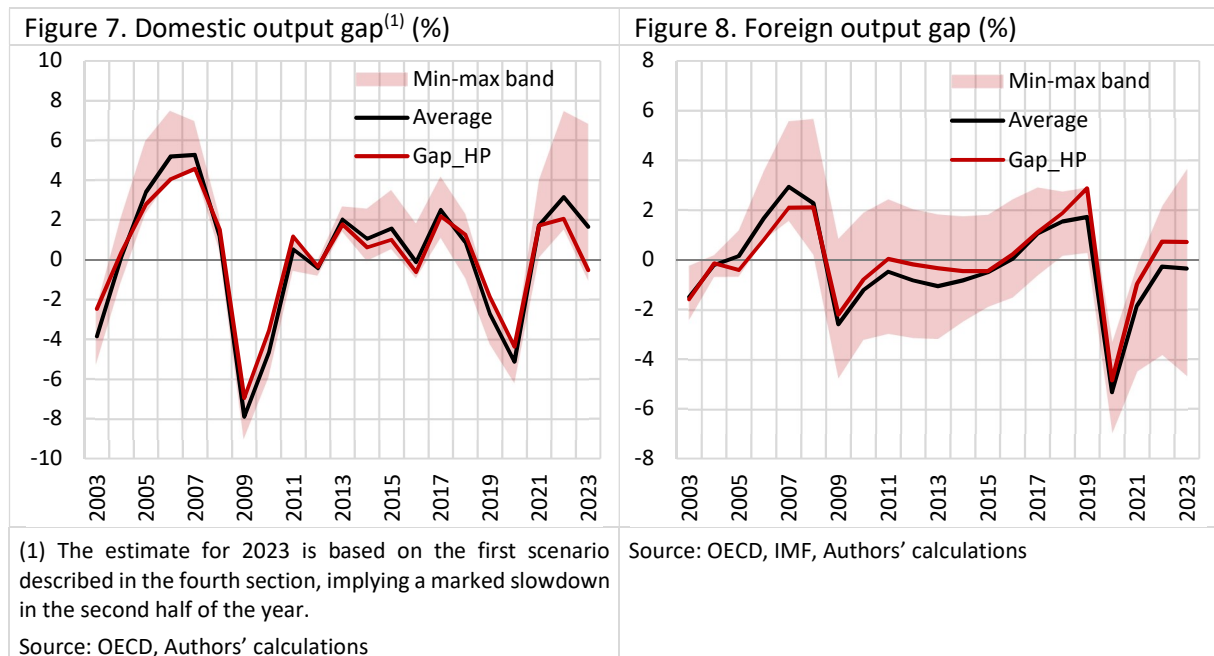
Business cycles have considerable impact on external balances. Cyclical positions of domestic and foreign economies affect their CABs through demand for imports and exports. Expansions (contractions) in domestic demand are generally associated with higher (lower) imports. CA deficit widens during overheating periods due to increased demand for imports, while it improves during contractions or stagnant growth episodes due to import compression. Similarly, fluctuations in global growth may lead to cyclical movements in export demand and external accounts. Regarding the evolution of CAB with respect to the domestic economic activity, 2009-GFC and 2019-domestic crisis provide clear examples of cyclical improvements in CAB, while pre- and post-GFC as well as post-Covid-19 boom periods were characterized by marked deteriorations in external balances (Figure 1).

Accounting for the impact of cyclical fluctuations in the domestic economy and foreign trade partners would largely eliminate the transitory movements in the CAB, and thus result in an indicator of “underlying” external balance. In doing so, one would need the respective output gaps, measured by the percentage deviation of output, i.e. GDP, from its trend. To this end, once again we utilize standard statistical models and incorporate expert judgment to choose the appropriate filter(s). Trend estimates for domestic and foreign output gaps are presented below (Figure 5 and 6). Y and Y*

represent the domestic GDP and export-weighted global production index in logs, respectively.⁶ Trend output levels are calculated by using linear, HP, and seven-year centered MA filters.



In addition to the statistical filters, we also consider the output gap estimates produced by various international organizations. For domestic slack, the OECD estimate reported in the most recent Economic Outlook (June 2023) is added to the dataset. For external slack, the OECD measures estimated for the Euro area-17 and OECD regions, as well as the IMF measure estimated for the advanced economies, reported in the latest dataset of the World Economic Outlook (April 2023), are taken into account.⁷ Hence, we consider four indicators for domestic output gap, and six indicators for external output gap.



Using all the measures mentioned above, we construct the min-max bands and averages for the output gap estimates of domestic and foreign economies (Figures 7 and 8). The estimates for

⁶ For the methodology of constructing the export-weighted production index, see Erduman and Ekşi (2018). Eren and Yavuz (2020) provide a more recent update.

⁷ See OECD (2023), IMF (2023b).

external output gap vary in a wider band compared to those for domestic output gap. The difference between the linear filter and the filters allowing for variation in trend growth is noticeable for the external output gap, possibly due to the long-term scarring effects of the GFC on productivity growth and potential output in advanced economies.⁸ We think that the filters allowing for time-variation in trend would yield a better characterization of the post-GFC break in advanced economies' trend output. Nevertheless, while the linear filter produces an extremely large slack for external demand, the MA filter does exactly the opposite toward the end of the sample, which may not be intuitively plausible (Figure 6). As the global economies were dragged into a deep recession by the Covid-19 shock in 2020Q2, time-varying trend indicators started to adjust to the new levels of contracted output, and the downtrend in MA trends proved relatively more persistent than HP trends (Figure 5 and 6). Highly positive output gaps in the last two years, depicted by upper bounds of the pink-shaded regions in Figure 7 and Figure 8, reflect this persistently subdued trend growth of MA filters, which may not be a proper tool for de-trending the indicators of economic activity according to our judgment.

Counterintuitive values of the external slack produced by the linear and MA filters lead us to consider the remaining indicators, HP-filtered, OECD, and IMF gap estimates, as potentially more representative candidates of economic slack. Still, given the high degree of uncertainty in identifying the cyclical position, we proceed with the simple average of the six alternative estimates to characterize the cyclical variations in external demand for Türkiye. Regarding the domestic slack measures, for which the choice of de-trending method seems relatively less controversial due to the tighter band of alternative estimates, we will follow the same approach by taking the average of the aforementioned four indicators of output gap in our benchmark calculations. For robustness checks, we also investigate the sensitivity of these results to the alternative measures of slack, to assess whether taking simple averages or using HP-trends makes substantial difference for economic inference and policy implications (Appendix 1).

3.4. Adjustment for other (exogenous) factors

Cyclical variations in prices and output may not be the sole drivers of the gap between actual CAB and its underlying trend. In fact, economic variables may be subject to various sectoral shocks originating from geopolitical developments or other exogenous sources. For the Turkish case, this has been particularly relevant for some components of services exports. During the last decade, the political events surrounding the general elections in 2015, as well as the pandemic-related mobility restrictions in 2020 and 2021 had prolonged effects on tourism and transportation activities in Türkiye, which weighed on the revenues collected from exports of services (Figure 9 and 10).

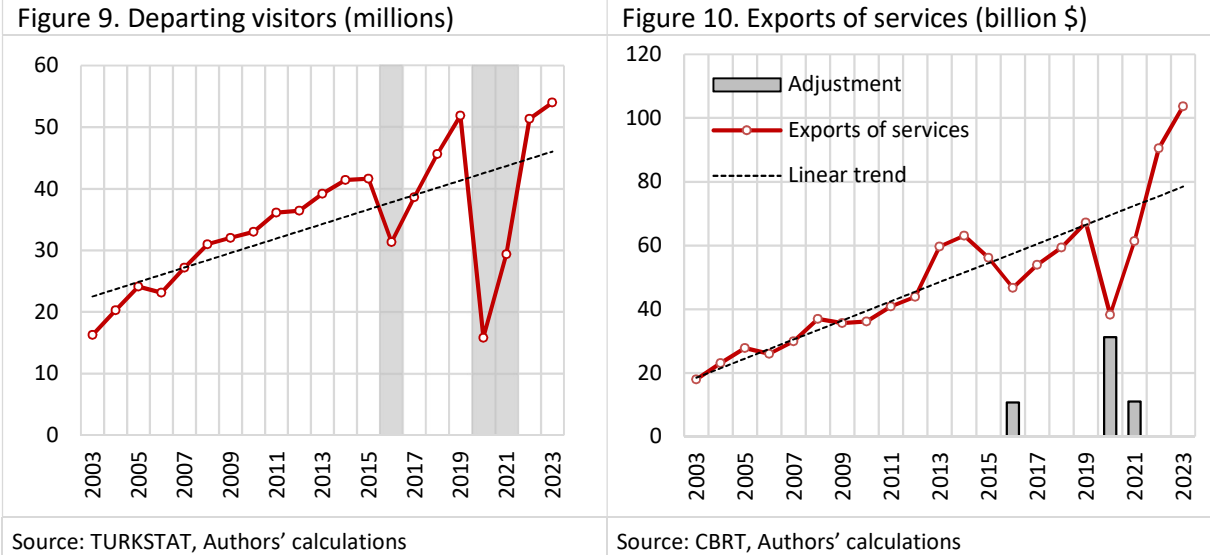
The question of how to account for such transitory effects in calculating the UCA calculations will eventually depend on the assessment of the size and persistence of these shocks.⁹ In this respect, we deploy the data on the number of foreign visitors to identify the periods shaped by exogenous factors. The below-trend course of services exports during 2016 and 2020-21 is attributed to exogenous shocks derailing the CAB from its underlying trend. We assume that the exports of services would have remained on trend, should the aforementioned events had not occurred. For these periods, we take the difference between actual observations and linear trend to calculate the necessary adjustment.¹⁰ Accordingly, as shown by gray bars in Figure 10, the adjustment to the CAB

⁸ See Dieppe (2021) for a comprehensive analysis and discussion on global productivity trends.

⁹ For instance, IMF reports the Covid-19 adjustments to CAB by 1.1%, -0.2%, and -0.2% for 2020, 2021 and 2022 respectively. See IMF (2021), IMF (2022b) and IMF (2023a) for individual economy assessments in Chapters 3.

¹⁰ One may argue that the trend was affected by the two major data revisions in the balance of payments statistics, which lifted up the current account balance by 0.8% of GDP during post-2013, as discussed in the next section. When we account

will be \$10.8 billion (1.2% of GDP), \$31.2 billion (4.4%) and \$11.1 billion (1.4%) for 2016, 2020 and 2021 respectively. For example, we can interpret that, in 2016, the deficit would have been smaller by 1.2% of GDP in the absence of exogenous adverse shocks. Pandemic lock-downs had a more profound impact on CAB in 2020, where the decline in exports of services accounts for almost the whole deficit (Figure 1 and 10).



3.5. Adjustment for gold trade

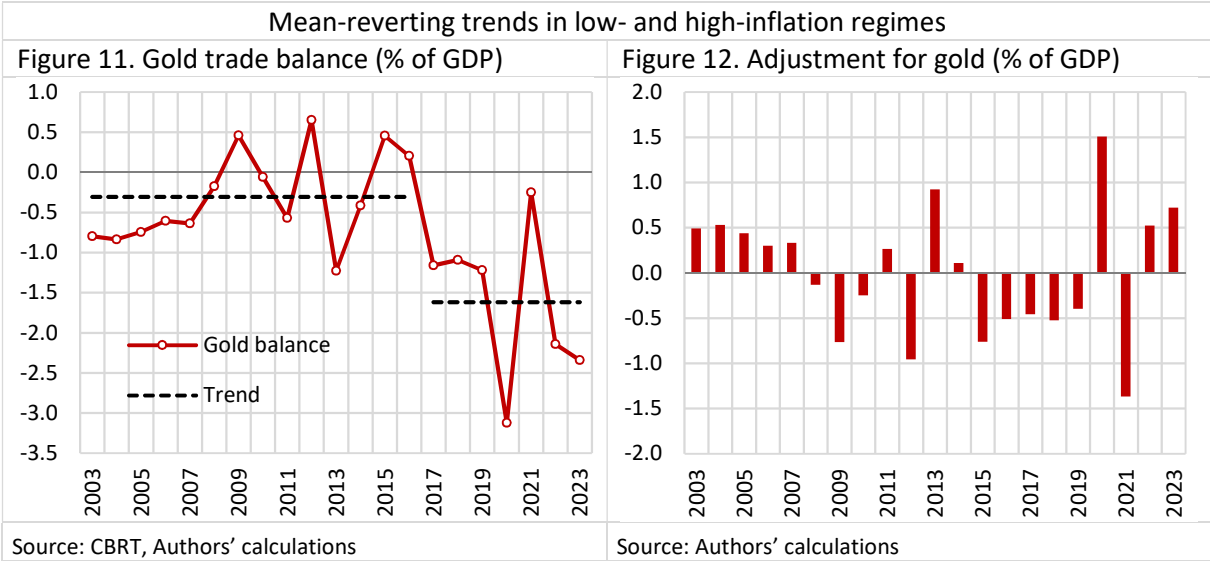
Türkiye has been historically a net importer of gold. An important portion of household savings is traditionally maintained in the form of physical or digital gold. Due to the long-standing cultural aspects or persistent economic drivers, a significant part of the trade deficit in gold can be considered as permanent, thus can be attributed to the structural component of the CA deficit. The demand for gold can be also attributed to some form of dollarization, which is driven by the strong memory of high and volatile inflation. Changes in the inflation uncertainty or the degree of attractiveness of alternative instruments can lead to fluctuations in gold demand. For example, the shift in the level and volatility of gold demand after 2017 is likely to be driven by precautionary motives against persistent inflationary cycles. That means, prudent economic policy focused on achieving price stability and maintaining confidence in domestic currency would decrease the gold demand through time. In other words, provided that the macroeconomic policies deliver a credible disinflation signal, increased confidence in the financial system and the decline in inflation uncertainty would reduce gold demand.

Given this backdrop, we assess that some portion of the increased gold demand in Türkiye in recent years is likely to be associated with the inflation uncertainty and higher dollarization.¹¹ Hence, the identification of the cyclical component of CAB necessitates a judgmental assessment of policy-induced excessive fluctuations in gold trade. In doing so, we divide our sample into two periods: before and after 2017, i.e. low- and high-inflation episodes, which clearly marks the variations in gold trade. Low-inflation period pertains to single-digit inflation, whereas high-inflation episode covers the years of double-digit inflation starting from 2017. Gold trade balance as a share of GDP averaged at -0.3% in the low-inflation period and -1.5% during the high-inflation period, indicating that gold

for these revisions and adjust pre-2013 accordingly by shifting up the series by the same amount, the deviations from linear trend, shown in gray bars, become 12.5 vs. 10.8 for 2016; 29.4 vs. 31.2 for 2020; 11.3 vs. 11.1 for 2021. Therefore, the impact of data revisions on the necessary adjustments for exogenous events is found to be negligible.

¹¹ For an analytical decomposition of the drivers of deposit dollarization in Türkiye see CBRT (2021).

has constituted a significantly larger part of the external deficits in the high-inflation regime (Figure 11).¹²



The de-trending process for the gold trade is more challenging compared to extracting typical cyclical factors, as it requires a significant amount of judgment. Because of the change in the inflationary environment, we assume that gold demand exhibits a regime shift after 2017, yet it is mean-reverting within each regime. Therefore, we calculate the excess demand for gold as the gap between the realized balance on gold trade and period-averages. Accordingly, in 2020 the temporary surge in gold demand seems to have led the CA deficit to be wider than its underlying value. For the years where the gold trade deficit falls short of the period-average, as in 2021, the adjustment is made with a negative sign, implying that the gold trade temporarily supported the external position, and the underlying balance was actually worse than the actual figures (Figure 12).

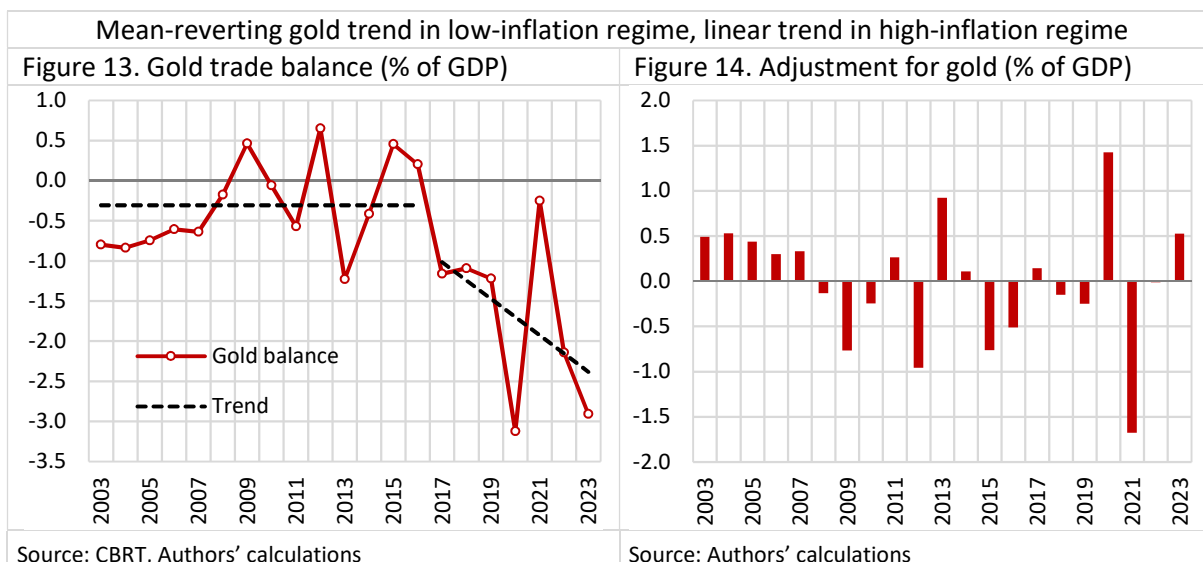
3.5.1. Alternative view on the cyclical in gold demand: the role of economic policies

The treatment of gold trade in the cyclical adjustment process is crucial for the assessment of UCA. In the previous subsection, we have assumed that gold demand is mean-reverting across two different inflationary regimes, which may be a strong assumption for a high and volatile inflationary environment. In fact, the trade balance in gold has been deteriorating during the high-inflation period starting from 2017. In the absence of stabilizing policies, gold demand would remain high and may even accelerate due to the “inflation hedge motive”.

If the economic agents do not expect the authorities to respond to inflationary pressures in a timely manner, it may be more plausible to presume a downtrend in gold trade balance instead of mean-reversion (Figure 13). This is equivalent to attributing a larger part of the gold trade deficit to the structural component of CAB, particularly for the last four years, compared to the “average” deficit of 1.6% from 2017 to 2023 (Figure 11 and 13).¹³ In other words, this approach implicitly assumes that a significant part of the increased demand for gold imports reflects the high inflation environment which is likely to prevail in the foreseeable future.

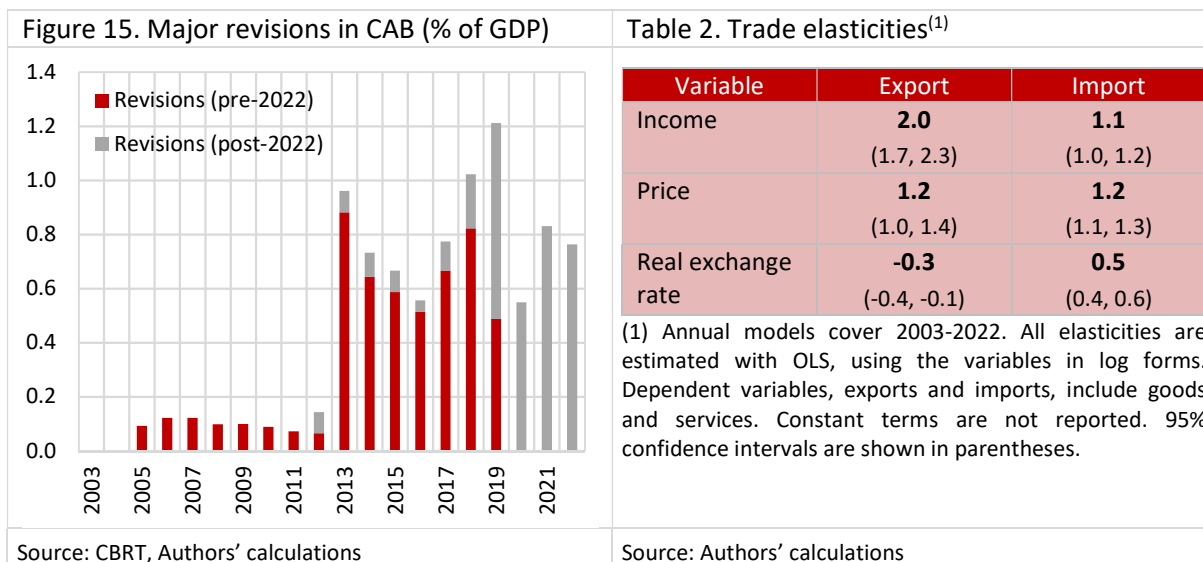
¹² The projection for 2023 is excluded from the high-inflation period average (-1.5%) in the text.

¹³ Note that the projections for the gold trade deficit in 2023 are conditional on the macro policy approach that will be pursued in the second half of the year. The deficit is envisaged to be smaller under the scenario of macro stability-oriented policies in comparison to the prospective outcome of the existing policy approach (Figure 11 and 13). The outlook for 2023 under two different policy approaches is discussed in the fourth section.



3.6. Adjustment for data revisions

Balance of payments statistics had been subject to two major revisions in the last three years, which had considerable impact on CAB figures. The first one, made by TURKSTAT in 2020, was due to the methodological changes in international trade in services and foreign trade statistics. This revision, covering the period 2013-19, led to an average annual improvement of \$ 6.3 billion in CAB, corresponding to 0.7% of GDP.¹⁴ The second revision was made to the tourism and primary income statistics in 2022, as part of a collaborative work of several governmental institutions, and the CAB was revised up by \$ 26.8 billion on cumulative basis for the period between January 2012 and August 2022.¹⁵ Large part of this revision was made for 2019-22, where the average annual improvement in CAB is calculated as 0.6% of GDP with real-time data.



Apart from the major changes in data compilation methods, balance of payments statistics are subject to revisions on a regular basis, with the arrival of new information each month. Adding up these less significant revisions to the aforementioned two major updates, we calculate the average annual upward revision as 0.8% of GDP for 2013-2022 (Figure 15). As the revisions affect the pre- and

¹⁴ The sources of the revision are documented in CBRT (2020).

¹⁵ See the press release of the CBRT (2022).

post-2013 periods in an asymmetric way, they can have an artificial impact on the trend of CAB, which must also be taken into account in UCA assessments. In order to address this issue, we adjust the CAB figures by simply adding 0.8% of GDP for the pre-2013 period as well. That is, we assume that the data revisions would have been of similar size compared to the post-2013 period, had all the data sets comprising the revisions been extended back to pre-2013 period.

3.7. Trade elasticities

Our calculations for cyclical adjustments are built on the methodology used in Kara and Sarıkaya (2013).¹⁶ Nevertheless, the major revision in national accounts statistics made in 2016, which resulted in a considerable increase in GDP growth rates for post-2009, as well as the two major revisions on balance of payments statistics made in 2020 and 2022, require an update for trade elasticities. In this note, we follow a simple OLS estimation framework using annual data, to capture the lagged effects of the explanatory variables (Table 2). The estimated elasticities are broadly in line with the results of the previous studies.¹⁷ Multiplying these elasticities with corresponding estimated gaps, we calculate the contribution of cyclical adjustment for each component (global output, domestic output, and terms of trade). For example, if domestic output gap is 1% positive for a particular year, we assume that CAB would have been $1\% \times 1.1 = 1.1\%$ higher (through lower imports) had the domestic GDP been at its trend level. In this particular case, cyclically adjusted CAB will be higher than the actual CAB.

4. Results and policy implications

4.1. The outlook for 2023 under alternative scenarios

This study is conducted by mid-2023 and we wish to include the year 2023 in our analysis, which is likely to reflect a significant reversal of the underlying dynamics of the external balance. Therefore, before discussing the historical results of the cyclical adjustment to the CAB, it is worth to elaborate on the short-term macroeconomic outlook conditional on the domestic policies in shaping the external balance.

Table 3. Selected macroeconomic indicators⁽¹⁾

	2021	2022	2023 ⁽²⁾	2023 ⁽³⁾
CPI (avg., yoy, %)	19.6 (36.1)	72.3 (64.3)	51.0 (59.7)	54.4 (68.2)
GDP (yoy, %)	11.4	5.6	3.0	4.5
CAB (% GDP)	-0.9 (-7.2)	-5.3 (-48.4)	-3.9 (-40.1)	-4.8 (-49.6)
Gold bal. (% GDP)	-0.2 (-2.0)	-2.1 (-19.4)	-2.3 (-23.2)	-2.9 (-30.0)

(1) The values in parentheses are year-end inflation rates for the CPI; USD values for the CAB and gold trade balance, which are expressed in billions.

(2) Forecasts under macro-stability oriented policies.

(3) Forecasts under pro-growth policies.

Source: CBRT, TURKSTAT, Authors' calculations

¹⁶ Eren and Tüzün (2019) produce a measure of cyclically-adjusted current account balance for Türkiye at quarterly frequency for 2003Q1-2019Q1.

¹⁷ See Kara and Sarıkaya (2013), and Erduman and Ekşi (2018) for the literature on trade elasticities. Eren and Tüzün (2019) and Eren and Yavuz (2020) provide more up-to-date elasticities.

Table 3 depicts the realizations and projections of relevant macroeconomic variables. The economy was operating above its trend level of output by mid-year.¹⁸ Domestic-demand driven strong growth, coupled with the real appreciation trend until June, have exacerbated external imbalances in the first half of the year, bringing year-to-date CAD to USD 36.8 billion as of June. For the rest of the year, we base our projections on two different scenarios, conditional on the macro policy approach.

To this end, we evaluate the implications of two hypothetical policy preferences: (i) a macro stability-oriented policy approach with strong focus on disinflation and macro-financial excesses, (ii) a pro-growth policy approach with less emphasis on inflation and external finance. Short-term projections associated with these two scenarios are presented in the last two columns of Table 3. Under the first scenario (blue-shaded area, left column), current account is projected to post a small deficit in the second half of 2023, through a marked slowdown in economic activity. This also keeps inflation broadly in check with the authorities' forecasts.¹⁹ The latter scenario (blue-shaded area, right column) illustrates the macro outcomes of a pro-growth, expansionary policy stance, with higher inflation and persistent external imbalances. Note that, gold trade deficit is projected wider in the second scenario, due to unmoored inflation expectations and continued dollarization.

In the next section, we present the results for underlying current account balance and discuss the implications of these two scenarios with regards to the policy trade-offs. Potential costs of de-stabilization as well as the benefits of rebalancing will be covered through the lens of an external adjustment narrative.

4.2. Underlying current account balance

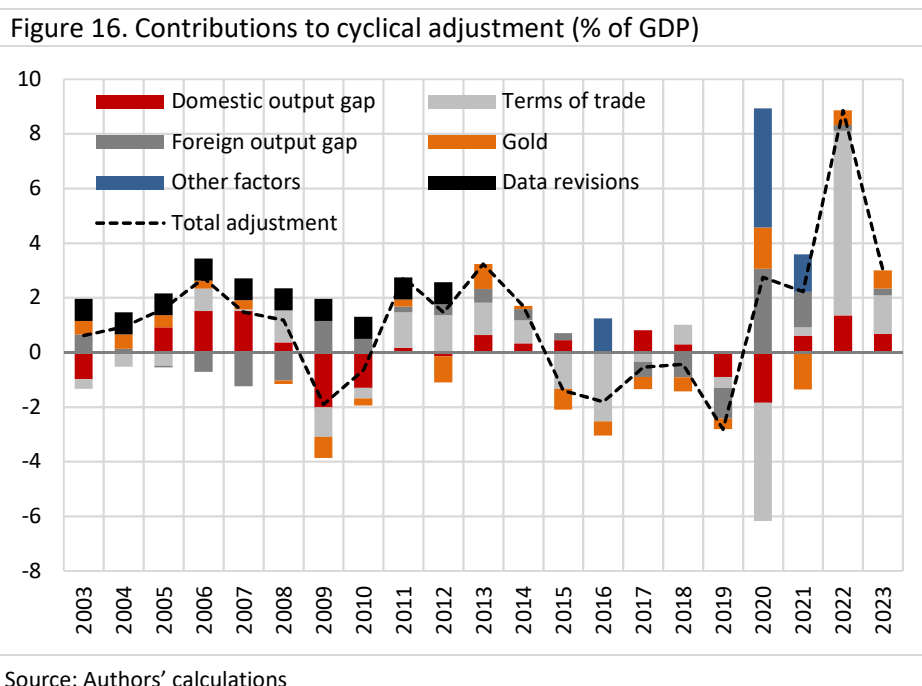
The breakdown of the cyclical adjustment to CAB are presented in Figure 16. For the sake of simplicity and in order to give a broad sense of inference, initially we present our findings for the first scenario defined above, i.e. macro stability-oriented policy approach.²⁰ The bars indicate the extent of the cyclical adjustment to CAB as percent of GDP for each component, and the dashed-black line shows the total adjustment. Positive numbers for the dashed-black line can be interpreted as a better underlying trend compared to the actual CAB. For instance, the deterioration in CAB associated with the surge in energy prices due to the war in 2022 is deemed transitory to a great extent, and thus the adjustment for terms of trade takes a large positive value (light-gray bar).

Historically, deep negative adjustments tend to be associated with economic stagnation or recession periods, as in 2009 and 2019. A large fraction of the improvement in external balances during these years can be attributed to below-trend domestic output and the consequent import compression. Similarly, the sharp drop in oil prices in 2015 and 2016 seem to be the major driver of the relatively benign picture of the actual CAB in these years (light-gray bars). One may also note the opposite signs of the business cycle adjustments regarding global and domestic economic slacks in general (dark-gray and red bars respectively). This reflects the fact that synchronized booms improve the external balance by stimulating exports on one hand, and deteriorates it by boosting imports on the other. For example, during the onset of the pandemic in 2020, net adjustment for the restrained output levels in domestic and foreign economies was positive, as the contraction in external demand accounted for a larger part of the CA deficit. More recently, external demand remains slightly restrictive for export growth, while the overheating in domestic economy continues to underpin import demand.

¹⁸ Output gap estimates provided in the CBRT's Inflation Report 2023-III remain at positive territory in the second quarter, implying an overheating in the economy. See CBRT (2023).

¹⁹ The mid-point of the inflation forecast band for end-2023 is reported as 58% in the CBRT's Inflation Report 2023-III.

²⁰ The contributions to cyclical adjustment for each of the two scenarios are provided in Appendix 2.



4.2.1. A closer look at the post-pandemic dynamics

At first glance, it is striking to observe that the main drivers of the CAB have been largely on the upside since the pandemic, meaning that the underlying deficit is smaller than the actual deficit by a large margin. Various factors have contributed to this divergence:

First, the contribution of gold balance to the movements in CAB has increased with the heightened volatility in gold imports in recent years. The extraordinary exogenous events such as the pandemic and the war have partly contributed to the fluctuations in gold demand. However, there has been also a strong domestic component. Excessively low policy rates and suppressed deposit rates in recent years, coupled with the rapid erosion of purchasing power, have led domestic residents to purchase substantial amounts of gold and other physical assets (cars, durables, etc.) to protect themselves against inflation. This has boosted the import demand beyond the levels implied by the domestic income growth. Moreover, financial repression policies implemented to offset the ultra-low real interest rates in the last couple of years, have led to a widely increased perception of uncertainty among economic agents. Hence, returning to a more conventional and predictable monetary policy setup has the potential to drive a substantial adjustment in the CAB, especially through gold imports. Gold demand might somewhat normalize, should the macroeconomic policies revert to an anti-inflationary stance. On the contrary, if the policies fail to prevent high inflation from becoming more entrenched, dollarization may strengthen further and the demand for gold may prove more ingrained in the structural component of external deficits.

Second, given the large share of energy in total imports, terms of trade have been a major driver of the fluctuations in CAB in recent years. The collapse of energy prices during the pandemic and its unprecedented surge during the war in Ukraine has considerably blurred the underlying picture of the CAB. The contribution of energy trade deficit to the CA deficit in 2022 was as high as 8.9 pps. While this adverse terms of trade shock has proved highly persistent, intuitively one may consider the exceptionally high impact of energy to the CA deficit in 2022 as a temporary phenomenon, given that the average contribution of the energy item was 4.3 pps during 2003-21. Taking into consideration the prices of all imported goods and exports, we find that the excess contribution of

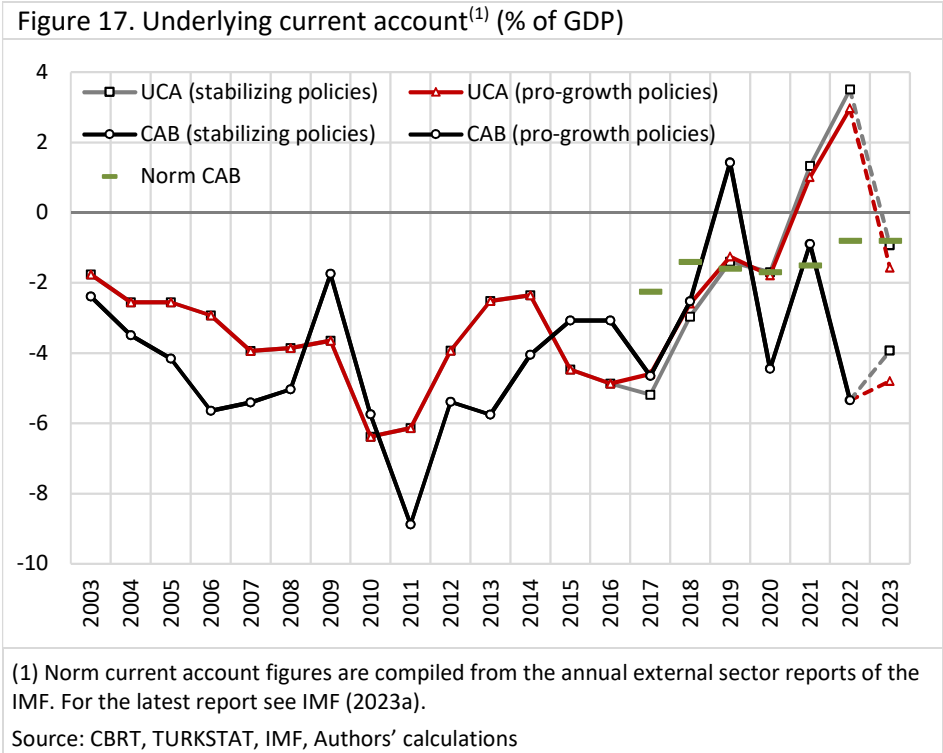
the overall terms of trade in 2022 has reached to a whopping 6.8% of GDP. Although energy prices have broadly normalized by mid-2023, the lagged impact has continued to weigh on the CAB.

Third, domestic output gap was significantly positive in recent years on the back of credit-driven policies, adding to the cyclical component of the external deficit. Fiscal stimulus before the presidential elections has also contributed to the widening of the deficit during the first half of 2023. We calculate that, in the last two years, CAB would have been at least 1 pp lower on average, if domestic output had remained on its trend level.²¹ Hence, for the upcoming years, there seems to be a large room for improvement in the external balance under stabilizing policies that would dampen the excessive domestic demand.

Overall, our decomposition makes clear that the terms of trade and the overheating in domestic economy have been the main drivers of the deteriorating CAB during 2022-2023. Note that, the total contribution of domestic economic slack and gold trade is estimated higher than that of terms of trade in 2023, suggesting that the deterioration in the CAB can be largely attributed to inflation uncertainty, financial repression, and pro-growth policies fueled by easy domestic fiscal and financial conditions.

4.2.2. Policy preferences and external adjustment

After stripping out the cyclical and temporary factors from the actual CAB, we come up with an indicator of underlying trend of the external balance, namely UCA (Figure 17). The red and gray lines correspond to the outcomes of the two distinct scenarios described above. Before going deep into the policy discussion, we can start with some striking initial observations.



First of all, by controlling for the contribution of large idiosyncratic shocks, UCA provides a clearer picture for the external deficit. The results show that the underlying balance has improved almost steadily during the past decade, especially after 2017 when capital inflows have slowed and the real

²¹ See Appendix 2 for the individual contribution of domestic output gap to cyclical adjustment.

depreciation of domestic currency has accelerated. The sustained real depreciation trend, which has gained pace during the last five years, is associated with a marked improvement in the underlying trend. However, the progress reversed in 2023, mainly due to the acceleration of import demand in the first half of the year, driven by a sharp real appreciation and accommodative monetary and fiscal policies.

Second, regardless of the immediate outcomes of the policy approach that will be pursued in the second half of 2023, we assess that the post-pandemic gains in the external balance have been more than offset by the pre-election policy choices. The underlying trend of the current account is estimated to have returned to negative territory this year (Figure 17). Our analysis suggests that the gains from the substantial adjustment during 2021-2022 could be restored to some extent under tighter monetary and financial conditions and a prudent macro policy setting. On the other hand, the continuance of the deep negative real rates and financial repression policies would be de-stabilizing, and the pressure on international reserves would pile up under a belated policy response. Apparently, this picture calls for a policy reversal that would steer the economy to a more balanced path.

Looking forward, the evolution of risks associated with the high external deficit and financing need will hinge on the policy preferences. Given the low level of international reserves, adopting a macro financial stability-oriented policy mix would drive the economy toward a healthier route, in comparison to the counterfactual case under expansionary policies. Among the two distinct policy preferences summarized in Table 3, “stabilizing policies” would deliver positive outcomes even in the very short-run. Using the forecasts depicting the potential outcomes of the two policy approaches, we estimate the UCA for 2023 by significantly lower under a macro stability-oriented policy design. Note that, this policy-induced external adjustment in the rest of the year would keep the UCA in track with the *norm* CA deficit estimate of the IMF (2023).²² Indeed, such an adjustment is not costless, and may not be facilitated solely through depreciating the lira. A sufficiently restrictive policy stance in the second half, consistent with 3% growth for the whole year, would largely wipe out the excess domestic demand, yet secure a less risky route for the economy from a longer-term perspective.²³

5. Conclusion and final remarks

This paper attempts to decompose the cyclical drivers of the CAB in Türkiye and assess the relevant macro policy implications. We show that substantial fluctuations in the headline deficit in recent years can be attributed to a combination of unusually large external shocks such as the pandemic and the war, along with a peculiar domestic monetary policy experiment bringing real policy rates to a record-low level in the midst of surging inflation. Correcting for the impact of such factors, we estimate that the underlying CAB has moved from -6.4% in 2010 to a range of -0.9% to -1.6% in 2023, suggesting a substantial improvement in the external balance through time. Nevertheless, we observe a marked deterioration in the first half of 2023 due to the policy mix pursued before the general elections, characterized by a massive credit expansion and a pronounced real appreciation.

²² IMF defines the CA gap as the difference between the underlying and *norm* CABs. When the underlying deficit exceeds (falls short of) the *norm* deficit, the policy prescription suggests depreciation (appreciation) of domestic currency. Obstfeld (2017) provides a stepwise guide for external balance assessments conducted by the IMF staff.

²³ As a robustness check, we investigate the sensitivity of UCA estimates to HP-filtered output gaps (Appendix 1). For both of the 2023 scenarios, UCA deficits are estimated to be wider than the baseline and the IMF staff-assessed *norm* figures. A wider CA gap signals the need for a larger adjustment in the real exchange rate.

These findings imply that, if (i) the recent terms of trade shock fades away, (ii) the authorities switch to a more restrictive macro-financial policy stance by focusing on the disinflation path, and (iii) overvaluation of the domestic currency is avoided; the CAB has the potential to post a significant improvement in the forthcoming period. However, strong domestic demand and weak emphasis on disinflation has somewhat been a persistent policy preference in recent years. Therefore, whether the authorities will deliver the necessary adjustment, especially on the domestic demand front, is yet to be seen. Given the upcoming local election in March 2024, bulk of the needed cyclical adjustment may be shifted to the post-election period. Overall, the extent and the timing of the eventual adjustment in the external accounts will depend on the willingness of the authorities to curb the excess domestic demand, thereby to deliver the needed cyclical adjustment.

The improvement in the UCA during 2021-2022 period should not be taken for granted, as it came at the cost of a sharp increase in inflation. To be fair, one-time large depreciation in the exchange rates initially brought some price competitiveness. Yet, as inflation quickly moved to elevated levels and expectations were de-anchored, the speed and magnitude of the pass-through from exchange rates to domestic prices have increased substantially, offsetting the initial gains.²⁴ Therefore, the impact of any competitiveness gain through exchange rate adjustment is likely to be short-lived beyond this point. In other words, so long as inflation stays at high levels, further external adjustment needs to take place through demand compression rather than exchange rate depreciation, implicitly requiring economic activity to slow down significantly in 2024.

As of the writing of this piece, Türkiye continues to have extremely high inflation, projected by the Central Bank to be 58% at the end of the year, with risks on the upside. The policy makers will eventually have to implement a disinflation program, possibly incorporating a real appreciation of the lira, which may reverse some of the improvement in the CAB. On the other hand, should a credible disinflation program foster capital inflows, the authorities will have room to resist excessive exchange rate appreciation through reserve build up, given the deeply negative FX position of the Central Bank. Moreover, anchoring inflation expectations to a credible disinflation path can be expected to weaken dollarization and gold demand, thereby to mitigate the adverse effects of real appreciation on external accounts. Overall, striking a good balance between bringing down inflation and keeping external balances in check should entail a coordinated policy mix of monetary, fiscal, and macroprudential policies as well as FX reserve management, with special emphasis on the complementary tools designed for safeguarding financial stability.

Last but not least, it is worth to mention that this note is about accounting for the cyclical component of the external deficit rather than evaluating its structural drivers. External deficit has been an issue for Türkiye for at least 60 years. From a long-term perspective, CA deficits are largely driven by structural factors such as low productivity and saving rates. In that sense, it is important to be aware of the boundaries of macroeconomic policies: Monetary/exchange rate policy cannot substitute for sound structural adjustments. Therefore, possible attempts to stabilize the CAB in the long-term should aim at enhancing saving rates and bolstering productivity through efficient distribution of resources, rather than just relying on real exchange rate depreciation. This is essential for improving the trade-off between inflation and external balance, and for ensuring the sustainability of any macroeconomic stabilization program.

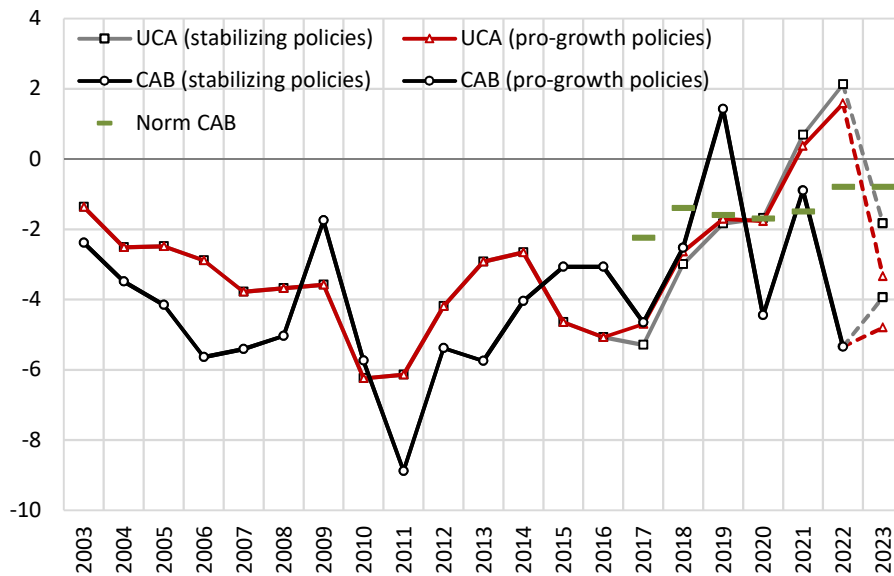
²⁴ See Kara and Sarıkaya (2021) for some evidence on the shifting exchange rate pass-through behavior with the transition from single-digit to double-digit inflation in recent years.

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Appendix 1. Underlying current account based on HP-filtered output gaps

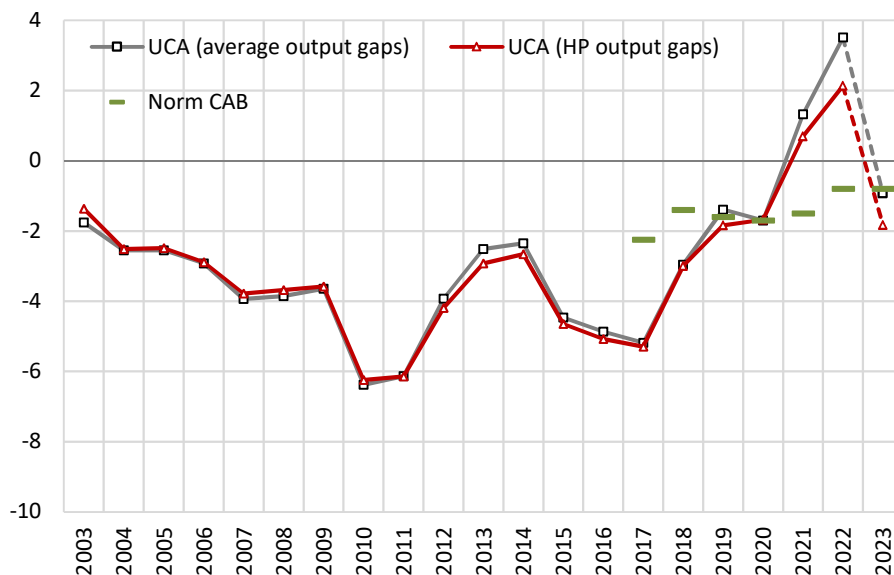
Figure A.1. Underlying current account with HP gaps⁽¹⁾ (% of GDP)



(1) Norm current account figures are compiled from the annual external sector reports of the IMF. For the latest report see IMF (2023a).

Source: CBRT, TURKSTAT, IMF, Authors' calculations

Figure A.2. Comparison of average gaps with HP gaps^{(1),(2)} (% of GDP)



(1) Norm current account figures are compiled from the annual external sector reports of the IMF. For the latest report see IMF (2023a).

(2) Underlying current account estimates under the scenario of stabilizing policies in 2023.

Source: CBRT, TURKSTAT, IMF, Authors' calculations

Appendix 2. Contributions to cyclical adjustment (% of GDP)

Scenario 1	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Domestic gap	-1.0	0.0	0.9	1.5	1.5	0.4	-2.0	-1.3	0.2	-0.1	0.6	0.3	0.4	0.0	0.8	0.3	-0.9	-1.8	0.6	1.4	0.7
Import price	-1.9	0.4	-0.2	0.4	1.3	4.9	-2.9	-1.6	2.6	2.6	2.7	2.5	-2.6	-4.3	-1.0	1.3	-2.1	-7.1	0.6	10.6	4.0
External gap	0.7	0.1	-0.1	-0.7	-1.2	-1.0	1.2	0.5	0.2	0.4	0.5	0.4	0.2	0.0	-0.5	-0.9	-1.1	3.1	1.3	0.2	0.3
Export price	1.6	-0.9	-0.3	0.4	-1.2	-3.7	1.8	1.2	-1.3	-1.2	-1.6	-1.7	1.3	1.9	0.7	-0.6	1.7	2.8	-0.3	-3.8	-2.6
Other factors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.2	0.0	0.0	0.0	4.4	1.4	0.0	0.0
Gold	0.5	0.5	0.4	0.3	0.3	-0.1	-0.8	-0.2	0.3	-1.0	0.9	0.1	-0.8	-0.5	-0.4	-0.5	-0.4	1.5	-1.4	0.5	0.7
Data revisions	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total adj.	0.6	0.9	1.6	2.7	1.5	1.2	-1.9	-0.6	2.7	1.5	3.2	1.7	-1.4	-1.8	-0.5	-0.4	-2.8	2.7	2.2	8.9	3.0
Scenario 2	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Domestic gap	-1.0	0.0	0.9	1.5	1.5	0.4	-2.0	-1.3	0.2	-0.1	0.6	0.3	0.4	0.0	0.8	0.3	-0.9	-1.8	0.6	1.4	1.0
Import price	-1.9	0.4	-0.2	0.4	1.3	4.9	-2.9	-1.6	2.6	2.6	2.7	2.5	-2.6	-4.3	-1.0	1.3	-2.1	-7.1	0.6	10.6	4.0
External gap	0.7	0.1	-0.1	-0.7	-1.2	-1.0	1.2	0.5	0.2	0.4	0.5	0.4	0.2	0.0	-0.5	-0.9	-1.1	3.1	1.3	0.2	0.2
Export price	1.6	-0.9	-0.3	0.4	-1.2	-3.7	1.8	1.2	-1.3	-1.2	-1.6	-1.7	1.3	1.9	0.7	-0.6	1.7	2.8	-0.3	-3.8	-2.5
Other factors	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.2	0.0	0.0	0.0	4.4	1.4	0.0	0.0
Gold	0.5	0.5	0.4	0.3	0.3	-0.1	-0.8	-0.2	0.3	-1.0	0.9	0.1	-0.8	-0.5	0.1	-0.2	-0.3	1.4	-1.7	0.0	0.5
Data revisions	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total adj.	0.6	0.9	1.6	2.7	1.5	1.2	-1.9	-0.6	2.7	1.5	3.2	1.7	-1.4	-1.8	0.1	-0.1	-2.7	2.7	1.9	8.3	3.2

Appendix 3. Current account balance and selected items

Billion \$	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Current account balance	-7.6	-14.2	-21.0	-31.2	-36.9	-39.4	-11.4	-44.6	-74.4	-47.3	-55.1	-38.0	-26.6	-26.7	-40.0	-20.2	10.8	-31.9	-7.2	-48.4
Balance on goods & serv.	-3.0	-9.7	-17.1	-27.0	-32.7	-34.0	-6.0	-39.6	-68.9	-42.1	-47.8	-31.3	-18.3	-19.0	-31.8	-9.8	21.8	-23.5	2.5	-39.5
Balance on trade	-13.4	-22.4	-32.9	-40.9	-46.8	-52.9	-24.8	-56.3	-89.2	-65.4	-81.9	-66.6	-49.0	-39.9	-58.6	-40.7	-16.8	-37.9	-29.3	-89.5
Balance on services	10.4	12.7	15.9	13.9	14.1	18.9	18.7	16.7	20.3	23.2	34.1	35.2	30.7	20.9	26.8	30.9	38.6	14.4	31.8	50.1
Balance on primary inc.	-5.6	-5.6	-5.4	-6.0	-6.3	-7.6	-7.7	-6.5	-7.2	-6.6	-8.6	-8.2	-9.7	-9.2	-10.7	-11.1	-11.8	-8.6	-10.7	-8.6
Balance on secondary inc.	1.0	1.1	1.5	1.8	2.1	2.2	2.3	1.5	1.7	1.5	1.3	1.5	1.4	1.5	2.5	0.8	0.9	0.2	0.9	-0.4
Gross domestic product	316.6	407.0	504.8	552.4	683.0	782.9	651.5	777.5	837.9	877.7	958.1	939.9	867.1	869.2	859.1	797.2	759.3	717.1	807.1	905.5
% of GDP	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Current account balance	-2.4	-3.5	-4.2	-5.6	-5.4	-5.0	-1.7	-5.7	-8.9	-5.4	-5.7	-4.0	-3.1	-3.1	-4.7	-2.5	1.4	-4.4	-0.9	-5.3
Gold trade balance	-0.8	-0.8	-0.7	-0.6	-0.6	-0.2	0.5	-0.1	-0.6	0.7	-1.2	-0.4	0.5	0.2	-1.2	-1.1	-1.2	-3.1	-0.2	-2.1
Energy trade balance	-3.3	-3.2	-3.7	-4.6	-4.2	-5.2	-4.0	-4.4	-5.7	-6.0	-5.0	-5.2	-3.9	-2.8	-3.8	-4.7	-4.4	-3.4	-5.2	-8.9
Current account bal. (x-gold)	-1.6	-2.7	-3.4	-5.0	-4.8	-4.9	-2.2	-5.7	-8.3	-6.0	-4.5	-3.6	-3.5	-3.3	-3.5	-1.4	2.6	-1.3	-0.6	-3.2
Current account bal. (x-gold&enr)	1.8	0.5	0.3	-0.5	-0.6	0.3	1.8	-1.3	-2.6	-0.1	0.5	1.5	0.3	-0.5	0.3	3.3	7.0	2.1	4.6	5.6