Box 1.1

Effects of the Pandemic on the Turkish Economy: Transmission Channels and Macro Policy Mix

The global growth outlook weakened due to preventive measures against the spread of the coronavirus, while uncertainties regarding the pandemic led to a sharp rise in risk perceptions and financial market volatilities. Health policies to slow the pace of the virus' spread with the ultimate aim of protecting public health are of critical importance. Meanwhile, the role of economic policies is to minimize the economic and financial impact of the pandemic and the related containment measures on households, firms and the financial sector and to ensure the continuous flow of money between them (Gourinchas, 2020).

Due to the pandemic, unlike previous global crises, both the real sector (households and firms) and the financial sector are hit at the same time by multiple adverse shocks in almost all countries, which manifests as a substantial weakening in the global economic outlook as a result of the strong interactions across different sectors (Box 2.1). As the global trade volume declines, increased risk perceptions lead to a sell-off in relatively risky financial assets and a tightening in global financial conditions. Accordingly, large scale monetary, financial and fiscal measures are being implemented across the globe against the effects of the economic and financial impact of the pandemic (Box 2.2). Besides global developments, measures against the spread of the virus in each particular country such as self-isolation, quarantines and travel restrictions have a negative impact on income flows between households, firms and the financial sector. In order to minimize these negative effects, a comprehensive set of monetary, financial and fiscal measures have also been implemented in Turkey (Box 5.1 and Box 6.1).

This box examines the channels through which the pandemic affects the Turkish economy and discusses which channels are targeted by the macro policy mix. For this purpose, a circular diagram showing the trade and financial linkages between the domestic economy and the rest of the world as well as the flows of goods/services and income across different sectors in the domestic economy is used (Diagram 1). In the diagram, disruptions in the flows across different economic units are depicted by a red cross (X) and different effects are marked.[1]

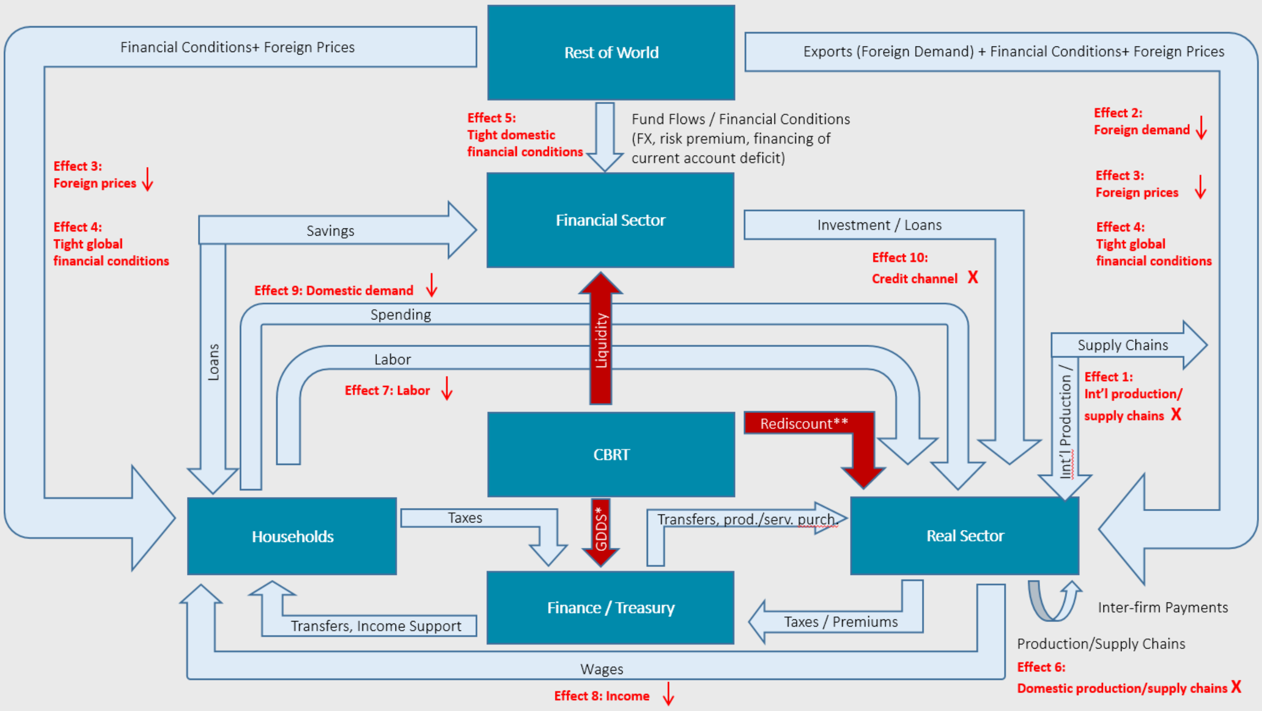
Global Economic Outlook and External Trade

The epidemic emerged in China in December 2019 and spread to other countries in a short time, affecting the whole world. As the outbreak started in China, the second largest economy in the world with a critical role in the global supply chain, its implications for the domestic economy have initially revealed themselves through weakening in global growth outlook and possible disruptions in the supply chain (Chart 1, Effect 1 and Effect 2). However, the outbreak rapidly spread to Turkey's trading partners across its borders such as Iran and Iraq, and to European countries that have an important share in Turkey's exports, forcing many countries, including Turkey, to take measures such as border closure, travel restrictions, quarantine and stay-at-home orders. With the outbreak spreading to all countries, the weakening in the global growth outlook became more evident (Box 2.1). These factors affect the Turkish economy especially through exports, tourism and related sectors (Box 4.1).

[1] Another version of the diagram focusing only on money flows is used in Baldwin (2020).

On the other hand, the downturn in global economic activity limited the demand for commodities, while supply-side effects driven by disagreements among oil exporters regarding the amount of oil production caused crude oil prices to plummet (Chart 1, Effect 3). While this adversely affects the growth outlook for Turkey's oil-exporting trading partners, it has a favorable impact on its current account deficit through a reduced energy import bill and on its inflation through energy prices (Box 3.1 and Box 4.1).

Chart 1: Flow Chart Showing the Effects of the Pandemic on the Domestic Economy



* Includes the direct purchase of Government Domestic Debt Securities (GDDS) by the CBRT and the facility to sell government securities purchased from the Unemployment Insurance Fund to the CBRT for a temporary period.
** Rediscount credits provided by the CBRT to the real sector are extended through financial institutions.

Global Financial Conditions

The weakening of the global growth outlook and the uncertainties regarding the course of the pandemic, especially in advanced economies, the duration of its effects and the measures to be taken against the pandemic in these countries caused the global risk appetite to decrease significantly. Accordingly, almost all financial assets were sold, and global financial conditions tightened significantly due to falling asset prices, increasing liquidity needs and ongoing uncertainties (Chart 1, Effect 4). In addition, with the decreased global risk appetite and the flight to safe havens, the demand for emerging market financial assets declined, fueling capital outflows from these countries. In this process, local currencies depreciated, the exchange rate volatility increased and country risk premia rose in emerging economies as well as in Turkey. In addition to the increase in the country risk premium and the exchange rate volatility, the heightened volatility in financial asset prices may tighten domestic financial conditions through external financing and balance sheet effects (Chart 1, Effect 5). Global and domestic monetary measures to expand and facilitate access to liquidity and credit are critical to contain these impacts and prevent a negative feedback loop between real and financial sectors.

Domestic Economic Activity and Sectoral Income Flows

Similar to other countries dealing with the pandemic, preventive measures to slow down the spread such as social isolation, travel restrictions and lockdowns have been put in practice in Turkey. These preventive measures cause significant economic slowdown, primarily in the services sector and in small enterprises (Chart 1, Effect 6). While targeting public health as a natural priority, these preventive measures would mean withdrawal from production and consumption activities for a certain part of the population in the short run. Furthermore, people who get infected, have high risk of infection or who are unable to work from home leave the labor force, while increased responsibilities to care for elders, patients and children lead to a significant losses in hours worked and productivity (Chart 1, Effect 7). These factors disturb production and supply chains, and reduce domestic demand (Chart 1, Effect 9) due to income losses (Chart 1, Effect 8). Consumption and investment behavior are also adversely affected due to higher uncertainty and lower confidence. Moreover, the slowdown in sales and the increase in financial volatility pose risks for firms' balance sheets and cash flows. In order to contain the effects of these risks on the borrowing costs of firms and on the lending appetite of banks, it is extremely important to provide liquidity to the financial sector and to take measures to support the income/cash flows to firms and households. These supportive policies aim to prevent a deterioration of balance sheets and minimize problems related to credit repayments. Accordingly, a possible weakening of bank balance sheets due to delayed loan repayments and, a possible adverse feedback loop between the real sector and the financial sector balance sheets (Chart 1, Effect 10), which might further tighten financial conditions, can be averted. Within this framework, a comprehensive macro policy combination has been put into effect to enable the healthy functioning of the financial market and the credit channel, preserve employment and household income, and support cash flow to firms. The monetary, financial and fiscal measures that have been taken in order to deal with the aforementioned negative effects are explained in detail in Box 5.1 and Box 6.1.

It is surely beyond doubt that the greatest priority is to protect public health and to prevent the spread of the virus. Bearing this in mind, it is essential to sustain the coordination between monetary and fiscal policies in order to minimize pandemic-related economic and financial risks. Since the epidemic has multifaceted effects on the economy, it is considered to be of critical importance that macro-scale monetary and fiscal policies be complemented with policy measures that target the most-affected economic units based on sectoral interactions. Meanwhile, ensuring that policy measures are designed in a targeted and temporary fashion would support policy effectiveness.

References

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Gourinchas, P.O. (2020), "Flattening the pandemic and recession curves", in *Mitigating the COVID Economic Crisis edited by Richard Baldwin and Beatrice Weder di Mauro,* CEPR Press.