TURKEY: In the shade of the government's growth targets

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The Turkish economy performed reasonably well in the first half of 2014 despite the turmoil in the wake of the FED announcing a tapering of its monetary policy. Given both the continuing acceleration in internal demand sparked by the 'dovish' policy stance adopted by the Central Bank to the political pressure and expansionary fiscal policy caused by the elections and the rebalancing of external demand following the depreciation of the Turkish lira, the economy is expected to grow by 3.7% in 2014. Further credit growth will be difficult to forge. Given that constraint and the tensions on Turkey's southern borders, we expect economic growth to decelerate to 2.7% and 2.8% in 2015 and 2016, respectively.

Although the Turkish Central Bank (CBRT) has raised the policy rates in order to stop the decrease in the value of the Turkish lira against the US dollar at the beginning of the year, the Turkish economy has benefited from an impressive adjustment in the first half of 2014 and the growth rate of the economy stood at 3.3% in this period. Three main forces drove the growth in the economy: the dovish policy stance of the CBRT, the expansionary fiscal policy by reason of elections and the current account rebalancing.

The monetary policy settings have loosened since May 2014 by cutting the one-week repo rate by a cumulative 175 bp in order to decrease the tensions with the government. Negative policy rates in real terms have lowered the borrowing costs since May and prevented the growth of private consumption expenditures from turning negative; on the contrary, they increased by 1.8% in the first half of the year. As it is difficult to sustain a negative real interest rate policy for a long time because of the dependence on external financing, there is a possibility of rising demand for foreign exchange in the course of the next couple of months which may again trigger an increase in the policy rates via the CBRT's reaction function. But before the end of the year of 2014, we do not forecast an increase in the policy rates which will preserve a positive but smaller growth of private consumption expenditures. On the other hand, in 2015, we expect the CBRT to loosen inflation targets in order to keep the policy rate at a slightly higher level which may decrease the growth rate of credits and private consumption expenditures.

With the local elections and the presidential elections held on 30 March and 10 August 2014, respectively, public spending rose by 5.6% in the first half of the year on average, with both employees' compensation and public spending rising, and hence it became one of the driving forces behind economic growth. Since the government has been eager to sustain economic growth ahead of the parliamentary elections which will be held in the summer of 2015, it is likely that the government consumption expenditures will continue to rise until next summer. A higher interest bill and increases in military expenses due to the tensions at the southern borders of Turkey will also put some pressures on the budget in 2015. We expect a temporary rise in the budget deficit in 2015 by 1.5 percentage points to 3% of GDP but do not see parallels to earlier episodes of excessive budget deficits.

However, the main contribution to GDP growth came from the net export channel in the first two quarters of 2014 which shows that the growth drivers are shifting to the external sector. Turkey's export activity relies on a wide range of enterprises in the interior of the country which produce more traditional, labour-intensive types of products and are catering to regional, non-EU markets. These developments make the Turkish exports more sensitive to exchange rate developments and hence the 8.1% growth in exports which contributed to the economic recovery owed much to the devaluation process earlier this year. But it should be noted that the export volume has slowed over recent months although it started tremendously at the beginning of the year. The ongoing events in Iraq and Syria have greatly affected Turkish exporters. For example, in July 2014, exports to Iraq fell by 45% year on year, subtracting 3.7 percentage points from headline export growth. But the possibility of Russia to boycott imports from Europe as part of the ongoing tensions between Russia and the European Union could mitigate indirect risks on total exports of Turkey via trade diversion effects.

On the other side of the trade balance, we could see a sharp reduction in import growth by 2.1%. The contraction in imports is nourished from two important factors: the relatively high level of the exchange rate plus a legal arrangement imposed by the Banking Regulation and Supervision Agency (BRSA) at the beginning of the year whereby the agency restricted payments with credit cards in instalments. Although the current account deficit narrowed by 38% in the first seven months of the year because of the strong devaluation of the Turkish lira, we expect the current account deficit to drop anchor at around 6% of GDP in 2014. It is quite likely to be of similar size also in 2015 and 2016 because of the high dependency on energy inputs and imported intermediaries.

Unlike in 2013 when gross fixed capital formation was growing at an average rate of 4.2%, it fell by 1.9% in the first half of 2014. Although construction activity financed by both the private and the public sector registered positive growth, the reduction in public and private investment in machinery and equipment dominated the development of gross fixed capital formation in the first two quarters. However, massive government-led infrastructure projects such as a third airport in Istanbul, the Channel Istanbul and a third bridge across the Bosporus will be important drivers of Turkey's construction activities ahead of the parliamentary elections and stimulate future investments of the private sector. But the general economic outlook and changes in the borrowing costs will also have major impacts on future decisions of the private sector.

Meanwhile, also political developments play a crucial role for Turkey's medium- to long-term growth outlook. The clash between Erdogan and the Gulen movement which clearly appeared after the corruption scandal (which saw the sons of three cabinet ministers detained as part of a probe investigation in mid-December 2013) increased the political tensions in the country. For instance, Erdogan is intensifying his attacks against Bank Asya whose shareholders have close relations with the Gulen movement. This has the potential to also deteriorate the financial situation in Turkey.

In a nutshell, we expect internal demand to continue to accelerate through the end of 2014 thanks to the dovish policy stance of the Central Bank against the political pressures and rebalancing in external demand in the wake of the depreciation of the lira, which is the main reason why we have increased our forecast for Turkey's GDP growth in 2014 from 2.2% to 3.7%. On the other hand, we expect a rise in demand for foreign exchange through the end of 2014 because of the negative real interest rate policy that has been followed since May. As it is difficult to sustain such a policy for a longer time because of the dependence on external financing, we expect a slight increase in policy rates at the beginning of 2015 and, immediately thereafter, the CBRT to loosen inflation targets in order to keep the policy rate at a slightly higher level. While this policy will tighten the growth rate of credits and private consumption expenditures, we still expect internal demand to be strong because of the expansionary fiscal policy by reason of elections and net exports to increase as a result of an ongoing devaluation of the exchange rate through 2015. Therefore, we project GDP growth of 2.7% in 2015 and a minimal acceleration of growth in 2016 (2.8%).

Table 1 / Turkey: Selected Economic Indicators

	2010	2011	2012	2013 1)	2013 January-June	2014 January-June	2014 Forecast	2015 Forecast	2016 Forecast
Population, th pers., average	73,142	74,224	75,176	76,148	.	.	77,700	78,700	79,600
							.	.	.
Gross domestic product, TRY bn, nom.	1,099	1,298	1,417	1,565	742	832	1,760	1,940	2,120
annual change in % (real)	9.2	8.8	2.1	4.1	3.9	3.3	3.7	2.7	2.8
GDP/capita (EUR at exchange rate)	7,500	7,500	8,100	8,100	.	.	7,800	7,800	8,000
GDP/capita (EUR at PPP)	12,200	13,300	13,700	14,100	.	.	.	.	.
Consumption of households, TRY bn, nom.	788	924	994	1,109	537	577	.	.	.
annual change in % (real)	6.7	7.7	-0.5	5.1	4.3	1.8	2.4	1.3	1.8
Gross fixed capital form., TRY bn, nom.	208	283	287	318	158	177	.	.	.
annual change in % (real)	30.5	18.0	-2.7	4.2	1.9	-1.9	1.0	1.5	4.0
Gross industrial production									
annual change in % (real)	12.8	10.0	2.4	3.0	2.2	3.9	3.1	2.5	6.0
Gross agricultural production 2)									
annual change in % (real)	2.4	6.1	3.1	3.1	.	.	.	.	.
Construction industry									
annual change in % (real)	18.6	11.4	0.7	7.5	7.2	4.4	2.0	2.0	5.5
Employed persons, LFS, th, average	22,593	24,100	24,820	25,520	25,338	25,768	26,200	26,600	27,100
annual change in %	6.2	6.7	3.0	2.8	4.2	1.7	2.5	1.7	2.0
Unemployed persons, LFS, th, average	3,048	2,616	2,517	2,750	2,705	.	.	.	.
Unemployment rate, LFS, in %, average	11.9	9.8	9.2	9.7	9.7	.	9.2	9.5	9.1
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	8.6	6.5	9.0	7.5	7.1	8.7	8.6	7.4	6.1
Producer prices in industry, % p.a. 3)	6.2	12.3	6.1	5.7	4.0	11.5	8.0	7.1	5.9
General governm. budget, EU-def., % of GDP 4)									
Revenues	37.3	36.6	36.2	37.6	.	.	37.0	36.0	38.0
Expenditures	40.2	37.4	38.6	39.3	.	.	38.5	39.0	39.5
Net lending (+) / net borrowing (-)	-2.9	-0.8	-2.4	-1.7	.	.	-1.5	-3.0	-1.5
Public debt, EU-def., % of GDP	42.4	39.9	36.2	34.6	.	.	36.0	40.0	40.0
Central bank policy rate, % p.a., end of period 5)	6.50	5.75	5.50	4.50	4.50	8.75	8.25	12.00	10.50
Current account, EUR mn	-34,215	-53,891	-37,043	-48,683	-28,234	-17,623	-36,000	-36,000	-39,000
Current account, % of GDP	-6.2	-9.7	-6.0	-7.9	-9.1	-6.3	-6.0	-5.9	-6.2
Exports of goods, BOP, EUR mn	91,292	103,086	127,126	123,036	61,654	63,194	126,000	137,000	148,000
annual change in %	16.1	12.9	23.3	-3.2	1.3	2.5	2.8	9.0	8.0
Imports of goods, BOP, EUR mn	133,962	166,978	178,003	183,236	92,557	84,590	180,000	192,000	206,000
annual change in %	39.3	24.6	6.6	2.9	5.8	-8.6	-2.0	6.6	7.5
Exports of services, BOP, EUR mn	27,776	29,427	34,260	35,674	15,085	15,523	37,000	40,000	43,000
annual change in %	9.1	5.9	16.4	4.1	13.5	2.9	5.0	8.6	8.0
Imports of services, BOP, EUR mn	15,033	15,051	16,280	17,995	8,679	8,739	19,000	21,000	23,000
annual change in %	21.8	0.1	8.2	10.5	17.0	0.7	4.0	8.0	8.0
FDI inflow (liabilities), EUR mn	6,803	11,581	9,708	9,554	4,023	4,935	8,500	10,000	10,000
FDI outflow (assets), EUR mn	1,108	1,710	3,142	2,336	1,085	1,550	2,000	3,000	3,000
Gross reserves of NB excl. gold, EUR mn	60,404	60,531	75,749	80,435	80,709	81,897	.	.	.
Gross external debt, EUR mn	218,415	234,679	255,937	281,444	279,998	280,524	.	.	.
Gross external debt, % of GDP	39.7	42.3	41.8	45.6	42.6	47.3	.	.	.
Average exchange rate TRY/EUR	2.00	2.34	2.31	2.53	2.38	2.97	2.90	3.15	3.35
Purchasing power parity TRY/EUR	1.23	1.31	1.37	1.46	.	.	.	.	.

1) Preliminary. - 2) According to gross value added. - 3) Domestic output prices. - 4) According to ESA'95 excessive deficit procedure. -
5) One-week repo rate.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.