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Turkey:
Policy challenges of a European emerging economy

Thus far in 2013 Turkey has been recovering from the dramatic growth slowdown in 2012. The Central Bank of Turkey (CBRT) had induced that slowdown by shifting perceptibly towards tight monetary policy. Any recovery since then has been associated with a certain loosening of that stance, but the bank is still using tools designed to control credit growth. Apart from the above, the CBRT has had to undertake attempts to discourage too strong an inflow of capital (short-term in nature) by reducing interest rates. Recent political developments, as well as the announcement of possible shifts in the US Fed's policy with respect to quantitative easing, have added an additional element of uncertainty regarding the nature of possible instabilities (e.g. leading to capital outflows rather than inflows) and the country's policy response to the same. Those uncertainties notwithstanding, Turkey is expected to grow at 3.5% in 2013 and 4.5% in 2014.

Turkey is a successful catching-up economy in Europe, with an estimated potential growth path of close to 5% per annum, a relatively robust banking system (in contrast to most of Europe), low levels of public and external debt, and improving indicators on labour markets. By all these accounts, Turkey is managing its policy challenges well. However, in today's international and particularly European climate, there is a high degree of risk of various types of negative spillovers: firstly, from international monetary and financial developments; secondly, from the business cycle dynamic in the European economy (not to speak of a highly volatile neighbourhood in the Middle East).

Some of these challenges affect not only Turkey but also other emerging market economies (EMEs) in Europe and globally. First of all, there is the impact of monetary easing adopted now in all the major advanced economies (US, euro area, UK, Japan): Monetary easing has dramatically increased international liquidity at the global level and relatively successful EMEs worldwide have to deal with strong short-term capital inflows leading to real exchange rate appreciation and thus to external imbalances. Turkey is an important country of destination of such capital inflows in Europe and has for a number of years been dealing with this challenge by means of a variety of monetary policy manoeuvres by the Turkish Central Bank.

The most recent steps in this direction took place on 16 May when the Central Bank of Turkey (CBRT) cut all three of its major policy rates more dramatically than most analysts had expected: the one-week repo rate fell from 5.0% to 4.5%; the overnight lending rate dropped from 7.0% to 6.5%, and the overnight borrowing rate from 4.0% to 3.5%. Alongside the interest rate cuts, the CBRT raised the required foreign exchange reserve requirements on a number of securities and increased the reserve requirements lenders must maintain in order to hold a certain portion of their required reserves in a foreign currency. This is a two-pronged monetary policy aimed at dampening the inflow of foreign capital while still trying to contain domestic credit growth. By lowering interest rates the Bank attempts to discourage foreign portfolio investment inflows and by raising reserve requirements it hopes to contain credit growth.

The latest move follows a succession of interest rate cuts since September 2012 when the upper limit of the overnight interest corridor (the lending rate) still stood at 11.5% (now 6.5%) and the lower bound (the borrowing rate) at 5.0% (now 3.5%). This aggressive policy was designed to counteract the rather dramatic slowdown of the economy in 2012 (GDP growth had fallen to 2.2% in 2012 from 8.8% in 2011). This in turn had been the outcome of an earlier phase of restrictive monetary policy which attempted to stem high and deteriorating current account deficits (-9.7% – in % of GDP – in 2011 which then came down to -5.9% in 2012) and very high private sector credit growth. Monetary policy has thus followed see-saw moves over the past few years, using a range of tools and quite strong doses at times leading to overshooting of targets. The external environment with much global liquidity looking for higher yielding investment opportunities in a limited set of relatively large EMEs does not make the task of monetary authorities in Turkey any easier.

While monetary policy is currently still strongly directed towards stimulating domestic demand, there is also a discussion of a possible shift in the external environment where the recovery of the US economy could lead in due course to a return of higher interest rates resulting in a change of global capital flows. Turkey might not be in a very good position to face such a reversal of capital flows at this stage, as the current account has again deteriorated due to the pick-up of domestic demand (it amounted to -7.9% in the first quarter of 2013) and the maturity structure of its foreign debt has shifted over the years strongly towards short-term borrowing (which requires rolling over): of the USD 208 billion foreign capital which has entered Turkey since end-2009, USD 54 billion has been long-term in nature (FDI, long-term bank and non-bank corporate borrowing) and USD 154 billion has been short-term (portfolio flows, currency and deposits, short-term bank and non-bank corporate borrowing). This compares to an inflow of short-term capital into Turkey over the period 2000 to 2007 of USD 60 billion. Hence if a new scenario materialises with a tendency towards capital outflows from EMEs, the Turkish Central Bank would be forced to move again towards a higher interest rate trajectory. This scenario has gained much more relevance in the light of recent political developments in Turkey of which more below.

In any case, at the moment the policy is directed towards stimulating domestic demand and the cost of this policy is a recurrence of higher current account deficits (driven by both declining export growth and increased imports) which is seen so far as acceptable collateral damage. This was easier to accept over the recent months as commodity price inflation has come down and this is reflected in lower overall inflation rates. It is difficult to evaluate at this stage how the current account situation will develop as it depends very much on the external environment (from the trade balance side on the developments in the main export markets, EU and Middle East, on the prospects for tourism and on the harvest; and from the capital accounts side on the issues raised above with respect to international capital market developments).

The fiscal policy situation reflects the pick-up of domestic demand with revenue growth outstripping expenditure growth: over the Jan-April 2013 period central government's non-interest expenditures amounted to TRY 106.71 billion (these amounted to TRY 89.60 billion in Jan-April 2012) as against revenues of 124.63 billion over that period (106.55 billion in the period Jan-April 2012) which amounted to a primary surplus of TRY 17.92 billion. Given the easing of financing conditions (lower interest rates), interest expenditure amounted to 18.22 billion over the period Jan-April 2013 as against 21.97 billion in the period Jan-April 2012, i.e. a decrease of 17% compared to the same period of the previous year. Turkey is thus further heading towards a declining public debt burden in GDP.

One further news event of 16 May was Moody's raising of Turkey's credit rating to investment grade (Baa3) following a similar move by Fitch in November last year (S&P is still two notches below that). The implication of this is that investment grade by two of the leading rating agencies broadens significantly the investment base to asset managers who are not allowed to invest into sub-investment grade assets. This can further accentuate the potential for capital inflows and thus for an appreciating currency; the likely impact would therefore be to push the CBRT towards interest rate cuts while further tightening reserve requirements (as there is no evidence for a weakening of domestic private sector credit growth). Again, this scenario has to be set against the impact of the current political turbulence and how financial markets will react to it.

The labour market situation is improving along with the general upswing in the economy: the seasonally adjusted unemployment rate stands now at 9.2% (compared to 9.5% at the end of last year) and the labour force participation rate has reached an all-time high of 51.0% (which is still low by European standards and reflects the low – but rising – female participation rate).

wiiw forecasts GDP growth of 3.5% for 2013 and 4.5% for 2014 which is some decimal points lower than the current Consensus forecasts and reflects our more pessimistic view regarding prospects in the main export markets which show up in current trends of export and industrial production developments. On top of this, it is difficult to evaluate the toll which the current turbulent political developments will have on macroeconomic developments in Turkey. On the one hand, they might alleviate the constraint on monetary policy which had to deal with the pressure of short-run capital inflows; on the other hand, a strong destabilisation through capital outflows is not desirable either and could lead to a reversal of interest rate policy with a dampening effect on domestic private (household and investment) spending; this might occur in any case simply because of the uncertainty generated by the new political situation. A further policy reaction could be the loosening of fiscal policy by the Erdogan government to regain some political capital; such loosening would in any case have been expected in the presidential election year 2014 but the current situation might provide further incentive in this direction and might move some of it forward to 2013.

Table TR

Turkey: Selected Economic Indicators

	2009	2010	2011	2012 1)	2012	2013	2013	2014	2015
					1st quarter			Forecast	
Population, th pers., average	72050	73003	73950	74885	.	.	75700	76900	80000
Gross domestic product, TRY bn, nom.	952.6	1098.8	1297.7	1416.8	326.9	357.9	1560	1730	1930
annual change in % (real)	-4.8	9.0	8.8	2.2	3.3	3.0	3.4	4.5	5.0
GDP/capita (EUR at exchange rate)	6100	7500	7500	8200	.	.	8600	9600	10500
GDP/capita (EUR at PPP - wiiw)	10900	12200	13100	13300	.	.	.	.	.
Consumption of households,TRY bn, nom.	680.8	787.8	923.8	992.7	236.3	261.9	.	.	.
annual change in % (real)	-2.3	6.7	7.7	-0.7	-0.4	3.0	3.2	4.5	5.0
annual change in % (real)	-19.0	29.9	18.0	-2.5	0.7	0.2	4.5	8.0	10.0
Gross industrial production									
annual change in % (real)	-9.8	12.8	10.0	2.4	3.8	1.3	4.5	5.5	6.5
Gross agricultural production 2)					.	.	.	.	.
annual change in % (real)	3.6	2.4	5.6	3.3					
Construction industry					.	.	.	.	.
annual change in % (real)	-16.3	18.7	11.4	0.4	1.7	.	5.0	9.0	12.0
Employed persons - LFS, th, avg.	21271	22593	24099	24819	23338	24546	25700	26900	28100
annual change in %	0.4	6.2	6.7	3.0	2.4	5.2	3.5	4.5	4.5
Unemployed persons - LFS, th, average	3053	2696	2324	2202	2406	2541	.	.	.
Unemployment rate - LFS, in %, average	12.6	10.7	8.8	8.2	9.4	9.4	9.2	9.0	8.8
Reg. unemployment rate, in %, average	.	.	.	.			.	.	.
Average gross monthly wages, manuf.ind., TRY	.	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	6.3	8.6	6.5	9.0	10.5	7.4	6.6	6.0	6.0
Producer prices in industry, % p.a. 3)	1.0	6.2	12.3	6.1	9.9	3.9	5.5	5.0	5.5
General governm. budget, EU-def., % of GDP 4)									
Revenues	33.5	36.7	39.5	37.5	.	.	37.0	36.8	37.0
Expenditures	40.4	39.4	41.4	39.8	.	.	39.5	39.4	39.5
Net lending (+) / net borrowing (-)	-6.9	-2.7	-1.9	-2.3	.	.	-2.5	-2.6	-2.5
Public debt, EU-def., % of GDP 4)	46.1	42.4	39.2	36.8	.	.	36.0	35.5	35.2
Central bank policy rate, %, p.a., end of period 5)	9.00	6.50	5.75	5.50	5.75	5.50	5.00	5.50	5.50
Current account, EUR mn	-9551	-34215	-53891	-36400	-12433	-12055	-47000	-55000	-65000
Current account, % of GDP	-2.2	-6.2	-9.7	-5.9	-9.0	-7.9	-7.3	-7.5	-7.7
Exports of goods, BOP, EUR mn	78616	91292	103086	127183	28566	30211	140000	158000	182000
annual change in %	-17.7	16.1	12.9	23.4	17.6	5.8	10.0	12.5	15.0
Imports of goods, BOP, EUR mn	96145	133962	166978	178299	41368	43121	193000	212000	237000
annual change in %	-26.7	39.3	24.6	6.8	5.2	4.2	8.0	10.0	12.0
Exports of services, BOP, EUR mn	24251	27776	29427	34899	4872	6074	39000	44000	49000
annual change in %	1.3	14.5	5.9	18.6	3.4	24.7	12.0	12.0	12.0
Imports of services, BOP, EUR mn	12024	15033	15051	16056	3308	3898	17000	19000	21000
annual change in %	-1.3	25.0	0.1	6.7	-6.8	17.8	6.0	12.0	12.0
FDI inflow, EUR mn	6085	6803	11581	9632	3480	1547	9000	12500	13000
FDI outflow, EUR mn	1110	1108	1710	3152	1744	521	3000	3500	4000
Gross reserves of CB, excl. gold, EUR mn	49088	60411	60538	75749	60010	82507	.	.	.
Gross external debt, EUR mn	186883	218473	235109	255315	236806	.	.	.	.
Gross external debt, % of GDP	42.4	39.7	42.4	41.7	38.7	.	.	.	.
Average exchange rate TRY/EUR	2.1631	1.9965	2.3378	2.3135	2.3551	2.3578	2.40	2.35	2.30
Purchasing power parity EUR/EUR	1.2116	1.2387	1.3409	1.4182	.	.	.	.	.

Note: Gross industrial production and construction output refer to NACE Rev. 2.

1) Preliminary. - 2) Gross value added of agriculture, forestry and fishing. - 3) Domestic output prices. - 4) According to ESA'95 excessive deficit procedure. - 5) From 2010 one-week repo rate, overnight lending rate before.

Source: National statistics (Central Bank, Turkish Statistical Institute - TSI, etc), Eurostat. Forecasts by wiiw.