TURKEY: Shifting from external to internal demand

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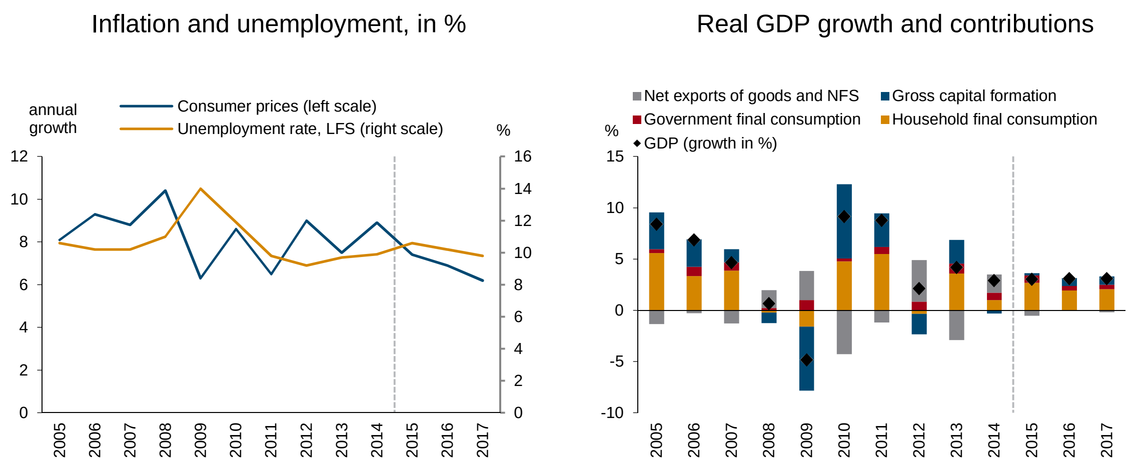
Economic growth has accelerated in the first half of 2015, driven by a hike in final consumption expenditures and an increase in private investment despite the current political uncertainties. However, the parity between dollar and euro and weak global growth led to the contribution of exports to Turkish GDP growth turning slightly negative. Overall, we expect GDP growth of around 3% for 2015 and the years to come.

Figure 61 / Turkey: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

Although the Justice and Development Party (AKP) has won the parliamentary polls, it has lost its parliamentary majority that it had since 2002. None of the four parties in parliament could ensure an absolute majority. After the election, the AKP's coalition talks with the two opposition parties (CHP and MHP) yielded no results (the pro-Kurdish HDP had ruled out the possibility of a coalition with the AKP even before the elections). The opposition parties accused the AKP and President Recep Tayyip Erdogan of deliberately stalling coalition negotiations by letting 45 days pass, by which the time limit allowed to form a government after formal issuance of a mandate expires. Three months after the election of 7 June 2015, a new election has been called by President Erdogan for 1 November 2015. These developments have increased uncertainties for the Turkish economy.

Despite these uncertainties, real GDP growth has been still following its trend, which has been around 3-4% since 2011, with a growth rate of 3.1% in the first half of 2015. In this period, growth was mainly driven by consumption spending, which grew by 3.8%. Sales of durable goods, especially automobiles, underpinned the growth of household consumption. A rise in hourly wages in real terms was the main driver of private domestic demand at the beginning of the year. On the other hand, public purchases of goods and services (especially due to a rise in highway construction expenditures and capital transfers to special provincial administrations ahead of the parliamentary elections) and compensation of employees registered an increase by about 20% and 10%, respectively, and caused government consumption spending to rise faster than expected in the medium-term programme of the government. Therefore, we forecast that final demand (both private and public) will continue to expand at a moderate pace for the rest of the year.

On the central government budget side, we see a surplus in the first half of 2015 compared to the same period of the previous year. The central government expenditures increased by some 11% while the target was 5.5% for the same period in the government's medium-term programme. Both interest expenditures and primary expenditures rose by about 12% and 10%, respectively. Purchases of goods and services and compensation of employees have rapidly accelerated among primary expenditures.

The central government revenues soared at a rate well above the historical average, by almost 16% in the first two quarters of 2015. The high increase in minimum wages and the hike in sales of automobiles were the main drivers behind the collection of tax revenues in this period. Since primary expenditures are expected to be elevated for the rest of the year, we forecast the general government budget balance to turn out to be negative and the budget deficit as a share of GDP to rise slightly to 1.5% in 2015.

The inflation rate was at 8.2% (end-of-period) while the average inflation rate over the year was 8.9% in 2014. A sharp drop in global oil prices in late 2014 helped inflation rates to decline at the beginning of 2015. But high prices for unprocessed food restricted the decrease in the inflation rate. In the first eight months of 2015, the annual inflation rate declined to 7.1% with the help of a correction in food prices. Even though the inflation forecast of the Central Bank of the Republic of Turkey (CBRT) in its third inflation report is 6.9% for 2015, we forecast higher inflation rates because of the ongoing depreciation of the domestic currency. With global oil prices remaining flat and moderate unprocessed food prices, our projected consumer price inflation decelerates from 7.4% in 2015 to 6.2% in 2017.

After loosening the monetary policy between May and July 2014 by cutting the one-week repo rate by a cumulative 175bp because of political pressures, the CBRT maintained a flat policy rate until the beginning of 2015. Because the pressures continued ahead of the election, the CBRT gradually cut its policy rate to 7.50% in the first two months of 2015. But then, the Governor of the CBRT Erdem Basci gave President Erdogan a presentation on 'restoring confidence to the economy and limiting public debt' in order to soften the political pressures. Since then, the CBRT has kept interest rates unchanged in order to restrict the high volatility in exchange rates, although the inflation outlook has been improving when the 12-month moving average inflation rate decreased from 8.9% in December 2014 to 7.8% in September 2015. As currently there is uncertainty especially regarding the global markets and the volatility in food and energy prices, we assume that the CBRT will keep the policy rate at this level in 2015. Since the domestic currency has already depreciated during the year, we do not expect a higher depreciation that will force the CBRT to raise the policy rates in case of an increase in the policy rate of the Fed. For 2016 and 2017, therefore, we forecast the policy rates to fall moderately, to 7.0% and 6.5%

respectively, as we expect the inflation outlook to improve slightly. In addition, we do not expect any additional political pressures over interest rates to push economic growth.

The Turkish lira has been weakening, especially against the US dollar. On 15 September 2015, the lira reached an all-time low against the dollar, ending the day at 3.06 TRY per USD. As of that day, the Turkish lira had lost 31.5% against the dollar since 1 January 2015. The fragility of the exchange rate arises from several factors. On the global part, the expected interest rate hike by the US Fed is quite important. On the domestic side, the chronically large and ongoing deficit of the current account plays an important role. But more recently, political uncertainties are more likely to influence the depreciation process of the domestic currency. The ceasefire between the Turkish army and the PKK collapsed in July 2015 just after the June elections. Opposition parties accused the AKP to cancel the ceasefire in order to leave the HDP under the threshold in the re-elections and thus to obtain the parliamentary majority. Since the domestic currency has already depreciated during the year, we forecast a further mild depreciation regarding uncertainties over the rest of the year.

The 12-month rolling cumulative current account deficit has been decreasing since the end of 2011 from USD 77 billion to USD 45 billion in July 2015, amounting to more than 6% of GDP. The trade deficit also narrowed by 17% in the first eight months of 2015 as compared to the same period of the previous year. The main drivers behind the decline in the trade deficit are the change in the parity of the US dollar to the euro as well as the economic slowdown in the Asian countries and especially in Russia, the depreciation of the domestic currency and the sharp drop in energy and commodity prices. In the first eight months of 2015, exports declined by 8.7% in US dollars, but rose by 12% in euro terms in comparison with the same period of the previous year (according to the overall export volume index, there is no change in exports in the first seven months of 2015 as compared with the same period a year earlier). We expect imports to continue to fall in dollar terms with the global oil prices remaining flat (due to a supply glut in the oil market following the negotiations with Iran), ongoing slight depreciation of the domestic currency and ongoing tensions on Turkey’s southern borders. Therefore, the current account deficit is anticipated to recover further over the rest of 2015 and decline from 5.6% in 2015 to 5.0% in 2017 as a share of GDP.

The lifting of sanctions on Iran may also have some impacts on the Turkish economy besides the rest of the world. The sanctions restrained the trade between industrialised countries - especially the countries in Europe - and Iran. The share of oil imports from Iran in total oil imports of Turkey was 30% in 2014 while it had been 51% in 2011. It had shifted from Iran mostly to Iraq and Nigeria; but the same is not true for natural gas imports because the share and the volume of gas imports from Iran have not changed significantly due to long-lasting agreements. On the other hand, both the volume and price of imports have been changing, which affects the amount of oil imports of Turkey from Iran. On the export side, we should distinguish the exports to Iran into two parts: exports and exports except gold. Due to the sanctions, Turkey paid oil and gas imports from the country via gold bullion, which is the main reason for the fluctuations in the amount of exports to Iran. In fact, we do not observe any substantial change in the amount of exports except gold to Iran. Thus we forecast that the possible benefits from the lifting of sanctions will not be too large since the trade share of Iran in Turkey’s foreign trade is already high as a neighbouring country. But other possible benefits might be a decrease in oil payments of Turkey because of an additional decrease in oil prices in case of a stronger supply glut in the oil market, an increase in exports because of a prospective economic recovery in Iran and an increase in exports to other Gulf countries via Iran – export markets that Turkey lost because of the war in Syria and Iraq and political frictions with Egypt.

As for gross fixed capital formation, we saw a fall by 1% in 2014 but an increase by 5% in the first half of 2015. Public investment showed strongly negative growth in the first quarter (-10%) but then turned out to be positive in the second quarter with a growth rate of 1% in 2015. Therefore, the hike in private investment dominated the growth performance of gross fixed capital formation in the first half of 2015. In detail, machinery and equipment expenditures became the main driver of investment. Public machinery and equipment expenditures rose by 2% while private machinery and equipment expenditures by 7% in the first two quarters of 2015 compared to the corresponding period of the preceding year. Construction activity of the private sector registered positive growth whereas it contracted in the public sector in the first half of 2015.

In summary, we expect domestic demand to continue to expand modestly throughout the current year thanks to a rise in both public and private consumption expenditures. On the other hand, we have revised our forecast for Turkey's GDP growth downwards, from 3.3% to 3.0% for 2015. For 2016 and 2017, we expect the CBRT to loosen its policy rate in line with the improvements in the inflation outlook. In addition, we project exports to recover owing to the base effect and ongoing depreciation of the domestic currency which may help the GDP growth rate to expand at a moderate pace of 3.1% in the following years.

Table 26 / Turkey: Selected economic indicators

	2011	2012	2013	2014 1)	2014 January-June	2015 January-June	2015 Forecast	2016 Forecast	2017 Forecast
Population, th pers., average	74,224	75,176	76,148	77,182	.	.	78,500	79,400	80,400
Gross domestic product, TRY bn, nom.	1,298	1,417	1,567	1,747	839	926	1,930	2,130	2,330
annual change in % (real)	8.8	2.1	4.2	2.9	3.7	3.1	3.0	3.1	3.1
GDP/capita (EUR at exchange rate)	7,500	8,100	8,100	7,800	.	.	7,300	8,400	8,700
GDP/capita (EUR at PPP)	13,300	13,600	14,000	14,300	.	.	.	.	.
Consumption of households, TRY bn, nom.	924	994	1,110	1,204	578	646	.	.	.
annual change in % (real)	7.7	-0.5	5.1	1.4	1.5	5.1	3.8	2.8	3.0
Gross fixed capital form., TRY bn, nom.	283	287	319	352	178	201	.	.	.
annual change in % (real)	18.0	-2.7	4.4	-1.3	-2.0	5.2	2.8	2.8	2.8
Gross industrial production									
annual change in % (real)	10.1	2.5	3.0	3.6	4.2	2.6	3.8	3.5	3.5
Gross agricultural production 2)									
annual change in % (real)	5.2	5.5	2.8	2.0	.	.	.	.	.
Construction industry									
annual change in % (real)	11.5	0.8	7.7	2.9	5.3	-0.1	.	.	.
Employed persons, LFS, th, average	24,100	24,820	25,520	25,931	25,768	26,324	26,400	26,900	27,400
annual change in %	6.7	3.0	2.8	1.6	1.7	2.2	1.8	2.0	2.0
Unemployed persons, LFS, th, average	2,616	2,517	2,750	2,854	2,682	2,999	3,130	3,060	2,980
Unemployment rate, LFS, in %, average	9.8	9.2	9.7	9.9	9.5	10.3	10.6	10.2	9.8
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	6.5	9.0	7.5	8.9	8.7	7.7	7.4	6.9	6.2
Producer prices in industry, % p.a.	13.0	5.3	5.9	10.9	13.5	4.0	6.5	5.8	5.2
General governm. budget, nat.def., % of GDP									
Revenues	34.6	35.7	37.8	37.3	.	.	39.5	39.5	39.5
Expenditures	35.9	37.7	39.2	38.2	.	.	41.0	41.0	40.5
Net lending (+) / net borrowing (-)	-1.3	-2.0	-1.5	-0.9	.	.	-1.5	-1.5	-1.0
Public debt, nat.def., % of GDP 3)	39.1	36.2	36.1	33.5	.	.	35.0	35.5	36.0
Central bank policy rate, % p.a., end of period 4)	5.75	5.50	4.50	8.25	8.75	7.50	7.50	7.00	6.50
Current account, EUR mn 5)	-53,828	-37,659	-48,752	-35,179	-17,908	-19,980	-35,000	-35,000	-35,000
Current account, % of GDP 5)	-9.7	-6.1	-7.9	-5.9	-6.3	-6.2	-5.6	-5.2	-5.0
Exports of goods, BOP, EUR mn 5)	102,365	126,137	121,819	127,237	62,424	69,641	139,000	153,000	168,000
annual change in %	12.0	23.2	-3.4	4.4	2.2	11.6	9.0	10.0	10.0
Imports of goods, BOP, EUR mn 5)	166,271	177,043	182,049	175,303	83,869	92,068	187,000	200,000	215,000
annual change in %	24.1	6.5	2.8	-3.7	-8.8	9.8	6.5	7.0	7.5
Exports of services, BOP, EUR mn 5)	29,561	34,078	35,506	38,142	15,704	17,940	42,000	46,000	50,000
annual change in %	6.7	15.3	4.2	7.4	2.9	14.2	9.0	8.5	8.5
Imports of services, BOP, EUR mn 5)	15,191	16,472	18,290	19,152	9,077	10,445	21,000	22,000	23,000
annual change in %	1.2	8.4	11.0	4.7	1.4	15.1	8.0	5.0	5.0
FDI liabilities (inflow), EUR mn 5)	11,679	10,303	9,359	9,474	5,109	5,665	11,000	.	.
FDI assets (outflow), EUR mn 5)	1,724	3,167	2,716	5,377	1,675	1,933	3,500	.	.
Gross reserves of NB excl. gold, EUR mn	60,531	75,749	80,435	88,058	81,897	90,050	.	.	.
Gross external debt, EUR mn	234,890	256,970	282,175	331,704	294,602	362,162	361,100	392,700	417,300
Gross external debt, % of GDP	42.3	42.0	45.6	55.2	49.0	58.2	58.0	59.0	60.0
Average exchange rate TRY/EUR	2.34	2.31	2.53	2.91	2.97	2.86	3.10	3.20	3.35
Purchasing power parity TRY/EUR	1.31	1.38	1.47	1.59	.	.	.	.	.

1) Preliminary. - 2) Based on UN-FAO data, 2014 wiiw estimate. - 3) Defined according to EU standards. - 4) One-week repo rate. - 5) BOP 6th Edition.

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