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Turkey:
A sound or overheated and relapse-threatened economy?

Record GDP growth, 8.9% in 2010 and 11% in the first quarter of 2011, heightened the country's attractiveness to international investors. Nonetheless, that rapid growth, coming as it does in tandem with a trade deficit that expanded rapidly and has become alarmingly high, has triggered fears of the bubble bursting all of a sudden. The central bank has not responded by increasing interest rates, but has chosen to impose higher reserve requirements on commercial banks. Signs of growth deceleration have already become visible in the course of the current year; however, the extent to which this can be attributed to monetary policy is still unclear. Fiscal policy may also become more restrictive, with the ruling party having secured a landslide victory in the elections. The forecast hints at the possibility of the boom gradually cooling down.

Rapidly expanding markets and accordingly high and growing profits have supported international investors' perception of Turkey as one of the globe's El Dorado's. Increasingly however, the more cautious ones among them feel alerted by Turkey's high and widening trade and current account deficits. Throughout 2011, the deficit has increased from month to month and surpassed the previous year's levels by far. In May, the publication of new high trade deficit figures triggered a decline in Istanbul's Stock Market Index; the main responsible were sales by foreign investors. This may be interpreted as not much more than a short blinking of a warning signal, whereas a positive evaluation of Turkey's economy continues to prevail. Quite possibly, international rating agencies will publish credit upgrades up to investment grade. If so, strong capital inflows will continue to cover not only rising current account deficits, but also increase currency reserves. In recent years, only a small fraction of this inflow has been foreign direct or portfolio investment. Mostly, it was loans. In recent months, with approval by the Capital Markets Board, several commercial banks have launched large bond issues, which help them to keep their lending business at high gear, in spite of the central bank's efforts to squeeze loan expansion from over 35% (December 2010) down to 25% by the end of this year.

To slow down loan expansion, the central bank has chosen a strategy that is rather unusual but makes a lot of sense. It consists in keeping the policy rate constant at a relatively low level (6.25%), at the same time pushing up the commercial banks' reserve requirements (starting from December 2010 by about ten percentage points in four steps). This policy lowered bank profits and reduced their stock market value. A further increase in reserve requirements has become unlikely. So far, this policy may have prevented loan growth from being even more pronounced rather than slowing it down. It remains to be seen whether deceleration will follow in the second half of the year.

The government expresses support for the policy of loan growth slowdown. However, the first half of 2011 was characterized by a fierce fight for votes in the parliamentary elections scheduled for 12 June, and in such a situation any government would be happy about economic prosperity and refrain from all kinds of austerity measures. Several aspects have created favourable conditions for revenue collection or will do so in the future. The high real and even higher nominal GDP growth boosts the government's revenues. An amnesty offering a three-year period for paying overdue tax, social security premiums and public utility bills received over 5 million responses. After the application deadline (31 May) proceeds of over EUR 25 billion were counted. A new commercial code will oblige all equity companies to subscribe to an electronic trade register, something which will make grey economy activities more difficult. Last but not least, from the very beginning of Recep Erdogan's term in office as prime minister, sales of state property have generated additional room for manoeuvre. In this way, the government was able to finance large investments into infrastructure, thus the promises of future huge investments such as by-passing the Bosporus Straights, new metro lines in larger cities, intercity high-speed railways, and ambitious energy projects (including nuclear power plants) do not sound unrealistic in the ears of a large part of the population.

Turkey's distribution of wealth and income is extremely unequal, and this provokes a need for huge security expenditures, both public and private. Erdogan-led governments did quite well in improving social security and living conditions of citizens with low income; many of the latter regard Erdogan both as an advocate of their needs and as a person energetic enough to push through whatever he wants. As the Brazilian experience shows, support for the poor can have a growth-stimulating impact. In the second half of 2011, fiscal policy may become a bit more restrictive.

By keeping its policy rate low, the central bank did not fuel inflation, which has fluctuated between 6% and 10% for a number of years now. A higher rate could stimulate capital inflow and push the currency towards appreciation – something that would lead to even higher trade deficits because of loss of competitiveness of domestic producers of tradable goods and services. Depending on the strength of capital inflows, the central bank performs daily US dollar purchases (50 billion up to end of May, 40 billion in June).

Some segments of Turkey's manufacturing are quite competitive, such as textiles and clothing, in spite of strong competition from East Asia after the global trade liberalization. Also the producers of transport equipment, household appliances and agricultural products are strong. However, rising incomes have swelled the demand for high-tech products, most of which are not part of the product range of Turkish producers, as a recent report[1] stresses. As in most emerging markets, imports of helicopters, airplanes, cell phones, consumer electronics and IT equipment or medical and other precision instruments are high. This is one of the reasons for the rising trade deficit. Another one are the high and rising quantities and prices of energy, most of which needs to be imported. Up to now, investment into new industrial equipment as well as into the construction of industrial and residential buildings has followed rather traditional patterns, as awareness of energy-saving technologies is low. About three thirds of Turkey's population live now in urban areas including nineteen cities with more than one million habitants. Apartment buildings with standard public utility supply are the rule. In many cases, each flat has its own air conditioning. Mobility is high, with combustion engines as the driving force; pedestrians and even more so bicyclists are the pariahs. The government has done a lot with regard to public investment into environmental protection such as wastewater treatment plants, but industrial production and the lifestyle of most of the 73 million citizens remain characterized by high energy intensity and high pollution.

In past years, an important stimulus of GDP growth was migration of labour force from sectors that generate only low value added, such as agriculture, to those generating higher value added, such as manufacturing. This type of stimulus is now drying out.

Recent research has identified de-industrialization tendencies, or more precisely 'de-manufacturing': Investment priorities are switching from manufacturing to energy.[2] With regard to the problem of trade deficits this is no good news, as manufacturing is the sector with the highest export intensity. Good news, however, is that export activities are no longer confined mainly to the western part of Turkey, i.e. the Marmara and Aegean Sea areas, but have become more widespread and are increasingly found in the very east of the country thanks to an open-border and trade liberalization policy.

1 Report issued by the Istanbul Chamber of Certified Public Accounts.

2 'De-Industrialization: A dangerous trend in Turkish economy?', TEPAV (Economic Policy Research Foundation of Turkey), 2011. The study is based on merger and acquisition applications filed to the Turkish Competition Authority.

Turkey may well continue on a path of high long-term growth, but this will require a switch to a new industrial policy facilitating energy saving and a widening of the product range, as well as securing sufficient supply of skilled labour. Equally important will be sound macroeconomics including exchange rate stability. In the short term, dependence on high capital inflows will keep the economy vulnerable to all kinds of shocks. There are several reasons why we forecast a growth deceleration in the second half of 2011 as well as for 2012 and 2013: After the shock in early 2009, the expansion of production could rely on existing capacities, but in the meantime capacity utilization has returned to standard levels, so that further expansion of production needs the backing by capacity expansion; in recent months there has been a marked deceleration in the seasonally adjusted month-on-month growth of industrial production; fiscal policies will curtail public expenditure growth at least to some degree; the central bank's efforts to slow down loan expansion will have an impact; and the recent decline in Istanbul's real estate sales is likely to have a negative impact on private residential-building and construction-related activities. If we ask whether Turkey's economy is sound or overheated and relapse-threatened, the answer may be that it is basically sound in most respects, not necessarily overheated, but nevertheless relapse-threatened.

Internal inflationary pressure has been low in recent months and years. However, external pressure will keep inflation above 5%, as global energy and food prices will follow a long-term growth trend due to income growth which will face less limitation than the expansion of supply.

Close to one million young people enter the Turkish labour market every year: this is a major growth stimulus, but at the same time it is a challenge for the educational system to keep path with skill requirements. The reliability of labour market data is limited as they report on labour relations, the full reflection of which in official figures is difficult. The unemployment rate is likely to keep fluctuating around 10%.

Table TR

Turkey: Selected Economic Indicators

	2007	2008	2009	2010 1)	2010	2011	2011	2012	2013
					1st quarter			Forecast	
Population, th pers., average 2)	70215	71095	72050	73003	.	.	73200	73900	74600
Gross domestic product, TRY bn, nom.	843.2	950.5	952.6	1105.1	241.6	284.9	1250	1380	1520
annual change in % (real)	4.7	0.4	-4.8	8.9	12.0	11.0	6.0	4.5	4.0
GDP/capita (EUR at exchange rate)	6700	7000	6100	7600	.	.	7800	8900	9700
GDP/capita (EUR at PPP - wiiw)	11300	11700	10700	11800	.	.	12400	13200	14500
Consumption of households,TRY bn, nom.	601.2	663.9	680.8	786.1	182.0	213.5	.	.	.
annual change in % (real)	5.5	-0.3	-2.3	6.6	7.5	12.1	5	4	3
Gross fixed capital form., TRY bn, nom.	180.6	189.1	160.7	206.9	43.8	63.8	.	.	.
annual change in % (real)	3.1	-6.2	-19.0	29.9	16.8	33.6	15	10	10
Gross industrial production									
annual change in % (real)	7.0	-0.6	-9.7	13.1	17.3	14.2	10	7	7
Gross agricultural production									
annual change in % (real)	-7.3	.	.	.	.	.	.	.	.
Construction industry									
annual change in % (real)	5.5	-7.6	-16.3	17.8	9.4	.	12	9	9
Employed persons - LFS, th, avg.	20750	21193	21271	22593	21267	22802	23000	23450	23800
annual change in %	1.5	2.1	0.4	6.2	7.5	7.2	1.8	2.0	1.5
Unemployed persons - LFS, th, average	2019	2279	3053	2696	3173	2637	2520	2600	2700
Unemployment rate - LFS, in %, average	8.9	9.8	12.7	10.7	13.0	10.4	9.9	10.0	10.2
Reg. unemployment rate, in %, average	.	.	.		.				
Average gross monthly wages, manuf.ind., TRY	1437	1590	.	.	.	.	.	.	.
annual change in % (real)	1.6	0	.	.	.	.	.	.	.
Consumer prices, % p.a.	8.8	10.4	6.3	8.6	9.3	4.3	7.0	6	6
Producer prices in industry, % p.a.	6.0	13.0	1.0	6.2	4.6	10.1	8.5	7	6
General governm. budget, EU-def., % GDP 3)									
Revenues	.	32.3	33.8	34	.	.			
Expenditures	.	34.5	40.6	38	.	.			
Deficit (-) / surplus (+)	-1.0	-2.2	-6.8	-4	.	.	-2.8	-2.2	-2
Public debt, EU-def., in % of GDP 3)	39.4	39.5	43.8	41.2	.	.	39.7	38.1	38
Central bank policy rate, %, p.a., end of period 4)	20.0	17.5	9.0	6.5	7.0	6.25	6.25	6.25	6.25
Current account, EUR mn	-27915	-28108	-9995	-36578	-7245	-16181	-55000	-62000	-68000
Current account in % of GDP	-5.9	-5.6	-2.3	-6.6	-6.3	-12.3	-9.7	-9.4	-9.4
Exports of goods, BOP, EUR mn	84001	95484	78616	91307	20144	24201	100000	110000	121000
annual change in %	12.9	13.7	-17.7	16.1	0.4	20.1	10	10	10
Imports of goods, BOP, EUR mn	118053	131095	96145	133934	26525	39297	162000	180000	200000
annual change in %	10.3	11.0	-26.7	39.3	26.2	48.2	21	11	11
Exports of services, BOP, EUR mn	21116	23928	23923	25773	3561	4271	30000	34000	38000
annual growth rate in %	4.7	13.3	0.0	7.7	-5.0	19.9	16	13	12
Imports of services, BOP, EUR mn	11408	12186	12105	14879	2940	3498	17000	18500	20000
annual growth rate in %	22.0	6.8	-0.7	22.9	1.0	19.0	14	9	8
FDI inflow, EUR mn	16238	13217	6085	6723	1123	2892	10000	11000	8000
FDI outflow, EUR mn	1568	1707	1110	1338	324	689	1500	1500	1500
Gross reserves of CB, excl. gold, EUR mn	49804	51022	49088	60411	51520	61094	65000	68000	65000
Gross external debt, EUR mn	169471	201449	186351	216669	197994	210332	.	.	.
Gross external debt in % of GDP	35.9	40.4	42.3	39.1	35.8	37.0	.	.	.
Average exchange rate TRY/EUR	1.7865	1.9064	2.1631	1.9965	2.0868	2.1576	2.20	2.10	2.10
Purchasing power parity TRY/EUR	1.0642	1.1456	1.2368	1.2838	.	.	1.38	1.41	1.41

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

1) Preliminary. - 2) TSI projections. - 3) According to ESA'95 excessive deficit procedure. - 4) From 2010 one-week repo rate, overnight lending rate before.

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