

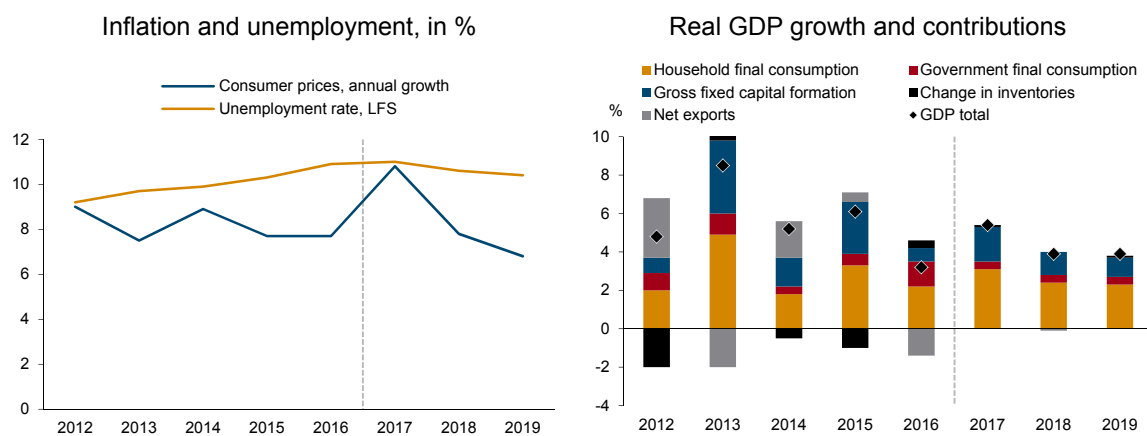


## TURKEY: Economy shrugging off political noise with help of external demand

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The economy is growing strongly, thanks to both government-driven stimulus and robust foreign demand. However, continued political noise – both at home and abroad – risks knocking the recovery off course. Rapid private credit growth is also a source of concern, although the main risk remains the large external financing requirement, which leaves Turkey highly exposed to further tightening of monetary policy in the US.

Figure 50 / Turkey: Main macroeconomic indicators



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

**The political situation has calmed down a bit over the past six months, but political risk remains high and a potential impediment to growth.** There is an awareness in the government that the crackdown after the coup attempt had worried domestic and foreign investors, and risked really knocking the economy off track. In addition, the government was rattled by how close the referendum result was ('yes' took just 51.4% of the vote), and the loss of all the big cities.

**The next elections (both parliamentary and presidential) are due to take place in 2019.** These will be the first under the recently amended constitution, which creates a powerful president. Prime Minister Recep Tayyip Erdoğan will stand for president and probably win, but is keen to secure a strong mandate, something that looks more challenging in light of the referendum result. Mr Erdoğan has demanded a 'renewal' in the party and called for 'radical' change. He will also keep pushing the

economy hard (see below), aware that much of the popularity of the AKP party is due to its record in delivering sustained growth and increases in living standards since 2002. If the economy is still growing quickly in 2018, a snap election is very possible.

**Foreign policy, and its impacts on domestic policy, represent a challenge to overall political stability and the economy.** There are concerns about the approaching defeat of the Islamic State and what will come next in Syria. The recent Kurdish independence referendum has also provoked significant unease in Turkey, which firmly opposes the creation of a separate Kurdish state. Turkey has been expanding its role abroad, including its military presence in Qatar (in defiance of demands from Saudi Arabia to wind down its presence there). In September, Turkey opened a military base in Somalia, its biggest military base abroad.

**Tensions with some Western countries are elevated, and are likely to remain so.** Turkey has agreed to buy the S-400 missile defence system from Russia, which should mean US sanctions (these are required for any foreign entity that has significant transactions with Russia's defence and intelligence sectors). Tensions between the US and Turkey have increased, particularly following the arrest of a US embassy employee in Turkey. Relations with some EU countries, including (but not limited to) Germany and Austria, are even worse. On 3 September Angela Merkel, the German Chancellor, said that Turkey should not become an EU member. This was met by strong criticism on the Turkish side. 12 German citizens were under arrest in Turkey at the time of Ms Merkel's announcement. The recent German election result, which saw Ms Merkel's CDU lose votes and the far-right Alternative für Deutschland enter parliament for the first time, are likely to produce a more hawkish foreign policy, which is unlikely to calm German-Turkish tensions in the next few years. However, the refugee deal should hold, given strong incentives on both sides. Moreover, the economic impact of these tensions is likely to be limited.

**Despite continued political noise, the economy is doing well, and the near-term outlook is very positive.** Working-day adjusted real GDP rose by 4.9% year on year in Q1, and 6.5% in Q2, indicating a sharp bounce-back from the slowdown at the end of 2016. Household consumption (+8.2%) and gross fixed capital formation (+9.5%) rose particularly strongly in Q2. We have revised up our forecasts accordingly. Q3 GDP is also likely to be strong in the year-on-year comparison, given the contraction in the same period of 2016. However, there are growing suggestions that official data are being manipulated, and that the economy is not growing as fast as the published numbers suggest. A detailed report released by one foreign bank research team in early September argued that Turkey's GDP data were 'more than questionable' and could be 'politically influenced'.

**There are two broad reasons for the strength of the economy.** First, domestically the government is using various levers to increase momentum, including tax breaks on white goods (which are due to run until October), and fiscal stimulus (including via higher infrastructure spending). 80% of the TRY 250 billion (USD 70 billion) Credit Guarantee Fund (CGF) is reported to have been drawn down, and so far the government has said that it will not be extended. This has supported a significant increase in credit expansion to non-financial companies. Credit growth has risen back above 20% year on year since March. This has had a positive impact on economic confidence, especially that of businesses. Economic confidence reached a five-year high in August. Confidence is also benefiting from the (relatively) calmer political situation. Moreover, positive momentum in the labour market is increasingly visible. Employment growth has improved gradually since the start of the year, and reached 3.8% year

on year in June. Working-day adjusted retail trade rose by an average 1.8% year on year in May-August (after being consistently negative between October 2016 and April 2017), while industrial output was up by an average 6.7% on the same basis in April-August.

**The second factor driving growth, which should continue in the near term, is the strength of external demand, including from the EU, Turkey's main export market.** Nominal merchandise exports increased by an average 12.1% year on year in March-September. The real effective exchange rate (REER) is back to 2003 levels, implying better external competitiveness, although this appears to be much less important than the strength of demand in driving exports. The central bank has noted that Turkish exporters are again nimbly switching between markets depending on demand (this is a historic strength of the export sector). Better external conditions are also contributing to tourism growth, and here the weaker REER may be more important, particularly in terms of arrivals from Russia, which have recovered very strongly this year after a political rapprochement between the two countries. Foreign tourist arrivals rose by an average 34% year on year in April-August.

**The lira has broadly stabilised, although is prone to bouts of volatility.** Moreover, it is still significantly weaker on the year-on-year comparison, which is continuing to push up inflation. Having fallen somewhat over the summer, inflation rose back to 11.2% year on year in September, the highest level since May. In combination with strong economic growth, this means that the case for cutting rates is weak, although there is a certain amount of political pressure in this direction. We expect inflation to remain high during the forecast period. Foreign exchange deposits have continued to rise in 2017, suggesting a lack of domestic confidence in the lira.

**The domestic credit boom is a potential source of risk.** The CGF only covers banks with non-performing loans (NPLs) ratios below 7% of total assets; above that level lenders have a significant incentive to be prudent. NPLs for the sector as a whole are currently in the 4.5-5% range, a low level by regional standards. However, overall private credit is booming. The volume of new lending rose by over 20% year on year in January-September. Moreover, with the CGF mostly run down, and banks reporting huge profits in the first part of the year, there will be more pressure on lenders to cut interest rates on new loans. Mr Erdoğan has already demanded more support from banks for the economy. There is a danger that as a result of this pressure, credit conditions are loosened, which would create problems further down the line.

**We continue to see the risks emanating from the large external financing need as much more significant.** Higher oil prices on the year-on-year comparison saw the current account deficit widen by 9% year on year in the first half of 2017. A wider goods deficit (+10.5% year on year) was partly offset by a higher services surplus (+24% year on year), the latter partly reflecting a recovery in tourism. Net FDI inflows have remained quite steady, despite political noise, but are nowhere near enough to cover the shortfall (and remain among the lowest, relative to GDP, of all the CESEE countries that we cover). 'Hot money' inflows remain the primary source of external financing, which creates clear risks in the case of changes in global (and particularly US dollar) interest rates and investor sentiment. The loans/deposits ratio in the banking sector is already high, creating a need to borrow more money from abroad to finance domestic lending. Istanbul's ISE30 stock index was the worst performing major emerging market exchange in September, suggesting some investor jitters. Persistent external deficits have increased the stock of debt owed to foreigners. In Q1 2017 (latest data available), gross external debt stood at 59% of GDP, its highest level since 2001. 37% of this was held by banks, while 25% of all external debt was

short term. Turkish firms' ability to continue to roll over external debt will depend a lot on what happens in the US.

**In summary, after real expansion of 5.4% this year, we expect full-year economic growth to slow to 3.9% in both 2018 and 2019.** Although the government will remain committed to supporting the economy ahead of the next election, at least some of the stimulus measures will be unwound by the end of the year. Sticky inflation and downside risks to the lira will prevent significant monetary loosening by the central bank. The current account deficit will remain at around 4% of GDP, and continue to be financed largely by 'hot money' inflows. This will keep Turkey highly exposed to US monetary tightening.

**Table 25 / Turkey: Selected economic indicators**

	2013	2014	2015	2016 <sup>1)</sup>	2016 January-June	2017	2017 Forecast	2018 Forecast	2019
Population, th pers., average	76,148	77,182	78,218	79,278	.	.	80,100	80,900	81,700
Gross domestic product, TRY bn, nom. <sup>2)</sup>	1,810	2,044	2,339	2,609	1,195	1,384	3,000	3,400	3,800
annual change in % (real)	8.5	5.2	6.1	3.2	4.9	5.1	5.4	3.9	3.9
GDP/capita (EUR at PPP) <sup>2)</sup>	16,300	16,900	18,000	17,900	.	.	.	.	.
Consumption of households, TRY bn, nom. <sup>2)</sup>	1,120	1,242	1,412	1,561	723	826	.	.	.
annual change in % (real)	7.9	3.0	5.4	3.7	3.9	3.3	5.2	4.0	3.8
Gross fixed capital form., TRY bn, nom. <sup>2)</sup>	516	591	695	765	353	418	.	.	.
annual change in % (real)	13.8	5.1	9.3	2.2	3.9	6.5	6.0	4.0	3.5
Gross industrial production									
annual change in % (real)	3.0	3.6	3.2	1.9	4.2	1.9	5.2	3.5	3.0
Gross agricultural production <sup>3)</sup>									
annual change in % (real)	3.2	-4.3	2.0	2.0	.	.	.	.	.
Construction industry									
annual change in % (real)	7.7	3.0	1.7	3.1	.	.	.	.	.
Employed persons, LFS, th, average	25,520	25,931	26,619	27,216	27,161	27,722	27,800	28,400	29,000
annual change in %	2.8	1.6	2.7	2.2	3.2	2.1	2.0	2.0	2.0
Unemployed persons, LFS, th, average	2,750	2,854	3,050	3,332	3,048	3,539	3,440	3,370	3,370
Unemployment rate, LFS, in %, average	9.7	9.9	10.3	10.9	10.2	11.4	11.0	10.6	10.4
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	7.5	8.9	7.7	7.7	7.6	10.8	10.8	7.8	6.8
Producer prices in industry, % p.a. <sup>4)</sup>	5.7	10.1	5.3	4.3	4.0	15.2	12.0	7.6	6.0
General governm. budget, nat.def., % of GDP									
Revenues	32.7	31.9	31.9	33.0	.	.	37.8	37.5	37.4
Expenditures	34.0	32.7	32.9	34.7	.	.	40.0	39.7	39.5
Deficit (-) / surplus (+)	-1.3	-0.8	-1.0	-1.7	.	.	-2.2	-2.2	-2.1
Public debt, nat.def., % of GDP <sup>5)</sup>	31.3	28.6	27.5	28.1	.	.	28.0	27.9	27.7
Stock of loans of non-fin.private sector, % p.a.	33.6	19.4	19.4	15.2	13.9	24.7	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.8	3.1	3.2	3.3	3.1	.	.	.
Central bank policy rate, % p.a., eop <sup>6)</sup>	4.50	8.25	7.50	8.00	7.50	8.00	8.00	8.00	8.00
Current account, EUR mn	-47,989	-33,011	-28,926	-29,441	-17,017	-19,147	-31,000	-33,000	-36,000
Current account, % of GDP	-6.7	-4.7	-3.7	-3.8	-4.6	-5.4	-4.1	-3.9	-3.9
Exports of goods, BOP, EUR mn	121,819	127,237	136,978	135,795	67,521	75,435	132,000	144,000	155,000
annual change in %	-3.4	4.4	7.7	-0.9	-2.6	11.7	-3.0	9.2	7.8
Imports of goods, BOP, EUR mn	182,057	175,312	180,341	172,671	85,687	96,081	165,000	180,000	195,000
annual change in %	2.8	-3.7	2.9	-4.3	-7.0	12.1	-4.4	9.2	8.4
Exports of services, BOP, EUR mn	36,306	39,105	42,279	34,012	14,682	15,625	34,000	36,000	39,000
annual change in %	6.5	7.7	8.1	-19.6	-18.0	6.4	-1.0	7.0	9.0
Imports of services, BOP, EUR mn	18,457	18,915	20,445	20,096	10,315	10,091	20,000	21,000	23,000
annual change in %	12.9	2.5	8.1	-1.7	1.0	-2.2	0.0	6.0	8.5
FDI liabilities, EUR mn	9,682	9,637	15,811	11,147	4,780	4,538	7,900	.	.
FDI assets, EUR mn	2,716	5,379	4,594	2,845	1,435	1,568	2,500	.	.
Gross reserves of NB excl. gold, EUR mn	80,435	88,058	85,355	87,331	91,591	79,033	.	.	.
Gross external debt, EUR mn <sup>7)</sup>	282,625	330,955	363,813	383,698	377,990	378,857	369,300	419,800	477,300
Gross external debt, % of GDP <sup>7)</sup>	39.6	47.0	47.1	49.2	48.4	50.3	49.0	50.0	51.5
Average exchange rate TRY/EUR	2.5335	2.9065	3.0255	3.3433	3.2587	3.9379	3.98	4.05	4.10

1) Preliminary. - 2) According to SNA 2010. - 3) Based on UN-FAO data, from 2015 wiiw estimate. - 4) Domestic output prices. - 5) Defined according to EU standards. - 6) One-week repo rate. - 7) BOP 5th Edition.

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