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Turkey: high interest rates slow down growth

Turkey's economic growth has slowed down considerably in the third and fourth quarters of 2006. While GDP growth was 7.2% in the first half year of 2006, it declined to 3.4% in the third quarter and the estimate is of a further slowdown to just under 2% in the fourth quarter. This brings the annual growth rate for 2006 to 5%, down from the high growth rates in the previous two years (2004: 8.9%, 2005: 7.4%). Hence the energetic response by the Central Bank to the May-June turbulence in international financial markets which hit Turkey temporarily quite strongly (the Turkish lira devalued initially by about 20% vis-à-vis the euro) by increasing interest rates in a number of steps above the 20% mark, has taken its toll in terms of a slowdown in economic growth.

The decline in GDP growth was mainly driven by the considerable slowdown in private sector consumption expenditure (it had risen by 9.4% in the first half of the year and only by 1.3% in the third quarter). Most dramatic was the decline in expenditures on durable goods by 8.9% in the third quarter, while expenditures on non-durable goods held up. Also private investment slowed down from high growth rates in the first half of the year to 13% in the third quarter. There was also a slowdown of industrial production from August onwards to monthly growth rates of 4.3% compared to 7% over the January-August period.

Apart from high nominal interest rates one has to consider developments in inflation rates in order to understand the developments in domestic expenditure components. The deviation of actual price movements from inflation targets set by the Central Bank which wanted to achieve a 5% inflation rate by the end of year 2006 are of course the main reason for the strong interest rate hikes initiated by the Central Bank from May onwards. CPI inflation, which had come down to 7.7% by end-year 2005, nudged up to 9% by May 2006, peaked at 11.7% in July in the wake of the strong devaluation and ended the year at 9.7% growth. Even more dramatic were developments in producer prices (strongly affected by the volatility in energy prices and then the pass-through of devaluation): PPI inflation rates declined to 4.9% in April 2006 and then rose to 9.2% by the end of the year. The inflation developments together with stable nominal wage growth led to almost stationary real wage growth over the year 2006 (0.1% for the year as a whole) with modest positive real wage growth in the first half-year (0.3 and 0.4% in the first two quarters) and negative growth in the second half of the year. Hence the high real interest rate regime in the second half of the year plus stationary real wage income developments explain well the slowdown in domestic demand components.

Very important are developments in the Turkish current accounts which have long been recognized as being the most problematic aspect with regard to the sustainability of the otherwise remarkable economic growth performance since the crisis in 2001. It is well known that the Turkish trade performance is characterized by a strong deficit in goods trade and – because of tourism – a surplus in services trade. Overall developments on the trade accounts in 2006 are worrying: while there was strong export growth in goods (18% in 2006 as compared to 14.6% in 2005, all in current euro terms) there was also strong import growth (+21% in 2006). As the export-import coverage ratio in goods trade is only about 60%, the deficit in goods trade has increased from EUR 26.4 billion in 2005 to EUR 33.9 billion in 2006. Also, there was a fall in the net surplus on services trade in 2006 (EUR 9.3 billion as compared to 11.2 billion in 2005) because of the birds flu scare in the early booking season. Given that the income accounts also contribute a deficit (due to profit repatriation from multinationals which is not compensated by the amounts of transfers sent back home by Turkish expatriates) the overall current account situation continued to deteriorate (in per cent of GDP: from 3.3% in 2003 to 5.2% in 2004 to 6.4% in 2005 and 8.9% in 2006). One might very well argue that there were special circumstances in 2006: very high energy prices, bad tourism incomes, a poor harvest, the terms-of-trade deterioration due to the devaluation – but there is no denying that the current accounts situation puts the Turkish economy in a vulnerable position.

The long-run prospects are good as there are very substantial foreign direct investment inflows (EUR 15.6 billion in 2006 as compared to 7.8 billion in 2005 and 2.3 billion in 2004) and there is evidence of significant industrial diversification, restructuring and qualitative upgrading which will continue to support the export performance in the future. But in the short run there is a severe imbalance in the current accounts. The strong nominal devaluation in May/June was a step in the right direction, but in the meantime there was a slight nominal appreciation and the high inflation differentials with the main trading partners has left only a modest real depreciation of 6.5% by December 2006 (compared to end 2005). On top of that there is the danger that the high interest rates to be earned in Turkey make speculative inflows attractive and this adds an appreciation pressure. The ease by which the current account deficit is being financed through international capital flows (only about 40% of these are accounted for by foreign direct investment) and the fact that international reserves are increasing indicate that this process is well on its way. Given the high interest rate differential, there is a strong incentive to borrow in foreign currency and there is evidence that the increase in foreign debt stemmed mostly from the private sector (which reached a level of USD 110.5 billion at the end of the third quarter as compared to the foreign debt stock of the public sector of USD 67 billion). Overall gross external debt in per cent of GDP has increased – after some years of decline – from 47.3% in 2005 to 51% in 2006, most of which is accounted for by changes in the exchange rates.

Turkey's monetary policy hence has to perform a tightrope act over the next year and we believe that there is a good chance that it will not work out. At some point there will be a response by international investors to enforce a further devaluation. This in turn will generate another pass-through to inflation. Although there was a spectacular performance of fiscal consolidation over the past few years bringing down the general budget deficit to 0.5% of GDP in 2006 (with a primary surplus of over 6.1%!) there is likely to be some loosening of fiscal spending in the year of both parliamentary and presidential elections. This in turn will spur the Central Bank to maintain its restrictive monetary stance as the inflation record in 2006 has been thrown off the intended course. Hence, with the Central Bank keeping its eye firmly on the narrow reputation track for maintaining monetary stability, the fiscal authorities being affected by the election cycle, the private sector having a strong inducement to avoid high domestic interest rates and borrowing abroad and international short-term capital flows exploiting high interest rate differentials, this could be an unstable mix leading to a further devaluation experience. We, in fact, project such a devaluation and this together with the slower GDP growth rate might bring about a modest turnaround in the current account situation.

Another vital longer-run issue for Turkey is the utilization of the one resource which makes Turkey so attractive from an overall European perspective: the favourable demographic situation and the relatively young and growing labour force.

There was positive employment growth in 2006 (in line with the previous years of about 1.5% per annum) and the rate of unemployment has fallen to just below 10%, but at the same time the employment rate (those employed in per cent of those of working age) has actually fallen and remains at a very low level (44.3% in 2006; it was 44.8% in 2005). Hence relatively high output growth over the past years goes along with relatively slow employment growth and even a tendency of people of working age to leave the labour force ('discouraged workers'). Underlying these developments are strong structural shifts in the employment structure, with agricultural employment accounting now for about 28% of the labour force (down from 35% in 2002), while the share of non-farm employment has increased. This shift has a number of implications: there is less scope for unpaid family employment (which is common in agriculture), the qualification demands in non-farm labour jobs are higher and hence there is a skill mismatch to which the Turkish educational system has to respond; further – especially in industry – there is high productivity growth (and hence low employment elasticity of output growth). These underlying features of the Turkish labour market situation are likely to prevail for the years to come. The slowdown in growth in the short run will not be beneficial to improve the labour market situation over the next year.

Table TR

Republic of Turkey: Selected Economic Indicators

	2000	2001	2002	2003	2004	2005	2006 [1]	2007	2008
Population, th pers., mid-year [2]	67420	68365	69302	70231	71152	72065	72974	.	.
Gross domestic product, YTL mn, nom.	124583	178412	277574	359763	430511	487202	560700	632900	707700
annual change in % (real)	7.4	-7.5	7.9	5.8	8.9	7.4	5.0	5.5	6.5
GDP/capita (EUR at exchange rate)	3215	2367	2782	3022	3405	4030	4250	.	.
GDP/capita (EUR at PPP - wiiw)	6000	5370	5650	5740	6140	6470	6780	.	.
Gross industrial production									
annual change in % (real)	6.1	-8.7	9.5	8.7	9.8	5.5	6.3	6	9
Gross agricultural production									
annual change in % (real)	3.9	-6.5	6.9	-2.5	2.0	5.6	.	.	.
Construction industry									
annual change in % (real)	0.2	-10.6	-5.6	-9.0	4.6	21.5	.	.	.
Consumption of households,YTL mn, nom.	89098	128513	184420	239586	284631	328561	.	.	.
annual change in % (real)	6.2	-9	2.1	6.6	10.1	8.8	5.5	5	6
Gross fixed capital form., YTL mn, nom.	27848	32409	46043	55618	76722	95307	.	.	.
annual change in % (real)	16.9	-31.5	-1.1	10.0	32.4	24.0	13.5	8	15
LFS - employed persons, th, avg.	21580	21524	21354	21147	21791	22046	22247 [I-IX]	.	.
LFS - employed pers. in agricult. th, avg.	7769	8089	7458	7165	7400	6493	6155 [I-IX]	.	.
LFS - employed pers. in industry th, avg. [3]	5174	4884	4912	4811	5017	5452	5564 [I-IX]	.	.
LFS - employed pers. in services th, avg.	8637	8551	8984	9171	9374	10101	10528 [I-IX]	.	.
LFS - unemployed, th pers. average	1497	1967	2464	2493	2498	2520	2440	.	.
LFS - unemployment rate in %, average	6.5	8.4	10.3	10.5	10.3	10.3	9.8	9.5	9
Reg. unemployment rate in %, average	3.3	3.2	1.9	2.5	.	.	.	.	.
Average gross wages in manuf.industry (YTL/Hour)	1.48	1.95	2.68	3.30	3.74	4.20	4.70	.	.
annual change in % (real)	0.8	-14.6	-5.4	-1.9	2.5	2.0	0.1	1	.
Consumer prices, % p.a. [4]	54.9	54.4	45.0	25.3	8.6	8.2	9.6	7	5
Wholesale prices in manufacturing, % p.a. [4]	56.1	66.7	48.3	23.8	14.6	5.9	9.7	7	5
General governm. budget, EU-def., % GDP [5]									
Revenues	.	.	25.9	24.4	31.2	37.0	.	.	.
Expenditures	.	.	38.8	35.7	36.9	38.1	.	.	.
Deficit (-) / surplus (+)	.	-33	-12.9	-11.3	-5.7	-1.2	-0.5	-1.8	.
Public debt, EU-def., in % of GDP [5]	.	104.4	93.0	85.1	76.9	69.6	.	.	.
Discount rate % p.a., end of period [6]	204.9	58.9	51.0	31.0	22.0	17.5	22.5	18	15
Current account, EUR mn [7]	-10629	3787	-1613	-7106	-12550	-18602	-27600	-28000	-30000
Current account in % of GDP	-4.9	2.3	-0.8	-3.3	-5.2	-6.4	-8.9	-8.4	-7.6
Gross reserves of CB, excl. gold, EUR mn	23996	20975	28370	29725	28962	40604	46392 [XI]	.	.
Gross external debt, EUR mn	128250	126820	137678	128141	130460	137511	157901 [IX]	.	.
Gross external debt in % of GDP	59.2	78.4	71.4	60.4	53.9	47.3	.	.	.
FDI inflow, EUR mn [7]	1063	3742	1203	1549	2282	7868	15600	.	.
FDI outflow, EUR mn [7]	942	555	185	441	691	868	710	.	.
Exports of goods, BOP, EUR mn [7]	33248	38376	42464	45279	53927	61818	72900	87000	106000
annual change in %	23.0	15.4	10.7	6.6	19.1	14.6	18	20	22
Imports of goods, BOP, EUR mn [7]	57013	42543	50171	57667	73132	88269	106800	124000	146000
annual change in %	55.8	-25.4	17.9	14.9	26.8	20.7	21	16	18
Exports of services, BOP, EUR mn [7]	21054	16969	14843	15868	18441	20766	18700	22000	24000
annual growth rate in %	37.3	-19.4	-12.5	6.9	16.2	12.6	-10	15	10
Imports of services, BOP, EUR mn [7]	8753	6773	6504	6580	8159	9546	9400	10000	11000
annual growth rate in %	5.3	-22.6	-4.0	1.2	24.0	17.0	-2	8	10
Average exchange rate YTL/USD	0.6221	1.2308	1.5236	1.4987	1.4293	1.3480	1.4407	1.51	1.43
Average exchange rate YTL/EUR (ECU)	0.5748	1.1024	1.4397	1.6949	1.7771	1.6771	1.8090	1.89	1.80
Purchasing power parity YTL/USD	0.2711	0.4240	0.6115	0.7549	0.8315	0.8768	0.9215	.	.
Purchasing power parity YTL/EUR	0.3081	0.4859	0.7084	0.8920	0.9861	1.0452	1.1338	.	.

Note: The term 'industry' refers to NACE classification C+D+E.

1) Preliminary. - 2) 2004 and 2005 SIS projections. - 3) Industry including construction. - 4) From 2004 new methodology. - 6) According to ESA'95, excessive deficit procedure. - 7) CBRT interest rate - overnight, lending. - 8) Converted from USD.

Source: CBRT-EDDS (Central Bank of Turkey, Electronic Data Distribution System), SIS (State Institute of Statistics), SPO (State Planning Organization), UT (Undersecretary of Treasury), Eurostat; wiiw forecasts.