

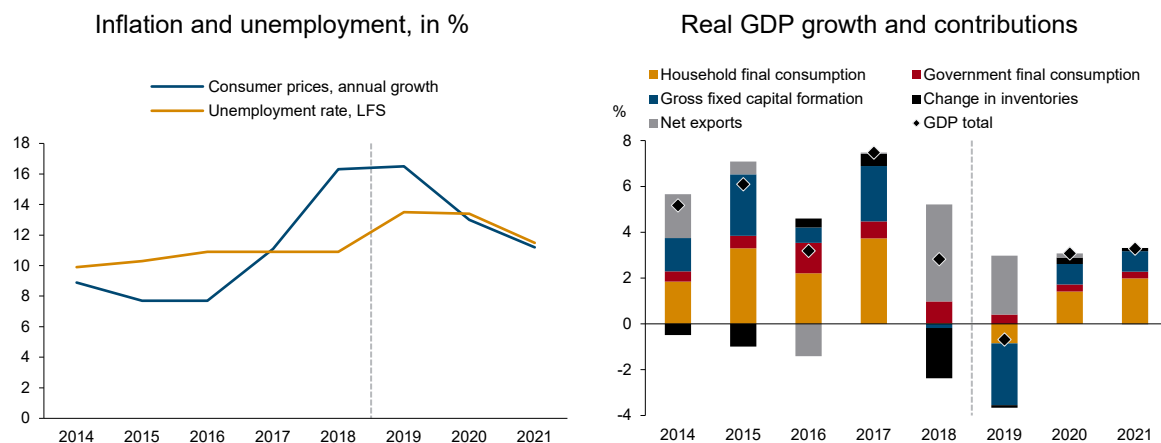


TURKEY: Recovery arrives but risks rising again

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The economy is expanding in quarterly terms, but overall growth is still likely to be negative in 2019. From next year the recovery will firm; we expect the economy to expand by a bit more than 3% in 2020-21. However, while external vulnerabilities are much reduced, the possibility of serious sanctions and volatility in the exchange rate related to the military operation in Northern Syria pose material downside risks to our forecasts.

Figure 5.22 / Turkey: Main macroeconomic indicators



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

After a sharp downturn in the second half of 2018, the economic recovery has taken hold this year, and should continue to firm in 2020-21. As expected, the Turkish economy has staged a typically rapid bounce-back from a period of weakness, with positive quarterly growth posted in both Q1 and Q2 2019. As a result, we have revised our 2019 real GDP growth estimate up to -0.7%, compared with -1.2% previously. This forecast is on the conservative side, and would be higher were it not for the huge uncertainty surrounding the recent military operations in Syria and potential for international sanctions.

The economic impact of Turkey's military operations in Northern Syria launched in October is highly uncertain, although the net impact is likely to be negative. The US has already introduced, and then quickly removed, limited sanctions. At present, it appears that US President Donald Trump is unwilling to take sterner action, although much of the rest of Washington (including key players in both parties) is keen to impose tougher sanctions. There remains the possibility that the conflict will escalate, with a series of armies present in the region, including the US, Russia and Syria, as well as the Kurdish forces that Turkey is attacking (although at the end of October Russia and Turkey reached an

agreement on a 'buffer zone' in Northern Syria). Missiles have already been fired into Turkey in retaliation, and if the security situation inside the country deteriorates, it will likely have an impact on tourism inflows.

At present, the drivers of growth are fairly diverse, indicating a broad-based recovery. Economic growth is being underpinned by state bank credit provision, exports (including both goods and tourism), and better international market sentiment (bolstered by a more dovish Fed and ECB stance). Importantly, higher-spending Western tourists have returned amid a reduction in perceived security risks. Total tourist arrivals rose by 16% year on year in January-July. It is highly doubtful that these positive trends can continue at the same level considering the operations in Northern Syria.

Despite the increasingly positive headline numbers, and aside from events in Syria, there are reasons to remain cautious on near-term momentum. Investment in particular remains very weak, reflecting low levels of confidence among firms and historically high real interest rates. Meanwhile the labour market is struggling, with the unemployment rate set to rise from 10.9% on average last year to 13.9% in 2019. Linked to this, consumer confidence continues to struggle as well (albeit improving recently relative to recent quarters). The manufacturing sector remains stuck in a rut, reflecting the broader global weakness of this sector. However, here the worst appears to have passed, with the most recent manufacturing purchasing managers' index (PMI) for Turkey, compiled by the Istanbul Chamber of Industry, standing at 50 in September (exactly on the mark separating contraction from expansion). This was up from 48 in August, and the first non-contraction (i.e. sub-50) reading for 17 months.

High inflation is less of a barrier to the economic recovery than was the case at the start of the year. The consumer price index rose by 9.3% year on year in September, the first sub-10% outturn since mid-2017. Base effects clearly had a large influence on the reading, although a sharp (albeit delayed) hike to the policy rate in the second half of 2018 also had an impact. Inflation has fallen from over 25% at the end of last year, and the central bank has been quick to take advantage, cutting interest rates aggressively from 24% to 14% as of late October. Real interest rates are still in strongly positive territory, which will almost certainly prompt further loosening from the central bank. However, with the lira weakening following the incursion into Syria, imported inflation is likely to be higher in the remainder of the year than would otherwise have been the case.

Doubts over the capacity and independence of the central bank have increased in recent months which will increase the lira's vulnerability if investor sentiment turns again. During the summer, the president, Recep Tayyip Erdoğan, removed Murat Cetinkaya, the bank's head, a year ahead of the end of his term, as well as dismissing nine other high ranking officials from their posts. Mr Erdoğan said the sacking was because Mr Cetinkaya 'wouldn't follow orders' (reinforcing concerns in the market about political influence on central bank decisions). The removal of the chief economist, Hakan Kara, appears to have particularly unsettled some investors.

The new head of the central bank is Murat Uysal who appears to have the relevant qualifications to do the job. However, after his appointment he almost immediately faced allegations about plagiarising his masters' thesis on inflation targeting, a less-than-ideal start to his tenure. Mr Uysal is likely to face political pressure to further lower interest rates, and real interest rates may well return to negative territory. The lira has recovered strongly since 2018, but is likely to gradually weaken versus the euro over the forecast period.

External conditions have generally improved from the perspective of Turkey. Although the slowdown in global growth is a net negative, the impact on Turkey's relatively closed economy (in terms of goods exports/GDP) will be limited, and less than in most of its regional peers. More important for Turkey is that global growth weakness has prompted major central banks, including the US Federal Reserve and the European Central Bank (ECB), to move in the direction of further monetary loosening. Given Turkey's large external debt rollover needs, this increase in global liquidity will act as a factor of stability. Turkey's short-term external debt is equivalent to around 17% of last year's GDP, and of this 80% is in either US dollars or euros.

The external adjustment that Turkey has undergone since mid-2018 has been quite severe, but is now over. The current account deficit has basically disappeared; we expect a deficit equivalent to 0.3% of GDP this year, from 3.4% in 2018 and 5.5% in 2017. Lira weakness, the tourism recovery, and the traditional strength of Turkish goods exporters in adjusting to external shocks have prompted a robust increase in exports. Meanwhile imports have fallen, reflecting weaker consumption and investment. Along with positive real interest rates, this is a big part of why Turkey had been relatively immune from market volatility so far this year (in stark contrast to 2018), at least up until the military operations in Syria.

Following the move into Syria, the lira weakened, although so far the sell-off has been nowhere near as dramatic as last year. The lira had appreciated from around TRY 7/EUR at the start of the year to TRY 6.3/EUR in September-October, but has since fallen back to around TRY 6.4/EUR at the time of writing. In general, we still expect the current account deficit to start widening again from here, financed by a new wave of hot money inflows. Portfolio investors are searching desperately for yield in an environment of mostly scant returns on any remotely 'safe' asset (German sovereign debt yields are not negative out to a 30-year maturity, for example). This makes Turkey, with its positive real interest rates, quite attractive to many investors. However, on the other hand, the conflict in Syria introduces a significant degree of uncertainty, and is likely to put off some investors.

President Erdoğan and his AKP party are on the back foot, amid the greatest challenge to their power for many years (and potentially since they came to power in the early 2000s). This opposition comes from two main sources. First, the National Alliance, a broad coalition of parties opposed to the AKP, and whose candidate Ekrem İmamoğlu won the election for Istanbul mayor (twice) earlier this year. Second, several prominent former close Erdoğan allies have split off from the AKP to form or join opposition factions, including former Prime Minister Ahmet Davutoğlu, former Deputy Prime Minister Ali Babacan and former President Abdullah Gül. Although Mr Erdoğan still has a large and loyal voting base, these splinter groups may well eat into his vote share at the next election. At least in the short term, however, his support will be swelled by the military operations in Syria.

The government's announced economic policy programme up to 2022 is on the optimistic side. They assume real GDP growth of 5% in 2020 and 2021. Although not impossible, we view this as a very much optimistic scenario (our baseline forecasts are for growth of slightly above 3% for both years). To achieve growth of 5% next year, the economy will probably need to attract pre-2018 levels of 'hot money'. Although as stated above, global liquidity conditions are highly favourable, the collapse of the lira and the very delayed central bank response in 2018, as well as events in Syria, are likely to keep at least some portfolio investors wary this time.

The old economic model is unlikely to deliver growth at the same rate in the future as during most of the AKP's time in office. In 2002-2017, the economy grew by an average of 5.9% per year. However, this growth model relied quite heavily on working-age population growth, urbanisation, construction investment and hot money inflows. As already stated, hot money inflows are likely to be reduced, while the working-age population is set to grow significantly more slowly in the coming years according to UN projections. Although there remains the possibility to lift the activity rate, this is not guaranteed and may require significant reforms.

The main risk to the forecast is to the downside, both in the near and medium term, and is centred chiefly on the relationship with the US. Turkey has faced the threat of US sanctions for some time but the likelihood has increased sharply following the operations in Syria. The risk of sanctions related to the purchase of a Russian missile defence system or allegations that a Turkish bank helped Iran to evade US sanctions, is also non-negligible during the forecast period. Should sanctions be enacted, they would likely have a significant and negative impact on growth, not least because of the Turkish economy's heavy reliance on short-term dollar funding.

Table 5.22 / Turkey: Selected economic indicators

	2015	2016	2017	2018 ¹⁾	2018 January-June	2019	2019 Forecast	2020 Forecast	2021
Population, th pers., average	78,218	79,278	80,313	81,407	.	.	81,900	82,700	83,600
Gross domestic product, TRY bn, nom.	2,339	2,609	3,111	3,724	1,681	1,945	4,300	4,900	5,600
annual change in % (real)	6.1	3.2	7.5	2.8	6.5	-1.9	-0.7	3.1	3.3
GDP/capita (EUR at PPP)	19,300	19,200	19,900	20,100	.	.	.	.	.
Consumption of households, TRY bn, nom.	1,412	1,561	1,836	2,111	970	1,114	.	.	.
annual change in % (real)	5.4	3.7	6.2	0.0	4.3	-2.9	-1.5	2.5	3.5
Gross fixed capital form., TRY bn, nom.	695	765	936	1,114	533	522	.	.	.
annual change in % (real)	9.3	2.2	8.2	-0.6	8.1	-18.0	-9.0	3.0	3.0
Gross industrial production ²⁾									
annual change in % (real)	6.2	3.4	9.1	1.1	6.8	-4.5	-1.0	2.8	3.0
Gross agricultural production ³⁾									
annual change in % (real)	5.2	0.5	2.0	0.5	.	.	.	.	.
Construction industry ²⁾									
annual change in % (real)	1.7	2.9	3.8	-5.0	.	.	.	.	.
Employed persons, LFS, th, average	26,619	27,216	28,197	28,734	28,652	27,812	28,000	28,700	29,400
annual change in %	2.7	2.2	3.6	1.9	3.4	-2.9	-2.5	2.5	2.5
Unemployed persons, LFS, th, average	3,050	3,332	3,451	3,535	3,245	4,444	4,370	4,440	3,820
Unemployment rate, LFS, in %, average	10.3	10.9	10.9	10.9	10.2	13.8	13.5	13.4	11.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY ⁴⁾	2,014	2,280	2,470	2,690	.	.	3130	3640	4190
annual change in % (real, gross)	2.8	5.2	-2.5	-2.0	.	.	0.0	2.8	3.5
Consumer prices (HICP), % p.a.	7.7	7.7	11.1	16.3	11.6	18.9	16.5	13.0	11.2
Producer prices in industry, % p.a. ⁵⁾	5.3	4.3	15.8	27.0	16.7	29.2	22.2	15.0	13.0
General governm. budget, nat.def., % of GDP									
Revenues	31.9	33.0	30.1	30.0	.	.	31.0	32.2	33.5
Expenditures	32.9	34.7	32.1	32.8	.	.	34.0	35.0	36.2
Deficit (-) / surplus (+)	-1.0	-1.7	-2.0	-2.8	.	.	-3.0	-2.8	-2.7
General gov.gross debt, nat.def., % of GDP	27.6	28.3	28.2	30.2	.	.	32.0	32.0	31.2
Stock of loans of non-fin.private sector, % p.a.	19.4	15.2	19.9	9.6	19.4	4.4	.	.	.
Non-performing loans (NPL), in %, eop	3.1	3.2	2.9	3.9	3.0	4.4	.	.	.
Central bank policy rate, % p.a., eop ⁶⁾	7.50	8.00	8.00	24.00	17.75	24.00	15.00	13.00	12.00
Current account, EUR mn	-28,986	-29,981	-41,679	-22,119	-25,583	-2,509	-1,100	-11,176	-16,253
Current account, % of GDP	-3.7	-3.8	-5.5	-3.4	-7.5	-0.8	-0.2	-1.6	-2.3
Exports of goods, BOP, EUR mn	136,978	135,795	147,218	148,024	70,889	78,847	155,000	159,000	167,000
annual change in %	7.7	-0.9	8.4	0.5	-6.0	11.2	5.0	2.5	5.0
Imports of goods, BOP, EUR mn	180,353	172,701	198,906	182,938	98,773	86,040	174,000	188,000	201,000
annual change in %	2.9	-4.2	15.2	-8.0	2.7	-12.9	-5.0	8.0	7.0
Exports of services, BOP, EUR mn	42,419	34,125	38,691	41,614	16,923	19,640	43,000	44,000	46,000
annual change in %	8.3	-19.6	13.4	7.6	9.4	16.1	4.0	2.0	5.0
Imports of services, BOP, EUR mn	20,563	20,366	21,250	19,497	9,687	9,930	19,000	20,000	22,000
annual change in %	7.9	-1.0	4.3	-8.3	-5.5	2.5	-1.0	7.5	8.0
FDI liabilities, EUR mn	17,376	12,627	10,201	11,078	4,327	4,041	9,000	.	.
FDI assets, EUR mn	4,595	2,837	2,419	3,069	1,667	1,318	1,750	.	.
Gross reserves of NB excl. gold, EUR mn ⁷⁾	85,356	87,334	70,202	63,666	64,804	64,564	.	.	.
Gross external debt, EUR mn ⁷⁾	367,873	388,730	379,459	388,261	392,464	392,671	409,800	408,300	411,100
Gross external debt, % of GDP	47.6	49.8	50.3	59.5	60.1	58.4	61.0	60.0	58.0
Average exchange rate TRY/EUR	3.0255	3.3433	4.1206	5.7077	4.9551	6.3543	6.40	7.20	7.90

1) Preliminary. - 2) Enterprises with 20 and more employees; for construction wiiw estimate from 2017. - 3) Based on UN-FAO data, wiiw estimate from 2017. - 4) Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social security. wiiw estimate from 2016. - 5) Domestic output prices. - 6) One-week repo rate. - 7) Converted from USD.

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