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Turkey:
Recovery from credit brakes

Turkey experienced a strong slowdown of growth to 2.9% in 2012 compared to 9.0% in 2010 and 8.5% in 2011. This was mostly due to policy reactions (particularly monetary policy) to an overheating economy characterized by very fast credit growth and sharply negative current accounts developments. Monetary policy has now eased somewhat, inflation has come down, and we expect Turkey to resume growth at 3.8% in 2013, 4.5% in 2014 and 5.0% in 2015.

Turkey, which had experienced a very strong and fast recovery in the years 2010 and 2011 with GDP growth rates of 9.0% and 8.5% respectively, switched to a drastic slowdown in growth in 2012 with GDP growth of only 2.9% for the year as a whole. This decline of growth was mostly the result of policy measures designed to break a cycle of overheating, characterized by very strong private sector credit growth (in real terms +20.6% in 2010 and +35.8% in 2011), strong deteriorations in the current account balance (-6.4% of GDP in 2010 and -10.0% in 2011), and substantial volatility of the exchange rate (TRY/EUR moved from 2.07 year-end in 2010 to 2.45 year-end in 2011).

The fear of vulnerability associated with strongly negative current accounts is a perennial worry of policy-makers in Turkey and hence there is a willingness to apply a range of tools to put the brakes on an overheating economy. The Turkish Central Bank (CBRT) applied a range of partly non-traditional methods (an interest rate corridor, effective liquidity management and reserve requirements; on this more below) to deal with the so-called ‘trilemma’ whereby the authorities attempt to steer the economy towards a low inflation path and at the same time avoid large inflows of capital which would put an undue upward pressure on the exchange rate, thus making the current account situation worse. Furthermore the government attempted to move towards a more restrictive fiscal policy scenario which was reinforced by the more recent publication of its Medium-Term Programme (2013-2015) which includes a Medium-Term Fiscal Framework.

If we look at more recent developments, the general assessment is that the Turkish economy is in a robust state: in early November 2012, Fitch upgraded Turkey’s foreign currency debt to investment grade which reflects also a widely held view that there are favourable medium-term growth prospects, the banking system is in a robust state, government debt burden is falling (already from quite low levels) and inflation – after the recent hike – is on a downward path.

Monetary policy has moved through a number of phases. From November 2010 through October 2011, the focus was on limiting short-term capital inflows: the interest rate corridor was widened by lowering the borrowing rate to discourage short-term capital inflows; banks' reserve requirements were raised substantially and the banking supervision was tightened. The exchange rate depreciated and credit growth started to come down. After October 2011, monetary policy shifted to avoid excessive currency depreciation as it was feared to feed through to domestic inflation (rates had hiked up substantially also through high energy costs and high food prices): the CBRT provided less liquidity through the one-week repo facility which caused short-term interest rates to jump, but attempted to provide longer-term liquidity through one-month repo auctions; it also engaged in foreign exchange reserve sales. Monetary policy was seen as a mixed success: it brought down credit growth quite strongly and the economy slowed down substantially leading to a 'rebalancing of the economy' (through a sharp fall in domestic demand) but contributed to strong inflation instability. More recently, the emphasis has shifted towards more steady inflation targeting: the one-week repo rate was reduced in December 2012 by 25bps (the first reduction in 16 months) as demand conditions were seen as justifying the easing, but the Central Bank's flexible policy mix was maintained (specifically utilizing the wide interest rate corridor – with an overnight borrowing rate of 5% and an overnight lending rate of 9%) as the main policy tool to manage liquidity.

The current situation is one in which net exports are the main contributor to GDP growth (full year growth for 2012 has been estimated at 2.9%), while domestic demand had turned negative due to shrinking private investment activity (investment spending fell by 4.1% in the 3rd quarter despite strong government capital spending, after a 6.5% drop in the second quarter; the estimate for 2012 as a whole is -5.0%) and low private consumption spending (real private consumption growth was slightly negative for the year as a whole at -0.5%). The current accounts deficit, which had reached -10.0% of GDP by end-2011, has come down to -6.0% by end-2012. This was largely driven by a sharp decline in imports growth (imports growth was – in current euro – 6.7% for goods and 4.0% for services in 2012 as compared to +24.6% and +2.2% respectively in 2011; this reflected also energy price adjustments, energy being a major import item for Turkey) while exports of goods increased by 23.2% in 2012 (12.9% in 2011) which included substantial gold exports to Iran (in payment for energy imports) and growth of exports in services was also very considerable (+17.2% as compared to +5.0% in 2011).

Important for medium-term developments is that inflation rates have been easing (headline inflation was 6.2% in December 2012; as compared to 10.5% at end-2011) and this has eased inflation expectations which in turn creates the space for less restrictive monetary policy. Part of the inflation deceleration however stems from lower food prices due to a favourable harvest. The fiscal deficit (at 2.3% of GDP in 2012) was somewhat higher compared to the fiscal target of 1.5%; main reasons being losses from state enterprises and an underperformance of revenues due to the slowdown in household consumption. In the final quarter of 2012 there was evidence of some recovery in domestic demand which went along with a recovery of some credit growth which was benefitting from lowering of interest rates. The general tenor for the next two years is a steady recovery of economic growth to – our forecasts – 3.8% in 2013, 4.5% in 2014 and 5.0% in 2015. The underlying assumptions are that 4.5-5.0% growth reflects Turkey's sustainable growth rate without an accelerating deterioration in the current accounts, fiscal policy which sticks to its medium-term targets to bring public debt stock further down in a gradual manner from an already low level of currently 36.8% of GDP (it was 39.3% in 2011) to close to about 35.5% in 2015, but also a far from easy external environment both in the European Union and in the Middle East.

Let us cover two further issues regarding longer-term developments: one are rather interesting developments on the employment front, the other are developments on the export side. In the short run, the marked slowdown in growth in 2012 has led to an increase in the unemployment rate from 8.8% in 2011 to 10.1% in 2012. In the longer-run context, however, there was a significant improvement in a number of labour market indicators (see Gönenc et al., 2012): thus participation rates in all age groups, including those with traditionally very low rates, increased, e.g. that of the age group 20-24 rose from 2006 to 2001 from 49.5% to 54%, that of the age cohort 50-60 increased from 38 to 42%.[1] Gönenc et al. point out (p. 6) that over the past decade many new jobs have been created in the so-called 'Anatolian tiger' regions for the low-skilled outside traditional agriculture. This is driven by the emergence of new, first generation enterprises – mostly medium-sized (50-250 employees) – in previously non-industrial, low-income regions in inland Anatolia. Furthermore, these enterprises are quite strongly export-oriented, with employment and exports growing about 8% and 15% annually, respectively. They specialize in less sophisticated, relatively low-tech manufacturing activities such as textile, food, plastic and metal products; furthermore, while Western regions are strongly integrated with EU economies (and have undergone significant technological and structural

[1] Nonetheless, participation rates remain very low for the very low-skilled (those without any school diploma which represent 18% in 2011), women and elderly (54-65 years) at 26%, 29% and 33% respectively in 2011.

upgrading over the past decade), the newly exporting regions trade more with countries in the Middle East and Northern Africa (MENA). These developments have strongly contributed to diversification and resilience in Turkey's employment and export performance.[2]

Reference cited:

R. Gönenc, O. Röhn, V. Koen and S. Saygili (2012), 'Structural Reforms to Boost Turkey's Long-Term Growth', OECD Economics Department, *Working Paper* 987, OECD, Paris.

[2] Further interesting features on the export and FDI front are: the importance of Turkish construction companies which have gained considerable market shares in expanding markets such as Russia, Kazakhstan, Turkmenistan, Saudi Arabia and Iraq; this has given Turkey second place after China in terms of share in the total number of global construction companies; exports of construction equipment and materials made up – in 2011 – 20% of Turkish exports. Alongside these developments Turkish Western regions – specifically the Istanbul region – are making inroads in advanced manufacturing and expanding their attraction to foreign investors also in banking, insurance, and transportation. Thus Microsoft's office in Istanbul e.g. is the company's centre for operations in 79 countries, Intel manages its operations in 64 countries from Istanbul, and Coca Cola in about 90 countries. See Gönenc et al. (2012), p. 7 and p. 18.

Table TR

Turkey: Selected Economic Indicators

	2008	2009	2010	2011	2012 [1)]	2013	2014	2015
Population, th pers., average	71095	72050	73003	73950	74885	75700	76900	80000
Gross domestic product, TRY bn, nom.	950.5	952.6	1098.8	1298.1	1460.0	1630	1810	2000
annual change in % (real)	0.7	-4.8	9.0	8.5	3.0	3.8	4.5	5.0
GDP/capita (EUR at exchange rate)	7000	6100	7500	7500	8400	9200	10200	11100
GDP/capita (EUR at PPP - wiiw)	11700	10900	12200	13100	13600	.	.	.
Consumption of households,TRY bn, nom.	663.9	680.8	787.8	923.6	1000.0	.	.	.
annual change in % (real)	-0.3	-2.3	6.7	7.7	-0.5	3.2	4.5	5.0
Gross fixed capital form., TRY bn, nom.	189.1	160.7	207.8	282.8	290.0	.	.	.
annual change in % (real)	-6.2	-19.0	29.9	18.3	-5.0	5.0	9.0	12.0
Gross industrial production								
annual change in % (real)	-0.6	-9.7	13.1	8.9	2.9	5.0	6.0	7.5
Gross agricultural production [2)]								
annual change in % (real)	4.3	3.6	2.4	5.6	3.3	.	.	.
Construction industry								
annual change in % (real)	-7.6	-16.3	18.7	11.2	0.0	5.0	9.0	12.0
Employed persons - LFS, th, avg.	21193	21271	22593	24099	24700	25600	26800	28000
annual change in %	2.1	0.4	6.2	6.7	2.5	3.5	4.5	4.5
Unemployed persons - LFS, th, average	2279	3053	2696	2324	2200	.	.	.
Unemployment rate - LFS, in %, average	9.8	12.6	10.7	8.8	8.2	8.0	7.8	7.5
Reg. unemployment rate, in %, average	.	.	.	.	.	.	.	.
Average gross monthly wages, manuf.ind., TRY	1590	.	.	.	.	.	.	.
annual change in % (real)	0	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	10.4	6.3	8.6	6.5	9.0	7.8	6.0	5.0
Producer prices in industry, % p.a. [3)]	13.0	1.0	6.2	12.3	6.1	5.5	5.0	5.5
General governm.budget, EU-def., % of GDP [4)]								
Revenues	32.0	33.5	36.7	39.5	37.5	37.0	36.8	37.0
Expenditures	34.8	40.4	39.4	41.4	39.8	39.5	39.4	39.5
Net lending (+) / net borrowing (-)	-2.8	-6.9	-2.7	-1.9	-2.3	-2.5	-2.6	-2.5
Public debt, EU-def., % of GDP [4)]	40.0	46.1	42.4	39.2	36.8	36.0	35.5	35.2
Central bank policy rate, %, p.a., end of period [5)]	17.50	9.00	6.50	5.75	5.50	.	.	.
Current account, EUR mn	-28108	-9551	-35135	-55363	-38011	-51000	-59000	-68000
Current account, % of GDP	-5.6	-2.2	-6.4	-10.0	-6.0	-7.3	-7.5	-7.7
Exports of goods, BOP, EUR mn	95484	78616	91292	103086	127035	145000	167000	192000
annual change in %	13.7	-17.7	16.1	12.9	23.2	14.0	15.0	15.0
Imports of goods, BOP, EUR mn	131095	96145	133986	166943	178063	192000	211000	236000
annual change in %	11.0	-26.7	39.4	24.6	6.7	8.0	10.0	12.0
Exports of services, BOP, EUR mn	23928	24251	26604	27929	32743	36000	39000	43000
annual growth rate in %	13.3	1.3	9.7	5.0	17.2	9.0	9.0	9.0
Imports of services, BOP, EUR mn	12186	12024	14759	15084	15683	17000	19000	21000
annual growth rate in %	6.8	-1.3	22.7	2.2	4.0	6.0	12.0	12.0
FDI inflow, EUR mn	13217	6085	6805	11453	9635	12000	12500	13000
FDI outflow, EUR mn	1707	1110	1108	1791	3178	3000	3500	4000
Gross reserves of CB, excl. gold, EUR mn	51022	49088	60411	60637	77150	.	.	.
Gross external debt, EUR mn	202074	186974	218537	235840	230000	.	.	.
Gross external debt, % of GDP	40.5	42.5	39.7	42.5	36.4	.	.	.
Average exchange rate TRY/EUR	1.9064	2.1631	1.9965	2.3378	2.3135	2.35	2.30	2.25
Purchasing power parity EUR/EUR	1.1385	1.2116	1.2387	1.3409	1.4386	.	.	.

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

1) Preliminary. - 2) Gross value added of agriculture, forestry and fishing. - 3) Domestic output prices. - 4) According to ESA'95 excessive deficit procedure. - 5) From 2010 one-week repo rate, overnight lending rate before.

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