

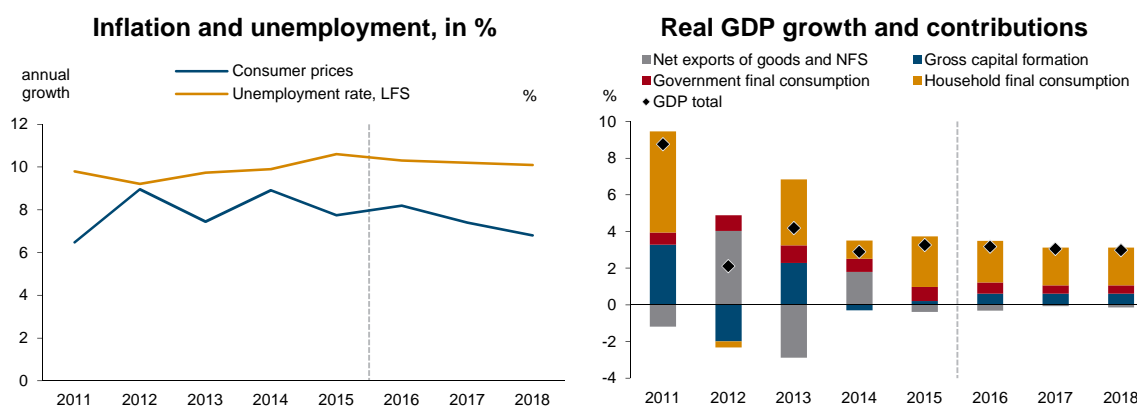


TURKEY: Strong domestic demand offsets external sector weakness

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Owing to both a 30% net rise in minimum wages and the current strong government spending, we expect GDP to expand by 3.2% in 2016. Given the ongoing tensions along the Turkish-Syrian border and with the decline in oil prices finally bottoming out, a recovery of (net) external demand is unlikely in 2016. As for 2017 and 2018, we expect GDP to grow by 3.1% and 3.0%, respectively, owing to the recovery of foreign demand following a steady depreciation process and positive but lower growth rates of consumer loans, ultimately leading to a firm policy stance being adopted by the Central Bank of the Republic of Turkey.

Figure 56 / Turkey: main macroeconomic indicators



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

The rising tensions both in the Kurdish-majority region in Turkey after the collapse of the Kurdish peace process in mid-2015 and along the southern border of Turkey because of the ongoing war in Syria have been raising both social and political uncertainties. The downing of a Russian war plane by the Turkish Air Force in November 2015 at the Syrian border increased the risks by deteriorating the political and economic relations between Turkey and Russia. Moreover, the conflict between the Turkish government and the United States on the issue of the Democratic Union Party (PYD) – the only reliable ally of the USA fighting against ISIS in Syria but a terrorist organisation in the eyes of the Turkish government – brought Turkey closer to the Syrian conflict. Since it is not clear whether the Turkish government will be

able to restore stability in its external relations, these developments compound the uncertainties affecting the Turkish economy.

Despite these developments, GDP increased by 3.4% in the first nine months of 2015 as compared to the same period of the previous year. Economic growth was still following its steady-state equilibrium, at around 3-4% since 2011. Although the political tensions and uncertainties remained high from mid-2015 onwards, GDP growth accelerated in the third quarter of the year: this was mainly on account of a hike in government spending and a rise in private consumption, which grew by 7.8% and 3.4%, respectively, year on year. Capital transfers, purchases of goods and services and compensation of employees were the main drivers of the hike in government expenditures in the first three quarters of 2015, with growth rates of 30.1%, 15.3% and 12.6%, respectively. On the private consumption side, sales of durable goods, in particular automobiles, continued to underpin the growth of household consumption. A rise in hourly wages in real terms was the major driving force of private domestic demand during 2015. We expect both private and public demand to have continued expanding at a moderate pace in the rest of the year and hence we estimate a GDP growth of 3.3% for 2015.

Central government expenditures in nominal terms increased by 12.8% in 2015, year on year, which is far from the 5.5% target of the medium-term programme of the government. But the central government budget deficit slightly narrowed by registering a deficit of TRY 22.6 billion (close to 1.5% of GDP) since revenues increased by 13.6%, primarily due to strong tax revenues. On the expenditure side, purchases of goods and services and compensation of employees were the main items in primary expenditures, increasing by 15.3% and 12.6%, respectively. On the tax revenue side, the collection of consumption-based taxes and income tax recorded an upsurge in 2015. As income tax revenues are largely provided through withholding taxes on salaries and wages, the strong increase in minimum wages in 2015 improved the collection of income taxes. The hike in sales of automobiles was the other main driver behind the surge in tax revenues in the first half of 2015. For 2016, we expect both the government's personal income tax revenues and consumption-based tax revenues to increase owing to higher minimum wage and the expansion in private consumption. We therefore forecast a slight improvement in the budget deficit as a share of GDP in 2016 and the years to come.

Despite lower energy prices throughout 2015, the annual inflation rate was 8.8% (end-of-period). The ongoing depreciation of the domestic currency both pushed the prices of core goods up and restricted the positive effect of the decline in energy prices. Additionally, prices of unprocessed food accelerated in the third and fourth quarters of 2015. The following three main developments are likely to play a crucial role for inflation in 2016. First, we are at the end of falling oil prices because the key OPEC and non-OPEC oil producers (Russia and Saudi Arabia) have reached an agreement on freezing the oil production. Second, the prices of unprocessed food might remain volatile because of the ongoing volatility of global food prices. And third, domestic demand may continue to rise due to the minimum wage hiked by 30% at the beginning of 2016. Therefore, we forecast average inflation rates to remain high, reaching 8.2% in 2016. For the years to come, our expectations of declining inflation are grounded on the following three reasons. First, we expect that the Central Bank of the Republic of Turkey (CBRT) will keep its tight policy stance in favour of price stability. Second, the exchange rate pass-through will decelerate due to the base effect since the nominal exchange rate significantly depreciated in 2015. And third, the slowdown in growth rates of consumer loans will restrict the growth rate of domestic demand and hence the inflation rate.

On the monetary policy side, the CBRT has been following a policy of flat interest rates since the beginning of 2015. It is unlikely that the CBRT will loosen its monetary policy unless they see positive developments in the inflation outlook. Against the backdrop of the uncertainty around the global markets and the volatility in food and energy prices which may lead to high prices in 2016, we assume that the CBRT will keep the policy rate at the current level rather than raising it in 2016. Since our inflation expectations up to 2018 are gradually decreasing, we forecast a moderate fall in the policy rates from 7.5% in 2016 to 6.5% in 2018.

The Turkish lira weakened, especially against the US dollar, in the first three quarters of 2015. After reaching an all-time low against the USD by ending the day at 3.06 TRY per USD on 15 September, the exchange rate stood at around 2.90 TRY per USD in the last quarter of 2015 and at around 3 TRY per USD so far in the current year. One of the main reasons behind the settling-down of the exchange rate depreciation is the improvement in the current account deficit with the help of lower oil prices and restrictions on consumer loans. Since tensions are high both in the southern part of the country and along Turkey's border with its neighbours including Russia, and the current account deficit is still high in spite of lower energy prices, we forecast a steady depreciation for the current year and the years to come.

The current account deficit decreased from USD 43.5 billion in 2014 to 32.2 billion in 2015. The trade deficit also narrowed in 2015. The main drivers behind the decline in the trade deficit are the change in the parity of the US dollar to the euro, the depreciation of the domestic currency and the sharp drop in energy and commodity prices. In 2015, cumulative exports declined by 8.7% in US dollars, but rose by 9.3% in euro terms in comparison with 2014; there was almost no change in export volumes. The share of the euro-area and EU countries in total exports increased while the share of Middle East countries was falling. Since the economic outlook for the euro-area countries and the EU is turning positive, we expect Turkey's exports to recover in 2016 in euro terms.

Trade relations with Russia are likely to play a crucial role in the goods and services trade deficit, hence also in the current account deficit. Russia was one of Turkey's largest trading partners. The economic slowdown in Russia already affected the trade relations in 2015. The share of Russia in Turkey's total exports was 3.8% in 2014 but decreased to 2.5% in 2015. The sanctions imposed after a Russian jet had been shot down by a Turkish fighter jet at the Syrian border will restrict Turkey's exports of goods (foodstuffs) and services (tourism, construction) to Russia. The first effect of the sanctions was the reduction of Turkish total export to Russia by 39% in December 2015, year on year. We forecast the main impact of the economic sanctions to be on tourism revenues in the summer of 2016. Russian travel agencies restricted selling tour packages to Turkey on the request of the Kremlin. The number of Russian tourist therefore fell by 47% in December 2015 and by 81% in January 2016. Since the share of Russian tourists in Turkey's total tourist number has been high (12.2% in 2013 and 2014, 10.1% in 2015), the effects of a Russian boycott of Turkish resorts will be substantial. We expect the share of Russian tourists in Turkey's total tourist number to be 6.4% in 2016. The civil war in Iraq and Syria and frictions with Egypt also restrict Turkey's exports to the region although the sanctions on Iran have been lifted. Despite those negative developments in the South-East in the context of the trade deficit, the improvement in Europe might help Turkey's exports to remain stable.

Cumulative imports declined by 14.4% in US dollar terms, but rose by 2.3% in euro terms, with no change in the import volume. We expect the decline in dollar imports to stop because OPEC and non-

OPEC oil producers are likely to reach an agreement on freezing the oil production which will probably result in the fall in oil prices coming to a halt. Therefore, the current account deficit is anticipated to slightly recover this year and to decline from 5.2% in 2016 to 5% of GDP in 2017.

Gross fixed capital formation rose by 2.5% in the first three quarters of 2015. The hike in private investment dominated the growth performance of gross fixed capital formation. In detail, machinery and equipment expenditures grew by 6%, but turned out to be negative in the third quarter with a growth rate of -2%. On the public side, machinery and equipment expenditures showed -0.3% growth whereas construction activities decreased by 3% in the first three quarters of 2015, year on year.

While the economic sanctions against Turkey might restrict the growth performance of the economy in 2016, the hike in minimum wages at the beginning of the current year and the ongoing strong government spending might offset the negative impact. Because of the persisting tensions along the Turkish-Syrian border and the bottoming-out of the oil price decline, a recovery of (net) external demand is unlikely in 2016. We therefore project GDP growth to expand by 3.2% in 2016. As for the years to come, we expect GDP to grow by 3.1% and 3.0%, respectively, owing to the recovery of foreign demand following a steady depreciation process and positive but lower growth rates of consumer loans with the effect of a tight policy stance of the CBRT.

Table 25 / Turkey: selected economic indicators

	2011	2012	2013	2014	2015 ¹⁾	2016	2017	2018
						Forecast		
Population, th pers., average	74,224	75,176	76,148	77,182	78,500	79,400	80,400	81,400
Gross domestic product, TRY bn, nom. ²⁾	1,298	1,417	1,567	1,747	1,940	2,200	2,400	2,600
annual change in % (real)	8.8	2.1	4.2	2.9	3.3	3.2	3.1	3.0
GDP/capita (EUR at exchange rate) ²⁾	7,500	8,100	8,100	7,800	8,200	8,400	8,700	8,900
GDP/capita (EUR at PPP) ²⁾	13,300	13,900	14,100	14,500	15,100	.	.	.
Consumption of households, TRY bn, nom. ²⁾	924	994	1,110	1,204	1,350	.	.	.
annual change in % (real)	7.7	-0.5	5.1	1.4	3.9	3.3	3.0	3.0
Gross fixed capital form., TRY bn, nom. ²⁾	283	287	319	352	390	.	.	.
annual change in % (real)	18.0	-2.7	4.4	-1.3	2.5	-2.0	2.0	2.0
Gross industrial production								
annual change in % (real)	10.1	2.5	3.0	3.6	3.2	3.1	3.0	3.0
Gross agricultural production ³⁾								
annual change in % (real)	5.2	5.5	2.8	2.0	2.0	.	.	.
Construction industry								
annual change in % (real)	11.5	0.8	7.7	2.9	0.7	.	.	.
Employed persons, LFS, th, average	24,100	24,820	25,520	25,931	26,600	27,200	27,800	28,400
annual change in %	6.7	3.0	2.8	1.6	2.6	2.2	2.1	2.0
Unemployed persons, LFS, th, average	2,616	2,517	2,750	2,854	3,150	3,120	3,160	3,190
Unemployment rate, LFS, in %, average	9.8	9.2	9.7	9.9	10.6	10.3	10.2	10.1
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY								
annual change in % (real, gross)	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	6.5	9.0	7.5	8.9	7.7	8.2	7.4	6.8
Producer prices in industry, % p.a.	13.0	5.3	5.9	10.9	5.4	6.0	5.5	5.0
General governm. budget, nat.def., % of GDP								
Revenues	34.6	35.7	37.8	37.3	36.9	37.5	37.5	37.5
Expenditures	35.9	37.7	39.2	38.2	38.5	39.0	39.0	39.0
Deficit (-) / surplus (+)	-1.3	-2.0	-1.5	-0.9	-1.6	-1.5	-1.5	-1.5
Public debt, nat.def., % of GDP ⁴⁾	39.1	36.2	36.1	33.5	35.0	35.0	35.0	35.0
Central bank policy rate, % p.a., end of period ⁵⁾	5.75	5.50	4.50	8.25	7.50	7.50	7.25	6.50
Current account, EUR mn	-53,828	-37,659	-48,752	-35,179	-29,186	-35,000	-35,000	-36,000
Current account, % of GDP	-9.7	-6.1	-7.9	-5.9	-4.6	-5.2	-5.0	-5.0
Exports of goods, BOP, EUR mn	102,365	126,137	121,819	127,237	133,031	146,000	161,000	177,000
annual change in %	12.0	23.2	-3.4	4.4	4.6	10.0	10.0	10.0
Imports of goods, BOP, EUR mn	166,271	177,043	182,049	175,303	181,799	194,000	208,000	224,000
annual change in %	24.1	6.5	2.8	-3.7	3.7	6.5	7.0	7.5
Exports of services, BOP, EUR mn	29,561	34,078	35,506	38,142	41,634	45,000	49,000	53,000
annual change in %	6.7	15.3	4.2	7.4	9.2	9.0	8.5	8.0
Imports of services, BOP, EUR mn	15,191	16,472	18,290	19,152	20,082	22,000	24,000	26,000
annual change in %	1.2	8.4	11.0	4.7	4.9	8.0	7.0	7.0
FDI liabilities (inflow), EUR mn	11,679	10,303	9,359	9,474	14,944	.	.	.
FDI assets (outflow), EUR mn	1,724	3,167	2,716	5,377	4,603	.	.	.
Gross reserves of NB excl. gold, EUR mn	60,531	75,749	80,435	88,058	85,355	.	.	.
Gross external debt, EUR mn ⁶⁾	234,873	256,955	282,109	331,508	365,000	386,700	403,500	426,100
Gross external debt, % of GDP ⁶⁾	42.3	42.0	45.6	55.1	56.9	58.0	58.0	59.0
Average exchange rate TRY/EUR	2.34	2.31	2.53	2.91	3.03	3.30	3.45	3.60
Purchasing power parity TRY/EUR	1.31	1.36	1.46	1.56	1.63	.	.	.

1) Preliminary and wiiw estimates. - 2) According to ESA'95 (FISIM not yet reallocated to industries). - 3) Based on UN-FAO data, 2014 wiiw estimate. - 4) Defined according to EU standards. - 5) One-week repo rate. - 6) BOP 5th Edition.

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