Turkey: Turkey’s economy testing its mettle

Over the past few years resilient business dynamics was the main feature of the Turkish economy. Turkey, even though the recent onset of ‘stability’ has started to attract attention in both economic and political terms. Real GDP growth peaked at 9.4% in 2004. It decelerated only slightly thereafter up until the first quarter in 2007, before going into decline and dropping to 3.4% in the second half of 2007. For reasons described below, we expect growth rates for 2008 and 2009 to range between four and five percent, returning thereafter to normality: a high degree of dynamics. Data from April 2008 suggest that the economy has not run out of steam; year-on-year growth in manufacturing output was 6.7%. The main driving force was output growth of 32% in the automotive sector and similarly pronounced overall growth in exports.

Of the sectors contributing to GDP, the manufacturing sector was mainly responsible for the deceleration of growth in 2007. The expenditure side hints at the reason for the manufacturing sector’s failure to increase value-added: the massive growth in imports in the second half of 2007. The impact of foreign trade on GDP turned negative: a trend that growth in domestic demand could not offset.

In the context of reduced GDP growth, the rate of unemployment has been rising gradually since mid-2007: up to 11.4% in the first quarter of 2008. The number of persons of working age has risen steadily. In February 2008 they totalled 49.7 million, although the participation rate was lower than before: less than 46% (23% for women, 70% for men). It is unlikely that the rate of unemployment will decline in 2008-2009. Approximately 1 million newcomers join the labour force each year.

Higher than expected inflation slows down private consumption growth in 2008

For Turkey, single-digit inflation (as of 2005) was one of Turkey’s major achievements over the past few years. Quite remarkably, the rapid drop in inflation occurred in tandem with pronounced GDP growth. The hike in world market prices for fuel, metals and food in recent months is pushing the country’s inflation rate for the current year back up again - to more than 10%. The rise in most other prices has remained modest. Should further increases in food and energy prices be contained, inflation will return once more to single digits in 2009 and 2010. However, a note of caution should be struck. A somewhat pronounced depreciation of the lira (against USD and EUR) could mean inflation remaining above 10%. Inflation is definitely a matter of major concern to both the economy’s internal and external stakeholders. The central bank felt itself compelled to revert to a policy of increasing interest rates - despite the adverse effect on growth to be of such a step expected.
High inflation is also slowing down the growth of real income in large segments of the population; we will thus have to reckon with low growth in private consumption in 2008. In April 2008, consumer confidence dropped to an unusually low level. In recent years, Turkey has experienced a boom in household borrowing; this, too, is likely to decelerate. Commercial banks used to bolster their lending policies by borrowing from abroad; however, they have since become cautious. In the context of increased volatility on global markets, bank managers anticipate a decline in profitability and are thus turning to safer loans with greater risk diversification. A number of banks have identified agriculture as a promising market. Gradual adoption of the principles of the EU Common Agricultural Policy and the emergence of higher world market prices for output are fuelling expectations of higher farm incomes in future. By the end of March 2008, the commercial banks’ lending amounted to 37% of the GDP in 2007; this means that there should be space for further expansion in the long term.

Gross fixed investment, both private and public, grew only moderately throughout most of 2007. Surprisingly enough, growth was strongest in the final quarter thanks to private investment in machinery. Investment growth may well speed up in 2008, with government projects, such as the development project for south-east Turkey, playing a positive role. Exports are also likely to keep growing rapidly. In the course of the past 10 years, an increasing share of Turkish exports went to EU countries (56% in 2007 compared to 51% in 1997). At the same time, trade with neighbouring countries also intensified (Near and Middle East 14% in 2007 compared to 11% in 1997; partners in the Black Sea Economic Cooperation region \(^1\) 16% compared to 15%). Most probably, the expansion of trade with neighbouring countries will continue over the next few years and contribute to overall export growth. As for imports, the rise in energy prices has increased the share of oil producing countries, with a corresponding drop in the share of EU-27 in total imports (from 54% in 1997 to 40% in 2007).

The art of bridging a rising gap in the current account

Compared to previous years, the current account deficit in 2008 will be substantially higher: EUR 30-35 billion, (6-7% of GDP). It is not likely to decline substantially over the next few years. The net inflow of foreign direct investment should cover close to one quarter the gap, with the main job being left to loans. Between spring 2007 and 2008, the corporate sector borrowed about EUR 25 billion from abroad.

In recent years, Turkey has had no problem financing the current account deficit; on the contrary, capital inflow far exceeded the deficit and currency reserves were on the rise. At the same time, close on a decade of assertive reforms had proved most effective, helping the economy’s fundamentals to improve substantially. Almost nobody would really question this; however, the massive deceleration in GDP growth accompanied by a sharp rise in inflation has strained the markets’ confidence. Even more stress stems from the conflict that has escalated after the lifting of the ban on wearing headscarves. Society appears deeply divided and the rift is perceptible in several other respects. Risk premia are on the rise. Bridging the current account gap has thus become more costly and will remain so throughout 2008 and 2009.

---

\(^1\) Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Ukraine.
With the onset of turmoil on financial markets in mid-2007, the Istanbul Stock Market index fell. Whereas the Turkish lira appreciated during the first three quarters of 2007, a shift towards depreciation surfaced in the fourth quarter of 2007 and the first four months of 2008. The monthly YTL/EUR average dropped from 1.85 in January 2007 to 1.71 in October only to rise to 2.05 in April 2008. The lira appreciated once more in May 2008 (1.94), when the central bank increased the prime rate and made it quite clear that this was merely a first step. Whereas it is uncertain whether rising interest rates will curb inflation to any great degree, it will most probably slow down GDP growth. The central bank would prefer to see inflation being combated via fiscal austerity, an approach that the government cannot afford to pursue for political reasons. Further to the statement that 'stability' has become a matter of concern in Turkey, we should add that fear of 'stagflation' is growing; in mid-April, an article in the Wall Street Journal addressed that issue.

Turkey will need to enter into close cooperation with international financial players; it has already started strengthening ties with international financial institutions. New loans from the World Bank are on the agenda, further to which Turkey has applied for full membership in the EBRD, thus opening up an avenue to a new source of funds for private investment. An International Monetary Fund (IMF) lending accord expired on 10 May. Of course, large quantities of EU money are pouring in, one aim being, for example, to promote the development of SMEs.

Capital flows are not one-way; Turkish companies, especially the large conglomerates, are eager to invest abroad in a wide range of countries. One example is Iraq. With the support of the United States, the Iraqi government has opted for a new privatization policy, based on a public-private partnership approach, which includes guarantees and special export arrangements. The new strategy aims at promoting the rehabilitation, modernization and management of enterprises operating in such sectors as petrochemicals, textile, sugar and cement. Major Turkish companies and less prominent firms alike have sighted opportunities to participate in this programme; their investment could ultimately add up to some EUR 10 billion.

Concluding remarks

Both politically and economically, Turkey’s current situation provides space for a number of potentially diverging developments. Low growth and high inflation may well prove short-lived. On the other hand, the possibility of further aggravation cannot be dismissed, for example, in the context of adverse international developments. It is not unlikely that in a few years time improved fundamentals and forceful entrepreneurial thinking will pave the way back to high growth rates and low inflation.
### Table TR

**Turkey: Selected Economic Indicators**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>71152</td>
<td>559.0</td>
<td>4421</td>
<td>8150</td>
<td>71152</td>
<td>559.0</td>
<td>4421</td>
</tr>
<tr>
<td>2005</td>
<td>72065</td>
<td>648.9</td>
<td>5369</td>
<td>8770</td>
<td>72065</td>
<td>648.9</td>
<td>5369</td>
</tr>
<tr>
<td>2006</td>
<td>72974</td>
<td>758.4</td>
<td>5745</td>
<td>9700</td>
<td>72974</td>
<td>758.4</td>
<td>5745</td>
</tr>
<tr>
<td>2007</td>
<td>73894</td>
<td>856.4</td>
<td>6478</td>
<td>10290</td>
<td>73894</td>
<td>856.4</td>
<td>6478</td>
</tr>
<tr>
<td>2008</td>
<td>Forecast</td>
<td>188.7</td>
<td>4.4</td>
<td>40.5</td>
<td>1120</td>
<td>1270</td>
<td>6.4</td>
</tr>
<tr>
<td>2009</td>
<td>70586</td>
<td>5.6</td>
<td>8.5</td>
<td>7.9</td>
<td>2.7</td>
<td>2.4</td>
<td>5.7</td>
</tr>
<tr>
<td>2010</td>
<td>70586</td>
<td>5.6</td>
<td>8.5</td>
<td>7.9</td>
<td>2.7</td>
<td>2.4</td>
<td>5.7</td>
</tr>
</tbody>
</table>

**Table Notes:**

- **1)** Preliminary.
- **3)** From 2007 new methodology due to census 2006.
- **4)** Industry including construction.
- **5)** From 2004 including overtime payment.
- **6)** According to ESA95, excessive deficit procedure.
- **7)** CBRT overnight, lending.
- **8)** Calculated 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 and European Commission (Spring Report 2008).

---

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

---

1. Current Analyses and Forecasts | July 2008

---

### Table TR

**Turkey: Selected Economic Indicators**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>71152</td>
<td>559.0</td>
<td>4421</td>
<td>8150</td>
<td>71152</td>
<td>559.0</td>
<td>4421</td>
</tr>
<tr>
<td>2005</td>
<td>72065</td>
<td>648.9</td>
<td>5369</td>
<td>8770</td>
<td>72065</td>
<td>648.9</td>
<td>5369</td>
</tr>
<tr>
<td>2006</td>
<td>72974</td>
<td>758.4</td>
<td>5745</td>
<td>9700</td>
<td>72974</td>
<td>758.4</td>
<td>5745</td>
</tr>
<tr>
<td>2007</td>
<td>73894</td>
<td>856.4</td>
<td>6478</td>
<td>10290</td>
<td>73894</td>
<td>856.4</td>
<td>6478</td>
</tr>
<tr>
<td>2008</td>
<td>Forecast</td>
<td>188.7</td>
<td>4.4</td>
<td>40.5</td>
<td>1120</td>
<td>1270</td>
<td>6.4</td>
</tr>
<tr>
<td>2009</td>
<td>70586</td>
<td>5.6</td>
<td>8.5</td>
<td>7.9</td>
<td>2.7</td>
<td>2.4</td>
<td>5.7</td>
</tr>
<tr>
<td>2010</td>
<td>70586</td>
<td>5.6</td>
<td>8.5</td>
<td>7.9</td>
<td>2.7</td>
<td>2.4</td>
<td>5.7</td>
</tr>
</tbody>
</table>

**Table Notes:**

- **1)** Preliminary.
- **3)** From 2007 new methodology due to census 2006.
- **4)** Industry including construction.
- **5)** From 2004 including overtime payment.
- **6)** According to ESA95, excessive deficit procedure.
- **7)** CBRT overnight, lending.
- **8)** Calculated 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 and European Commission (Spring Report 2008).

---

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