Turkey Regular Economic Brief

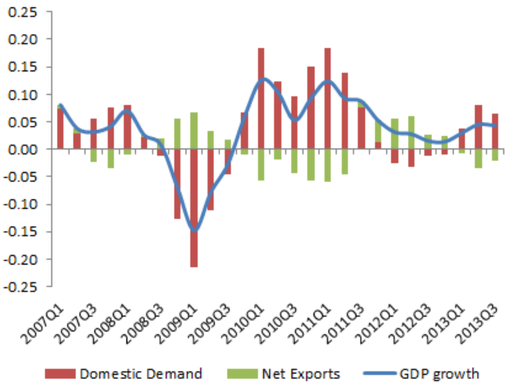
The World Bank

2014-I

- *Turkey's economy accelerated in 2013, but the medium-term prospects for growth are to remain below potential.*
- *With the recovery in domestic demand, concerns over external imbalances and inflation have also made a comeback in the context of less accommodating global financial conditions.*
- *To return to potential growth and ensure full use of Turkey's demographic window, structural reforms – including improvements in the business climate, upgrading of the quality of education, and measures to make the labor market more flexible – will be essential.*

Economic growth recovered in 2013 thanks to strong domestic demand. The economy expanded by 4.0 percent y-o-y in the first three quarters of 2013 on the back of private consumption, public investments and inventory build-up. The total contribution of domestic demand to headline growth was 6.1 pps while net exports shaved off 2.2 pps. Notably, after declining for six consecutive quarters, private investment grew by 5.3 percent in the third quarter. Almost all economic activity indicators indicate continued momentum in the fourth quarter and we thus estimate real GDP growth in 2013 to reach 4.3 percent.

Figure 1: GDP growth and contributions



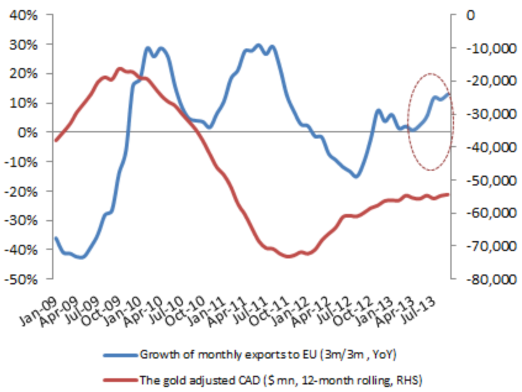
Source: TURKSTAT

External imbalances have increased again. Although lower energy prices, the recovery in the in EU and strong tourism revenues have kept the deterioration of the current account deficit (CAD) in check. Adjusting for net gold sales, the 12-month rolling CAD has little changed from $54.2 billion in December 2012 to $51.9 billion. The nascent recovery in the EU was the main driver of a 7.0 y-o-y increase in gold-adjusted exports in the first three quarters of the year. Tourism revenues, which increased by 13 percent since the beginning of the year, as well as lower energy prices, contributed further to the improvement in the gold-adjusted CAD. However, taking into account the large downward adjustment in net gold sales in 2013, the headline 12-month rolling current account deficit (CAD) increased to $60.9 billion (7.2 percent of estimated 2013 GDP) in October, up from $48.5 billion (6.2 percent of GDP) at end-2012.

Turkey's total external financing requirements over the next 12 months remain high at around $225 billion (more than 25 percent of estimated GDP). Financing of the CAD still largely depends on short-term inflows with the share of FDI and other long-term inflows accounting for 50 percent of total deficit financing. However, roll-over rates have remained comfortable, even during the summer of 2013, when Turkey recorded significant capital outflows related with concerns over "tapering" of extraordinary monetary policies in the US.

Exchange rate depreciation, hikes in unprocessed food prices and stronger domestic demand have pushed inflation well above the Central Bank's target in 2013. Annual inflation reached 7.3 percent in November 2013, compared to 6.4 percent a year ago and the central bank target range of 3-7 percent for the end of 2013. Core inflation (which excludes food, energy, tobacco and alcohol prices) stood at 7.2 percent, the second highest level in the last sixteen months. This signals that exchange rate pass-through and upward pressures exerted by domestic demand were the main drivers of the higher than targeted inflation. With recent hikes of petroleum prices, inflation is expected to increase further in December and reach 7.5 percent at the end of this year.

Figure 2: Growth of exports to EU



Source: TURKSTAT

Uncertainties over global financial conditions have led to a course correction by the Central Bank of the Republic of Turkey (CBRT). The Fed's announcement that it was considering tapering its asset purchases put the lira under pressure, together with other emerging market currencies, although Turkey was affected relatively more than its peers as a result of its large external imbalances. The CBRT reacted by increasing the upper-end of the interest rate corridor by an aggregate 125 bps point since July to 7.75 percent. In addition, the Bank also increased the number of exceptional days (during which it does not provide any liquidity to the financial system at the policy rate of 4.5 percent) to two. As a result, the overnight interbank rate increased to 7.75 percent in December 2013 from 6 percent in July. At the same time, the CBRT shifted from

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Medium-Term Macroeconomic Projections

	2013	2014	2015	2016
Real GDP growth rate (percent)	4.3	3.5	3.9	4.2
Consumer price inflation (end period, in percent)	7.5	6.2	5.4	5.0
Public sector primary balance (in percent of GDP)[1]	1.6	1.7	1.8	1.9
Gross public debt (in percent of GDP)	39.2	38.4	37.3	35.8
Gross external debt (in percent of GDP)	43.6	43.8	43.5	42.4
Current Account Deficit (in billions of US dollars)	61.1	59.7	59.1	57.8
Current Account Deficit (in percent of GDP)	7.4	7.1	6.8	6.5
Reserves (incl.gold, in billions of US dollars)	124.3	127.3	129.8	131.4

Source: World Bank Staff Projections, [1]Program definition

a stance that sought to discourage hot money flows through volatility in interbank rates to provide forward guidance to the market on interbank rates and accepting greater exchange rate volatility instead. With the potential tightening of global liquidity conditions, the CBRT's room for maneuver to support the domestic economy is decreasing.

Budget performance in the first ten months of 2013 was solid thanks to a recovery in domestic demand with the budget deficit in the first ten months reaching 0.5 percent of GDP compared to 2.2 percent at the end of 2012 and 1.2 percent targeted for 2013. The year-to-date central government budget deficit reached TL7.6bn ($3.7 billion) in October 2013, equivalent to 39.2% of the recently revised government year-end estimate for 2013 (1.2 percent of GDP). Meanwhile, the year-to-date primary surplus reached TL38.6 billion ($19.2 billion) compared to the latest official full year estimate of TL31.1 billion (2 percent of GDP). These headline numbers have been driven by tax revenue growth of 10.3 percent y-o-y in real terms during the first ten months of 2013, driven in turn by the recovery in domestic consumption as well as higher collections following a tax restructuring program (TL24.3 billion has been collected so far under the restructuring program since 2011). Government expenditures increased by 5.4 percent in real terms over the same period, on the back of growing capital spending and transfers. Revenues remain highly dependent on domestic consumption and the resulting cyclicality continues to pose fiscal risks going forward especially given high rigidities on the expenditure side.

We expect economic growth to stay below potential in 2014, while both inflation and the current account deficit are forecast to decline. Public investments, one of the main drivers of growth in 2013, are expected to be less buoyant in 2014 (as outlined in the Government's Annual Program). Private consumption is also estimated to lose momentum as a result of monetary tightening and the recent tightening of restrictions on consumer credit by the banking regulator (BRSA), while the base effect will not be as supportive as in 2013. Reduced volatility in domestic interest rates and rising capacity utilization on the other hand could help private investment recover (see focus note), and a further pick-up in EU demand is likely to support export performance. All in all, economic growth is forecast to remain below potential at 3.5 percent in 2014, with a limited reduction in the current account deficit to 7 percent of GDP while inflation is projected to ease to around 6 percent at year end.

Looking ahead, Turkey may have to settle for a period of modest growth given the prospect of tighter global financing putting an upper limit on the desirable level of external financing. Under the baseline scenario, Turkey is expected to finance around 7 percent current account deficit albeit at higher costs given the upcoming normalization of global liquidity conditions. Assuming no major changes in energy prices, this deficit level is in line with a growth rate of close to 4 percent in the medium term. Turkey's fundamentals are strong relative to previous domestic crisis episodes, and the risk of an imminent balance of payment crisis is very low. However, the country's large external financing needs leave it vulnerable to significant changes in global risk appetite. Turkey may thus have to adjust itself to modest growth as the price to pay to mitigate this vulnerability.

Continued progress with structural reforms would help reduce Turkey's dependence on external financing and help lower the volatility of Turkey's growth over the medium term. The Government published its Tenth Development Plan in July 2013 outlining directions for further progress on a broad ranging reform agenda. A voluntary savings program was implemented in January 2013 and has so far led to a 30 percent increase y-o-y in the first half of the year. Two important reforms stand out in the immediate term. A new income tax law is currently in Parliament, simplifying the income tax system and bringing it in line with international good practice. Finalization and implementation of the New Employment Strategy would help make Turkey's labor markets more flexible, in turn supporting a further increase in Turkey's low (female) labor force participation rates. Over the medium term, further upgrading of the quality of education is also critical to move to a more technology and innovation intensive growth path.

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