Turkey Regular Economic Brief

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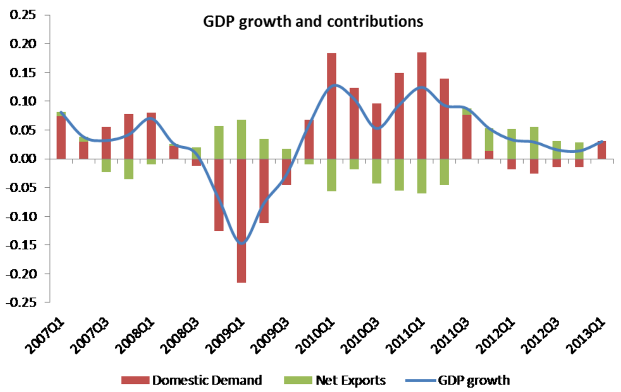
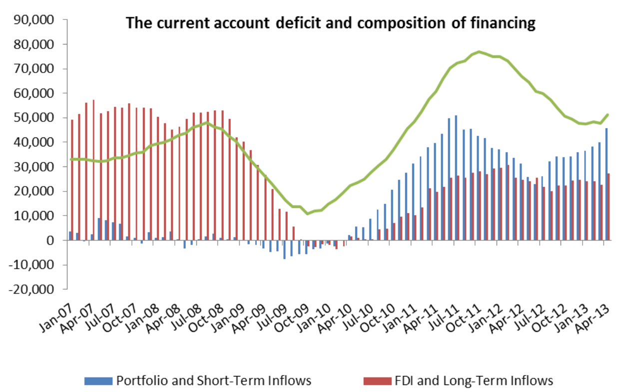
- **Growth in 2013 to remain below trend, at an estimated 3.6%.**
- **The 12-month rolling CAD amounted to $51.3 billion; it is mostly financed by portfolio inflows.**
- **Global trends may limit the room for the Central Bank to support the economy.**

Following the soft landing in 2012, economic growth is staging a moderate recovery in 2013. Real GDP expanded by 3 percent year-on-year (YoY) in the first quarter after expanding by 1.4 percent in the fourth quarter of 2012 and 1.6 percent in the third quarter. Domestic demand was the sole contributor to growth (with 3.1 pps) in the first quarter on the back of an 81.9 percent YoY surge in public investment. Net exports, which were the main driver of growth in 2012, did not contribute to growth. Going forward, our growth forecast for end-year 2013 is 3.6 percent.



The current account deficit (CAD) is likely to widen again as domestic demand accelerates, and the external financing requirement remains high. In the first four months of the year, the CAD increased by 17.1 percent YoY. However, adjusting for the gold trade the year-to-date CAD was down by 5.4 percent YoY thanks to a 27.6 percent YoY surge in tourism revenues. As of April 2013, the 12-month rolling current account deficit amounted to $51.3 billion (6.2 percent of estimated 2013 GDP) and the CAD remains mostly financed by portfolio inflows. FDI inflows were muted in the first four months of 2013 at just $3.1 billion compared to $5 billion a year earlier. As domestic demand picks up, we expect the CAD to widen further in the coming months and amount to 6.9 percent of GDP in 2013 as a whole, up from 6.1 percent in 2012. As of April, Turkey's total external financing requirement remains high at an estimated $220 billion (more than 25 percent of GDP) in the coming 12 months.

Inflation is likely to remain within the Central Bank's 3-7 percent target range this year. After hovering above 7 percent in the first quarter of 2013, headline 12-month inflation eased to 6.5 percent in May. The decline reflected lower food price inflation and favorable base effects. Meanwhile, in May, the core inflation measure, CPI-I, which excludes food, energy and alcohol prices increased slightly to 5.6 percent, but it is still at the second lowest level since August 2011. Inflation is likely to stay within the CBRT's target interval of 3-7 percent unless there is a significant further depreciation in the Lira and/or administrative prices hikes in the remainder of the year.



In response to significant capital outflows since mid-May, the CBRT increased borrowing costs and intervened in the foreign exchange market to stem lira depreciation. Outflows from emerging markets accelerated after the FED's announcement that it may reduce the amount of monthly bond purchases at the end of 2013. Since mid-May, the TL depreciated by 8 percent against $ and $/TL exchange rate reached a record high of 1.95. The main stocks market index (ISE-100) eased by 20 percent during the same period, and the benchmark yield jumped by almost 300bps. In response to these developments, the CBRT sold $1.9 billion dollars of reserves, which, however, remain comfortably high at $127.5 billion (6 months of imports) as of June 21st. The CBRT also increased effective borrowing costs by 100bps by limiting the amount of liquidity provided to the market. Tighter global liquidity conditions could limit the room for the CBRT to support economic growth going forward.

Medium-Term Macroeconomic Projections

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	3.6	4.5	4.7	5.1	5.1
Consumer price inflation (end period, in percent)	6.2	5.2	5.0	5.0	5.0
Public sector primary balance (in percent of GDP)[1]	1.6	1.7	1.7	1.8	1.8
Gross public debt (in percent of GDP)	39.2	37.7	36.1	34.6	33.6
Gross external debt (in percent of GDP)	43.6	43.4	42.7	42.4	41.8
Current Account Deficit (in billions of US dollars)	57.2	61.2	64.9	64.2	62.5
Current Account Deficit (in percent of GDP)	6.9	7.1	7.2	6.8	6.3
Reserves (incl.gold, in billions of US dollars)	124.3	127.3	129.8	131.4	132.6

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

- **Number of participants in the private pension system increased by 14 percent.**
- **We expect growth to increase gradually to 5 percent over the medium term.**
- **The government's new Development Plan outlines ambitious targets.**

Solid fiscal performance in the first five months of 2013 has been supported by domestic consumption; year-end targets seem attainable. The central government budget posted a surplus of TL4.3 billion ($2.2 billion) in the first five months of 2013 compared to a deficit of TL432 million ($222 million) a year earlier. In the same period, primary balance also increased by 8.7 percent YoY and reached TL26 billion ($13.4 billion). Total revenues increased by 8.0 percent YoY in real terms thanks to increased VAT revenues, while real expenditures rose by 4.8 percent YoY. Absent unexpected shocks, end-year fiscal targets look attainable. However, revenues remain highly dependent on domestic consumption and the resulting cyclicality poses fiscal risks going forward.

We expect growth to increase gradually to 5 percent over the medium term. Thanks to a recovery in private investment and a gradual improvement in global demand, we forecast growth to accelerate to 4.5 in 2014 and to 4.7 percent in 2015. Despite some expected tightening in global liquidity conditions, financing is expected to remain adequate, facilitated by continued solid macroeconomic management in Turkey. With reforms likely to boost productivity and competitiveness, the current account deficit is projected to ease to around 6 percent despite stronger growth.

Turkey's continued dependence on short-term external financing poses the main downside risk in the short term. A decline in risk appetite among emerging market investors prompted by an early exit from expansionary policies in advanced economies or a worsening of conditions in the Euro zone could dampen Turkey's growth performance. Compared to the risks emanating from the global economy, the possible adverse impacts of the recent social disturbances are likely to be muted, unless the tourism sector sustains lasting damage which presently seems unlikely. Strong first quarter growth provides a solid basis for 2013 and we thus have not revised our short-term outlook since mid-May.

Recent structural reforms brought a second investment grade rating in May (Moody's). Further progress is essential to mitigate external risks and increase potential growth. Developments since mid-May have highlighted again the volatile nature of capital flows to emerging markets, including Turkey, with the accompanying risks to growth and long-term prosperity. To help sustain strong growth, Turkey needs to pursue structural reforms, including those that boost productivity to support competitiveness, help increase domestic savings, and attract more FDI and other sources of long-term finance. Private pension reform was a positive step towards this goal with the number of participants in the private pension system increasing by 14 percent since the beginning of the year. In addition, a new commercial code and a capital markets law should help the country attract more FDI and increase competitiveness. Highlighting these reforms and remaining fiscal and financial sector buffers, Moody's joined Fitch in rating Turkey's sovereign debt at investment grade in May. But to tackle Turkey's structural vulnerabilities and prevent further volatility in its growth performance, a sustained reform effort will be necessary.

The government's new Development Plan is an opportunity to deepen the reform effort during 2014-2018. The macroeconomic targets are ambitious, with growth rising to 5.5 percent a year, inflation slowing to 4.5 percent, and the current account deficit stabilizing around 5 percent of GDP. To help achieve these goals, the plan outlines 25 program areas for further structural reforms, to be backed with specific action plans and target outcomes. To boost the economy's potential, the plan includes measures in the areas of competitiveness (innovation, business climate, financial markets), inclusion (female employment, labor markets, health, education, and also justice and human rights), public sector management (local government, spending efficiency, tax reform), sustainable development and resource management (energy efficiency, water management, sustainable cities, disaster risk management).

Contacts:
Marina Wes: mwes@worldbank.org
Cevdet Cağdaş Ünal: cunal@worldbank.org