Turkey Regular Economic Note

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- Public spending offset weaker private demand to keep growth solid in the first quarter
- Despite declining food prices, lira depreciation and increases in oil prices pushed inflation higher.
- Political uncertainty continues after the parliamentary election, creating downside risks to our 2015 growth forecast of 3 percent.

Growth remained resilient in Q1, thanks to public spending and lower imports. Seasonally adjusted (SA) GDP expanded by 1.3 percent q-o-q in Q1, a surprisingly strong outcome. The expansion of production continued the upward trend since Q3 of 2014. On the expenditure side, private consumption lost momentum and investment spending declined, this was more than offset by a rise in public spending and a positive contribution from net exports. Export performance was strong on the back of exports of gold, which has been imported in 2014 and drawn from inventory in Q1. Moreover, significant inventory accumulation in 2014 and weak demand led to a decline in imports in Q1 of 2015.

Job creation recovered in Q1, driven by services and industry. The economy created 254 thousand new jobs (SA) in the non-agricultural sector in Q1, while 154 thousand people entered the labor force (SA). The services and industrial sectors created 222 thousand and 78 thousand new jobs, respectively, while employment in construction sector dropped by 46 thousand. As a result, non-agricultural unemployment (SA) fell by 100 thousand in Q1. However, recent datapoints to a slowdown in job creation by 92 thousand in the three months through April, although the decline in unemployment continued thanks to a slower increase in the labor force. The non-agricultural unemployment rate (SA) dropped to 12.1 percent by April (from 12.2 in Q1).

Turkey`s current account deficit narrowed since January, thanks to gold exports. However, the gold adjusted deficit, a more accurate measure of external demand, deteriorated due to persistent weaknesses in Turkey's trading partners. The energy import bill continued to decline despite the rebound in global oil prices since January. As a result, the 3-month rolling gold adjusted current account deficit (SA) increased by $2.3 billion to $12.6 billion in the three months through April. On the financing side, short-term financial inflows significantly slowed due to election uncertainty, while long-term inflows remained strong. Particularly, nonresidents sold portfolio assets as the risk premium increased. However, net errors and omissions showed an inflow of $7.8 billion. This, together with a drawdown of foreign exchange reserves by $5.7 billion financed most of the current account deficit. The Central Bank of the Republic of Turkey (CBRT) efforts to defend the local currency via daily FX auctions and direct FX sales to public energy importing companies reduced gross foreign reserves by $9.9 billion to $120.7 billion in the five months from January through May 2015.

Inflation is likely peaking. Exchange rate depreciation amplified the impact of the oil price rebound since January and outweighed the relief from lower May food prices. Food prices had remained high since bad weather in the spring of 2014 led to a poor harvest, but this effect is slowly disappearing as the 2015 harvest sets in. Higher local energy prices fed into transport costs, which together created substantial upward pressure on prices. Against this backdrop, the annualized 3-month inflation (SA) increased to 12.1 percent in May, from 5.5 percent in March. In parallel, 12-month headline inflation escalated to 8.1 percent by May. Looking forward, favorable weather and a better harvest will help bring food inflation down. Under the assumption that further pressures on the exchange rate can be contained, 12-month inflation is likely to decline to 7 percent by December 2015.

Figure 1. Contributions to Quarterly GDP growth – Q1 2015

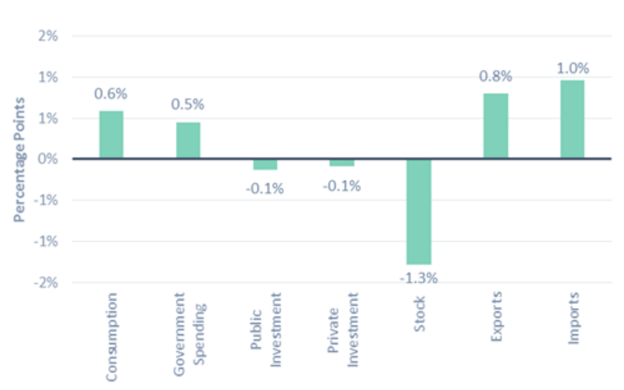
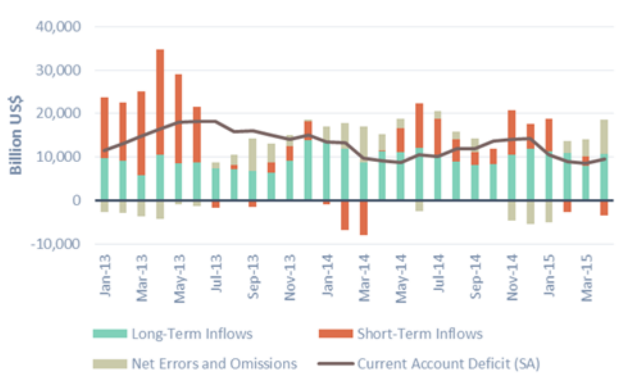


Figure 2. Foreign Financial Flows to Turkey (3-Month Sum)



Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.2	2.9	3.0	3.5	3.5
Consumer price inflation (end period, in percent)	7.4	8.2	7.0	6.5	6.5
Central government primary balance (in percent of GDP)	2.0	1.6	0.5	0.8	1.1
General government debt (in percent of GDP)	36.1	33.5	31.8	31.1	30.4
Current account balance (in billions of US dollars)	-64.7	-46.5	-34.7	-40.2	-44.7
Current account balance (in percent of GDP)	-7.9	-5.8	-4.6	-5.1	-5.5
Gross external debt (in percent of GDP)	47.3	50.3	51.0	51.0	51.2

Source: World Bank staff projections, TURKSTAT, CBRT, Undersecretariat of Treasury

The CBRT maintained an unchanged policy stance. The CBRT decided to leave its interest rate corridor unchanged at its April, May and June meetings. However, the CBRT tightened its liquidity stance further as a response to FX volatility in the market due to the risks concerning the inflation outlook. The share of overnight lending in the CBRT`s total lending increased to around 30 percent by mid-June, from around 15 percent in early April. As a result, the average cost of CBRT funding has risen, while the interbank lending rate remained at the upper end of the policy corridor. The expected FED lift-off will lower the returns on carry trade and is likely to put emerging market currencies under pressure. The CBRT will thus have limited room to be accommodative whilst maintaining financial stability.

Fiscal balances remained solid in the run-up to the June elections. Tax revenues recovered notably in the first five months of the year, allowing for strong budget spending without a deterioration in fiscal balances. The year-to-date tax revenues increased by 14.7 percent y-o-y in May, while non-interest expenses surged by 12 percent in this period. Especially, real spending on goods and services rose by 8 percent y-o-y and supported economic activity in this period. Thanks to strong revenues, budget balances remained robust with the year-to-date budget deficit declining to TL2.4 billion in May, from TL2.8 billion a year ago.

The outlook for 2015 depends on the resolution of the political uncertainty following the June 7 parliamentary election. The AK Party lost its parliamentary majority and coalition building efforts are likely to dominate Turkey's political scene for the coming weeks. The outcome is far from certain, and new elections in the coming 12 months cannot be ruled out. Investors' initial reaction to the election results was sharp. Turkish stocks lost 8 percent of their value, and the Turkish Lira depreciated almost 5 percent to touch 2.81 per USD on the morning of June 8. However, financial markets stabilized afterwards. Since the trough, the lira appreciated to 2.66 per USD by June 26, bond yields eased by 65 basis points, and stock prices rose by 7.4 percent.

We keep our full year 2015 growth forecast at 3.0 percent. The stronger than expected growth in Q1 is balanced by the uncertain political environment in the aftermath of the June elections. Leading indicators point to moderate growth in Q2. Industrial production growth slowed in April, but the momentum is still strong. Moreover, consumption spending continued at a good pace through April, with greater demand for consumer goods despite weak consumer confidence. However, we expect private consumption to lose momentum and investment to remain depressed in the second half of the year, as households and corporates are likely to postponekey spending decisions until political uncertainty is resolved. Going forward, the nascent recovery in the EU and real exchange rate depreciation should support industrial activity and exports in the remainder of the year. Thus, we maintain our growth forecast at 3 percent for 2015, with the current account deficit falling to 4.6 percent of GDP and inflation easing to 7 percent. However, we downgrade our growth forecast for 2016 and 2017 to 3.5 percent, against the backdrop of uncertain political outlook in a gradually tightening global financial environment.

Developments since the release of the April Turkey Regular Economic Note issue have changed the distribution of risks to the growth outlook. Risks are now evenly balanced. On the downside, an extended period of political uncertainty, due to failed attempts to form a stable government, may negatively affect investment sentiment and consumer confidence, resulting in increased volatility in financial markets. The main upside risk is a recovery in private demand as a result of the quick formation of a stable government.

Restoring investor confidence is key to growth over the short to medium term. Private investment has been weak for the last three years and started the year with a decline in Q1. Investor sentiment heavily depends on how the political process resolves itself. Structural reforms were on the political back-burner throughout the recent electoral cycle, although the authorities had been preparing to re-launch structural reforms after the elections. There is an urgent need for a stable, inclusive government and the return to implementation of the structural reform agenda to restore investor confidence. Over the medium-term, greater political checks and balances would likely be seen as positives by investors, and thus contribute to rebooting economic growth.

[1] For the April issue, please see: http://www.worldbank.org/tr/country/turkey

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