Turkey Regular Economic Note

2014-2

THE WORLD BANK

- Weaker domestic demand is projected to slow real GDP growth to 2.4 percent in 2014 from 4.0 percent in 2013.
- Turkey's fiscal and financial sector buffers are sufficient to ward off further possible shocks to investor confidence in spite of the country's large external financing needs.
- Measures to promote transparency and good governance in the short term can help build investor confidence. Renewed structural reform will be critical to maintain competitiveness and return to stronger growth over the medium term.

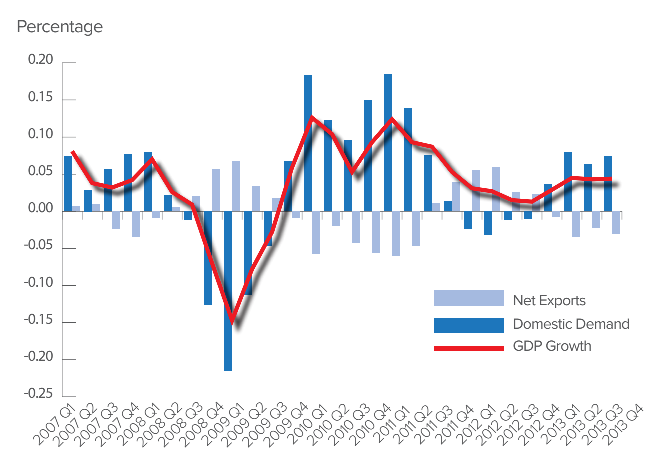
Economic growth recovered in 2013 thanks to strong domestic demand. The economy expanded by 4.0 percent y-o-y in 2013 up from 2.1 percent in 2012, on the back of stronger private consumption, public investment and inventory build-up. The contribution of domestic demand to headline growth was 6.4 percentage points (pps) while net exports subtracted off 2.3 pps. Notably, after declining for six consecutive quarters, private investment grew by 3.6 percent in the third quarter and 4.9 percent in the fourth quarter. In seasonally adjusted terms, there was some momentum loss in the final quarter of the year with q-o-q growth easing 0.5 percent from 0.8 in the third quarter and 2.0 percent in the second quarter. Meanwhile, per capital GDP reached $10,782 up from $10,459 in the previous year.

The current account deficit (CAD) widened significantly in 2013 mostly due to a large decrease in net gold exports. The CAD amounted to $64.9 billion (7.9 percent of GDP) in 2013 up from $48.5 billion (6.2 percent of GDP) in 2012, as large gold imports offset the positive impact of the recovery in the EU and the increase in tourism revenues. Adjusted for net gold sales, the CAD stood at $51.4 billion (6.3 percent of GDP) in 2013, marginally below the 2012 level. Net FDI inflows amounted to only 15 percent of total current account deficit financing in 2013 whereas the share of portfolio and other short-term inflows in total financing reached 46 percent. Rollover rates for external debt of financial and non-financial companies (excluding Eurobond issuances) remained high at 208.8 and 99.8 percent, respectively. Although borrowing costs increased in the wake of tighter global liquidity and domestic political uncertainty, Turkish firms' access to external financing remained solid.

Exchange rate depreciation kept inflation well above the Central Bank's (CBRT) 5 percent target. The 12-month inflation rate increased to 7.9 percent in February compared to 7.0 percent in the same month of last year. Over the same period, 12-month core inflation (CPI-I, which excludes food, tobacco, alcohol, gold and energy prices) rose sharply from 5.8 percent to 8.4 percent, the highest level in six years. As illustrated by an 11.9 percent y-o-y increase in durable goods prices, exchange rate pass-through was one of the main factors behind these increases.

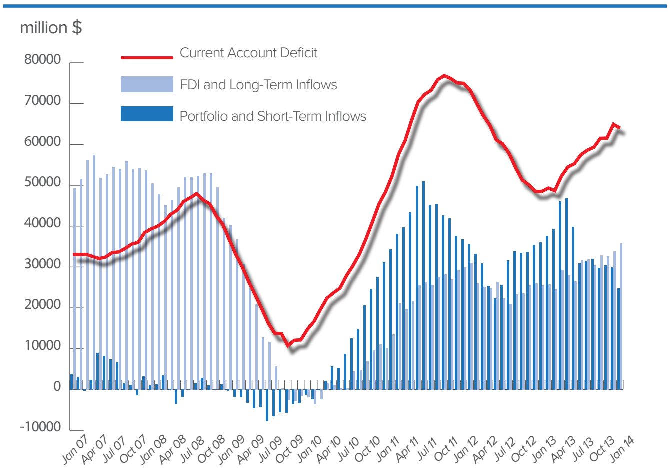
After substantial volatility at the end of 2013, financial markets have calmed down since the central bank's interest rate increase in January 2014, along with a return to more conventional monetary policy. In the wake of heightened domestic political uncertainty, the Turkish lira depreciated by 14.8 percent between December 17th and January 27th and reached a record low of 2.34 per US dollar. The CBRT's initial response to capital outflows was to increase the number of additional monetary tightening days

Figure 1. GDP growth and contributions



Source: TÜRKSTAT

Figure 2. The current account deficit and composition of financing



Source: TÜRKSTAT

Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.0	2.4	3.5	3.9	4.2
Consumer price inflation (end period, in percent)	7.4	7.8	6.2	5.0	5.0
Public sector primary balance (in percent of GDP)	0.9	0.6	1.2	1.0	0.9
Gross public debt (in percent of GDP)	40.0	39.1	37.8	36.6	35.1
Current account balance (in billions of US dollars)	-64.9	-50.6	-56.9	-57.0	-58.4
Current account balance (in percent of GDP)	-7.9	-6.4	-7.0	-6.8	-6.7
Gross external debt (in percent of GDP)	47.3	48.4	49.1	49.5	49.8
Foreign exchange reserves (in billions of US dollars)	110.3	108.9	109.8	115.6	122.3

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

and intervene in the exchange rate market by selling more than $9.5 billion (between December 17th and January 28th) despite a relatively low level of net reserves ($41.5 billion as of end-February). Yet, these measures failed to contain market pressures and in late January the bank returned to a more conventional monetary policy framework, increasing its policy rate (1-week repo) by 550 basis points. As a result, the weighted average cost of CBRT funding increased from 7.2 percent before the hikes to the current level of 10.2 percent. Financial markets have settled following this decision with the lira appreciating to around 2.14 per US dollar in the aftermath of the local elections. Should depreciation pressures re-emerge, we think that the CBRT has still room for further tightening.

The fiscal deficit narrowed considerably in 2013 and early results for 2014 indicate continued improvement. In line with the budget target, the central government budget deficit narrowed to 1.2 percent of GDP in 2013 from 2.1 percent in 2012. Tax revenues increased by 8.8 percent y-o-y in real terms in 2013 accounting for almost 80 percent of the deficit reduction. Solid budget performance has continued in the first two months of 2014 and the year-to-date budget surplus reached TL3.6 billion ($1.6 billion). The expected slowdown in domestic demand is likely to affect revenue performance and budget balances could thus deteriorate going forward. However, the special consumption tax increase at the beginning of 2014 will limit this deterioration while low public debt levels should allow the government to absorb shocks to domestic demand.

Economic growth is likely to slow significantly in 2014, with high inflation but a narrower current account deficit. Political uncertainty, the sharp depreciation of the lira, and monetary and macroprudential tightening have negatively affected consumer confidence since the beginning of the year. Thus, private consumption is estimated to lose considerable momentum, while the incipient recovery in private investment is likely to be interrupted. The weaker lira and a further pickup in EU demand should help support exports but this is unlikely to offset the slowdown in domestic demand. All in all, we forecast growth to ease to around 2.4 percent in 2014, with a reduction in the current account deficit to 6.4 percent of GDP. Inflation is projected to stay above the target interval, driven by the exchange rate pass-through and increases in unprocessed food prices.

Looking two to three years ahead, Turkey may have to settle for a period of modest growth, as higher global interest rates and risk re-pricing increase the cost of external financing. In our baseline scenario, we assume Turkey is able to finance a current account deficit of about 6.7 percent of GDP, albeit at higher cost. Assuming only modest declines in global energy prices, this deficit level is in line with a growth rate of close to 4 percent in the medium term. Meanwhile, inflation is projected to ease towards the official target of 5 percent in the medium term, helping limit real exchange rate appreciation.

Turkey's dependence on external financing and the corporate sector's large open foreign exchange position are the main risks to the baseline economic outlook. Turkey's external financing needs amount to about $210 billion (27 percent of GDP) in the coming 12 months and are likely to remain high over the medium term. Further depreciation of the lira could strain the balance sheets of corporates with large FX liabilities which in turn could have spill-over effects on the banking sector and the labor market, especially through the construction sector. These two risks are largely offset by solid fiscal balances and a well-capitalized banking sector, keeping the risk of an imminent crisis low.

Measures to promote transparency and good governance could help build investor confidence and lower risks in the short term, while over the medium term renewed structural reforms will be critical for growth. Recent government efforts to increase transparency have focused on independent financial audit and investor protection, but additional steps are needed to strengthen the rule of law and public sector governance. Medium-term structural reforms have been outlined in the Government's 2014-18 Development Plan and comprehensively cover competitiveness, inclusion and sustainability challenges. Particular efforts are needed to increase Turkey's attractiveness to FDI, given the country's financing needs and the potential for technological upgrading that foreign investment can bring. Additionally, important reforms on the government's agenda this year include the adoption of a new Employment Strategy to make labor markets more flexible and the enactment of a new income tax law to simplify the tax system.

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