Turkey Regular Economic Note

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- Growth slowed to 2.9 percent in 2014 and short-term prospects remain subdued.
- The fall in energy prices and weak domestic demand are helping bring the current account deficit down, but in the face of further exchange rate depreciation, the impact on inflation is less than expected.
- Uncertainty related to the upcoming parliamentary elections continues to weigh on investor sentiment; rapid implementation of key structural reforms is critical to restore confidence.

Subdued aggregate demand in the second half of 2014 kept growth at 2.9 percent in 2014. While the pace of expansion accelerated to 0.7 percent q-o-q in Q4, the full year print remains below potential. Externally, net exports subtracted 2.9 pps from growth in Q4, as a dip in the global economy translated into negative export growth while import demand recovered. Private consumption added 1 pps to sequential growth in Q4, but with private investment falling, and government spending overall remaining flat, this was hardly enough to compensate for weak external demand. Inventories increased substantially, making the largest contribution to growth with 2.5 pps in Q4. The unexpected inventory build-up and a series of poor leading indicators suggest the current economic weakness is likely to be extended into the first half of 2015. We revise our end-year growth forecast down to 3 percent.

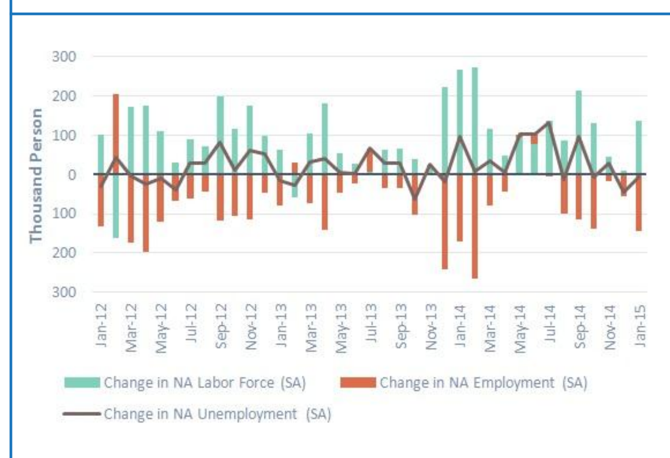
Weak industrial activity has slowed the pace of job creation. The seasonally adjusted (SA) job creation in the non-agricultural sectors slowed to 215 thousand in the three months through February 2015, from 354 thousand in the previous three months. Employment in the industrial sector declined by 4 thousand while employment in construction and services increased by 34 thousand and 185 thousand, respectively, over this period. At the same time, the increase in the non-agricultural labor force (SA) slowed to just 191 thousand, allowing unemployment (SA) to fall by 24 thousand. As a result, the non-agricultural unemployment rate (SA) declined to 12.4 percent, from 12.6 percent, in the period December-February.

The pace of disinflation has markedly slowed, leading us to revise upward our end-year projection to 7 percent. The strong price rise before August 2014 kept twelve-month headline inflation well above the CBRT`s target rate of 5 percent throughout 2014. Headline inflation started to decline in December and slowed to 7.2 percent in January 2015. However, since then, inflationary pressures have been building again. Monthly energy inflation (SA) accelerated in February and March, due to another considerable depreciation of the Lira and a small recovery in global energy prices, feeding through to rising transport prices (SA) as well. Moreover, monthly food inflation (SA) along with the prices of catering services (SA) rose in February and March, bringing the annualized 3-month food inflation (SA) to 12.9 percent in March, up from 4.5 percent in December. While a better 2015 harvest should help bring food prices down as the year progresses, the broad range of price increases in the past two months indicates that the pace of disinflation is slower than we had forecast in December.

External adjustment continues, driven by an increase in gold exports and a lower energy bill. The 12-month rolling current account deficit declined to $42.8 billion (5.4 percent of GDP) in February 2015, from $46.9 billion (5.8 percent of GDP) in September 2014. Substantial gold exports lowered the annual gold deficit by $2.1 billion while the annual energy deficit declined by $3.1 billion over the same period. However, the non-gold non-energy current account balance deteriorated by $1.1 billion, as export performance weakened markedly in the second half of 2014. In addition to weak global conditions, the depreciation of Euro against USD also put pressure on the dollar value of total exports, given around 45 percent of exports are invoiced in Euro. For some companies, reportedly falling export earnings and rising import bills due to changes in the Euro/USD parity have depressed profitability, but for the economy as a whole the effect has not been large. On the financing side, inflows to Turkey accelerated in Q4, but weakened in the last three months through February, driven by slower portfolio and other investment inflows. Turkey attracted $4.1 billion worth of FDI inflows and another $1.6 billion worth of portfolio inflows, and received $2.7 billion worth of other investment in this period.

Figure 1. Contributions to Quarterly GDP growth – Q4 2014

Figure 2. Monthly Change in Non-Agricultural (NA) Unemployment



Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.2	2.9	3.0	3.9	3.7
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	0.8	1.2	1.3
General government debt (in percent of GDP)	36.1	33.5	32.0	31.0	30.0
Current account balance (in billions of US dollars)	-64.7	-45.9	-34.6	-41.5	-44.8
Current account balance (in percent of GDP)	-7.9	-5.7	-4.4	-4.9	-5.0
Gross external debt (in percent of GDP)	47.3	50.3	50.8	50.6	50.0
Foreign exchange reserves (in billions of US dollars)	110.9	106.9	104.0	106.6	107.3

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

After two rate cuts in January and February, the CBRT has signaled a pause as inflation has remained above target levels and the TL suffered from repeated downward pressures. At its January and February meetings, the Monetary Policy Committee (MPC) cut the 1-week repo rate by 75 bps, lowered the overnight lending rate by 50 bps, and reduced the overnight borrowing rate by 25 bps. The sharp rise of the USD and domestic uncertainty put pressure on the currency, with the TL depreciation among the strongest in emerging markets since the start of the year. In reaction, the CBRT increased the daily FX selling auction amount and maintained a tight liquidity stance by keeping the interbank overnight lending rate at the upper end of its policy rate corridor. In its March meeting, the MPC kept rates unchanged. On the fiscal side, Prime Minister Davutoglu announced a new set of measures worth of TL7.5 billion (0.4 percent of GDP) to support growth and employment in April. Although the total cost of the new measures is manageable, some introduce new long-term commitments, which could limit budget flexibility going forward.

With economic confidence subdued, we adjust our forecast for 2015. Domestic uncertainty continues in the face of approaching parliamentary elections in June 2015. The PMI slipped to 48 in March 2015 while consumer confidence fell to 64.4 the lowest level since March 2009. With mixed impulses from the global economy, despite signals of a recovery in the Eurozone, it is likely that households and corporates will postpone key spending decisions until after the elections. Under the assumption that domestic demand recovers sharply after the elections, as uncertainty is resolved, growth will accelerate in the second half of the year, but the carry-over from a weak start will keep the yearly pace of expansion to 3 percent. Rising import demand and uncertain export prospects will dampen the pace of external adjustment, although lower oil prices should keep the current account deficit to 4.4 percent of GDP. Accordingly, the external financing requirement is expected to decline to about $200 billion in 2015, from $220 billion in 2014. Quarterly dynamics will push up 2016 growth to 3.9 percent, before regaining trend levels of 3.7 in 2017.

Risks to our forecast are evenly balanced; the key to faster growth is to restore confidence. Weak investment has lowered Turkey`s GDP growth since 2012 and reduced its medium-term potential. Against this background, a credit-driven consumption-based growth strategy is no longer a viable option for Turkey. Households and corporates are now more leveraged compared to the early 2000s, and with banking sector profitability declining and the loan-to-deposit ratio rising to 115 percent, the ability of the banking sector to support rapid credit growth is more limited going forward. These factors may explain why domestic demand remains subdued despite considerable policy stimulus, as domestic actors prepare to rebuild buffers against downside risks. Restoring confidence through strong reform signals is critical to boost investment and increase the economy's medium-term potential. The key reform priorities are well known: improvements in the business climate, investments in skills and education and reforms to the labor market to facilitate job creation, and a commitment to the rule of law and independent economic institutions. Implementation of Government`s announced 25 Transformation Programs would do much to put Turkey back on a higher growth path and to lower risks to the economic outlook.

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