Turkey Regular Economic Note

December 2014

- Economic growth disappointed in the third quarter, due to a shift to inventory destocking. We downgrade our growth estimate for the full-year 2014 to 3.1 percent.
- The outlook for inflation and the current account has improved substantially due to the sharp decline in oil prices.
- Renewed weakness in the currency showed, once again, that Turkey is vulnerable to changes in investor sentiment; the room for maneuver on monetary policy thus remains limited.

The economic outturn disappointed in the third quarter, as a shift from inventory accumulation to destocking more than offset the recovery in other components of domestic demand. Real GDP expanded 0.4 percent q-o-q in Q3 2014, after a 0.5 percent contraction in the previous quarter (Figure 1). The year-on-year expansion was 1.7 percent, the lowest since Q4 2012. Despite a disappointing headline number, the composition of growth became more balanced. Private consumption and private investment recovered markedly, and government spending expanded at a reasonable rate. Moreover, net exports continued to support growth. Turkey's growth rate outperformed that of Brazil, South Africa, and the Euro Zone, but fell behind in comparison to Hungary, Poland, Romania, China, UK, and USA. We revise down our estimate of GDP growth in 2014 to 3.1 percent from our October forecast of 3.5 percent.

Despite strong job creation, unemployment increased as the labor force expanded rapidly. Supported by industry and services, in September the economy created 113 thousand non-farm jobs in seasonally adjusted terms, compared to 94 thousand in August and 2 thosaund in July. Industry, construction and services sectors created 49 thousand, 15 thousand, and 49 thousand new jobs, respectively. At the same time, the non-agricultural labor force increased by 210 thousand in September pushing non-agricultural unemployment up by 97 thousand (Figure 2). The seasonally adjusted unemployment rate in non-agriculture rose to 12.8 percent in September from 12.5 in August. The sharp increase in the labor force reflects both demographic change and increases in labor force participation among women, both of which are expected to continue and contribute to raising Turkey's growth potential over the medium term.

Headline inflation is peaking. Twelve-month inflation increased slightly to 9.15 percent in November, as food prices continued rising at a high pace. Food prices surged 14.7 percent year-on-year in November, up from 12.7 percent in October. Non-food inflation eased by 0.4 pps to 7.5 percent still well above the official target of 5 percent, while the annual core inflation measure, the CPI-I index, remained unchanged at 9 percent in November. In seasonally adjusted terms, however, monthly inflation has slowed substantially, suggesting 12-month inflation is set to decline in the absence of shocks. Seasonally adjusted (SA) annualized inflation slowed to 3.8 percent in November from 13.7 percent in July, while the annualized core inflation (SA) dropped to 6.0 percent from 10.2 percent. The sharp decline in oil prices, the expected mean reversion in food prices, and the favorable base effect will support disinflation in early 2015. The renewed depreciation trend in the Lira is the main downside risk on the positive inflation outlook.

External adjustment continued through October, thanks to the resilience of exports. The 12-month rolling current account deficit declined to 5.7 percent of GDP in October from 6.5 percent in June. Gold trade accounted for 0.2 pps of the adjustment, while the remaining 0.6 pps came from non-gold components. Despite a slowdown in the second half of the year, exports to the EU remained the main drivers of export performance in 2014. Weak domestic demand led to a decline in imports which contributed to the adjustment. We expect weaker export performance going forward, mainly because of weak EU growth and geopolitical tensions, while imports should increase as domestic demand recovers, though the increase will be moderated by lower energy prices.[i] We estimate the current account deficit at 5.6 percent of GDP in 2014. Net FDI inflows amounted to only 16.1 percent of the year-to-date financing whereas the share of net portfolio inflows, net other investment inflows and net errors and omissions stood at 46.6 percent, 32.8 percent and 17.9 percent, respectively. Because of the sizable adjustment in the current account deficit, Turkey`s total external financing requirement over the next 12 months eased to $210 billion (24 percent of estimated GDP).

Figure 1. Contributions to Quarterly GDP growth – 3Q 2014

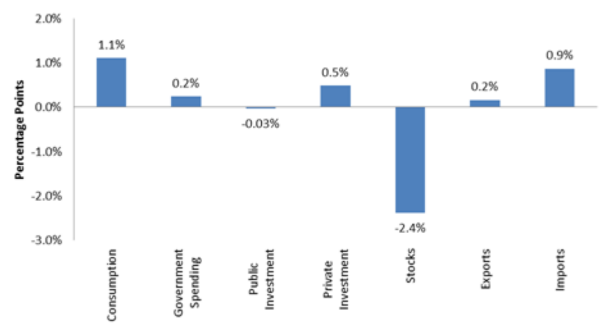
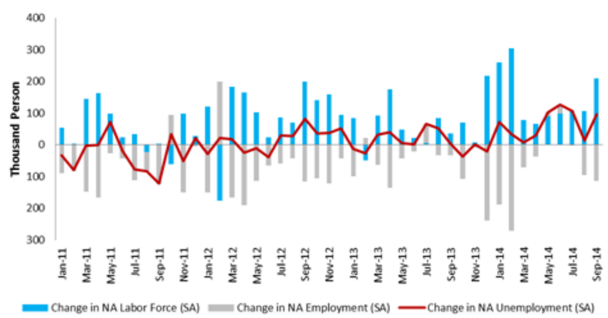


Figure 2. Monthly Change in Non-Agricultural (NA) Unemployment



Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.1	3.1	3.5	3.7	3.9
Consumer price inflation (end period, in percent)	7.4	9.0	6.7	5.0	5.0
Central government primary balance (in percent of GDP)	2.0	1.3	0.8	0.8	1.2
Gross public debt (in percent of GDP)	39.8	40.9	38.3	35.4	32.0
Current account balance (in billions of US dollars)	-65.0	-44.9	-38.4	-44.9	-50.3
Current account balance (in percent of GDP)	-7.9	-5.6	-4.5	-4.9	-5.0
Gross external debt (in percent of GDP)	47.2	48.8	48.6	48.0	47.0
Foreign exchange reserves (in billions of US dollars)	110.9	112.6	113.4	116.0	116.7

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

Budget performance in the first eleven months of 2014 was weaker than last year, but in line with fiscal targets. The year-to-date central government budget deficit reached TL11.3 billion in November 2014, equivalent to 34.1 percent of the full year target of TL33.3 billion (1.9 percent of GDP). Meanwhile, the year-to-date primary surplus amounted to TL37.1 billion, compared to the official year-end target of TL18.7 billion (1.1 percent of GDP).[ii] Weak consumption spending weighed on tax revenues which increased by just 7.4 percent y-o-y, compared to 17.1 percent y-o-y in November 2013. Indirect tax revenues expanded by only 4.7 percent y-o-y, down from 21.8 percent y-o-y in November 2013. While spending traditionally increases in the final month of the year, and despite lower revenue growth, the government's fiscal targets for 2014 are attainable.

The Central Bank (CBRT) reacted to changes in investor sentiment by actively managing liquidity. The fall in oil prices, and more dovish statements from the US Federal Reserve sparked a mini-rally in Turkish assets until late November. The benchmark equity index rose 14.5 percent, while the benchmark bond yield dropped 234 bps in this period. The Turkish Lira was the best performing currency against the US dollar among major Emerging Market currencies until November 27. As the pressure on the Lira softened, the CBRT eased liquidity and the cost of CBRT funding and overnight interbank rates converged towards the policy rate. Since late November, most Emerging Markets came under pressure once again, and the Lira depreciated 7.4 percent to 2.37 against the US dollar as of December 17. The CBRT responded to the increased volatility in the FX market by providing less funding (compared to the demand) through the 1-week repo facility. The average overnight interest in the interbank market hit the upper-end of the corridor at 11.24 percent, while the average cost of CBRT funding jumped to 8.78 percent as of December 17. Recent currency volatility once more underscores the vulnerability of Turkey to changes in investor sentiment, which limits the room for maneuver of the CBRT to react to the improved inflation outlook and external adjustment with reductions in policy rates.

We expect private consumption to pick up and become the main driver of growth again in 2015. In our baseline forecast, we expect growth to rise marginally to 3.5 percent in 2015, while the current account deficit narrows to 4.5 percent of GDP, and inflation moderates to 6.7 percent at year end. Private consumption is expected to continue to recover thanks to falling inflation and accommodative fiscal and monetary policies ahead of the June 2015 General Elections. However, despite the positive impact of lower oil prices, political uncertainty and volatility in global financial markets will continue to weigh on investor sentiment. The contribution of net exports will turn negative again, as the recovery in domestic demand will boost real import growth while sluggish EU growth and geopolitical challenges constrain real export performance. Our baseline forecast is predicated on the assumption that the Federal Reserve and Bank of England will start gradually increasing the interest rates only in the second half of 2015. An earlier than expected tightening of international liquidity presents a downward risk, particularly if it leads the recent turn of investors away from Emerging Markets to be sustained.

Over the medium-term Turkey`s growth prospects depend on the recovery of private investment and this in turn is linked to the implementation of structural reforms. Bewteen 2002 and 2007, private investment was one of the main growth drivers, contributing 2.9 pps or around half of the average annual growth rate during this period. Since 2012, private investment has been subdued, however. This has constrained growth and persistent investment weakness would weigh down on the economy's potential. The Government's announced 25 Transformation Programs provide an opportunity to regain the momentum on structural reforms and signal the government's commitment to a level playing field for all investors. Moving beyond announcements to implementation will be critical.

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[i] Please see the complementary Focus Note for a detailed discussion of the impact of falling oil prices on macroeconomic variables.

[ii] Central government budget deficit and primary surplus year-end estimates are updated to 1.4 percent and 1.5 percent of GDP, respectively, in the 2015-2017 Medium Term Program.

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