Turkey Regular Economic Note

2014-3

THE WORLD BANK
IBRD • IDA

- Thanks to stronger exports and sustained government demand, the economy has remained resilient and we upgrade our full-year growth forecast for 2014 to 3.5 percent.
- While the economy started to rebalance in the first quarter of 2014, more adjustment is needed to reduce external financing risks, calling for prudent monetary and restrained fiscal policies.
- Reforms to increase transparency and improve the investment climate are needed to boost investor confidence and strengthen Turkey's growth potential over the medium term.

GDP growth has remained resilient in the first quarter of 2014 despite a loss of momentum in domestic demand. The economy expanded by 4.3 percent y-o-y in the first quarter of 2014. However, with more subdued private demand, the contribution of domestic demand declined to 2.8 percentage points (pps) from 6.0 pps in the fourth quarter of 2013 and 4.6 pps in the third. The main contribution to economic resilience came from exports thanks to the recovery in the EU and the real exchange rate depreciation. Net exports added 2.7 pps to GDP in the first quarter of 2014 after subtracting 2.3 pps in 2013 as a whole. As a result, Turkey's economy has started to rebalance again.

Rapid employment creation has continued. The economic slowdown in 2012 affected the labor market with a lag and the seasonally adjusted unemployment rate increased to 9.5 percent in September 2013 up from a record low of 8.1 percent in June 2012. Since then, unemployment has steadily come down to 9.1 percent in March, despite the rapid increase in labor force participation which reached a record level of 50.4 percent of the working age population in the same period. Although employment creation has been broad-based, growth in construction employment has been particularly rapid, surging by almost 12.4 percent compared to a year ago.

Turkey's current account deficit (CAD) has come down somewhat thanks to the recovery in the European Union (EU) and the exchange rate depreciation, but imbalances remain high. Adjusting for net gold sales, which added 1.4 percent of GDP to the current account deficit in 2013, the 12-month rolling current account deficit declined to 6.2 percent of GDP in March 2014 from 6.7 percent a year earlier. The recovery in the EU and a 6.6 percent y-o-y depreciation of the real effective exchange rate were the main factors behind a 7.2 percent y-o-y increase in gold-adjusted exports in March. Short-term inflows accounted for almost half of current account deficit financing in 2013. In the first quarter of 2014, turbulence in financial market led to portfolio outflows, and net errors and omissions along with a drawdown in reserves accounted for the bulk of CAD financing. However, banking and corporate sectors roll-over ratios have remained comfortably above 100 percent. More recently, uncertainties have declined and supported by improved global prospects capital inflows have resumed. In April, net FDI inflows recovered to $3.2 billion, portfolio inflows amounted $4.2 billion and foreign exchange reserves increased by $2.7 billion.

Inflation remains significantly above the central bank`s (CBRT) target of 5 percent. Consumer prices continued to increase in May, bringing 12-month inflation to 9.7 percent from 7.4 percent in December 2013. Over the same period, core inflation, which excludes food, tobacco, alcohol, energy and gold prices, reached 9.8 percent, its highest level since April 2007. Exchange-rate depreciation, the deterioration in inflation expectations and the resulting pass through to pricing behavior were the main drivers of headline inflation. Accordingly, the CBRT revised its end-year inflation forecast up by 1.0 pp to 7.6 percent in its second inflation report of the year (compared to our forecast of 8.2 percent).

Figure 1. GDP growth and contributions

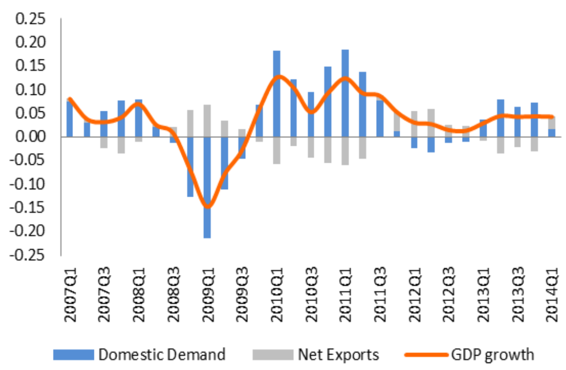
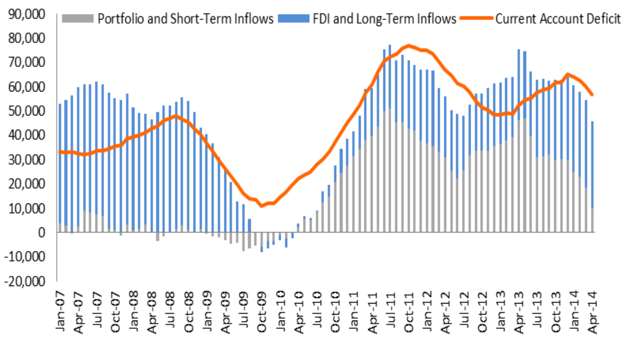


Figure 2. The current account deficit and composition of financing



Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.0	3.5	3.5	3.7	3.9
Consumer price inflation (end period, in percent)	7.4	8.2	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	-52.2	-54.4	-55.8	-54.5
Current account balance (in percent of GDP)	-7.9	-6.3	-6.2	-6.0	-5.6
Gross external debt (in percent of GDP)	47.3	48.0	48.3	48.6	48.7
Foreign exchange reserves (in billions of US dollars)	110.3	112.6	113.4	116.0	116.7

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

Despite the unfavorable inflation outlook, the CBRT cut the policy rate by 50 bps in May. While the Bank cut the policy rate (1-week repo), it kept the overnight borrowing and lending rates unchanged at 8 percent and 12 percent respectively. As a result, the weighted average cost of CBRT funding fell from 10.2 percent to 9.5 percent. The CBRT underscored the decline in uncertainty and reduced risk premia as the rationale behind the rate cut. To bring inflation back down to target levels, the CBRT will need to maintain a tight stance given the deterioration in inflation expectations.

Fiscal outcomes worsened somewhat on the back of underperforming tax revenues and large real spending increases. The central government deficit amounted to TL2.8 billion in the first five months of the year compared to surplus of TL4.3 billion a year earlier; the primary surplus fell by 15 percent y-o-y to TL22.1 billion. Real expenditures increased by 6.3 percent y-o-y compared to a 1.9 percent increase in real revenues[1]. Tax revenues increased by 0.6 percent in real terms. Nonetheless, with steady growth, year-end targets seem attainable. The cyclicality of revenues and the increasing weight of rigid non-discretionary spending continue to pose fiscal risks.

We are revising our full year 2014 growth forecast to 3.5 percent. Economic activity indicators point to contuinued rebalancing during the remainder of the year.While industrial production growth remains strong thanks to robust exports, slowing credit growth and a sluggish PMI signal weaker domestic demand. Growth during the remainder of the year should remain supported by export demand, relatively favorable global liquidity conditions, and continued gradual fiscal expansion. The CAD should stabilize at 6.3 percent for 2014, and more adjustment is needed to reduce external financing risks over the medium term. We see limited scope for further credit easing until inflation comes down within the CBRT's target range.

Growth is likely to remain below recent historical averages over the medium-term as a normalization of global liquidity conditions and another round of risk re-pricing makes external financing dearer. In our baseline scenario, Turkey should be able to finance a current account deficit of about 6.0 percent of GDP, albeit at higher cost. Assuming only modest changes 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 by 2016, helping limit real exchange rate appreciation.

Faster and more sustainable economic growth will ultimately rely on increasing investment and economic competitiveness. For this, structural reforms to improve transparency and the business climate and thus boost investor confidence are critical. 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.

[1] *Adjusted for 12-month average inflation.*

Contacts:
Marina Wes: mwes@worldbank.org
Ayberk Yılmaz: ayilmaz@worldbank.org