Turkey Regular Economic Note

2014-4

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- Economic activity weakened in the second quarter, as European growth faltered and geopolitical tensions grew.
- External adjustment continued but imbalances remain.
- Headline inflation remains well above the Central Bank target.
- Turkey needs to implement structural reforms to strengthen its growth potential over the medium term.

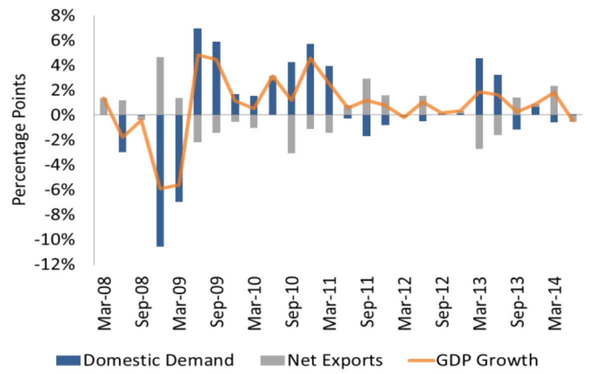
Economic activity weakened in the second quarter, as net exports turned negative and all components of domestic demand – except for inventory accumulation – fell. The economy contracted 0.5 percent q-o-q in Q2 2014. Private consumption and private investment continued to decline, though at a slower pace, and shaved off a total of 0.4 pps from GDP growth. Government consumption subtracted another 0.5 pps. Lower economic momentum in Europe together with rising geopolitical tensions caused a fall in demand for Turkey`s exports. As a result, net exports subtracted 0.5 pps in the second quarter of 2014, after adding 2.4 pps in the first quarter. The lack of demand for domestic goods led to inventory build-up, the only driver of economic activity in the second quarter, and added 1.0 pps to overall GDP growth. We maintain our 2014 and 2015 growth forecasts at 3.5 percent, but with increased downside risks.

Labor market developments paralleled the slowdown in economic activity in the second quarter. Seasonally adjusted unemployment increased from 9.1 percent in March to 9.9 percent in June. Unemployment in the non-agricultural sector had been increasing since September 2012, mostly because the number of new entrants to the labor force outnumbered the number of jobs created, reflecting both demographic factors and the continued increase in female labor force participation rates. Employment creation slowed substantially in the second quarter, leading to the highest annual increase in non-agricultural unemployment (384 thousand) since October 2009. Employment in industry and construction declined in April-June, while the employment creation in services slowed down.

Turkey`s current account deficit continued to decline, but external financing needs remain high. The current account deficit, which widened to 7.9 percent of GDP in 2013 due to large gold imports, sharply declined to 6.5 percent in the 12-months through June 2014. About 0.8 pps of the adjustment was due to a decline in gold imports. Exports lost momentum in the second quarter, mainly because of the slowdown in the EU and the disruption in exports to Iraq, while declining imports continued to support the external adjustment process, as domestic demand remained weak. FDI inflows were lower at $3.7 billion between April and July compared to $4.2 billion in the first quarter, as investment appetite weakened on the back of global growth concerns and growing geopolitical tensions. On the other hand, net portfolio inflows picked up to $16.3 billion as the risk premium improved following the local elections, whereas net other investment recorded $2.6 billion inflows. Despite the ongoing external adjustment, risks remain, given the high corporate sector open FX position in Turkey (equivalent to 22 percent of GDP) and large gross external financing needs (27 percent of GDP).

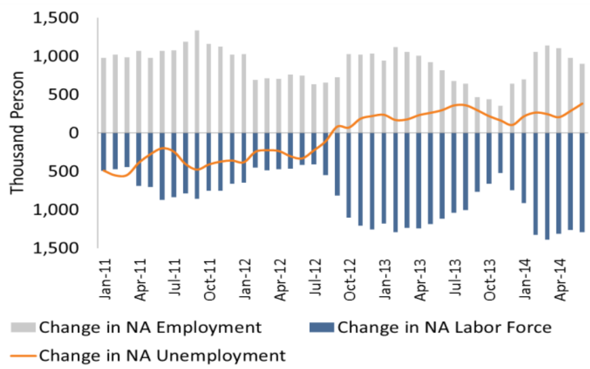
Consumer prices continued to increase at rates above historical averages. Annual inflation accelerated to 9.5 percent in August, up from 7.4 percent in December 2013. Food prices, which have the largest share in consumer basket, surged 14.8 percent in August, compared to the historical 12-month August average of 9.1 percent. Though elevated food prices were the main driver of rising inflation, the majority of the main groups of the consumer basket observed price increases above historical averages and added further pressure on inflation. The core inflation measure, CPI-I, which excludes food, alcohol, energy, and gold prices, remained high at 9.68 percent in August. According to the CBRT`s survey of expectations, year-end annual consumer inflation expectations deteriorated rapidly in the last two months, and median expectation increased from 8.30 percent in July to 8.90 percent in September. We revise our end-year annual inflation projection up to 9 percent (from 8.2 percent) for 2014, and up to 7 percent (from 6.2 percent) for 2015.

Figure 1. GDP growth and contributions



Source: TURKSTAT

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



Source: TURKSTAT

Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.1	3.5	3.5	3.7	3.9
Consumer price inflation (end period, in percent)	7.4	9.0	7.0	5.0	5.0
Public sector primary balance (in percent of GDP)	0.9	0.4	0.6	0.6	1.0
Gross public debt (in percent of GDP)	39.9	40.3	38.2	35.7	32.6
Current account balance (in billions of US dollars)	-65.1	-49.9	-52.2	-54.5	-55.4
Current account balance (in percent of GDP)	-7.9	-6.1	-6.0	-5.9	-5.6
Gross external debt (in percent of GDP)	47.2	48.1	48.6	48.4	47.8
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.

Reflecting falling risk premia the Central Bank (CBRT) cut interest rates in several steps. The Monetary Policy Committee (MPC) cut the one-week repo rate by 175 bps between May and July and reduced the overnight lending rate by 75 bps to 11.25 percent in August. As a result, the weighted average cost of CBRT funding declined to 8.29 percent in August from 10 percent in mid-May. In August, with the US dollar strengthening the Turkish lira started to depreciate again, reaching TL 2.28/USD end September, down 8.2 percent since late July. As a response to increased FX volatility, the CBRT increased the daily foreign exchange selling auction amount from a mimimum of $10 million to $40 million on September 29. In addition, CBRT`s tight liquidity management led to an increase in the share of funds provided through the overnight lending facility. As a result, the weighted average cost of CBRT funding increased to 8.72 percent, while the weighted average overnight rate in the BIST interbank repo market rose to 11.24 percent as of end-September. Tighter global liquidity conditions leave little room for the CBRT to support economic growth without putting price and exchange rate stability at risk.

Fiscal targets are attainable, despite weaker revenue performance so far in 2014. The year-to-date central government budget deficit reached TL2.7 billion in August, compared to a surplus of TL0.2 billion a year ago. Meanwhile, the year-to-date primary surplus amounted to TL30.9 billion in August, down from TL37.9 billion in August 2013. The somewhat weaker fiscal outturn was mainly due to underperforming tax revenues. Year-to-date tax revenues and total revenues grew respectively by 7.6 percent and 8.9 percent y-o-y, whereas the expenses were up by 10.1 percent y-o-y in August. Weak private consumption weighed on indirect tax revenues. In fact, year-to-date value added tax revenues increased only 0.4 percent y-o-y, while special consumption tax revenues increased 4.2 percent y-o-y in August. Although income and corporate tax revenues performed strongly, these improvements could not compensate for the deceleration in indirect tax revenues. Still, the end year primary surplus and budget deficit targets (1.1 percent and 1.9 percent respectively) are well within reach. In the medium-term, measures to balance the composition of revenues away from cyclical components, along with the measures to downscale the share of non-discretionary spending would enhance fiscal sustainability.

Turkey's slowdown in 2014 is not dissimilar to many other emerging markets. Reduced growth expectations in China, the struggling recovery in Europe and rising geopolitical tensions and risks have all weighed on investor sentiment and led to downward revisions in the short term global outlook. Five out of the six largest export markets for Turkey experienced an economic downturn in the second quarter, which constrained export performance. Economic activity indicators point to continued weak domestic demand in the third quarter of 2014. Consumer confidence deteriorated in the third quarter by 3.1 percent from a quarter earlier, and the seasonally adjusted real sector confidence indicator is also below its second quarter level, with mild improvements in both indicators in September. Consumer credit growth remains weak as of mid-September; outstanding credit card debts have been declining, supported by macro prudential measures in place since October 2013. Nonetheless, we expect a modest recovery in domestic demand in the fourth quarter, as a result of recent interest rate cuts. We maintain our growth forecast for 2014 at 3.5 percent, with current account deficit stabilizing at 6.1 percent of GDP in 2014. Downward risks weigh on this forecast, given regional uncertainties, while prospects of monetary tightening in the US limit the room for domestic stimulus. And while the authorities have some fiscal space to boost domestic demand, this risks exacerbating external imbalances. Growth prospects through 2015 thus remain moderate in our view.

Structural reforms and stronger economic institutions would lift Turkey's potential growth and could stimulate greater investment. Turkey's main assets include a young, dynamic population, a large domestic market, and a strategic location, combined with strong infrastructure and much improved public services. However, domestic and foreign investors remain deterred by the unpredictable business climate, and concerns over the strength of key economic institutions. An increase in investment in innovation as well as in education and skills is needed to boost productivity growth and create enough high productivity jobs to accommodate Turkey's rapidly rising labor force. In the face of less favorable global conditions and remaining external vulnerabilities, the drivers of Turkey's growth need to come from inside—a reform boost would do much to restore Turkey's luster as one of the most dynamic emerging market economies.

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