TURKEY: A tough adjustment and a challenging year ahead

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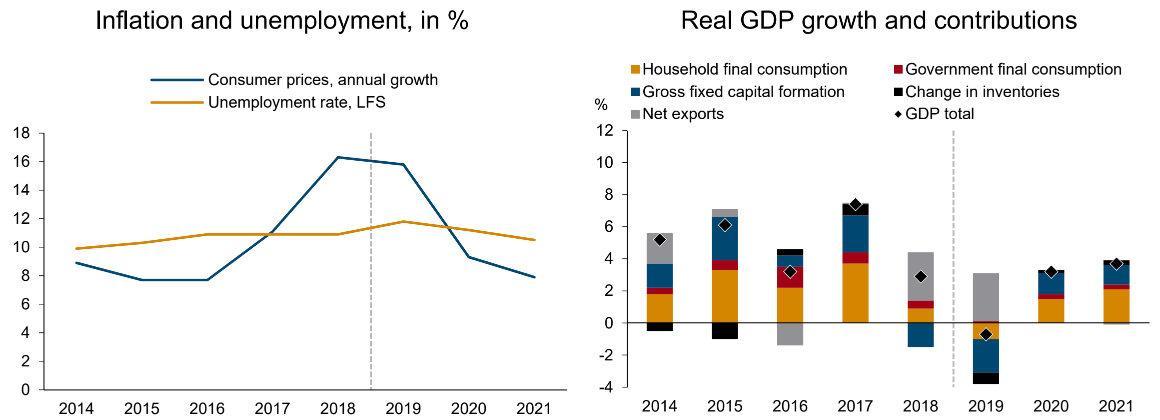
The worst of the crisis may have passed, assuming that the government does not attempt any radical measures and that relations with the US do not deteriorate. However, the economy will have a difficult year in 2019. Things should improve by 2020, with the economy bouncing back to reasonable growth. External risks remain, but the current account deficit has shrunk considerably, reducing vulnerabilities, and a more dovish US Federal Reserve provides important support.

Figure 6.22 / Turkey: Main macroeconomic indicators



Source: wiiw Annual Database incorporating national and Eurostat statistics, own calculation. Forecasts by wiiw.

The Turkish economy faced a big external shock in the middle of 2018, but in the end the necessary policy response arrived and the worst of the crisis is likely to have passed. After the lira collapsed, inflation rocketed and capital outflows increased sharply, the central bank responded with a hefty tightening of monetary policy. The lira has since stabilised and even recovered, and foreign investor confidence appears to have returned somewhat.

The economy has already undergone a strong external adjustment, with imports falling sharply and exports growing strongly. Investment has collapsed and private consumption is also struggling. Business and consumer sentiment has taken a knock from the spike in inflation, weaker lira, and much higher domestic interest rates. Even though economic growth was still very strong at the start of 2018, overall real GDP growth last year is likely to have only been around 3%, indicating a sharp slowdown in the final quarter of the year in particular.

The economy is now in recession, and will remain so for at least 1-2 more quarters, indicating that overall growth in 2019 is likely to be negative. The impact of the shocks that hit the economy in 2018 is still making its way through the system. Investment and private consumption are likely to struggle for several quarters at least. Real interest rates will remain firmly in positive territory this year, with the central bank set to remain wary of renewed lira volatility, which will weigh on investment. Turkey's labour market is suffering, with employment growth now negative for the first time since 2009, led above all by a collapse in construction jobs (the construction boom is firmly over). Employment growth in services and industry has also weakened.

The main support to growth will come from net exports, with weak domestic demand set to constrain imports, and exports likely to continue to perform well on the back of the weaker lira and Turkish firms' historic strength in reorienting sales towards pockets of stronger foreign demand. However, by CESEE standards Turkey is a fairly closed economy, which will limit the impact of the net export adjustment on headline real GDP growth. The government will keep fiscal policy as loose as it can get away with, but the contribution from this to overall growth will be quite limited.

We now expect a full-year contraction of 0.7% this year, down from our previous forecast of 0.5% growth. Predicting the extent of the downturn is tricky, given the scale of the shocks that have hit the economy, but it is clear that this year will be a difficult one for Turkey. Ahead of March's local election, the government loosened fiscal policy somewhat in late 2018 in an attempt to shore up support. However, the most recent leading indicators, such as retail sales and industrial output, suggest that the economy is in the midst of a fairly deep downturn. Both fell by around 7.5% year on year in the final quarter of 2018.

The risks of a return to the huge volatility of mid-2018 cannot be ruled out, but several stabilising factors suggest that these risks are lower than was the case last year. First, the improvement in relations with the US has been key, helped above all by the release of a jailed US pastor in Turkey. The risk of a broader economic conflict between the two countries, including the chances of serious US sanctions on Turkey, was a major factor behind the volatility of mid-2018 in our view. Turkey could not have withstood a barrage of US sanctions in the same way as Russia did. The second major stabilising factor is the much more dovish tone from the US Federal Reserve in recent months, with monetary tightening now set to continue at a much slower pace than previously expected (if at all). Third, Turkey's external borrowing needs will be much reduced relative to previous years, on the back of a smaller current account deficit (although rollover of existing external debt commitments remain significant). Finally, high domestic real interest rates will be a source of stability for the external accounts, and support continued capital inflows.

Some other factors could mitigate the downturn in economic growth this year. The recovery in and relative stability of the lira could support consumer and business confidence. Tourism has recovered strongly, and 2019 should be another good year of inflows. Meanwhile lower oil prices should help with the general easing of inflation that we expect during the year, thereby lending some support to private consumption.

Our view remains that the recession will be quite brief, and that the economy will return to growth in 2020. We have become slightly less optimistic about the scale of the bounce-back in 2020, but still forecast real GDP growth of a bit over 3% next year, and then around 3.7% in 2021, both respectable rates of expansion in the CESEE context. Oil prices will stay low, supporting real incomes and consumption. The weaker lira will help further growth of exports. The central bank will ease monetary policy as early as it can (meaning maybe 2019 but certainly by 2020), supporting a revival in credit growth. Meanwhile, unlike most countries in CESEE, Turkey's positive demographics will provide an underlying driver of economic growth.

A key reason that we are slightly less optimistic about 2020 than we were in the autumn is that Turkey is now operating in a different global economy. Over recent months it has become clear how much the global economy has slowed. By 2020, the US and China will be doing less well, and the eurozone is likely to continue to bump along the bottom. From the Turkish perspective, this is probably a net positive in terms of macroeconomic stability (as it suggests the monetary policy of the big central banks will be looser for longer), but negative from the perspective of external demand.

For 2019 and 2020, we see several big risks that will be key to determining the fortunes and stability of the Turkish economy. First, it will be important to see how well the banking sector can hold up, amid an expected deterioration in asset quality on the back of lira depreciation and recession. Although the starting point in terms of non-performing loans and capital levels appears to be sound, this will certainly be affected by the scale of the shocks of 2018. Second, relations with the US will remain key. US President Donald Trump's public utterances should always be treated cautiously, but this threat in January to 'devastate Turkey economically' if the country's military attacks US-backed Kurdish forces in Syria caused understandable concern. Any renewed downturn in relations between the two countries could increase speculation of new US sanctions on Turkey, thereby negatively affecting investor confidence and willingness to finance Turkish debt rollovers. Third, there remains the question of the economy's ability to meet its still-significant external debt rollover needs more generally (short-term foreign exchange debt totalled around USD 116bn at end-2018, equivalent to around 16% of last year's GDP).

Regarding external debt rollovers, recent developments appear supportive, with a more dovish Fed set to mean strong dollar liquidity conditions. Foreign inflows into Turkish equities, for example, were very strong at the start of 2019, implying returning investor confidence in Turkey. The government remains able to borrow in foreign currency, and the central bank dollar swap arrangement with Qatar has boosted reserves. The final risk is that, encouraged by the more dovish Fed, and under political pressure, the central bank loosens monetary policy prematurely. This could lead to renewed capital outflows and difficulties in rolling over external debt. Although probably only a small risk in the near term, given that the memory of the 2018 crisis is so fresh (and the central bank was quite strong and hawkish in its wording in January), as time passes, and if volatility remains low, this could become more tempting for the authorities.

A final medium-term concern is the decline in the quality of the business environment, including in regard to institutions. Turkey is hardly alone in this: institutional de-convergence with Western Europe has been apparent across much of CESEE in the past decade. Moreover, in terms of levels Turkey is far from the worst in the region (its institutions are generally much better than those of the CIS, for example). Nevertheless, on at least some measures, trends in Turkey (along with Hungary) appear to be particularly concerning. Turkey's scores for the World Bank Governance Indicators related to corruption, government effectiveness, the rule of law, regulatory quality and voice and accountability all deteriorated notably between 2007 and 2017. Transparency International's Corruption Perceptions Index also shows a decline for Turkey in recent years.

A decline in the quality of institutions and the business environment more generally will make it even more difficult for Turkey to shift to a more sustainable FDI-driven growth model. This means there are really only two alternatives for the Turkish economy in the medium term. First, Turkey can continue to rely on hot money flows to fund consumption and investment. This means that much of the time growth could be quite strong, but also that Turkey will be exposed to changes in foreign investor sentiment, and meaning that it will always face the risk of harsh adjustments like the one it is currently going through. If US rates continue to rise, this model will become even more problematic. Second, if hot money is not available, and with Turkey having such a low level of domestic savings, a much lower rate of growth than in the historical period will become almost inevitable. The first scenario looks more likely, but the cycles of boom and bust could become shorter.

Table 6.22 / Turkey: Selected economic indicators

	2014	2015	2016	2017	2018 [1]	2019	2020	2021
							Forecast	
Population, th pers., average	77,182	78,218	79,278	80,313	81,407	81,900	82,700	83,600
Gross domestic product, TRY bn, nom.	2,044	2,339	2,609	3,107	3,700	4,300	4,900	5,500
annual change in % (real)	5.2	6.1	3.2	7.4	2.9	-0.7	3.2	3.7
GDP/capita (EUR at PPP)	17,700	19,300	19,200	19,900	20,400	.	.	.
Consumption of households, TRY bn, nom.	1,242	1,412	1,561	1,834	2,170	.	.	.
annual change in % (real)	3.0	5.4	3.7	6.1	1.6	-1.7	2.5	3.5
Gross fixed capital form., TRY bn, nom.	591	695	765	932	1,030	.	.	.
annual change in % (real)	5.1	9.3	2.2	7.8	-5.0	-7.0	4.2	4.0
Gross industrial production [2]								
annual change in % (real)	5.8	6.2	3.4	8.9	1.7	-1.0	2.8	3.0
Gross agricultural production [3]								
annual change in % (real)	-2.9	5.2	0.5	2.0	0.5	.	.	.
Construction industry [2]								
annual change in % (real)	3.0	1.7	2.9	3.8	-5.0	.	.	.
Employed persons, LFS, th, average	25,931	26,619	27,216	28,197	28,734	28,700	29,400	30,100
annual change in %	5.4	2.7	2.2	3.6	1.9	0.0	2.5	2.5
Unemployed persons, LFS, th, average	2,854	3,050	3,332	3,451	3,535	3,840	3,710	3,530
Unemployment rate, LFS, in %, average	9.9	10.3	10.9	10.9	10.9	11.8	11.2	10.5
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY [4]	1,820	2,014	2,280	2,470	2,690	3120	3510	3920
annual change in % (real, gross)	1.3	2.8	5.2	-2.5	-2.0	0.0	2.8	3.5
Consumer prices (HICP), % p.a.	8.9	7.7	7.7	11.1	16.3	15.8	9.3	7.9
Producer prices in industry, % p.a. [5]	10.1	5.3	4.3	15.8	27.0	22.2	13.5	10.2
General governm. budget, nat.def., % of GDP								
Revenues	31.9	31.9	33.0	30.2	30.0	31.0	32.2	33.5
Expenditures	32.7	32.9	34.7	32.2	33.3	34.0	34.5	35.7
Deficit (-) / surplus (+)	-0.8	-1.0	-1.7	-2.0	-3.3	-3.0	-2.3	-2.2
General gov.gross debt, nat.def., % of GDP	28.8	27.6	28.3	28.3	30.5	31.0	31.0	30.5
Stock of loans of non-fin.private sector, % p.a.	19.4	19.4	15.2	19.9	9.6	.	.	.
Non-performing loans (NPL), in %, eop	2.8	3.1	3.2	2.9	3.9	.	.	.
Central bank policy rate, % p.a., eop [6]	8.25	7.50	8.00	8.00	24.00	22.00	15.00	13.00
Current account, EUR mn	-33,010	-28,919	-29,917	-41,758	-22,628	-2,500	-9,900	-15,100
Current account, % of GDP	-4.7	-3.7	-3.8	-5.5	-3.5	-0.4	-1.4	-1.9
Exports of goods, BOP, EUR mn	127,237	136,978	135,795	147,218	148,101	158,000	162,000	170,000
annual change in %	4.4	7.7	-0.9	8.4	0.6	7.0	2.5	5.0
Imports of goods, BOP, EUR mn	175,310	180,353	172,701	198,906	182,729	179,000	190,000	203,000
annual change in %	-3.7	2.9	-4.2	15.2	-8.1	-2.0	6.0	7.0
Exports of services, BOP, EUR mn	39,175	42,419	34,125	38,588	40,680	44,000	45,000	47,000
annual change in %	7.9	8.3	-19.6	13.1	5.4	7.0	2.0	5.0
Imports of services, BOP, EUR mn	19,050	20,563	20,366	21,250	19,519	19,000	20,000	22,000
annual change in %	3.2	7.9	-1.0	4.3	-8.1	-3.0	7.5	8.0
FDI liabilities, EUR mn	9,865	16,216	12,077	9,643	11,224	.	.	.
FDI assets, EUR mn	5,379	4,595	2,845	2,418	3,071	.	.	.
Gross reserves of NB excl. gold, EUR mn [7]	88,055	85,356	87,334	70,202	63,666	.	.	.
Gross external debt, EUR mn [7]	334,184	367,716	388,243	379,454	395,400	423,100	432,400	471,400
Gross external debt, % of GDP	47.5	47.6	49.8	50.3	61.0	61.0	60.0	60.0
Average exchange rate TRY/EUR	2.9065	3.0255	3.3433	4.1206	5.7077	6.20	6.80	7.00

1) Preliminary and wiiw estimates. - 2) Enterprises with 20 and more employees; for construction wiiw estimate from 2017. - 3) Based on UN-FAO data, wiiw estimate from 2017. - 4) Data based on Annual Industry and Service Statistics excluding NACE activities agriculture and fishing, finance and insurance, public administration, defence and social securtiy. wiiw estimate from 2016. - 5) Domestic output prices. - 6) One-week repo rate. -7) Converted from USD.

Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.