TURKEY: Growth will remain strong but external risks are significant

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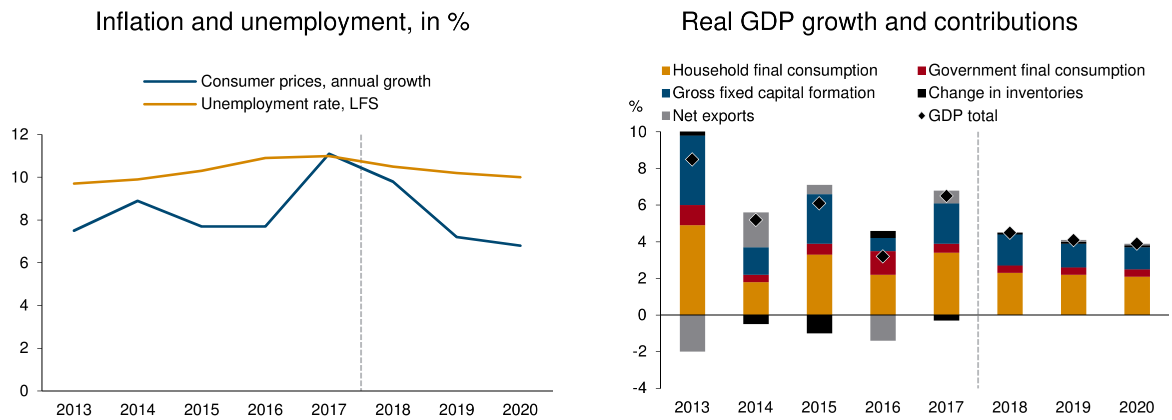
The economy had a strong 2017, underpinned by significant government stimulus and booming external demand. Growth will be lower during the forecast period, but still robust, driven by private consumption, and helped by benign external conditions. However, the downside risks are significant. The large external financing requirement will leave Turkey exposed to a sharper-than-expected hike in US rates or change in global investor sentiment.

Figure 60 / Turkey: Main macroeconomic indicators



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

The economy had a very good 2017, and is likely to continue growing fairly strongly during the forecast period. Real GDP growth is estimated to have reached 6.5% in 2017, on the back of significant government stimulus and robust foreign demand. Fiscal and monetary policy were highly supportive of growth, while the Credit Guarantee Fund (CGF) underpinned a strong expansion of lending. Booming foreign demand – not least from the EU – drove merchandise exports higher, while a surge of Russian tourists helped to offset continued declines in arrivals from Western Europe.

Some high frequency indicators suggest slower momentum towards end of 2017, but short-term momentum still remains strong in the context of the last few years. Consumer confidence fell somewhat towards the end of the year, likely reflecting the gradual withdrawal of stimulus measures (in particular the removal of tax incentives for the purchase of durable goods). However, employment, industrial output (especially capital goods), credit and tourism growth were still high and/or rising in the final months of 2017. Notably, manufacturing growth strengthened in Q4 according to the purchasing managers' index (PMI), reflecting strong increases in both domestic and external demand, and contributing notably to a further uptick in employment.

There are two big questions for the Turkish economy during the forecast period: a) how much longer will the government continue to push the economy, and b) how much longer will the external boom last? The former will at least partly depend on the latter; a continuation or further strengthening of already robust foreign demand will make the government more confident about withdrawing stimulus measures. Our view is that, while there are clearly risks, the coordinated global upswing (evident in the eurozone, the US and China) will continue, which will further support export growth and contribute to the recovery in the tourism sector. Most importantly, this will keep global investor sentiment bullish, supporting continued portfolio inflows (see below).

As a result, we expect the economy to grow at around 4% during the forecast period, driven primarily by household consumption. Investment should also be supportive, although this will depend on a more sustained recovery in private fixed capital formation (which has so far been quite tentative, perhaps reflecting domestic and geopolitical uncertainty). External trade is unlikely to make a material positive contribution to growth, given strong increases in private consumption and the much larger absolute size of imports compared with exports. However, robust manufacturing export growth is likely to continue for as long as the EU upswing remains on course. Real exchange rate depreciation will remain a supportive factor for export growth, although the long-standing ability of Turkish exporters to switch between markets will be more decisive.

The labour market has performed strongly in recent quarters on the back of robust headline growth, and we expect this to continue. Headline employment growth has picked up, while the labour force participation and employment rates rose notably in 2017 compared with the previous year. As of October 2017, the unemployment rate stood at 10.3%, a 1.5 percentage point decline compared with 12 months earlier; this was particularly impressive considering the 3.2% increase in the size of the labour force over the same period. Further expansion of employment will be a key driver of private consumption growth during the forecast period.

As a result of strong external demand, and with employment growing, the government will feel more confident about easing off its stimulus. A significant further expansion of the CGF looks very unlikely (although it also won't be drawn down). The corporate tax rate has already been hiked by 2 percentage points for 2018-20, although a planned increase in income tax on one bracket was abandoned. Additional revenues from corporate taxation have been earmarked to support an increase in military spending.

Inflation will remain far above the central bank's 5% target this year, and will be slow to come down during the forecast period. Monetary policy was tightened quite significantly in 2017, although the market continues to view it as too loose. The combination of a weak lira (meaning higher import costs), rising domestic demand, and higher oil prices, pushed up price growth in 2017. Core inflation was above 12% in the final quarter of 2017. We expect all of these factors to remain relevant in 2018, which will keep inflation in double digits for the year as a whole. Beyond that, price growth should slow, but only gradually, and will only get close to the central bank's target at the end of our forecast period. According to the central bank, medium-term inflation expectations hit an all-time high in 2017.

Relatively loose monetary policy and investor caution will probably keep the lira weak during 2018, although a sell-off on the scale of recent years is unlikely. The lira had a very weak second half of 2017, especially against the euro, but it has since stabilised and even come back a bit against the US dollar. The market was disappointed by a small rate hike in 2017, and significant monetary tightening looks unlikely this year.

Our long-held view has been that the main risk to the Turkish economy comes from its large external financing requirement, and this is likely to be even more the case this year. The current account deficit widened during 2017, with a large share of the uptick in consumption-driven growth financed by new foreign borrowing. As a result, while the rate of growth has risen, so have the risks and vulnerabilities. A very large share of Turkey's current account deficit is financed by potentially volatile portfolio inflows.

As a result, Turkey is highly exposed to a sharp hike in US rates, a change in global investor sentiment, or negative geopolitical developments. Corporates with a large share of US dollar-denominated debt and a lack of offsetting foreign exchange revenues are particularly at risk. Debt levels among some Turkish corporates have increased markedly in recent years. If the US Fed continues on its moderate tightening course (as appears likely), these risks are unlikely to materialise. However, a more aggressive series of hikes from the Fed – for example as a result of a faster-than-expected pick-up in inflation in the US – would certainly cause problems in Turkey.

We expect the current account deficit to remain in the 4-5% of GDP range during the forecast period, and for only a small share of this to be financed by foreign direct investment (FDI). This means that these vulnerabilities will not go away. Subdued oil prices (by the standards of recent years), the tourism recovery, and stronger merchandise export growth will provide some sources of stability.

Beyond the next three years, Turkey has one of the best long-term growth outlooks in the CESEE region. However, this relies heavily on positive demographic trends, particularly in the regional context, and is subject to domestic and geopolitical risks. The Medium Term Economic Programme for 2018-20 announced plans for structural reforms, fiscal transparency, disinflation, and an increase in high value-added manufacturing and FDI. However, it remains to be seen to what extent these aims will be achieved. FDI as a share of GDP has long been low in the regional context, and has fallen further recently. Domestic private investment remains subdued, while low productivity remains a long-standing issue. An upgrading of the customs union agreement with the EU beyond industrial goods could significantly lift medium-term growth prospects, but looks challenging in the current environment.

Table 30 / Turkey: Selected economic indicators

	2013	2014	2015	2016	2017 1)	2018	2019 Forecast	2020
Population, th pers., average	76,148	77,182	78,218	79,278	80,313	80,900	81,700	82,500
Gross domestic product, TRY bn, nom. 2)	1,810	2,044	2,339	2,609	3,100	3,600	4,000	4,400
annual change in % (real)	8.5	5.2	6.1	3.2	6.5	4.5	4.1	3.9
GDP/capita (EUR at PPP) 2)	16,300	17,700	18,800	18,600	19,700	.	.	.
Consumption of households, TRY bn, nom. 2)	1,120	1,242	1,412	1,561	1,729	.	.	.
annual change in % (real)	7.9	3.0	5.4	3.7	5.6	3.8	3.6	3.5
Gross fixed capital form., TRY bn, nom. 2)	516	591	695	765	847	.	.	.
annual change in % (real)	13.8	5.1	9.3	2.2	7.6	5.7	4.5	4.2
Gross industrial production								
annual change in % (real)	3.0	3.6	3.2	1.9	6.3	3.3	3.0	2.8
Gross agricultural production 3)								
annual change in % (real)	3.2	-4.3	2.0	2.0	2.0	.	.	.
Construction industry								
annual change in % (real)	7.7	3.0	1.7	3.1	3.8	.	.	.
Employed persons, LFS, th, average	25,520	25,931	26,619	27,216	28,150	29,300	30,200	31,000
annual change in %	2.8	5.4	2.7	2.2	3.4	4.0	3.2	2.5
Unemployed persons, LFS, th, average	2,750	2,854	3,050	3,332	3,525	3,440	3,430	3,440
Unemployment rate, LFS, in %, average	9.7	9.9	10.3	10.9	11.0	10.5	10.2	10.0
Reg. unemployment rate, in %, eop	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	7.5	8.9	7.7	7.7	11.1	9.8	7.2	6.8
Producer prices in industry, % p.a. 4)	5.7	10.1	5.3	4.3	15.8	8.4	7.0	6.0
General governm. budget, nat.def., % of GDP								
Revenues	32.7	31.9	31.9	33.0	32.3	33.0	33.2	33.5
Expenditures	34.0	32.7	32.9	34.7	34.2	35.0	35.5	35.7
Deficit (-) / surplus (+)	-1.3	-0.8	-1.0	-1.7	-1.9	-2.0	-2.3	-2.2
General gov.gross debt, nat.def., % of GDP 2)	31.4	28.8	27.6	28.3	28.2	27.9	27.7	28.0
Stock of loans of non-fin.private sector, % p.a.	33.6	19.4	19.4	15.2	19.9	.	.	.
Non-performing loans (NPL), in %, eop	2.8	2.8	3.1	3.2	2.9	.	.	.
Central bank policy rate, % p.a., eop 5)	4.50	8.25	7.50	8.00	8.00	8.00	8.00	8.00
Current account, EUR mn	-47,989	-33,011	-28,926	-29,809	-41,515	-43,400	-47,700	-54,100
Current account, % of GDP	-6.7	-4.7	-3.7	-3.8	-5.5	-5.5	-5.6	-5.9
Exports of goods, BOP, EUR mn	121,819	127,237	136,978	135,795	146,961	153,000	161,000	169,000
annual change in %	-3.4	4.4	7.7	-0.9	8.2	4.0	5.0	5.0
Imports of goods, BOP, EUR mn	182,057	175,312	180,341	172,671	198,386	208,000	221,000	236,000
annual change in %	2.8	-3.7	2.9	-4.3	14.9	5.0	6.2	7.0
Exports of services, BOP, EUR mn	36,306	39,105	42,279	34,070	38,550	40,000	43,000	46,000
annual change in %	6.5	7.7	8.1	-19.4	13.2	4.0	7.0	7.0
Imports of services, BOP, EUR mn	18,457	18,915	20,445	20,247	21,026	22,000	24,000	26,000
annual change in %	12.9	2.5	8.1	-1.0	3.8	5.0	7.0	7.0
FDI liabilities, EUR mn	9,682	9,637	15,811	11,637	9,606	.	.	.
FDI assets, EUR mn	2,716	5,379	4,594	2,845	2,418	.	.	.
Gross reserves of NB excl. gold, EUR mn	80,435	88,058	85,355	87,331	70,119	.	.	.
Gross external debt, EUR mn	282,707	331,065	364,115	384,338	372,000	391,300	438,300	476,700
Gross external debt, % of GDP	39.6	47.1	47.1	49.3	49.4	50.0	51.5	52.0
Average exchange rate TRY/EUR	2.5335	2.9065	3.0255	3.3433	4.1206	4.60	4.70	4.80

1) Preliminary and wiiw estimates. - 2) According to SNA 2010. - 3) Based on UN-FAO data, from 2015 wiiw estimate. - 4) Domestic output prices. - 5) One-week repo rate.

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