TURKEY: Inevitable economic slowdown in sight

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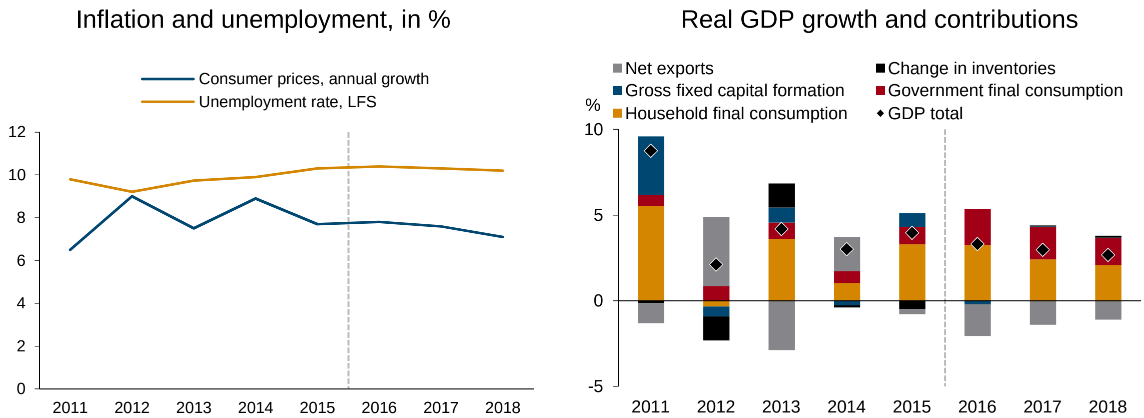
Although economic growth was firm in the first half of 2016, driven by an increase in private consumption and government spending, expectations have somewhat waned recently owing to rising vulnerabilities. Despite the government's measures to boost private consumption, we expect a GDP growth rate of 3.3% for the current year, before it slows down to 3% and 2.7% for 2017 and 2018, respectively.

Figure 43 / Turkey: Main macroeconomic indicators



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

The Turkish economy has lost momentum this year in the face of a string of extreme political and economic shocks. On the night of 15 July 2016, a group of Turkish military officers allegedly connected to the exiled preacher Fethullah Gulen tried to stage a coup against the Turkish government and President Recep Tayyip Erdogan. Following the failure of the coup attempt, the government declared a state of emergency for three months, allowing it to bypass parliament while drafting new laws and to restrict or suspend the rights and freedoms of citizens. So far, tens of thousands of people who are allegedly connected with the Gulen movement have been dismissed or suspended from government jobs, including education, police, military and judiciary. The ownership of more than 200 leading companies allegedly financing the Gulen movement has been transferred to the Saving Deposit Insurance Fund (TMSF) as part of the investigation into the so-called Gulenist Terror Group (FETÖ). The main opposition Republican People's Party (CHP) leader has accused the government of opportunistically using the state of emergency to go after its opponents. Many opposition-minded people have been removed from their positions, including academics and teachers who signed a pro-peace declaration earlier this year or are members of left-wing unions. In addition, the licences of some opposition television channels and radio stations have been revoked by statutory decree.

There have also been significant developments in Turkish foreign policy. The Turkish government has been trying to mend its relations with Russia, which had worsened after the downing of a Russian war plane by the Turkish military in November 2015. Additionally, since the Ataturk airport attack at the end of June 2016, Turkey has hardened its position towards the Islamic State of Iraq and the Levant (ISIS). In late August 2016, Turkish forces entered Syria in order both to enable Syrian rebels to take control of important strongholds in the region, and to prevent Kurds from establishing control of the border area on the Syrian side.

The conflict between the Turkish army and the Kurdistan Workers' Party (PKK) has intensified since the ceasefire collapsed after the June 2015 parliamentary elections. Since then, tension in the region has remained high. It appears that the Turkish government is reluctant to re-start peace talks with PKK. The parliamentary immunity of some pro-Kurdish People's Democratic Party (HDP) deputies was removed in June 2016 and some were accused of helping terrorist organisations and detained. Since then a crisis of confidence has emerged between the two sides. It is not clear how the major problems will be solved and whether the Turkish government will be able to restore stability in its internal and external relations.

These crucial developments have increased economic as well as political uncertainties. Moody's downgraded Turkey's sovereign rating to junk status at the end of September 2016, citing worries about the rule of law after the 15 July failed coup attempt and the risks from a slowing economy. Standard and Poor's, which has long rated Turkey below investment grade, cut its rating further immediately following the attempted coup in July to 'BB'. Fitch, the third major ratings agency, maintained Turkey at 'BBB-', the lowest investment grade rating, after its most recent review in August. The broadly negative trend in the agencies' assessments of Turkey's creditworthiness is particularly important given the country's large external financing needs.

Despite these unfavourable developments, the Turkish economy grew by 3.9% year on year in the first half of 2016, although the rate of growth decelerated from 4.9% year on year in the first quarter to 3.1% in the second quarter. The relatively strong economic growth was mainly due to a rise in private consumption and government spending. Household final consumption rose by 6.1% year on year in the first half of 2016, thanks to a strong rise in hourly wages in real terms following a 30% hike in the minimum wage at the beginning of the year. The favourable employment trends helped household consumption growth to remain strong because of substantial wage hikes. Since the last quarter of 2014, the real growth rate of government spending has been increasing. It reached 16% year on year in the second quarter of this year, the fastest pace recorded in 26 quarters. Because of increasing private and public consumption, net exports again made a negative contribution to GDP growth year on year in the first half of 2016: export growth slowed to 1.3% year on year due to decelerating global demand, while import growth accelerated to 7.5% year on year.

For 2016 as a whole, we expect GDP growth of 3.3%, implying a slowdown in the second half because of increased political and economic uncertainties. Although the government has attempted to ease monetary policy by relaxing the consumer loan maturity, increasing the mortgage loan/property's value ratio and increasing instalments for credit card purchases among others in order to boost private consumption, we still expect a slowdown in household consumption expenditure growth due to weaker consumer confidence. On the government spending side, we expect a continuation of the current growth level for the rest of this year because of the higher military expenditures. Following the agreement between OPEC countries in September to limit oil production, we also expect a moderate rise in oil prices during the rest of the year which may hinder a contribution of net exports to growth in the remainder of 2016. Additionally, the potential for a slump in investment in the United States and global uncertainties over Brexit could also limit foreign demand in the remainder of the year. Thereafter, we forecast a deceleration of GDP growth to 3.0% and 2.7% in 2017 and 2018, respectively, mostly due to an expected slowdown in domestic demand.

One of the vulnerabilities of the Turkish economy can be observed via the development of gross fixed capital formation. For the first two quarters of 2016, it provided a negative contribution to GDP growth by -0.3pp year on year. Investment in machinery and equipment fell especially strongly (particularly in the private sector). Investment has fallen in seven of the past ten quarters, which may constrain future production potential. In construction, we project a 5.9% and 6.9% growth rate for the current year for the public and private sector, respectively. Since the economic and political outlook remains uncertain and is likely to remain so in the near future, we expect gross fixed capital formation to continue contributing negatively to GDP growth until the end of the current year. In 2017-2018, we expect strong government spending on construction and the private sector's response to monetary loosening to offset the decline in machinery and equipment investment. Therefore we forecast a roughly zero contribution of gross fixed capital formation to growth in the next two years.

In the first two quarters of 2016, the central government budget balance and primary budget balance posted a surplus of TRY 1.1 billion (0.1% of GDP) and TRY 27.5 billion, respectively. The main drivers of the budget surplus were the fall in interest expenditures due to lower interest rates, continued strong tax revenue collection and increases in non-tax revenues for the first half of the year. Central government expenditure rose by 15.7% year on year in nominal terms in the first half of 2016, driven by transfers and government consumption. This was partly offset by an 8% decline in public investment expenditure over the same period. On the revenue side, central government budget revenue increased by 15.8% in nominal terms. This was largely driven by the inclusion of privatisation revenues (TRY 9.9 billion) into the budget in the first half of 2016, coupled with a substantial Central Bank profit transfer (TRY 9.3 billion). Therefore, we forecast a budget surplus of 0.7% of GDP in 2016. We expect it to return to deficits of -1.2% in 2017 and -1.5% in 2018, close to the average level of the budget deficit in the last five years.

Despite a relatively stable exchange rate of the Turkish lira against both the US dollar and the euro, and limited increases in the price of unprocessed food, the inflation rate only fell to 8% year on year in August 2016. This was due to a rise in import prices, especially oil. Regarding some negative expectations including a rise in oil prices, volatile prices of unprocessed foods, strong domestic demand and a rise in the policy rate of the Fed, we forecast average inflation rates of 7.8% in 2016, 7.6% in 2017 and 7.1% in 2018.

Following the appointment of a new governor in mid-April 2016, the Central Bank of the Republic of Turkey (CBRT) cut its upper bound interest rate by a cumulative 225 basis points between April and September 2016 (it had previously left interest rates unchanged since the beginning of 2015). This behaviour implies that the CBRT has been loosening its policy stance. Since the band between the upper bound and the policy rate already narrowed and, more importantly, the monetary policy-makers in the United States are leaning towards a rate hike after the US presidential elections, we do not forecast any further cuts in policy rates in 2016 and 2017 unless inflation rises. We expect the policy rate to be cut to 7% in 2018 as the inflation rate falls.

In 2014 and 2015, the Turkish lira weakened considerably, especially against the US dollar. In early 2016 the exchange rate stabilised, thanks in part to the narrowing of the current account deficit. However, for the remainder of 2016 and into 2017-2018, we forecast a gradual depreciation of the lira, owing to expected monetary tightening in the US, the possibility of further negative action by credit rating agencies, and the expected rise in the price of oil. The materialisation of one or more of these factors could prompt foreign capital to flow out of the country.

Although Russia used to be one of Turkey’s largest trading partners, its share in total exports decreased to 1% in the first three quarters of 2016 (from 3.8% and 2.5% in 2014 and 2015, respectively). However, the relationship between Russia and Turkey appears to have been improving since the summer of 2016, and we expect Turkey’s exports of goods (food) and services (tourism, construction) to Russia to rise during the rest of 2016. The recovery in Europe and steady depreciation of the value of the domestic currency might also help Turkey’s exports to remain stable or to rise moderately. On the import side, the expected slight but steady rise in oil prices may lead to higher import payments in 2017-2018. On the other hand, import growth for the rest of the year and in the following years will be restricted by the expected steady depreciation in the value of the Turkish lira.

In summary, risks to Turkish growth are increasing, owing to deterioration in economic sentiment and the weakening of the institutional environment in the aftermath of the failed coup attempt. Therefore, we expect a slowdown in the growth rate of GDP for the rest of the year, taking full-year growth to 3.3%. We expect GDP growth to decelerate to 3% and 2.7% in 2017 and 2018, respectively, due to the expected slowdown in domestic demand as well as ongoing weak foreign demand.

Table 26 / Turkey: Selected economic indicators

	2012	2013	2014	2015 1)	2015	2016	2016	2017	2018
					January-June			Forecast	
Population, th pers., average	75,176	76,148	77,182	78,218	.	.	79,000	79,800	80,500
Gross domestic product, TRY bn, nom. 2)	1,417	1,567	1,748	1,953	926	1,024	2,200	2,400	2,600
annual change in % (real)	2.1	4.2	3.0	4.0	3.1	3.9	3.3	3.0	2.7
GDP/capita (EUR at exchange rate) 2)	8,100	8,100	7,800	8,300	.	.	8,400	8,700	9,000
GDP/capita (EUR at PPP) 2)	13,900	14,100	14,500	15,000	.	.	.	.	.
Consumption of households, TRY bn, nom. 2)	994	1,110	1,204	1,349	645	719	.	.	.
annual change in % (real)	-0.5	5.1	1.4	4.8	4.9	6.1	4.7	3.5	3.0
Gross fixed capital form., TRY bn, nom. 2)	287	319	352	399	202	223	.	.	.
annual change in % (real)	-2.7	4.4	-1.3	4.0	5.5	-0.3	-1.0	0.2	0.2
Gross industrial production									
annual change in % (real)	2.5	3.0	3.6	3.2	2.4	4.2	2.1	2.2	2.5
Gross agricultural production 3)									
annual change in % (real)	5.5	2.8	2.0	2.0	.	.	.	.	.
Construction industry									
annual change in % (real)	0.8	7.7	3.0	1.7	-0.1	6.4	.	.	.
Employed persons, LFS, th, average	24,820	25,520	25,931	26,619	26,324	27,162	27,300	27,800	28,400
annual change in %	3.0	2.8	1.6	2.7	2.2	3.2	2.4	2.0	2.0
Unemployed persons, LFS, th, average	2,517	2,750	2,854	3,050	2,999	3,048	3,170	3,190	3,230
Unemployment rate, LFS, in %, average	9.2	9.7	9.9	10.3	10.3	10.2	10.4	10.3	10.2
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	9.0	7.5	8.9	7.7	7.7	7.6	7.8	7.6	7.1
Producer prices in industry, % p.a. 4)	6.1	5.7	10.1	5.3	4.6	4.0	3.7	4.0	4.0
General governm. budget, nat.def., % of GDP									
Revenues	35.7	37.8	37.3	36.9	.	.	39.8	37.8	37.5
Expenditures	37.7	39.2	38.2	38.5	.	.	39.1	39.0	39.0
Deficit (-) / surplus (+)	-2.0	-1.5	-0.9	-1.6	.	.	0.7	-1.2	-1.5
Public debt, nat.def., % of GDP 5)	36.2	36.1	33.5	32.9	.	.	36.0	35.0	35.0
Central bank policy rate, % p.a., end of period 6)	5.50	4.50	8.25	7.50	7.50	7.50	7.50	7.50	7.00
Current account, EUR mn	-37,208	-47,966	-32,951	-29,044	-19,630	-17,065	-37,000	-35,000	-36,000
Current account, % of GDP	-6.1	-7.8	-5.5	-4.5	-6.1	-5.4	-5.5	-5.0	-5.0
Exports of goods, BOP, EUR mn	126,137	121,819	127,237	136,978	69,331	67,558	134,000	141,000	148,000
annual change in %	23.2	-3.4	4.4	7.7	11.1	-2.6	-2.0	5.0	5.0
Imports of goods, BOP, EUR mn	177,043	182,057	175,312	180,381	92,144	85,742	171,000	176,000	183,000
annual change in %	6.5	2.8	-3.7	2.9	9.9	-6.9	-5.0	3.0	4.0
Exports of services, BOP, EUR mn	34,078	36,306	39,105	42,089	17,889	14,560	36,000	40,000	42,000
annual change in %	15.3	6.5	7.7	7.6	10.8	-18.6	-15.0	12.0	5.0
Imports of services, BOP, EUR mn	16,347	18,457	18,915	20,341	10,171	10,218	20,000	22,000	23,000
annual change in %	7.6	12.9	2.5	7.5	13.6	0.5	-0.5	10.0	4.0
FDI liabilities (inflow), EUR mn	10,305	9,297	9,447	15,238	6,368	3,683	4,500	.	.
FDI assets (outflow), EUR mn	3,167	2,716	5,377	4,593	1,721	1,409	2,000	.	.
Gross reserves of NB excl. gold, EUR mn	75,749	80,435	88,058	85,355	90,050	91,591	.	.	.
Gross external debt, EUR mn 7)	257,444	282,856	331,346	365,289	362,188	379,602	383,300	403,500	426,100
Gross external debt, % of GDP 7)	42.0	45.7	55.1	56.6	56.1	56.9	57.5	58.0	59.0
Average exchange rate TRY/EUR	2.31	2.53	2.91	3.03	2.86	3.26	3.30	3.45	3.60
Purchasing power parity TRY/EUR	1.36	1.46	1.56	1.66	.	.	.	.	.

1) Preliminary. - 2) According to ESA'95 (FISIM not yet reallocated to industries). - 3) Based on UN-FAO data, from 2014 wiiw estimate. - 4) Domestic output prices. - 5) Defined according to EU standards. - 6) One-week repo rate. - 7) BOP 5th Edition.

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