TURKEY: On a government-supported steady-state growth path

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Thanks to the continuing rise in foreign demand and with the help of major government transfers, the Turkish economy is likely to have grown by 3% in 2014. In 2015, we expect GDP to expand by 3.3% owing to the ongoing depreciation of the lira, a rise in transfer expenditures and a slight easing in monetary policy. Growth should even improve in 2016 and 2017 on account of probable cuts in the policy rate, continued government-induced consumption and investment, as well as improvements in net exports.

GDP growth has been following a new steady-state equilibrium which is around 3-4% since 2011 due to a novel policy mix. Household final consumption has not risen as fast as GDP in the first three quarters of 2014, because of both additional restrictions on domestic credits imposed by the Banking Regulation Agency and declining real wages owing to a rise in the inflation rate. Government final consumption expenditure contributed much more than household consumption due to election-induced spending (elections were held in March and August of 2014). Both the credit growth target of the Central Bank of Turkey (CBRT) and the ongoing depreciation process of the domestic currency suppressed private investments while massive government-led infrastructure projects such as a third airport in Istanbul, the Channel Istanbul and the third bridge across the Bosporus became the main drivers of public investments. Net exports have been increasing thanks to the depreciation of the lira. We therefore expect an annual GDP growth of 3% for 2014. For 2015 we expect government expenditures and net exports to be again the main drivers of economic growth - depending on ongoing government-led infrastructure projects, rising current transfer expenditures and depreciation of the domestic currency. In the years thereafter, policy rate cuts and growing investment will help to increase the growth of GDP, supplementing exchange rate developments.

The central government budget deficit remained slightly above the targets in the course of the year 2014. On the expenditure side, an escalation in primary expenditures plays a more important role than the rise in interest expenditures. Among primary expenditures, the growth rate of current transfers was higher than public expenditure and public investment induced by the elections in 2014. On the revenue side, consumption-based taxes showed a limited rise while non-consumption-based taxes surged in 2014. We forecast the general government budget deficit as a share of GDP to rise in 2015 ahead of the forthcoming parliamentary elections, which will be held in the summer of 2015, and then to gradually decline in the following years.

Although global oil prices had fallen sharply by the end of 2014, the inflation rate decreased only to 8.2% at the end of the year, while the CBRT target was 5%. In the first months of 2015, annual inflation dropped to 7.2%. Even though it seems that the year-end inflation expectations follow the year-end inflation forecast of the CBRT (6.1% in 2015), we forecast relatively higher inflation rates than the CBRT because of the ongoing depreciation of the domestic currency. With global oil prices remaining flat or rising only slightly, our forecast for consumer price inflation in 2015-2017 is a deceleration from 6.8% to 5.5%, respectively, due to a loose monetary policy.

Monetary policy is still under pressure over interest rates. They had been loosened between May and July 2014 by cutting the one-week repo rate by a cumulative 175bp in order to help silence politicians who have been pressuring the CBRT to ease their policy. After a flat period in the second half of 2014, the CBRT has cut its policy rate by 50bp to 7.75% in the first Monetary Policy Committee (MPC) meeting of 2015. Although this cut still seems insufficient for the politicians, we expect the CBRT to keep the policy rate at this level or 25bp less in 2015 until inflation prospects improve which indicates a tight monetary policy stance. Since our inflation expectations are higher than the forecasts of the CBRT for 2016 and 2017, we forecast the policy rates to fall to 7.0% and 6.5%, respectively.

Private sector loans denominated in Swiss francs amounted to USD 760 million at the end of November 2014, less than half a per cent of total private sector borrowing (USD 214 billion). Furthermore, 95% of the franc loans are long-term loans. On the other hand, the shares of USD- and EUR-denominated private sector loans are 59% and 33% of the total private sector debt, respectively. Moreover, Turkey's external debt stock, which is slightly higher than half of GDP, has been on an upward trend since 2010 and the share of short-term external debt in total external debt increased from 20% to 33% over the past couple of years. Although we do not expect an adverse effect for the Turkish economy regarding Swiss franc loans, it is clear that the ongoing depreciation process will increase the gross external debt to GDP ratio in the years to come. In our forecasts, we expect that gross external debt as a percentage of GDP will be 59% in 2015 and 60% in the two subsequent years.

The Turkish lira has weakened sharply against the US dollar in the last couple of weeks. On 11 February 2015, the lira reached an all-time low against the US dollar, ending the day at 2.50 lira per US dollar. The Turkish lira lost 8.2% against the dollar within one month and this was 12% weaker than the level observed on the same day of the previous year. The reasons behind the fragility of the exchange rate are the expected interest rate hikes by the US Fed, the chronically large deficit of the current account, an increasing share of the short-term external debt stock, the pressure of the government regarding a reduction of the interest rates and political interventions in the banking sector due to the ongoing clash between Prime Minister Erdogan and his opponent Gulen.[1] Since the domestic currency has already depreciated at the beginning of the year, we forecast a further mild depreciation against the US dollar over the rest of the year.

1 The clash between Erdogan and the Gulen movement became clearly evident after the corruption scandal (the sons of three cabinet ministers were detained as part of a probe investigation) in mid-December 2013. Erdogan blamed Gulen, calling it a coup attempt carried out by Gulen and his followers. Later on, Erdogan intensified his attacks on Gulen's supporters or institutions such as Bank Asya whose shareholders have close relations with the Gulen movement. On 3 February 2015, the Savings Deposit Insurance Fund (TMSF) took over management control of 63% of Bank Asya's privileged shares, citing violations of banking regulations on transparency in organisational and partnership structure.

The 12-month rolling cumulative current account deficit recorded a downward trend in 2014. While it stood at USD 64 billion in January 2014, it ended the year with USD 46 billion, amounting to more than 5.8% of GDP according to our forecast. The trade deficits also narrowed by 17.5% in December 2014 as compared to the same month of the previous year. The main drivers behind the decline in the trade deficit, and therefore the current account deficit, are the depreciation of the domestic currency, the recovery of the euro area and the decline in oil prices. Since Turkish exports are more sensitive to exchange rate developments because of the labour intensity of its export products, we expect further substantial increases in exports. The depreciation of the Turkish lira against the US dollar will further contribute to net exports by boosting exports and lowering imports. Since the euro had depreciated already before the Turkish lira, we do not forecast substantial changes in exports regarding the TRY/EUR rate. Assuming flat or only slightly higher oil prices in 2015, we forecast the current account deficit to be -5.5% in 2015 and -5.2% in both 2016 and 2017.

Industrial production increased by 3.6% on average in 2014; this value seems to be the new longer-term growth rate since the end of 2011 when the current policy mix had started to be effective. Although there are some uncertainties concerning the interest rate development, a number of positive trends have the potential to increase industrial production in the years to come. Falling oil prices are one of the cost-saving factors for companies while expectations of positive growth in the euro area and depreciation of the domestic currency might act as revenue-producing factors. With the assumption of slightly higher domestic demand levels for the foreseeable future, we forecast industrial production trend growth to range between 4.0% and 3.8% over the years 2015 to 2017.

Gross fixed capital formation fell by 1.4% in the first three quarters of 2014, as opposed to 2013 when it grew at an average rate of 4.2%. Although construction activity financed by both the private and the public sector registered positive growth, the reduction in public and private investment in machinery and equipment dominated the development of gross fixed capital formation in the first three quarters. As mentioned above, the massive government-led infrastructure projects will clearly be important drivers of Turkey's construction activities ahead of the parliamentary elections and stimulate future investments of the private sector. We therefore expect gross fixed capital formation to grow by 1.5% in 2015 and by 1.2% in the two years thereafter. Overall GDP is forecast to expand by 3.3% in 2015 and 3.5% in both 2016 and 2017 with the support of government-induced stronger consumption and investment as well as improving net exports due to depreciation.

Table 1 / Turkey: Selected Economic Indicators

	2010	2011	2012	2013	2014 1)	2015	2016	2017
							Forecast	
Population, th pers., average	73,142	74,224	75,176	76,148	77,700	78,700	79,600	80,600
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Gross domestic product, TRY bn, nom.	1,099	1,298	1,417	1,565	1,740	1,930	2,120	2,320
annual change in % (real)	9.2	8.8	2.1	4.1	3.0	3.3	3.5	3.5
GDP/capita (EUR at exchange rate)	7,500	7,500	8,100	8,100	7,700	7,200	8,100	8,500
GDP/capita (EUR at PPP)	12,200	13,300	13,700	14,100	14,300	.	.	.
Consumption of households, TRY bn, nom.	788	924	994	1,109	1,220	1,330	1,460	1,590
annual change in % (real)	6.7	7.7	-0.5	5.1	1.5	1.9	3.2	3.2
Gross fixed capital form., TRY bn, nom.	208	283	287	318	340	370	400	430
annual change in % (real)	30.5	18.0	-2.7	4.2	-1.5	1.5	1.2	1.2
Gross industrial production								
annual change in % (real)	12.8	10.0	2.4	3.0	3.6	4.0	3.8	3.8
Gross agricultural production 2)								
annual change in % (real)	2.4	6.1	3.1	3.5	-0.7	3.4	3.5	3.5
Construction industry								
annual change in % (real)	18.6	11.4	0.7	7.5	2.0	4.0	5.0	5.0
Employed persons, LFS, th, average	22,593	24,100	24,820	25,520	25,950	26,300	26,700	27,200
annual change in %	6.2	6.7	3.0	2.8	1.7	1.4	1.7	1.7
Unemployed persons, LFS, th, average	3,048	2,616	2,517	2,750	2,850	.	.	.
Unemployment rate, LFS, in %, average	11.9	9.8	9.2	9.7	9.9	10.5	10.0	9.5
Reg. unemployment rate, in %, end of period	.	.	.	.	.	.	.	.
Average monthly gross wages, TRY	.	.	.	.	.	.	.	.
annual change in % (real, gross)	.	.	.	.	.	.	.	.
Consumer prices (HICP), % p.a.	8.6	6.5	9.0	7.5	8.9	7.1	6.3	5.7
Producer prices in industry, % p.a. 3)	6.2	12.3	6.1	5.7	10.1	7.1	5.9	5.2
General governm. budget, nat.def., % of GDP								
Revenues	35.5	36.4	37.8	40.0	39.6	40.0	39.0	40.0
Expenditures	38.5	36.8	38.9	40.7	40.4	43.0	40.5	41.0
Net lending (+) / net borrowing (-)	-3.0	-0.4	-1.0	-0.7	-0.8	-3.0	-1.5	-1.0
Public debt, EU-def., % of GDP	42.3	39.1	36.2	36.2	35.0	40.0	40.0	40.0
Central bank policy rate, % p.a., end of period 4)	6.50	5.75	5.50	4.50	8.25	7.50	7.00	6.50
Current account, EUR mn	-34,215	-53,891	-37,043	-48,683	-34,520	-34,000	-33,000	-35,000
Current account, % of GDP	-6.2	-9.7	-6.0	-7.9	-5.8	-5.5	-5.2	-5.2
Exports of goods, BOP, EUR mn	91,292	103,086	127,126	123,036	128,745	135,000	142,000	149,000
annual change in %	16.1	12.9	23.3	-3.2	4.6	4.8	5.0	5.0
Imports of goods, BOP, EUR mn	133,962	166,978	178,003	183,236	176,915	174,000	176,000	180,000
annual change in %	39.3	24.6	6.6	2.9	-3.4	-1.5	1.0	2.0
Exports of services, BOP, EUR mn	27,776	29,427	34,260	35,674	38,037	41,000	44,000	48,000
annual change in %	9.1	5.9	16.4	4.1	6.6	8.0	8.0	8.0
Imports of services, BOP, EUR mn	15,033	15,051	16,280	17,995	18,661	19,000	20,000	21,000
annual change in %	21.8	0.1	8.2	10.5	3.7	3.0	4.0	4.0
FDI inflow (liabilities), EUR mn	6,803	11,581	9,708	9,554	9,145	10,000	10,000	10,000
FDI outflow (assets), EUR mn	1,108	1,710	3,142	2,336	5,016	3,000	3,000	3,000
Gross reserves of NB excl. gold, EUR mn	60,404	60,531	75,749	80,435	88,058	.	.	.
Gross external debt, EUR mn	218,415	234,679	255,937	281,444	348,000	367,000	385,000	409,000
Gross external debt, % of GDP	39.7	42.3	41.8	45.6	58.1	59.0	60.0	60.0
Average exchange rate TRY/EUR	2.00	2.34	2.31	2.53	2.91	3.10	3.30	3.40
Purchasing power parity TRY/EUR	1.23	1.31	1.37	1.46	1.57	.	.	.

1) Preliminary and wiiw estimates. - 2) According to gross value added. - 3) Domestic output prices. - 4) One-week repo rate.
Source: wiiw Databases incorporating Eurostat and national statistics. Forecasts by wiiw.