TURKEY: Political risk will continue to weigh on growth

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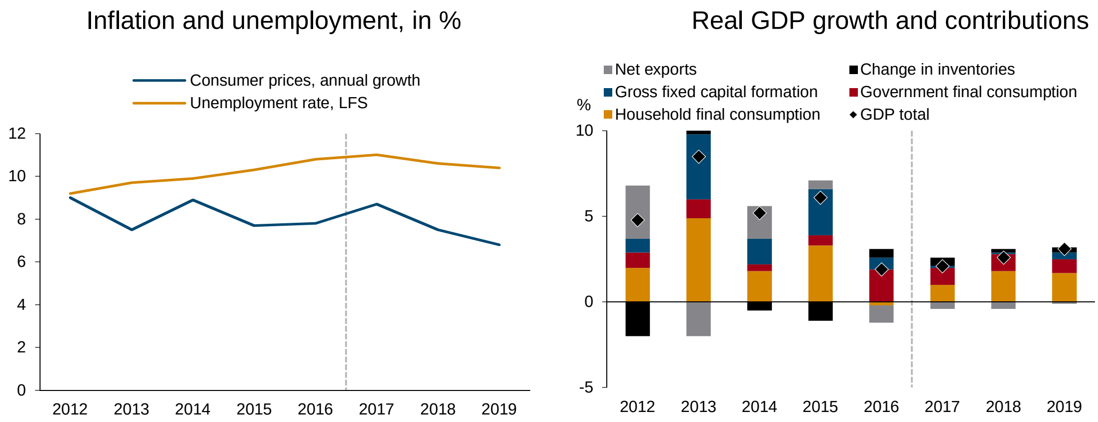
During the 2017-2019 forecast period, the Turkish economy will grow at a much slower rate than in recent years. This partly reflects political risks, both domestic and international. In this context, and at a time of monetary tightening by the US Federal Reserve, the financing of Turkey's large current account deficit will be more challenging. Monetary tightening by the Turkish central bank will remain limited, which will exacerbate the weakness of the lira and keep inflation high.

Figure 53 / Turkey: Main macroeconomic indicators



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

Turkey's political situation is in some ways more volatile than it has been for many years. The failed coup attempt in July 2016 by parts of the military has been followed by a widespread crackdown on suspected 'Gülenists' linked to the exiled preacher Fethullah Gülen. Around 100,000 people from the military, judiciary and public services are reported to have been suspended or sacked. Around 40,000 people are in prison pending trial. Emergency rule, which had been due to end in January 2017, has been extended for another three months. The government argued that this was necessary to continue the purge of suspected 'Gülenists' from state institutions. Under the emergency rule, the government can bypass parliament and suspend certain rights when it deems this necessary.

The president, Recep Tayyip Erdoğan, is pressing ahead with attempts to change the Turkish constitution and to create an executive presidency. The Justice and Development Party (AKP), which Mr Erdoğan founded in 2001 and led until he became president in 2014, together with the nationalist National Movement Party (MHP), voted the constitutional changes through parliament on 20 January (with 339 votes in the 550-seat parliament, passing the 60% threshold required). There is now likely to be a referendum in April. Voters will be asked to decide on a package of 18 constitutional changes, including the introduction of an executive presidency to replace Turkey's current parliamentary system of government. Other amendments include allowing the president to control the budget, appoint more senior judges, and to be the leader of a political party. It would also remove the post of prime minister. Mr Erdoğan has argued that the changes are necessary to rid Turkey of unstable coalition governments.

It is not yet clear which way the population will vote, and either outcome could result in further political instability. Opinion polls to date suggest a very close race. The part of the media that is not in favour of the government has been either shut down or is exercising self-censorship, which could affect the campaign. Mr Erdoğan is campaigning strongly, going to many different parts of the country and emphasising the link between a 'yes' vote and more public spending on infrastructure and health care. The Republican People's Party (CHP), the main opposition group, is against the changes, as are several Kurdish groups. The CHP has argued that the amendments would result in too few checks and balances on the power of the presidency. If the population votes in favour of the changes, they will come into force after parliamentary and presidential elections in 2019. Thereafter, any individual will be able to serve two five-year terms, creating the possibility that Mr Erdoğan could rule until 2029. A 'no' vote would be a serious setback for Mr Erdoğan, and his first significant political defeat since 2002. This would make a general election highly likely, where Mr Erdoğan would hope for the AKP to win a two-thirds majority, allowing the constitutional amendment to be approved by parliament without a referendum.

Other political risks, both domestic and international, remain relevant and could affect investor sentiment and growth. The Kurdish peace process in Turkey's south-east collapsed in 2015. Since then there have been several terrorist attacks linked to Kurdish extremists. Several members of the Kurdish Peoples' Democratic Party (HDP) have been arrested. Terrorist attacks in Istanbul and Ankara have contributed to a huge drop in tourist numbers. Tensions with the EU have increased. However, there was anyway only a very limited prospect of EU accession. There has been a rapprochement with Russia, after Mr Erdoğan apologised for the shooting down of a Russian jet over Turkey. This will be very positive for the economy (see below). Meanwhile, the election of Donald Trump as US president probably means that there will be less US criticism of Turkey. Mr Trump has in the past refrained from speaking negatively about Turkish internal affairs. One potential flashpoint could be over a request from Turkey for the rendition of Mr Gülen, who lives in the US.

The economy slowed markedly in 2016, with year-on-year growth turning negative in the third quarter for the first time since 2009. Turkey's economy contracted by 1.8% year on year in July-September, after having expanded by 4.5% in the first half of the year. The slowdown in growth in the third quarter is likely to have been related to the failed coup of July 2016, and a subsequent negative impact on consumption and investment. Gross fixed capital formation fell by 0.6% in the third quarter, while private consumption declined by 3.2%. Meanwhile, exports fell by 7%, reflecting in part a decline in tourist arrivals owing to security concerns. High-frequency indicators suggest no major bounce-back in economic activity in the fourth quarter.

Overall we estimate full-year growth of 1.9% in 2016, a big slowdown from the average of 6.1% posted in the previous four years. We expect growth to have been held back in particular by private consumption and exports. In the case of the former, uncertainty related to political developments and the impact of higher inflation on real incomes have restrained spending. Meanwhile, exports have been weighed down in particular by the weakness of tourism. Political tensions with Russia and Moscow's cancelling of package tours saw arrivals from Turkey's second most important source of tourists (after Germany) fall by 77.4% in January-November 2016. These negative factors were partly offset by government spending, which rose by an estimated 13.5% in 2016.

We think that a growth rate of 2.6% on average is achievable for the 2017-2019 forecast period. Growth will be more subdued this year, at 2.1%, as the above factors take time to wear off. However, momentum will improve from the levels seen in the second half of 2016. Consumer loan demand appears to have picked up during the final months of 2016 (although this could simply reflect a desire to bring forward purchases of bigger-ticket items before the exchange rate weakness pushes up domestic prices), while external demand for goods exports improved moderately. Private consumption in 2017 will be held back by political uncertainty, although the labour market appears to be coping relatively well. Employment growth slowed in the second half of the year, but remained positive. Although the unemployment rate is rising, this reflects larger numbers of new entrants into the labour force.

The tourism sector should start to recover gradually, beginning this year. In particular, arrivals from Russia will grow strongly, given the rapprochement between the two countries. The plunge in the value of the Turkish lira has significantly improved the cost competitiveness of the Turkish tourism sector (although higher inflation will gradually eat into these gains). Meanwhile merchandise exports will be supported by similar factors, as well as by robust EU demand, which is boosting Turkish automotive output in particular. Investment could be impeded by political uncertainty and weaker economic growth, although government fixed capital formation should be strong. Overall government spending will continue to contribute positively to growth.

Consumer price inflation will remain at high levels, in particular as a result of the weaker lira. The consumer price index (CPI) increased by an average 7.8% in 2016 as compared to a year earlier, and by 8.5% in December. This was the highest level since July, and was driven in particular by the weakness of the lira (see below) and the resulting increase in the cost of imported goods, as well as by hikes in alcohol and tobacco taxes. Meanwhile global energy prices are continuing to rise after bottoming out in the first half of 2016. Inflation rose further to 9.2% in January. We expect inflation to average 8.7% in 2017, with the full extent of the exchange-rate pass-through set to become evident only with a lag. Inflation will then fall to 7.5% in 2018 and 6.8% in 2019, still well above the central bank's 5% target.

Monetary policy has been loose in the context of the weakness of the lira and elevated inflation. The central bank significantly disappointed the market in December by keeping its benchmark one-week repo rate at 8%, the overnight lending rate at 8.5%, and the overnight borrowing rate at 7.5%. This caused a further sell-off of the lira. In January, the central bank again refrained from increasing the one-week repo rate, but did hike the marginal funding rate (+75 basis points) and the late liquidity window lending rate (+100 basis points).

The Turkish lira has weakened considerably. Heightened political risk, monetary tightening by the US Federal Reserve, a relative lack of tightening by the Turkish central bank, and the weakness of the external sector all pushed the lira down to 3.34 TRY/EUR in 2016, from 3.03 TRY/EUR in 2015. The currency has weakened much further since. We forecast an average exchange rate of 3.98 TRY/EUR in 2017. US monetary tightening in particular remains a concern for Turkey. As US rates rise, there is an increased risk of capital outflows from Turkey, which could force the Turkish central bank to tighten policy more sharply. This must be weighed against the slowdown in economic activity.

Despite the weakness of the lira, the Turkish banking sector remains in relatively good shape. Non-performing loans (NPLs) have been rising, but still remain quite low, at 3.3% of total gross loans in the third quarter of 2016. NPL levels for small and medium-sized enterprises (4.5%) and general-purpose retail credits (6.3%) are higher, whereas for housing loans the ratio is just 0.5%. Foreign-exchange (FX) NPLs are lower as a share of the total than for TRY-denominated credits, according to the central bank. This is quite surprising in the context of lira weakness, but historically the link between the exchange rate and NPLs is quite weak, according to central bank research. Total private sector credit growth has slowed since the second half of 2015, primarily reflecting a reduction in private sector FX borrowing. Profitability in the banking sector has risen. There has been little sign of deposit outflows in the wake of the coup attempt and political instability.

There are signs that fiscal policy management will not be as conservative as it has been in the past. The Turkish fiscal position has been generally strong in the last 15 years, with fiscal discipline being maintained by AKP governments over several election cycles. Fiscal deficits have generally been quite small, and public debt is well below 30% of GDP. This allowed the government to initiate a countercyclical increase in spending in 2016, partly in response to the failed coup. According to the Ministry of Finance, the central government budget recorded a deficit of TRY 29.3 billion in 2016, compared with TRY 23.5 billion in 2015. Revenue rose by 14.8%, thanks to non-tax revenue growth (growth in taxation receipts was weaker, owing to the slowdown in economic growth). Meanwhile, expenditure was up 15.3%, despite lower interest payments on public debt. Non-interest expenditure increased by 17.7%.

In 2017, we expect a fiscal deficit equivalent to 2.2% of GDP. The 2017 budget envisages a 30% increase in capital spending, with a focus on the country's poorer eastern and southern regions. Although the shortfall will be wider than in previous years during the forecast period, it will remain well below 3% of GDP, indicating continued relative commitment to fiscal discipline in the face of external risks and a desire not to widen the current account deficit further. Turkey has faced significant extra spending commitments owing to large refugee inflows from the war in neighbouring Syria.

The current account deficit widened to 4.9% of GDP in 2016, and will rise further over the forecast period. In 2016, the deficit was larger owing primarily to developments on the services account and to the collapse of tourism inflows. In US dollar terms, services credits fell by 20% year on year in January-November (data for December are not yet available). This was partly offset by a sharp decline in goods imports (-5.2%), related to the lower cost of energy, which resulted in a 14.8% year-on-year narrowing of the merchandise goods deficit. The latter factor was also supported by a declining trade deficit with the EU, as demand there remained robust. As energy prices pick up (particularly in lira terms), the overall current account deficit is likely to widen further, reaching 5.1% in 2017, 5.4% in 2018 and 5.7% in 2019. The fact that exports are typically priced in euros and imports in US dollars will be a negative factor for the trade balance, as the dollar continues to strengthen. However, a further widening towards the levels of the higher current account deficits of the relatively recent past is unlikely, due to a more subdued trend for domestic demand and much lower oil prices than in 2010-2014.

The fact that most of the financing of Turkey's current account deficit is debt creating remains a potential issue. Turkey has traditionally run quite large current account deficits, financed primarily by a combination of portfolio and other investment (loans), with net foreign direct investment (FDI) inflows contributing a fairly small share of the total (FDI financed 32% of the current account deficit on average in 2003-2015, compared with 55% for other investment). Gross external debt reached an estimated 48.5% of GDP in 2016. So far, the failed coup attempt (and the government's reaction to it) does not appear to have had much of an impact on external financing, but this is not certain to last. Globally, emerging markets have seen capital outflows in the wake of US monetary tightening. All major ratings agencies now rate the Turkish sovereign as junk (following a Fitch downgrade on 27 January).

Short FX positions of corporates have increased, and are a source of risk for the economy. Such positions stood at around 200% of FX reserves, and 100% of annual exports of goods and services in the third quarter of 2016, according to the central bank. However, the central bank has stated that FX borrowers typically have foreign currency revenue streams, and that FX borrowing is generally of an extended maturity. Meanwhile, the bank reports that short-term open FX positions are small.

Overall, the outlook for the Turkish economy is for subdued growth by recent standards throughout the forecast period. We see the economy expanding by 2.1% in 2017, rising to 2.6% in 2018 and 3.1% in 2019. Political risks will continue to weigh on consumer and investor sentiment, irrespective of the referendum result. Meanwhile the lira will remain weak and inflation high. Turkey should still be able to finance its current account deficit, but the risks of financing difficulties have increased, owing to both the heightened political risks and monetary tightening in the US.

Table 24 / Turkey: Selected economic indicators

	2012	2013	2014	2015	2016 [1]	2017	2018 Forecast	2019
Population, th pers., average	75,176	76,148	77,182	78,218	79,500	80,300	81,100	81,900
Gross domestic product, TRY bn, nom. [2]	1,570	1,810	2,044	2,338	2,600	2,900	3,200	3,500
annual change in % (real)	4.8	8.5	5.2	6.1	1.9	2.1	2.6	3.1
GDP/capita (EUR at PPP) [2]	15,500	16,300	16,900	18,000	18,400	.	.	.
Consumption of households, TRY bn, nom. [2]	979	1,120	1,242	1,412	1,516	.	.	.
annual change in % (real)	3.2	7.9	3.0	5.5	-0.4	1.6	3.0	2.8
Gross fixed capital form., TRY bn, nom. [2]	429	516	591	695	768	.	.	.
annual change in % (real)	2.7	13.8	5.1	9.2	2.5	0.2	0.2	1.5
Gross industrial production								
annual change in % (real)	2.5	3.0	3.6	3.2	1.9	2.2	2.5	3.0
Gross agricultural production [3]								
annual change in % (real)	5.5	2.8	2.0	2.0	2.0	.	.	.
Construction industry								
annual change in % (real)	0.8	7.7	3.0	1.7	3.2	.	.	.
Employed persons, LFS, th, average	24,819	25,520	25,931	26,619	27,240	27,800	28,400	29,000
annual change in %	3.0	2.8	1.6	2.7	2.3	2.0	2.0	2.0
Unemployed persons, LFS, th, average	2,517	2,750	2,854	3,050	3,280	3,440	3,370	3,370
Unemployment rate, LFS, in %, average	9.2	9.7	9.9	10.3	10.8	11.0	10.6	10.4
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	7.8	8.7	7.5	6.8
Producer prices in industry, % p.a. [4]	6.1	5.7	10.1	5.3	4.3	9.5	7.6	6.0
General governm. budget, nat.def., % of GDP								
Revenues	32.2	32.7	31.9	32.0	38.5	37.8	37.5	37.4
Expenditures	34.0	34.0	32.7	32.9	40.1	40.0	39.7	39.5
Deficit (-) / surplus (+)	-1.8	-1.3	-0.8	-1.0	-1.6	-2.2	-2.2	-2.1
Public debt, nat.def., % of GDP [5]	32.6	31.3	28.6	27.5	27.5	28.0	27.9	27.7
Stock of loans of non-fin.private sector, % p.a.	18.6	33.6	19.4	19.4	15.2	.	.	.
Non-performing loans (NPL), in %, Dec	2.9	2.8	2.8	3.1	3.2	.	.	.
Central bank policy rate, % p.a., end of period [6]	5.50	4.50	8.25	7.50	8.00	9.00	8.50	8.00
Current account, EUR mn	-37,208	-47,966	-32,951	-29,074	-29,504	-37,000	-43,000	-48,000
Current account, % of GDP	-5.5	-6.7	-4.7	-3.8	-3.8	-5.1	-5.4	-5.7
Exports of goods, BOP, EUR mn	126,137	121,819	127,237	136,978	135,820	127,000	138,000	150,000
annual change in %	23.2	-3.4	4.4	7.7	-0.8	-6.4	8.5	8.8
Imports of goods, BOP, EUR mn	177,043	182,057	175,312	180,341	172,644	162,000	177,000	194,000
annual change in %	6.5	2.8	-3.7	2.9	-4.3	-6.0	9.0	9.5
Exports of services, BOP, EUR mn	34,078	36,306	39,105	42,129	33,596	32,000	34,000	36,000
annual change in %	15.3	6.5	7.7	7.7	-20.3	-5.0	5.0	6.5
Imports of services, BOP, EUR mn	16,347	18,457	18,915	20,348	19,736	19,000	21,000	23,000
annual change in %	7.6	12.9	2.5	7.6	-3.0	-2.0	11.0	8.5
FDI liabilities, EUR mn	10,305	9,297	9,447	15,371	10,999	.	.	.
FDI assets, EUR mn	3,167	2,716	5,377	4,594	2,828	.	.	.
Gross reserves of NB excl. gold, EUR mn	75,749	80,435	88,058	85,355	87,331	.	.	.
Gross external debt, EUR mn [7]	257,418	282,858	331,195	365,308	377,200	371,600	410,900	439,600
Gross external debt, % of GDP [7]	37.9	39.6	47.1	47.3	48.5	51.0	52.0	51.5
Average exchange rate TRY/EUR	2.31	2.53	2.91	3.03	3.34	3.98	4.05	4.10

1) Preliminary and wiiw estimates. - 2) According to SNA 2010. - 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.