Developments in the first half of 2016 point to a moderation in GDP growth below the 4 percent seen in 2015.

Rebound in global oil prices and fall in tourism revenues will reverse the oil-price driven external adjustment.

Despite positive headline numbers, inflation is likely to increase in the second half, calling for a more cautious monetary policy to reaffirm commitment to price stability.

Despite a pick-up in domestic consumption, GDP growth slowed in Q1 because of slower inventory build-up. The seasonally and working day adjusted GDP growth slowed to an annualized rate of 3.3 percent q-o-q in Q1, as compared with 4 percent in 2015 as a whole. Inventory accumulation that led growth in the previous quarter slowed significantly in Q1, bringing growth down. Public investment declined somewhat to offset the current spending increase, and private investment weakened as well. Net exports had a negative impact, as imports grew faster than exports because of a stable Lira and stronger domestic consumption. Nevertheless, exports showed signs of recovery in Q1, following a contraction in the previous quarter, and contributed positively. On the other hand, private consumption strengthened thanks to a 30 percent rise in the minimum wage, recovery in consumer credit growth, and fall in food prices, while government spending rose considerably because of election promises.

Job creation maintained its momentum in Q1, as recovery in agriculture offset the slowdown in industry. The economy created 240 thousand new jobs (SA) in Q1, compared to 252 thousand in the previous quarter. While job creation somewhat slowed in all non-agricultural sectors, employment in industry actually fell in Q1. After contracting in the previous quarter, employment in agriculture recovered strongly in Q1, compensating for the weaknesses in the non-agricultural sectors. In the meantime, the labor force increased at a slower rate, helping the unemployment rate to decline by 0.4 percentage points (pps) to 9.9 percent in Q1. The 30 percent rise in the minimum wage boosted wage growth substantially in all sectors in Q1. Particularly, the annual wage growth increased to 18.8 percent in industry, 22.5 percent in trade and services, and 15.0 percent in construction.

Oil price-driven external adjustment is coming to an end. The 12-month gold-adjusted current account deficit narrowed by $13.3 billion to $29.9 billion (or 4.2 percent of GDP) between July 2015 and April 2016, thanks to a $12.4 billion decline in the energy deficit because of lower oil prices. However, the 12-month gold and energy excluded current account deficit has barely changed in this period. In the first four months of 2016, seasonally adjusted numbers point to a trend turn-around. On the positive side, exports excluding gold and energy increased because of stronger exports to EU and MENA markets, even though merchandise exports to Russia were in free fall after the impositions of sanctions in December 2015. On the other hand, imports excluding gold and energy recovered faster than exports because of stronger domestic consumption, leading to a deterioration in the 3-month core trade deficit. A slump in tourism due to Russian sanctions and security related issues exacerbated the negative merchandise trade developments. In addition, the rebound in global oil prices will slow the fall in energy deficit in the second half of the year, and reverse it eventually.

Inflation eased significantly in recent months, mostly driven by a fall in food inflation. The 12-month headline inflation rate dropped by 1.9 pps from its peak in January 2016 to 7.6 percent in June. Strong agricultural production thanks to good weather and sanctions against agricultural exports to Russia brought the 12-month food inflation to 6.3 percent in June, shaving off 1.2 pps from the headline inflation rate. While core (non-food, non-energy) inflation is still higher than headline inflation, the stable Lira helped abate inflationary pressures. In fact, the 12-month core inflation rate declined by 1.0 pps to 8.7 percent in this period. The core inflation momentum significantly eased in recent months as pass-through of exchange rate depreciation in 2015 continued to phase out, suggesting that 12-month core inflation is likely to come down further in the next few months.

Portfolio inflows recovered after January. An increase in global risk appetite triggered portfolio inflows to emerging markets after late February. Despite short-term volatility, the global environment remained mostly favorable, and Turkey received $7.4 billion worth of net portfolio inflows in the three months through April. The net FDI inflows slightly weakened in this period. The other investment inflows remained robust as corporates continued to borrow from abroad. However, the other investment outflows also increased in this period as domestic banks increased their currency and deposit holdings abroad. Net errors and omissions recorded $2.3 billion worth of unrecorded inflows, and the Central Bank’s foreign reserves increased by $2.6 billion in this period. Turkish financial markets rose considerably until early May, thanks to a recovery in portfolio inflows.
### Selected Economic Indicators

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<thead>
<tr>
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<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
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<tbody>
<tr>
<td>Real GDP Growth Rate (percent)</td>
<td>3.0</td>
<td>4.0</td>
<td>3.5</td>
<td>3.5</td>
<td>3.6</td>
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<tr>
<td>Consumer Price Inflation (end period, in percent)</td>
<td>8.2</td>
<td>8.8</td>
<td>8.5</td>
<td>8.0</td>
<td>7.5</td>
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<tr>
<td>General Government Budget Balance (in percent of GDP)</td>
<td>-0.6</td>
<td>0.0</td>
<td>-1.8</td>
<td>-1.3</td>
<td>-1.3</td>
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<tr>
<td>General Government Debt (in percent of GDP)</td>
<td>36.3</td>
<td>36.0</td>
<td>35.6</td>
<td>34.8</td>
<td>34.1</td>
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<tr>
<td>Current Account Balance (in percent of GDP)</td>
<td>-5.4</td>
<td>-4.5</td>
<td>-4.1</td>
<td>-4.3</td>
<td>-4.5</td>
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*Source: World Bank staff projections, TURKSTAT, CBRT, Undersecretariat of Treasury*

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The Central Bank loosened monetary policy against the favorable inflation backdrop. The recovery in portfolio inflows and significantly lower headline inflation due to the fall in food prices created a favorable environment for the Central Bank to cut interest rates. The Central Bank cut the overnight lending rate by 175 bps to 9 percent between March and June, while keeping the 1-week repo and overnight borrowing rates unchanged. The average cost of Central Bank funding dropped by 60 bps to 8.3 percent in this period, given that the Central Bank provides only around 43 percent of funding through the overnight lending facility. The fall in the average cost of Central Bank funding was passed on to loan rates with 70 bps and 100 bps drops in consumer and commercial loan rates, respectively.

Headline fiscal figures have improved but there are concerns about the underlying fiscal dynamics. The January-May central government surplus amounted to TL9 billion, reversing a deficit of TL2.4 billion a year earlier. However, the improving headline figures do not reflect the worsening fiscal dynamics. On the expenditure side, a significant decrease in capital and interest expenses more than offset the substantial rise in current transfers and the wage bill. Current spending rose considerably because of the higher minimum wage and a number of other spending promises, which had been promised ahead of the November 2015 election. On the revenue side, the increase in non-tax revenues has been faster than the slowdown in tax revenues, leading to an improved revenue performance. Therefore, one-off factors masked emerging developments so far, but rising pressures on both the revenue and the expenditure sides are likely to create long-term fiscal challenges.

Supply side indicators point to a continuing moderation of growth in Q2. The pace of job creation remained at about the same level as in Q1. The industrial production index also suggests a moderation in growth, albeit with some momentum loss in Q2. The demand side indicators suggest that private consumption maintains its momentum, thanks to stronger real wage growth and recovery in consumer credit growth. Particularly, demand for consumer goods is rising, while retail sales are robust. After a weak performance in Q1, private investment might recover somewhat in Q2, as indicated by the investment expenditure survey and rising demand for capital goods imports. Trade volumes suggest that net exports will contribute less negatively in Q2, partly driven by stronger gold exports.

We maintain our growth projection at 3.5 percent for 2016. GDP growth sequentially slowed down in Q1, and early indicators for Q2 suggest moderation, in line with our baseline scenario described in our April 2016 TREN issue. For the remainder of the year, we expect private consumption to maintain its momentum and continue to be the main driver of growth. There may not be another wealth effect, which supported private consumption in 2015 because of the foreign currency deposits that gained in value when the Lira depreciated substantially, provided that the Lira remains stable this year. Similarly, the income effect from falling energy prices in 2015 is unlikely to be repeated. However, the stronger real wage growth due to the 30 percent rise in the minimum wage, recovery in consumer credit growth, and lower food inflation will compensate for the diminishing wealth and income effects. Government spending will continue to contribute significantly to growth, as we have seen in Q1. Private investment should recover somewhat in the remainder of the year, but contribute marginally to growth in 2016 as a whole. The strong domestic consumption and stable Lira will continue to support imports, while problems in exports markets will restrict export growth in 2016.

Despite positive headline numbers, inflation is likely to increase in the second half of 2016. Headline inflation slowed rapidly in recent months, and core inflation is likely to decline in the next few months. However, inflationary pressures are building up in the economy, and will be visible towards the end of the year. The 30 percent increase in the minimum wage has already started to feed into wage growth in all sectors. Firms are likely to reflect the higher labor costs in prices, though the exact timing and magnitude is not clear and will depend on the market forces. On the other hand, stronger wage growth is supporting private consumption together with the recovering consumer credit growth, putting pressure on prices through the demand channel. Robust GDP growth in 2015 mostly closed the output gap, and the economy is expected to expand in line with its potential in 2016. Therefore, lower interest rates could exacerbate demand pressures. In addition, food prices have been highly volatile in the past few years, and can make a comeback if weather conditions worsen. These pressures are not yet visible, but warrant a more cautious monetary policy to reaffirm commitment to price stability.

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1 Turkey Regular Economic Brief is a brief that assesses recent economic developments in Turkey and provides World Bank forecasts on key macroeconomic variables. Given that the focus is on the recent past, the Note reports seasonally adjusted quarter-on-quarter changes (or 3-month-on-3-month changes). Although year-on-year rate is much less volatile, the main advantage of using a quarter-on quarter growth rate is that it is easier to identify turning points in the economy, such as the end of a recession or beginning of an expansionary period.

2 Currency and deposits held abroad cushion the adverse impact of external shocks.

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