Turkey Regular Economic Note

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- Growth outlook remains subdued, despite investment led surprise in the second quarter.
- The current account deficit remains large, while financing becomes challenging.
- Economic activity is likely to decelerate in the second half of the year as suggested by weakening early indicators.

A surprising surge in investment supported growth in the second quarter of 2015. Seasonally adjusted (SA) GDP grew by 1.3 percent q-o-q in the second quarter, despite uncertainty before the June parliamentary election. Private and public consumption continued to lose momentum as expected. Net exports, which contributed positively to GDP in the first quarter because of gold exports and a slump in imports, became a drag on growth with weak export demand in the second quarter. Inventory de-stocking did not help either. However, private investment unexpectedly surged and became the main driver of growth in the second quarter, an indication that the private sector carried out previously postponed investment spending, anticipating elimination of uncertainties after June election.

Inflation is likely to remain above target in 2015. After peaking in May, 12-month inflation eased by 1.3 pps to 6.8 percent in July, mainly owing to a drop in food prices in May and June. Energy inflation, which escalated until May because of the depreciation of the lira and increase in global oil prices, eased through September with global oil prices sliding towards $45 per barrel. However, food prices started to rise rapidly again, pushing food inflation momentum up to 14.7 percent in September. Renewed currency depreciation brought core inflation above 8 percent and its momentum above 10.5 percent. Particularly, a sharp increase in automobile prices due to depreciation added significantly to inflation in September. As a result, 12-month inflation climbed to 7.9 percent in September. Also, energy inflation tends to increase when depreciation feeds into local energy prices. Thus, we are revising up our inflation forecast to 7.5 percent for 2015.

The hoped-for external adjustment fueled by a weaker lira and significantly lower oil prices has not materialized. The Turkish lira depreciated by 18.4 percent against the U.S. dollar (7.6 percent against the Euro) in the first seven months of 2015. Despite a significantly lower energy deficit, Turkey`s current account deficit widened to $45 billion in the 12 months through July 2015 (gold adjusted), compared to $42.6 billion in 2014. The deterioration in the deficit is mainly due to weaknesses in trading partners, particularly slow growth in the EU, difficulties in MENA and Russia, and a fall in tourism revenues over the summer of 2015. Depreciation of the lira has continued, with a year-to-date loss of 29.8 percent against the U.S. dollar (20.1 percent against the Euro) by end of September.

Domestic political concerns and global financial market jitters dried up short-term inflows. Portfolio outflows accelerated in the three months through July, while long-term inflows strengthened due to the banking sector`s borrowing from abroad and a large FDI influx in July. Although the quality of finance improved thanks to lengthening maturity, net inflows fell short of financing the current account deficit in the first seven months of the year. A drawdown of foreign reserves by $2.5 billion financed some of the current account deficit, with the unrecorded transactions amounting to a positive $9.1 billion in this period.

The Central Bank remained on hold with policy decisions, while announcing a road map for its handling of possible rate increases by the US Federal Reserve. The Central Bank left the key interest rates unchanged at their current levels for the third quarter. However, the Central Bank`s injection of funds has risen to above TL90 billion in late September, from around TL65 billion in May, amid a growing liquidity need in the banking system. The Central Bank provided most of the excess funding through its overnight lending facility, increasing the share of overnight funding to 45 percent, up from 25 percent in May. As a result, the average cost of Central Bank funding reached 9 percent, compared to a 1-week repo rate of 7.5 percent. In addition, the Central Bank announced a road map, in which it promised to simplify the monetary policy framework by narrowing the width of the corridor.

Figure 1. Contributions to Growth - Q2 2015 (SA, q-o-q)

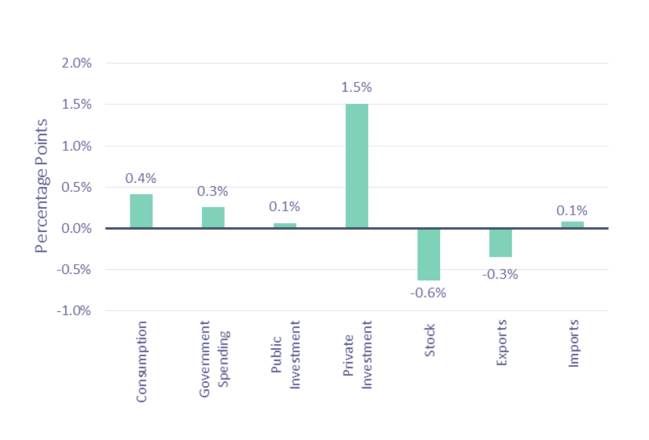
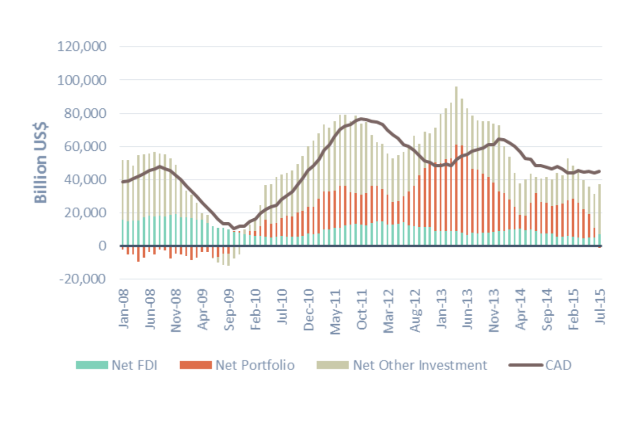


Figure 2. 12-Month Rolling Current Account Deficit and Its Finance



Selected Economic Indicators

	2013	2014	2015	2016	2017
Real GDP growth rate (percent)	4.2	2.9	3.2	3.5	3.5
Consumer price inflation (end period, in percent)	7.4	8.2	7.5	6.8	6.5
Central government primary balance (in percent of GDP)	2.0	1.6	0.3	0.8	0.9
General Government Debt (in percent of GDP)	36.1	33.5	31.1	29.4	27.8
Current account balance (in billions of US dollars)	-64.7	-46.5	-40.5	-44.6	-48.8
Current account balance (in percent of GDP)	-7.9	-5.8	-5.5	-5.7	-5.8

Source: World Bank staff projections, TURKSTAT, CBRT, Undersecretariat of Treasury

Better-than-expected revenue performance thanks to stronger growth leads to a budget surplus. The central government budget recorded a surplus of TL0.6 billion, with the primary surplus increasing to TL39 billion in the first eight months of the year, from TL30.9 billion a year ago. Fiscal policy remained growth supportive with year-to-date goods and service purchases rising by 17 percent by August. However, smaller increases in other accounts restricted the increase in total expenses to 11.8 percent. Also, stronger tax revenues brought total revenues up by 13.1 percent, improving the budget balance.

The economy quickened its pace of job creation, but a rapid rise in the labor force led to an increase in unemployment. The 3-month job creation (SA) in the non-agricultural sector reached 177 thousand in July, up from 150 thousand in April. At the same time, the labor force rose by 312 thousand, increasing non-agricultural unemployment by 135 thousand in the three months through July. As a result, the non-agricultural unemployment rate (SA) climbed to 12.6 percent in July, from 12.2 percent April.

Economic activity is expected to decelerate in the second half of 2015 against the backdrop of continued political uncertainty. Consumer confidence hit the lowest level since January 2009, and business confidence dropped notably in August and September. Moreover, credit growth momentum fell below the Central Bank`s reference rate of 15 percent by mid-September. The renewed currency depreciation and high single digit inflation are likely to decrease the purchasing power of households. Hence, we expect private consumption to slow in the remainder of the year. In addition, continuing political uncertainty and tensions in Turkey’s south-east make it difficult for the private sector to sustain the investment spending witnessed in the second quarter. Businesses are likely to cut investment spending from the second quarter and postpone investment decisions until a new stable political equilibrium is reached. On the external side, although the nascent recovery in the EU is expected to support exports, the economic difficulties in MENA and Russia are likely to restrain export growth in 2015. External adjustment should continue, as lower oil prices will likely bring the current account deficit down by another $5 billion in the remainder of the year.

Despite the expected slowdown in the second half of the year, we are revising up our growth forecast to 3.2 percent for 2015. The faster GDP growth in the second quarter leads us to revise our 2015 forecast up from 3.0 percent in the last Turkey Regular Economic Note in July. This builds on the expectation that growth will slow notably in the second half of the year. Considering the deterioration in the gold and energy adjusted current account balance, the positive impact of lower oil prices on the current account will be very limited. Moreover, nominal GDP is shrinking because of a weaker lira, reducing the denominator of the ratio. In light of this we are correcting our current account deficit projection to 5.5 percent of GDP for 2015, from 4.6 percent.

Political stability and continued progress with structural reforms are key to faster and sustainable growth over the medium-term. Weak investment, together with sluggish global growth and geopolitical tensions in the region, lowered GDP growth notably since 2012, but with only limited improvements in external vulnerabilities. Turkey`s current account deficit remains high and unlikely to fall below 5.5 percent without significant structural reforms, given the current external environment. Meanwhile, net financial inflows to Turkey dropped since May 2013, and normalization of global monetary policies will make the competition for foreign funds fiercer among developing countries with higher costs. There is an urgent need for political stability and to return to implementing the structural reform agenda to restore investor confidence, address vulnerabilities and lift growth.

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