Turkey Regular Economic Note

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Growth increased to 4 percent in 2015 as a whole, reflecting stronger private and public consumption. Private consumption rose thanks to strong real wage growth and the income effect due to lower oil prices. Moreover, many households hold foreign currency deposits, and thus the depreciation of the lira created a wealth effect, which also supported consumption. Public spending remained expansionary and also contributed significantly to growth in 2015. Private investment remained weak in 2015. Moreover, private investment was volatile throughout the year, and with a large share of it realized in Q2. Exports marginally declined in 2015, against the backdrop of the economic crisis in Russia, lower demand from the EU, and continued weaknesses in MENA. Imports sequentially dropped in the first three quarters of 2015, before recovering substantially in Q4 to bring import growth into positive territory. Inventory de-stocking continued in 2015, and made a negative contribution to growth.

Stronger growth led to a rise in employment creation but the unemployment rate was little changed. The non-agricultural labor force increased by 413,000 in Q4. At the same time, the non-agricultural job creation increased to 386,000 in Q4, from 41,000 in Q3, thanks to broad-based recovery across all sectors, particularly in industry. As a result, non-agricultural unemployment increased only by 27,000 in Q4, while the non-agricultural unemployment rate stabilized at 12.4 percent. The quarterly contraction in agricultural output was mirrored in the labor market, and led to an employment reduction by 159,000 in agriculture in Q4. Data for early Q1 of 2016 suggests a modest slowdown in job creation, but an improvement in unemployment thanks to a slower increase in labor force.

Lower energy prices helped reduce the current account deficit. Decline in energy deficit more than offset the rise in core current account deficit (excluding gold and energy) since the middle of 2015, reversing the earlier trend. After widening by $4.5 billion between January and June 2015, the 12-month gold-adjusted current account deficit improved by $9.9 billion to $33.1 billion by February 2016, as the energy deficit continued to decline while the core deficit largely stabilized. However, exports have struggled and the core deficit has remained unchanged, suggesting that the external adjustment has been driven mainly by cyclical factors instead of structural reforms.

Financial inflows somewhat recovered after November, but the central bank's reserves have declined in the last three months through February 2016. Net FDI inflows recovered to $1.7 billion in the three months through February 2016, which mostly reflected large inflows in December. Net portfolio outflows slowed to $1.1 billion in this period from $5.9 billion in the previous three months, as inflows recovered in February thanks to improvement in global risk appetite. In addition, foreign inflows to other investment accounts maintained their momentum, however, the rise in banks` currency and deposits holdings abroad brought net other investment inflows down to $1.9 billion, from $4.8 billion in the previous three months. Net errors and omissions, which showed $10.7 billion worth of unrecorded inflows in the first eleven months of 2015, dropped to $0.5 billion in this period, albeit with significant monthly volatility. Despite the recovery in financial inflows, the central bank`s reserve assets dropped by $6 billion in this period.

Inflation excluding volatile food and fuel prices is still high, but the outlook for the next few months is more promising thanks to the stable lira. Measures taken by the Committee of Monitoring and Evaluating Food and Agricultural Product Markets as well as weaker agricultural exports due to the Russian sanctions helped reduce food prices in February and March. On the back of lower food inflation, 12-month headline inflation eased by 2.1 percentage points (ppts) from its recent peak in January to 7.5 percent by March. However, 12-month core inflation declined only marginally by 0.1 ppts to 9.5 percent in this period. A stable currency will bring to nil the pass-through from exchange weakness to inflation and has helped improve the inflation outlook. Indeed, the core inflation momentum indicator that measures future inflation trends eased significantly, while the inflation diffusion index that measures the fraction of CPI sub-groups that are running above the 5 percent target dropped to 67 percent from over 80 percent.

Figure 1. Contributions to GDP Growth

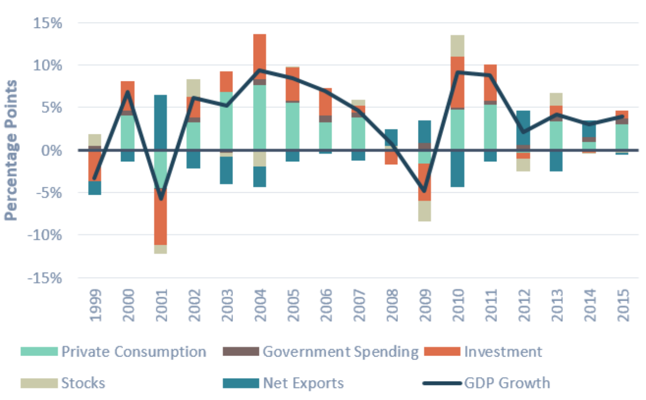
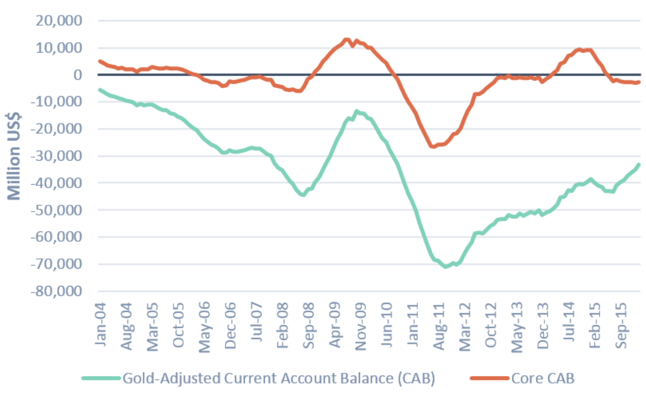


Figure 2. Current Account Balance (12-Month Rolling)



Selected Economic Indicators

	2014	2015	2016	2017	2018
Real GDP Growth Rate (percent)	3.0	4.0	3.5	3.5	3.6
Consumer Price Inflation (end period, in percent)	8.2	8.8	8.5	8.0	7.5
General Government Budget Balance (in percent of GDP)	-0.6	0.0	-1.8	-1.3	-1.3
General Government Debt (in percent of GDP)	36.3	36.0	35.6	34.8	34.1
Current Account Balance (in percent of GDP)	-5.4	-4.5	-4.1	-4.3	-4.5

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

The central bank loosened its monetary policy in March and April. Turkish financial markets have rebounded since late February, as a rally in oil prices and a recent more dovish US Federal Reserve rhetoric supported asset prices in emerging markets. On the back of a recovery in portfolio inflows, the lira appreciated by around 4.5 percent against the USD, and remained roughly flat against the EUR since late February. As the pressure on the lira abated, the central bank gradually cut the amount that it sells through daily FX selling auctions from $60 million in late February to $20 million by late March. As a result of stronger portfolio inflows and lower FX selling auctions, the central bank's gross reserves reached up to $116.6 billion by early April from $110.5 February 2016. Against the backdrop of a favorable global environment, the central bank cut the overnight lending rate cumulatively by 75 bps to 10 percent, while keeping the 1-week repo rate and overnight borrowing rate unchanged in its March and April meetings. Also, the central bank reduced the share of overnight lending in total funding, and as a result of these developments, the average cost of funding eased to 8.5 percent by mid-April, from around 9.1 percent in February.

The general government budget deficit is expected to widen to 1.8 percent in 2016, from a balanced budget in 2015. Early in the year, spending pressures are building up following the implementation of election pledges, while tax revenues slow. The government's revised Medium Term Program assumes a notable rise in expenditures due to election promises, but with a limited increase in the deficit (to 0.7 percent of GDP). The target reflects a stronger revenue performance than our estimate, because of the government's 4.5 percent GDP growth assumption. However, we forecast a larger deficit in 2016, as we anticipate a weaker revenue performance given our slower GDP growth projection. Although the central government budget balance was contained in Q1of 2016, the underlying trends imply a worsening. The decline in capital spending and interest expenses mostly offset the notable rise in current transfers and personnel expenses due to election promises. Thanks to these factors, the rise in expenditures was limited to 11 percent y-o-y in Q1 of 2016. On the revenue side, tax revenues lost some momentum because of weaker revenues from domestic VAT, special consumption tax, and VAT on imports. However, strong capital revenues brought total revenue growth to 16.4 percent y-o-y in this period, strengthening fiscal balances.

External demand will continue to be weak in 2016. Turkey`s real exports to the EU lost momentum early this year and are likely to grow modestly in the remainder of the year. Geopolitical problems in MENA continue, and Turkey`s exports to this region will continue to be weak. The economic crisis in Russia has limited Turkey`s exports somewhat in the past two years. This problem is exacerbated by the escalation of bilateral tensions following Turkey's downing of a Russian jet in November 2015. With a likely contraction in Russia`s output and no resolution of the tensions, exports to Russia will continue to fall in 2016. In addition, the downward trend in tourism revenues is expected to continue in 2016, because of an expected sharp drop in visitors from Russia and lower arrivals from Europe.

Private investment has remained depressed for the last four years. Private investment, which grew by 13.5 percent a year on average between 2002 and 2011, dropped 0.3 percent between 2012 and 2015. Weak private investment is now a structural rather than a cyclical problem. Leverage in the corporate sector has risen rapidly in the aftermath of the global crisis; thus, the room for debt financed growth has quite narrowed. Moreover, lira depreciation has strained balance sheets and raised the debt service burdens of the corporate sector, which has sizable foreign exchange exposure. These have weighed heavily on private investment by deteriorating investor confidence, along with a widespread perception of deteriorating institutional quality and business climate. [1]

We project growth to slow to 3.5 percent in 2016 because of more negative contribution from net exports compared to 2015. Imports recovered sequentially in Q4 of 2015, earlier than expected, and are likely to maintain this momentum throughout 2016. The external challenges will constrain export growth at a very low rate in 2016. The minimum wage increase will boost private consumption and keep it as the main driver of growth in 2016. Public spending is expected to contribute to growth, albeit at a decelerating pace. Private investment is expected to remain relatively weak in 2016, on the back of the above-mentioned structural problems. The recent increase in terrorist activity as well as the unrest in the Southeast are the downside risks to our growth forecast. Continued lower oil prices will help bring the current account deficit to around 4.1 percent of GDP in 2016. The FX pass-through is phasing out, thanks to the stabilization of the lira, but demand pressures are likely to arise towards the second half of the year, because of strong consumption, and make disinflation a slow process. Monetary policy credibility is somewhat disputable not least because of the policy framework with multiple objectives, and the recent easing cycle despite high core inflation, which will make disinflation even more difficult. We project inflation to be at 8.5 percent by end-2016.

[1] We track indicators from the following sources to asses the quality of institutions and business climate: World Economic Forum Global Competitiveness Indicators, Open Budget Index, Fraser Institute, World Bank Doing Business, and Heritage Foundation.

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