

## 30. TURKEY

### Drawn-out recovery after deep recession

#### Economic activity slumps in 2008

After an outstanding growth performance during 2002-06, the Turkish economy started to decelerate already in 2007. Domestic factors, such as increased political uncertainty, a slowdown of reforms and tight monetary policy following the currency crisis in mid-2006, took a heavy toll on the growth dynamics.

In 2008 the economic crisis hit Turkey mainly via the trade and financial channels. In the last quarter of the year real GDP contracted by 6½% in annual terms, as exports and investment declined by 8½% and 17⅔% respectively. Global demand shrank fast in sectors such as automotive and white goods, where Turkey had previously built a solid manufacturing basis for the European market. Simultaneously, lower private external inflows and decelerating domestic credit led to a 5⅓% annual decline in private consumption. The combined trade and financial shock disrupted activity in the manufacturing sector causing a 12⅔% decline of industrial output in the last quarter of 2008. Overall, real GDP growth slowed to below 1% while investment growth already turned negative by -5% in 2008.

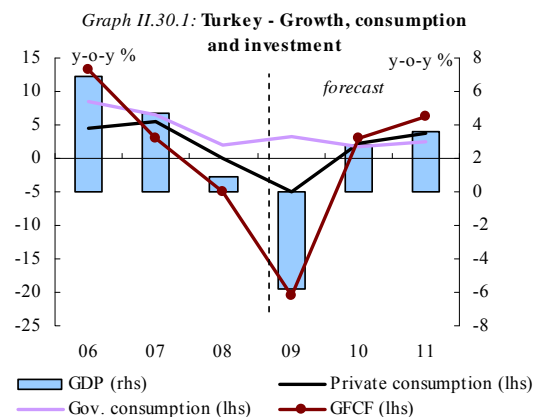
Previous structural reforms, in the banking sector in particular, had put Turkey on a sturdy footing. It was therefore rather resilient to the global turmoil and avoided a full-fledged financial crisis. The authorities could also afford to significantly loosen both the monetary and fiscal stance in response to the crisis. This helped cushion the downturn and in particular the decline in private consumption. The fiscal stimulus, planned at around 5% of GDP during 2008-10, was focused and prioritised after the local elections in March 2009, when significant consumption tax incentives and an investment scheme were introduced. Private sector confidence would have benefitted from clearer fiscal plans however, including a timely release of the Medium-Term Economic Programme.

#### Deep contraction in 2009 followed by gradual recovery

The recession hit its trough in the first quarter of 2009 when real GDP collapsed by 14⅓% year-on-year. The decline in private consumption, investment and exports were all in the double-digit

range. The anti-crisis measures introduced by the government, in particular the consumption tax cuts, helped limit the decline in private consumption to -1¼% year-on-year in the second quarter of 2009. Indeed, seasonally adjusted real GDP even increased by around 7% quarter-on-quarter in the second quarter of the year. But investments and exports improved only marginally compared to their disappointing performance in the first quarter, suggesting that the pace of the recovery would slow down once the effects of the fiscal stimulus fade away. Overall, economic output is expected to decline by 5¾% in real terms in 2009.

With regard to the GDP components, private consumption is expected to drop sharply by almost 5% even though it is cushioned by the government fiscal incentives. The decline in total domestic demand would be somewhat alleviated by the 3¼% growth in public consumption. Among the domestic demand components, investment is forecast to experience the sharpest decline in excess of 20%. A substantial destocking as companies try to adjust to lower sales is also expected to contribute negatively to growth, cutting about 1¼ pps. off the real GDP growth rate. The unfavourable external environment is expected to lead to a double-digit decline in exports, which represents a significant drag on economic activity in 2009.

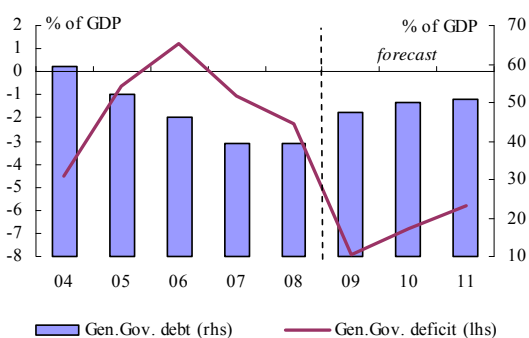


The feedback loop from the underperforming real economy to the financial sector is likely to remain subdued given the still moderate increase in non-performing loans. Having been reshuffled after the

2001 crisis, the banking sector is now well capitalised and its exposure to currency and maturity mismatches remains limited. Nonetheless, loan growth has decelerated markedly in the crisis due to external financing constraints, lower economic activity and tightened lending standards. This has negatively affected domestic demand in 2009 and is likely to slow the recovery of private consumption and investment also over the forecast horizon. Moreover, the notable increase in public sector borrowing requirements would further limit the availability of credit for the private sector.

The recovery of investment in equipment is likely to be hampered by the low capacity utilisation rate, which is still about 10 pps. below the 2007 average level. As the external demand is also projected to pick up only slowly and the fiscal expansion to be gradually reined in, the recovery is likely to be less robust than in previous boom-bust cycles. Therefore, real GDP growth is expected to return to positive territory, 2¾% in 2010 and 3½% in 2011, but to remain below potential growth over the forecast horizon. Unlike in 2009, domestic demand and stock-building are likely to make a positive contribution to growth, but the contribution of net exports will turn negative again.

Graph II.30.2: Turkey - Public finances



**Lower external imbalances**

The positive terms-of-trade shock caused by the decline in oil and commodity prices together with the depressed domestic demand are leading to a major contraction of the trade and current account deficits in 2009. In the first eight months of the year, the current account deficit declined by more than 80% year-on-year. It is projected to shrink from around 5¾% of GDP in 2008 to about 2% of GDP in 2009. Over the forecast horizon, it is

expected to grow moderately to around 3¾% of GDP in 2011, as foreign capital inflows recover.

Exports of goods and services will return to positive, but relatively slow annual growth of about 2% in 2010 and 4% in 2011. This is in line with an expected strengthening of external demand and benefits from the 2008 base effect. Helped by the recovery of domestic demand, imports are projected to pick up faster than exports, leading to wider external imbalances. At the same time, the high level of unaccounted inflows in foreign currency, which made up for the shortfall in official capital inflows since October 2008 are unlikely to continue at the same pace going forward.

The welcome adjustment of external imbalances together with the relatively smooth access to external financing relieved the pressure on the exchange rate. The continuation of FDI inflows in the crisis, albeit at a lower pace, may provide additional impetus to the recovery.

**Inflation to meet targets during 2009-11**

In 2009, the disinflation process has been supported by the depressed aggregate demand and the decline in energy prices which outweighed inflationary pressures stemming from the central bank's substantial interest rate cuts. The end-of-period inflation is expected to recede substantially below the central bank's target of 7½%. Inflationary pressures are likely to remain subdued over the forecast horizon. Given the slow and gradual recovery of domestic demand the 2010 and 2011 targets of 6½% and 5½% respectively are also expected to be met. The elevated unemployment rate is expected to help lower unit labour costs in real terms, thus facilitating the structural adjustment process.

**Unemployment shoots up**

The situation on the labour market worsened already in 2008, when the unemployment rate started to pick up, in particular in the last quarter of the year. The 2009 recession is likely to lead to the unemployment rate surging by almost 4% pps. Although employment is expected to grow over the rest of the forecast horizon, the unemployment rate will continue to rise towards 14% in 2010 and recede only modestly in 2011. The annual inflows into the labour force are large at around 2% annually given Turkey's young population.

Consequently, the relatively slow recovery foreseen during 2010-11 is unlikely to bring the unemployment rate down rapidly.

stabilisation of the public debt-to-GDP ratio over the programme period. As a result, the public debt-to-GDP ratio will continue to rise over the forecast horizon to 51% of GDP in 2011.

### Protracted fiscal adjustment after the crisis

In 2009, the fiscal stance was loosened significantly in response to the crisis and before the local elections. While revenues remained almost flat compared to 2008, public expenditures accelerated at a double-digit rate and in particular for current transfers. The authorities expect the central budget deficit – on a cash basis – to widen by almost 5% pps. to 6½% of GDP in 2009. Therefore, the general government balance is likely to reach almost 8% of GDP in 2009 in ESA 95 terms.

As a corollary, public debt is expected to surge to about 47½% of GDP from 39½% of GDP in 2008. The announcement of the Medium-Term Economic Programme - although delayed by several months - removed some of the uncertainty regarding the fiscal path. Pending further elaboration of the programme's measures to support the achievement of the fiscal targets, the budget deficit is expected to decline more slowly than foreseen in the programme and reach around 6¾% of GDP in 2010 and 5¾% of GDP in 2011. This would not be enough to ensure the planned

Table II.30.1:

#### Main features of country forecast - TURKEY

	2008			Annual percentage change						
	bn TRY	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	948.7	100.0	4.2	4.2	6.9	4.7	0.9	-5.8	2.8	3.6
Private consumption	663.0	69.9	4.3	4.3	4.6	5.5	-0.1	-4.9	2.2	3.7
Public consumption	121.9	12.8	3.8	3.8	8.4	6.5	1.9	3.2	1.8	2.6
Gross fixed capital formation	188.8	19.9	5.5	5.5	13.3	3.1	-5.0	-20.6	3.1	6.2
of which : equipment	98.4	10.4	7.3	7.3	10.2	1.2	-3.4	-22.3	3.3	6.3
Exports (goods and services)	227.7	24.0	9.5	9.5	6.6	7.3	2.3	-10.4	1.9	4.1
Imports (goods and services)	275.3	29.0	10.6	10.6	6.9	10.7	-3.8	-19.6	4.8	6.5
GNI (GDP deflator)	938.6	98.9	4.2	4.2	6.8	4.8	0.9	-5.8	2.8	3.6
Contribution to GDP growth :										
Domestic demand			4.9	4.9	7.4	5.4	-1.1	-7.6	2.4	4.1
Stockbuilding			0.1	0.1	-0.1	0.6	0.3	-1.2	1.2	0.2
Foreign balance			-0.7	-0.7	-0.4	-1.3	1.7	3.1	-0.7	-0.7
Employment			0.8	0.8	1.3	1.1	2.2	-1.3	0.9	1.4
Unemployment rate (a)			8.4	8.4	9.9	8.5	9.8	13.5	13.9	13.5
Compensation of employees/head			55.3	55.3	12.7	12.7	8.6	-1.2	6.4	7.2
Unit labour costs whole economy			50.2	50.2	6.8	8.9	10.0	3.5	4.4	5.0
Real unit labour costs			-2.6	-2.6	-2.3	2.5	-1.5	-2.0	-1.3	-0.3
Savings rate of households (b)			-	-	-	-	-	-	-	-
GDP deflator			54.3	54.3	9.3	6.2	11.7	5.6	5.8	5.3
Harmonised index of consumer prices			-	-	9.3	8.8	10.4	6.1	5.6	5.5
Terms of trade of goods			-0.1	-0.1	-4.9	3.3	-2.7	2.7	-1.0	-1.0
Trade balance (c)			-6.3	-6.3	-7.5	-7.3	-7.0	-3.6	-4.2	-4.8
Current account balance (c)			-2.2	-2.2	-6.1	-5.9	-5.7	-2.1	-2.8	-3.6
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			-	-	-	-	-	-	-	-
General government balance (c)			-	-	1.2	-1.0	-2.2	-7.9	-6.8	-5.8
Cyclically-adjusted budget balance (c)			-	-	-	-	-	-	-	-
Structural budget balance (c)			-	-	-	-	-	-	-	-
General government gross debt (c)			-	-	46.1	39.4	39.5	47.3	49.8	51.0

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.