

## 32. TURKEY

*A strong policy response softened the immediate economic repercussions of the crisis at the cost of further erosion of buffers. Although economic activity rebounded quickly in the summer, vulnerabilities and the withdrawal of policy stimulus are likely to sap the strength of the recovery. Despite subdued cost pressures, high inflation expectations and challenges to monetary policy credibility are expected to lead to a slow disinflation path. Risks are broadly balanced and partly influenced by geopolitical developments. Fiscal space is set to remain limited and the persistently high budget deficit and stock-flow adjustments are projected to push government debt further up.*

### Strong policy response softened the crisis but eroded buffers

The crisis hit strongly in the second quarter, when real GDP fell 9.9% y/y. Lockdown measures and uncertainty affected household consumption particularly badly, while disruptions in international travel and external demand severely damaged exports of goods and services. A sharp increase in inventories, however, contributed strongly to growth, sustaining a positive total domestic demand. Expansionary monetary policy boosted lending and, while instrumental in softening the immediate repercussions of the crisis, it led to a highly negative contribution of net exports to growth, eroding buffers such as foreign exchange reserves, and increasing the downward pressure on the lira. Since August, however, the monetary policy stance has become tighter.

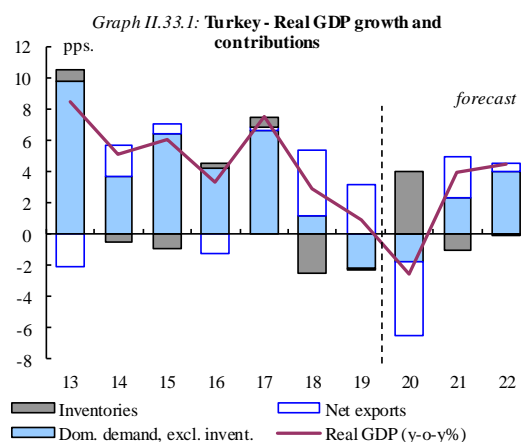
### Economic activity rebounded strongly in the summer

Manufacturing PMI has been above 50 since June and capacity utilisation approached its pre-crisis levels in September. Improved real sector confidence confirmed the strong growth momentum in the third quarter. However, despite a positive assessment of near-term volume expectations and of domestic and export orders, the assessment of the level of fixed investment expenditure was still subdued. The recovery remained uneven, with weaker results in retail trade and services. As the lira depreciated markedly in August and September and financial conditions started tightening, short-term sales expectations tanked again.

### Vulnerabilities and retraction of the policy stimulus to weaken the recovery

Economic recovery is expected to further gather pace next year, although its strength is likely to be suppressed by structural vulnerabilities and the

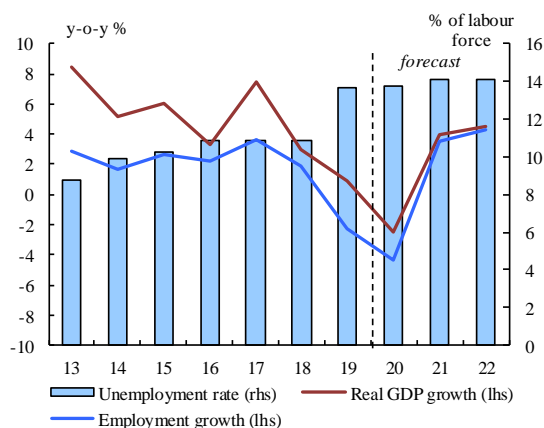
withdrawal of the monetary policy stimulus. Domestic demand contribution to growth is, thus, expected to be constrained and to increase more noticeably only in 2022. Private consumption is forecast to pick up, largely due to base effects, but to remain below its long-term trend. After three years of decline, investment is expected to revert to growth already next year. However, unresolved balance sheet problems of the business sector, policy uncertainty, and elevated geopolitical tensions are set to hold it back. Exports recovery, which has already begun in the third quarter of 2020, is likely to continue, supported by reviving external demand and a more competitive pricing due to past lira depreciation. Due to the relative importance of sectors like tourism, transportation, automotive, and textile, which have been strongly affected by the pandemic and are only slowly recovering, exports are not expected to revert to their pre-crisis level before the end of 2021. Nevertheless, net exports should contribute positively to economic growth, as imports are forecast to remain suppressed by relatively weak domestic demand.



Although employment creation is expected to rise alongside economic recovery, it may not be sufficiently strong to absorb new entrants to the market and, as a result, unemployment is likely to

stay elevated, creeping further up. Despite subdued cost pressures, high inflation expectations and low monetary policy credibility are set to keep the disinflation path slow and inflation to remain relatively high and much above the 5% target.

Graph II.33.2: Turkey - Labour market



### Risks are broadly balanced

While geopolitical tensions weigh heavily on the risk premium and economic developments, they could also be a source of positive surprises in case they materially subside. Domestically, a relatively tighter policy stance may not just weaken the

growth momentum, but also work to restore confidence, reduce vulnerabilities, and support faster investment and consumption recovery. The banking system is well capitalised, but financial stability challenges are likely to increase in light of the recent credit boom and weakening of the lira.

### Limited fiscal space

Past years' expansionary fiscal policy had slowly eroded fiscal buffers. Thus, in the crisis, direct fiscal transfers remained rather limited and most of them were in the form of postponement of certain tax obligations and social security contributions. However, despite these measures and rising interest payments, the increase in the budget deficit is expected to be relatively contained in 2020, as indirect tax collection held up well because of import tariff hikes and stronger than expected imports. The budget deficit, however, is forecast to remain elevated due to rising interest payments and rebalancing of growth away from revenue-rich domestic demand. Therefore, government debt is likely to continue growing, reflecting also sizeable contributions from exchange rate depreciation.

Table II.32.1:

### Main features of country forecast - TURKEY

	2019			Annual percentage change						
	bn TRY	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	4320.2	100.0	4.9	7.5	3.0	0.9	-2.5	3.9	4.5	
Private Consumption	2457.0	56.9	4.4	5.9	0.5	1.6	-0.7	2.5	2.8	
Public Consumption	670.8	15.5	4.9	5.0	6.6	4.4	1.8	2.9	3.3	
Gross fixed capital formation	1117.6	25.9	7.5	8.3	-0.3	-12.4	-6.4	2.0	7.8	
of which: equipment	-	-	6.2	-	-	-	-	-	-	
Exports (goods and services)	1414.5	32.7	5.9	12.4	9.0	4.9	-18.3	18.4	10.6	
Imports (goods and services)	1293.5	29.9	5.6	10.6	-6.4	-5.3	-4.2	8.1	9.2	
GNI (GDP deflator)	4247.2	98.3	4.9	7.2	1.5	2.0	-3.0	3.4	4.0	
Contribution to GDP growth:										
Domestic demand			5.4	6.7	1.2	-2.2	-1.8	2.4	4.0	
Inventories			-0.3	0.7	-2.4	-0.1	4.0	-1.0	0.0	
Net exports			-0.1	0.2	4.2	3.2	-4.7	2.5	0.5	
Employment			1.5	3.6	1.9	-2.3	-4.3	3.6	4.3	
Unemployment rate (a)			9.3	10.8	10.9	13.7	13.7	14.1	14.1	
Compensation of employees / head			16.2	8.8	17.0	22.8	7.7	10.0	14.4	
Unit labour costs whole economy			12.3	4.8	15.8	18.9	5.7	9.6	14.2	
Real unit labour cost			-0.6	-5.5	-0.6	4.4	-5.6	-2.0	4.3	
Saving rate of households (b)			-	-	-	-	-	-	-	
GDP deflator			13.0	11.0	16.5	13.9	12.1	11.9	9.4	
Consumer-price index			14.0	11.1	16.3	15.2	11.8	11.7	9.2	
Terms of trade goods			-0.2	-7.3	-5.7	-6.2	1.4	0.0	0.0	
Trade balance (goods) (c)			-6.3	-6.8	-4.8	-3.2	-3.1	-2.2	-3.8	
Current-account balance (c)			-4.0	-4.7	-2.6	1.2	-4.0	-2.0	-2.1	
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	-	-	-	-	-	-	
General government balance (c)			-	-2.8	-2.8	-3.0	-6.2	-6.0	-5.3	
Cyclically-adjusted budget balance (d)			-	-	-	-	-	-	-	
Structural budget balance (d)			-	-	-	-	-	-	-	
General government gross debt (c)			44.2	28.1	30.4	32.8	41.4	44.5	47.5	

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