32. TURKEY

Balance sheet and external financing vulnerabilities and expansionary policies prior to the crisis limit the policy space to mitigate the COVID-19 effects and remain a major source of risk. The economy is particularly exposed to the fallout from the crisis due to its high integration in global value chains and dependence on tourism and transport – two of the most heavily affected sectors. Following a steep decline in domestic demand and international trade this year, persistent uncertainty and a weak labour market are expected to dampen the strength of the recovery in 2021.

Starting from a strong growth momentum

Economic growth accelerated to 6.0% y-o-y in the fourth quarter of 2019, bringing the annual growth rate just under 1%. Household consumption, boosted by consumer lending and pent-up demand, drove the growth momentum along with rebounding investment activity. Although investment remained in negative territory, strong rises in machinery and equipment purchases and a build-up of inventories signalled that economic recovery was gaining speed. Construction was the only sector subtracting from growth.

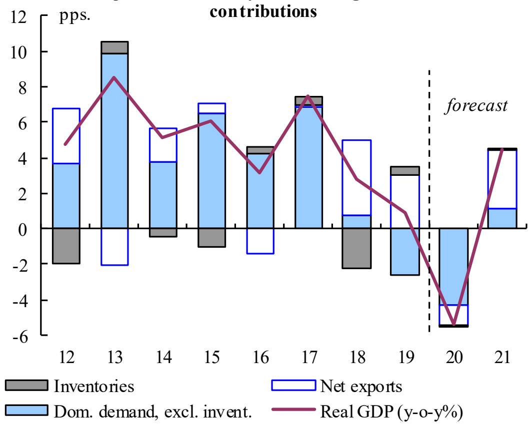
First signs of a steep fall in economic activity visible in March

The economy had not yet fully recovered from the dislocations caused by the 2018 recession when the COVID-19 pandemic started to disrupt the global economy. The first, more tangible signs of the pandemic effects on the Turkish economy became visible in March. Real sector confidence plummeted to 99.7, down 7.2 pps from the previous month. Its decline was mostly driven by deteriorating expectations for output and export orders in the next 3 months. In parallel, the manufacturing PMI fell steeply from 52.4 in February to 48.1 in March. General economic confidence declined as well, although March data did not yet fully capture COVID-19 effects on consumers, retail trade, and construction.

Multiple channels of contagion and limited policy space

The Turkish economy is particularly exposed to the effects of the pandemic due to its high integration in global value chains and dependence on tourism and transport – two of the most heavily affected sectors. As a result, net exports are forecast to have a negative effect on growth and external trade to contract by around a quarter this year. In a bleak international environment, as a net energy importer, the Turkish economy will benefit strongly from the lower international oil prices via the room created for more accommodative monetary policy and the reduction in the import bill. Nevertheless, the economy is expected to contract because of a large domestic demand shock, in both private consumption and investment, amid further decline in confidence and persistently high uncertainty. The recovery in 2021 is likely to be subdued in view of growing balance sheet problems and a weak labour market.

Graph II.32.1: **Turkey - Real GDP growth and contributions**



Financial market stress was quite pronounced already in early 2020, with credit default swap spreads rising to multi-year highs in April and the lira losing 17% of its value against the US dollar since the beginning of the year. While a weaker lira would work to compress imports and external imbalances, it will also stoke inflationary pressures and aggravate vulnerabilities caused by the large open net foreign currency position of the non-financial sector.

The policy space to mitigate the effects from the crisis is limited. Real interest rates became negative already before the crisis, while previous years' expansionary fiscal policy had reduced fiscal buffers. Nevertheless, the authorities took a number of measures to boost liquidity and provide favourable credit conditions. However, fiscal transfers, beyond the operation of automatic stabilisers, remained limited. In view of the economy's vulnerabilities and significant exchange rate pressures, addressing external financing needs and arresting the decline in international reserves will be crucial in order to allow a stronger policy reaction to cushion the social and economic effects of the crisis. Risks related to geopolitical and regional tensions remain elevated.

Significant labour market challenges and a growing fiscal cost

The steep contraction of domestic and external demand is expected to further weaken the labour market, with particularly negative employment effects in services and construction. Weak safety nets, coupled with widespread informal employment in these sectors, are unlikely to mitigate fully the social fallout of the crisis and to cushion the hit to private consumption.

Automatic fiscal stabilisers and initial fiscal measures would alleviate only partially the economic burden from the crisis. Nevertheless, the underlying fiscal position, which weakened already in 2019 due to one-off and temporary measures, is expected to worsen significantly. The main reason for this is the expected large decline in revenues because of the steep fall in economic activity. Therefore, even without additional, more decisive discretionary measures, the budget deficit is set to expand significantly, while government debt is forecast to increase above 40% of GDP. Ultimately, in view of the magnitude of the economic and financial challenges, and if the government takes further measures to aid companies and limit employment losses, the fiscal cost of the crisis may turn out to be even higher.

Graph II.32.2: **Turkey - Labour market**

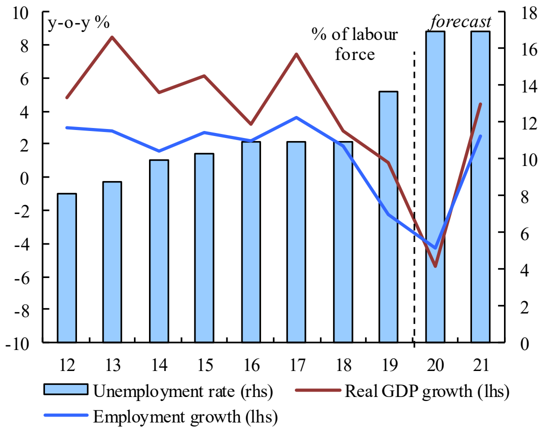


Table II.32.1:

Main features of country forecast - TURKEY

		2018			Annual percentage change					
		bn TRY Curr. prices	**% GDP**	**00-15**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GDP		3724.4	100.0	5.1	3.2	7.5	2.8	**0.9**	**-5.4**	**4.4**
Private Consumption		2111.3	56.7	4.5	3.7	6.2	0.0	**0.7**	**-2.1**	**1.9**
Public Consumption		552.4	14.8	4.6	9.5	5.0	6.6	**4.4**	**4.0**	**4.5**
Gross fixed capital formation		1114.1	29.9	8.7	2.2	8.2	-0.6	**-12.4**	**-14.3**	**-3.3**
of which: equipment		-	-	7.7	-	-	-	**-**	**-**	**-**
Exports (goods and services)		1099.8	29.5	7.0	-1.9	12.0	7.8	**6.4**	**-26.4**	**17.7**
Imports (goods and services)		1140.7	30.6	6.6	3.7	10.3	-7.8	**-3.6**	**-24.5**	**5.2**
GNI (GDP deflator)		3623.4	97.3	5.1	3.4	7.2	1.4	**2.0**	**-5.9**	**3.4**
Contribution to GDP growth:	Domestic demand			5.7	4.2	6.9	0.8	**-2.6**	**-4.3**	**1.1**
	Inventories			-0.2	0.4	0.5	-2.2	**0.5**	**0.0**	**0.0**
	Net exports			-0.2	-1.4	0.1	4.2	**3.0**	**-1.1**	**3.3**
Employment				1.2	2.2	3.6	1.9	**-2.2**	**-4.3**	**2.5**
Unemployment rate (a)				9.1	10.8	10.8	10.9	**13.6**	**16.9**	**16.9**
Compensation of employees / head				17.6	20.2	8.8	17.0	**18.7**	**5.3**	**8.6**
Unit labour costs whole economy				13.2	19.1	4.9	15.9	**15.0**	**6.5**	**6.6**
Real unit labour cost				-1.8	10.2	-5.5	-0.4	**1.0**	**-5.4**	**-4.3**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				15.3	8.1	11.0	16.4	**13.9**	**12.5**	**11.4**
Consumer-price index				16.6	7.8	11.1	16.3	**15.5**	**11.4**	**11.7**
Terms of trade goods				-	9.4	-6.9	-4.7	**-0.5**	**3.3**	**0.2**
Trade balance (goods) (c)				-	-4.8	-6.9	-4.9	**-2.5**	**0.6**	**3.0**
Current-account balance (c)				-4.1	-3.8	-5.6	-3.6	**0.2**	**-0.5**	**1.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-	-	-	**-**	**-**	**-**
General government balance (c)				-	-1.1	-2.8	-2.8	**-3.0**	**-7.8**	**-9.0**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				46.0	28.3	28.2	30.4	**33.1**	**43.1**	**47.7**

(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.