32. TURKEY

Following a stronger than expected economic rebound in the first half of the year, high frequency indicators point to a subsiding but still robust growth momentum in the third quarter. Growth is forecast to moderate in the next two years, with positive contributions from all domestic demand components except inventories. The foreseen recovery of the travel and tourism sectors is set to further boost exports and contribute to the narrowing of external imbalances. Expansionary monetary policy and global price pressures are expected to keep inflation persistently high. The fiscal position is likely to improve, but the perceived lack of monetary policy credibility and geopolitical tensions could derail the recovery.

An upbeat recovery

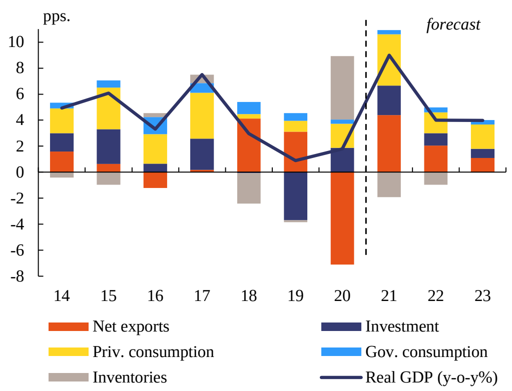
Economic growth was much stronger than expected in the first half of the year, with large contributions from both domestic and external demand. Tightened restrictions in the wake of another surge in COVID-19 infections in April and May did not affect the economy as much as during previous waves. Household consumption was particularly buoyant, while the sustained expansion of machinery and equipment investment boosted capital formation. Despite global supply bottlenecks, exports of goods have reached record high levels, supported by the ongoing recovery of the main trading partners and improved price competitiveness. A weaker lira, meanwhile, suppressed imports of goods and services.

High frequency indicators point to a subsiding but still robust growth momentum in the third quarter. Although positive base effects have started to fade away and production growth decelerated across some sectors, overall industrial performance remained solid. Manufacturing PMIs were firmly in the expansion zone, while real sector confidence improved across most of its sub-components. Furthermore, the index of economic confidence surpassed the threshold of 100 for the first time in three years. Only consumer confidence tanked in the third quarter as rising inflation sapped households' purchasing power.

Growth moderating amidst elevated inflation

Following a strong rebound in 2021, economic growth is forecast to moderate. Private consumption growth in particular is expected to decelerate markedly as pent-up demand dissipates, and elevated inflation eats up disposable income, despite rising employment. Growth of investment demand is forecast to weaken as well in view of the higher long-term financing costs and country risk premium. However, Turkey is poised to benefit from the shortening of global supply chains, as some companies move production closer to the EU market, and investment to meet increased environmental standards. The positive public consumption growth is likely to be sustained, while the crisis-related support measures are progressively withdrawn. The unwinding of inventories that had been built-up in the crisis is expected to spill over into next year and to be the only demand component to subtract from growth. Previous price competitiveness gains – the real effective exchange rate is still way below its pre-crisis level – are likely to boost exports further and to keep a lid on import growth. As pandemic-related restrictions are lifted, the expected recovery of the travel and tourism sectors is set to further boost export prospects and contribute to the narrowing of external imbalances. The labour market recovery is forecast to firm up, but institutional weaknesses and expansionary monetary policy, coupled with global price pressures, are expected to be the main factors that will keep inflation elevated over the medium term.

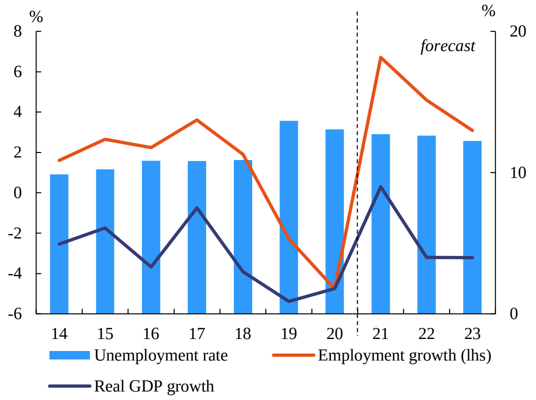
Graph II.32.1: **Turkey - Real GDP growth and contributions**



Persistent risks and uncertainty

The forecast balanced growth path is subject to significant risks. Domestically, the biggest threat comes from the perceived lack of monetary policy credibility and challenges to central bank independence. Frequent dismissals at the helm of the bank and persistent pressure to loosen monetary policy could fuel even more exchange rate volatility and dollarisation, further increase inflation expectations, keeping uncertainty and the country risk premium high. Although geopolitical risks have abated somewhat recently, they are still elevated and weigh heavily on the country risk premium.

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



A solid fiscal performance but scars remain

The rather limited fiscal reaction to the pandemic resulted in a muted expansion of the budget deficit during the crisis. Tight control over primary expenditure came at the cost of reduced public investment, which remained far below its level a few years ago. Nonetheless, government debt and interest payments went up markedly in 2020, affected by the large depreciation of the lira. As economic activity rebounded in 2021, revenue growth improved the budgetary performance further. Thus, the revised government target of a 3.5% of GDP budget deficit seems achievable.

In the next two years, the budget deficit is expected to decrease marginally. Risks, however, loom large in view of sizeable contingent liabilities and the political cycle.. Government debt-to-GDP ratio is forecast to remain broadly stable, despite a primary balance of close to zero or in surplus, and a strong nominal GDP growth. Elevated interest payments and valuation effects would remain major debt-increasing factors.

Table II.32.1:

Main features of country forecast - TURKEY

	2020			Annual percentage change						
	bn TRY	Curr. prices	% GDP	02-17	2018	2019	2020	2021	2022	2023
GDP		5047.9	100.0	5.8	3.0	0.9	1.8	**9.0**	**4.0**	**4.0**
Private Consumption		2864.0	56.7	5.3	0.6	1.5	3.2	**7.0**	**3.0**	**3.5**
Public Consumption		766.0	15.2	5.2	6.5	4.1	2.2	**2.1**	**2.7**	**2.8**
Gross fixed capital formation		1382.1	27.4	10.1	-0.2	-12.4	7.2	**8.3**	**3.4**	**2.4**
of which: equipment		:	:	:	:	:	:	**:**	**:**	**:**
Exports (goods and services)		1446.7	28.7	5.9	8.8	4.6	-14.8	**18.8**	**10.4**	**9.7**
Imports (goods and services)		1639.0	32.5	8.1	-6.2	-5.4	7.6	**3.1**	**4.5**	**7.0**
GNI (GDP deflator)		4992.7	98.9	5.9	1.7	1.5	2.7	**7.9**	**3.7**	**4.0**
Contribution to GDP growth:	Domestic demand			6.6	1.2	-2.2	4.0	**6.5**	**2.9**	**2.9**
	Inventories			0.0	-2.3	-0.2	4.9	**-1.9**	**-1.0**	**0.0**
	Net exports			-0.7	4.1	3.1	-7.1	**4.4**	**2.0**	**1.1**
Employment				:	1.9	-2.3	-4.8	**6.7**	**4.6**	**3.1**
Unemployment rate (a)				9.9	10.9	13.7	13.1	**12.7**	**12.6**	**12.2**
Compensation of employees / head				:	17.0	22.7	15.0	**17.9**	**24.1**	**23.3**
Unit labour costs whole economy				:	15.8	18.9	7.6	**15.4**	**24.8**	**22.2**
Real unit labour cost				:	-0.6	4.4	-6.2	**-4.0**	**5.6**	**4.5**
Saving rate of households (b)				:	:	:	:	**:**	**:**	**:**
GDP deflator				10.8	16.5	13.9	14.8	**20.2**	**18.3**	**17.0**
Consumer price index				11.2	16.3	15.2	12.3	**17.8**	**17.7**	**15.4**
Terms of trade goods				:	:	:	:	**:**	**:**	**:**
Trade balance (goods) (c)				-6.4	-5.5	-3.0	-6.3	**-5.2**	**-5.5**	**-5.5**
Current-account balance (c)				-4.0	-2.7	0.7	-4.9	**-2.7**	**-2.2**	**-1.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				:	:	:	:	**:**	**:**	**:**
General government balance (c)				-0.8	-2.8	-4.4	-4.7	**-3.6**	**-3.5**	**-3.1**
Cyclically-adjusted budget balance (d)				:	:	:	:	**:**	**:**	**:**
Structural budget balance (d)				:	:	:	:	**:**	**:**	**:**
General government gross debt (c)				41.2	30.4	32.6	39.7	**39.1**	**38.9**	**38.7**

(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.