32. TURKEY

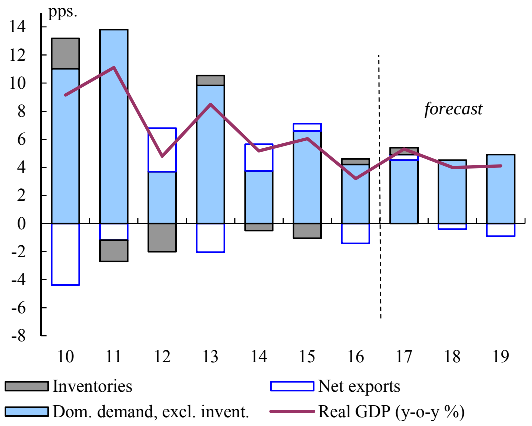
A risky path to sustainable growth

The Turkish economy registered strong growth recently, helped by foreign demand, construction activity and a range of government policies from expansionary fiscal policy to credit guarantees and loosening of macro-prudential regulations. Shifting to private consumption and investment in machineries and equipment, growth will move to a more sustainable base. Downside risks are sizable, however, and include past high loan growth, inflation infused by a legacy of monetary overhang, the uncertain business environment and high unemployment.

Positive growth surprises in the first half of 2017

Economic growth in Turkey was surprisingly strong in the first half of 2017, accelerating to 5.3% (y-o-y) from 3.2% in 2016, supported by stronger exports, a significantly depreciated Turkish Lira in comparison with last year and a strong boost from public finances and other policy incentives, intended to restore confidence in the Turkish economy. Construction volume was estimated to have grown by 25% (y-o-y) in the second quarter after an already solid 14% in the first quarter. The loosening of macro-prudential measures and government-sponsored bank lending to corporates provided a further stimulus to the domestic economy as visible in the renewed surge in corporate and consumer loans.

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



Monetary policy complicated by high money growth

The output gap has been closing quickly recently and capacity utilisation is at a historic high while inflation expectations are increasingly unanchored, feeding the high inflation rate that also suffers from base effects and end-of-this-year reversal of VAT reductions by the government. Low real interest rates in turn stimulate domestic demand that, in a context of a global search for yield, is partly financed through capital inflows from abroad. This is in particular visible in the parallel run-up of foreign liabilities by banks and an increasing loan-to-deposit ratio. While the Turkish central bank pursues a tight policy stance, “monetarist conditions” are still loose with M3 growth averaging 18.4% (y-o-y) in the first eight months of this year. Moreover, with M3 growth having outpaced nominal GDP growth by 55% since the depth of the economic and financial crisis in the first half 2009 there is a large legacy of loose monetary policy. Recent Lira depreciation will provide further inflationary pressure. Inflation is therefore expected to remain above 7% and risks are to the upside.

Broadening and more sustainable growth

The outlook for the business sector is currently highly positive, judging by the surveys for all sectors except the construction sector. After the surge in construction investment and high wage growth, a contained cooling down of construction activity is not a bad omen. Industrial production has expanded at an increasing rate since the beginning of this year and the expansion is broadening from foreign-demand exposed sectors to more domestically-oriented sectors. This broadening and strengthening of industrial production is expected to finally flow over into renewed investments in machinery and equipment, thus broadening and solidifying the growth base. The forecast therefore expects annual investment growth to accelerate to 4.1% over 2018-19.

Growth of private consumption is expected to increase towards the end of this year and continue its expansion in 2018-19. Employment growth is picking up and consumers are expecting a further reduction in the unemployment rate. The broadening of growth to domestically-oriented industry and services sector will further support employment growth in the near term. Further consumption impetus comes from disposable income which registered solid growth in the past two years, although inflation has eroded the real value of the increase.

A temporary break in expansionary policy impetus

In the first half of the year a broad range of policy incentives reaching from expansionary fiscal policy via a large increase in government guarantees for corporate lending to a loosening of macro-prudential regulation were implemented. The draft budget for 2018 forecasts a fiscal tightening which will lean heavily on raising tax revenues. The government is likely to succeed in reducing the deficit in 2018. Elections in 2019, however, are expected to reinvigorate policy makers' eagerness to stimulate economic growth. Implicit liabilities from recent policy initiatives (credit guarantees, macro-prudential relaxation) will not have abated fully by then, and financing conditions are unlikely to be as beneficial as currently. As a consequence, after hitting its target next year, the government is expected to run a larger deficit in 2019.

Downside risks aplenty

The implicit liabilities the government has built up this year are but one relatively minor risk to the outlook. A more important risk is household consumption not picking up as strongly as in this forecast. Consumer confidence is still at a relatively low level and the limited impact of government incentives has already partly faded. Additionally, the business environment still suffers from the state of emergency, unresolved seizures of companies and a lack of innovation and productivity growth. Corporate indebtedness has risen, also in foreign currency, making companies more vulnerable to changes in external financing conditions. In addition, high investments in construction in combination with high loan growth run the risk of having fuelled a real estate boom. A large part of the banks' increase in loans has been funded from abroad with longer maturity. Banks have passed on the exchange rate risks in part to Turkish companies by extending loans in foreign currency and part to foreign investors. The vulnerability to external conditions can also be seen from the current account that continues to be in negative territory and is expected to be even more so in the coming two years as the pick-up in domestic demand by a shift to private consumption and investment in machinery and equipment increases imports.

Table II.32.1:

Main features of country forecast - TURKEY

		2016		Annual percentage change						
	bn TRY	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		2608.5	100.0	4.4	5.2	6.1	3.2	**5.3**	**4.0**	**4.1**
Private Consumption		1560.5	59.8	4.0	3.0	5.4	3.7	**3.9**	**4.5**	**4.0**
Public Consumption		387.0	14.8	5.0	3.1	3.9	9.5	**8.5**	**4.5**	**8.9**
Gross fixed capital formation		764.7	29.3	6.4	5.1	9.3	2.2	**2.8**	**4.0**	**4.2**
of which: equipment		284.7	10.9	-	3.9	18.5	1.2	**3.7**	**6.9**	**6.7**
Exports (goods and services)		573.0	22.0	6.1	8.2	4.3	-1.9	**7.4**	**5.4**	**4.3**
Imports (goods and services)		648.2	24.9	6.4	-0.4	1.7	3.7	**5.0**	**6.4**	**7.1**
GNI (GDP deflator)		2581.4	99.0	4.4	5.2	5.8	3.3	**5.3**	**3.8**	**4.2**
Contribution to GDP growth:	Domestic demand			4.9	3.7	6.5	4.2	**4.5**	**4.5**	**4.9**
	Inventories			0.2	-0.6	-1.1	0.4	**0.3**	**0.0**	**0.0**
	Net exports			-0.3	1.8	0.5	-1.3	**0.4**	**-0.4**	**-0.8**
Employment				1.2	1.6	2.7	2.2	**2.8**	**3.1**	**3.1**
Unemployment rate (a)				8.8	9.9	10.3	11.0	**11.3**	**11.0**	**10.7**
Compensation of employees / head				23.0	14.8	12.8	20.2	**13.5**	**9.4**	**8.3**
Unit labour costs whole economy				19.2	10.9	9.1	19.1	**10.7**	**8.4**	**7.3**
Real unit labour cost				-1.9	3.2	1.2	10.2	**0.3**	**-0.3**	**-0.3**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				21.6	7.4	7.8	8.1	**10.3**	**8.8**	**7.6**
Consumer-price index				23.5	8.9	7.7	7.0	**11.0**	**8.5**	**7.4**
Terms of trade goods				-0.9	1.3	-0.3	-0.3	**-1.2**	**-0.1**	**-0.1**
Trade balance (goods) (c)				-6.1	-6.5	-7.0	-7.8	**-8.4**	**-8.2**	**-8.4**
Current-account balance (c)				-3.5	-4.7	-3.7	-3.8	**-3.9**	**-4.2**	**-4.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-4.7	-3.8	-3.8	**-3.9**	**-4.2**	**-4.4**
General government balance (c)				-	0.1	1.3	1.2	**-2.4**	**-1.8**	**-2.6**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	28.6	27.5	25.1	**28.2**	**27.9**	**28.0**

(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.