33. TURKEY

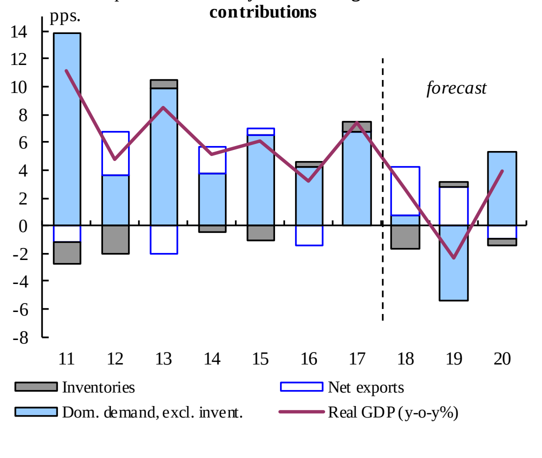
Rebalancing under way

The economy is rebalancing following last year's sharp depreciation of the lira. The correction of external imbalances and of past high credit growth leads to a contraction of domestic demand with a return to growth expected for the second half of 2019. A strong contribution of net trade, reflecting mostly a high income elasticity of import demand, dampens the shock to the domestic economy. Recent volatility confirms that the rebalancing trajectory is fraud with new financial market risks and depends on firm and credible policy action.

Large negative carry-over into 2019

The economy's loss in momentum from the second quarter of 2018 was aggravated during last summer's worsening of financial conditions. Large swings were observed in the demand components of GDP over the year with a drop in investment spending spreading from construction to machinery and a contraction in private consumption. Net trade developed largely in countermotion. In our central scenario, the trough of the contraction in domestic demand was in 2018. Still, the large negative carry-over effect from 2018 and the recovery only gaining traction in the second half of 2019 implies that Turkey will record the worst growth performance among emerging economies in 2019.

Graph II.33.1: **Turkey - Real GDP growth and contributions**



A tough period of rebalancing

High-frequency indicators – confidence indicators, core retail trade and manufacturing production – still point to a difficult period for domestic demand at the beginning of 2019 even if they appear to have hit bottom. In addition, after a period of relative low volatility and relaxation of financing conditions, financing conditions again sharply deteriorated towards the end of the first quarter. Financial conditions are expected to remain volatile in the first half of the year with interest rates and stock markets entering a more tranquil phase later in the year.

Easing loan conditions, in particular for consumers, initiated in part by state banks, and a reduction in the real debt burden will increasingly support private consumption in 2019. Turkish households hold only TL-denominated debt, the real value of which has declined with high inflation. Further support comes from high nominal wages increases that more than compensated for the high inflation in recent years and, as expected, in 2019. In the central scenario, admittedly surrounded with a high uncertainty, unemployment will show only a limited rise with employers hoarding labour in anticipation of the downturn being short-lived. As domestic consumption demand recovers and capacity utilisation rates increase, the recovery will spread to domestic investment in early 2020. This broadening of the recovery will reinforce consumer demand.

As domestic demand recovers, net trade will become a drag on growth. Imports are characterised by a high income elasticity. Exports thrived temporarily on the back of the TL depreciation in the second half of 2018. However, export price increases erode the gains in price competitiveness. The increases in real wages, following large hikes in the minimum wage in 2016 and 2019, reduce Turkish competitiveness further.

Inflation firmly into double digits

The fast opening of a negative output gap together with the lowering of VAT rates and stabilisation of the lira in the final months of 2018 reduced upward pressure on the price levels. The CPI index increased by only 0.4 % between October 2018 and March 2019. The cost of permanently lowering inflation and reducing inflation expectations, however, has increased with the loss monetary policy credibility, implying a higher cost to the economy of bringing inflation to the central bank's central target of 5 % (range of +/- 2 pps).

A slipping fiscal anchor

In response to the financial turmoil, the government stressed its commitment to fiscal discipline. Some slippage is nonetheless notable at the beginning of 2019 with nearly half of the budget target realised in the first quarter already. The tax base will be under pressure as nominal GDP growth decreases under the 'All-out war on inflation". Not only will the tax base be under pressure as nominal GDP growth declines but the average tax rate will also be lower because of the reduction in VAT rates. Finally, will the impact of lower nominal GDP growth likely differ between revenues and expenditures. The relatively high dependence on goods with a high income elasticity, luxury and imported goods, immediately affect government revenues while variables more relevant for expenditures, like wage and employment, react with a lag to the economic cycle. The budget also faces risks from contingent liabilities, which have increased over the past years due to large infrastructural works in public-private banks and worsening asset quality in state banks.

Large risks attached to rebalancing

The main risk to a consumption-led recovery is a sizable increase in unemployment. In early 2019, the non-agricultural unemployment rate jumped to 16.8 % and the impact of the recession was particularly large for the young and those with little or no education. If the credit crunch leads to a bigger effect on the labour market than currently anticipated, it will undermine the recovery of private consumption demand.

Such an extended period of weak consumption growth also puts the investment recovery at risk not just because of its impact on capacity utilisation, but also because it will be associated with more defaults and lower growth in the banks' assets. Positive readings of financial sector soundness have gone hand-in-glove with high loan growth in recent years. However, historically high debt service of non-financial companies and a surge in non-performing loans risk eroding the asset quality in the context of slowing nominal GDP growth.

Table II.33.1:

Main features of country forecast - TURKEY

	2017			Annual percentage change						
	bn TRY	Curr. prices	% GDP	99-14	2015	2016	2017	2018	2019	2020
GDP		3106.5	100.0	4.5	6.1	3.2	7.4	**2.6**	**-2.3**	**3.9**
Private Consumption		1834.2	59.0	4.1	5.4	3.7	6.1	**1.1**	**-3.6**	**4.0**
Public Consumption		450.5	14.5	4.7	3.9	9.5	5.0	**3.6**	**3.5**	**4.0**
Gross fixed capital formation		931.9	30.0	7.0	9.3	2.2	7.8	**-1.7**	**-12.9**	**9.2**
of which: equipment		323.1	10.4	4.6	18.5	1.2	-0.2	**-7.8**	**2.8**	**2.5**
Exports (goods and services)		770.6	24.8	5.9	4.3	-1.9	11.9	**7.5**	**5.1**	**3.3**
Imports (goods and services)		910.8	29.3	6.3	1.7	3.7	10.3	**-7.9**	**-7.8**	**8.4**
GNI (GDP deflator)		3063.8	98.6	4.5	5.7	3.4	7.2	**2.4**	**-2.1**	**3.9**
Contribution to GDP growth:	Domestic demand			5.1	6.5	4.2	6.7	**0.5**	**-5.7**	**5.4**
	Inventories			0.1	-1.1	0.4	0.6	**-2.0**	**-0.3**	**-0.2**
	Net exports			-0.3	0.5	-1.3	0.1	**3.5**	**2.8**	**-0.9**
Employment				1.1	2.7	2.2	3.9	**2.3**	**-0.2**	**3.0**
Unemployment rate (a)				9.0	10.3	10.9	10.9	**10.7**	**13.7**	**13.3**
Compensation of employees / head				19.8	12.8	20.2	8.5	**15.9**	**11.0**	**10.5**
Unit labour costs whole economy				15.9	9.1	19.1	4.9	**15.7**	**13.4**	**9.6**
Real unit labour cost				-1.6	1.2	10.2	-5.4	**-0.4**	**-0.6**	**-1.1**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				17.9	7.8	8.1	10.8	**16.2**	**14.1**	**10.8**
Consumer-price index				19.6	7.7	7.8	11.1	**16.3**	**13.1**	**9.7**
Terms of trade goods				-0.6	2.1	9.4	-6.9	**-4.4**	**-0.8**	**-0.1**
Trade balance (goods) (c)				-6.2	-5.6	-4.8	-6.9	**-4.9**	**-1.8**	**-2.9**
Current-account balance (c)				-3.9	-3.7	-3.8	-5.6	**-3.6**	**1.2**	**-0.5**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-3.8	-3.8	-5.6	**-3.6**	**1.2**	**-0.5**
General government balance (c)				-	0.6	-1.1	-2.8	**-2.6**	**-3.0**	**-2.5**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	27.6	28.3	28.3	**31.1**	**30.9**	**29.3**

(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.