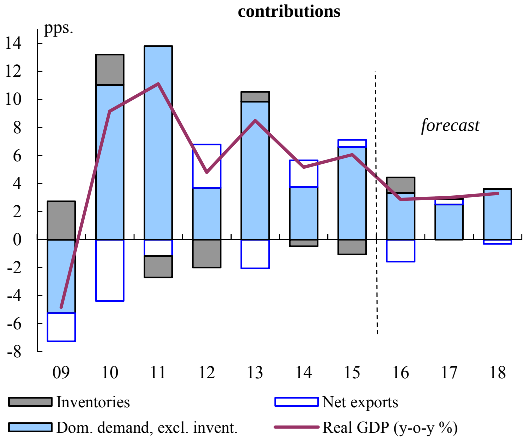
32. TURKEY
Slow recovery ahead amidst high inflation

The strong loss in momentum that the Turkish economy experienced during 2016 is expected to reverse only gradually as uncertainty recedes during the year. Supported first by net trade, momentum is set to improve towards the end of the year as domestic demand benefits from improvements in monetary conditions and in confidence.

Strong loss in momentum to be reversed gradually

Political and policy uncertainty following the attempted *coup d'etat* aggravated the deteriorating business environment with the loss in momentum deepening during 2016 before rebounding in the fourth quarter when real GDP increased by 3.5% y-o-y, according to Turkstat's revised methodology. Together with significantly revised figures for the second and third quarter, 2016 growth is estimated to have been 2.9%, significantly lower than the year before (6.1%) and with a sizable contribution from inventories.

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



The latest figures are an example of the opposing forces that are currently at play in the Turkish economy. Confidence indicators, unemployment and inflation appear to a certain degree detached from the national accounts figures. While industrial and consumer confidence have been on a declining trend over the past four years and hovered around historical lows, industrial output recorded a solid 7.2% y-o-y growth and household consumption spurred ahead by 5.7% y-o-y in the final quarter of 2016.

Notwithstanding the positive development in household consumption in the last quarter of 2016, the fundamentals for a broad-based recovery should only come into place in the second half of this year. Such a gradual recovery of household consumption is consistent with the continued slide in retail sales in the first two months of 2017. Moreover, unemployment is still on an upward trend, the value added in the services sector was limited in 2016-Q4 and consumer sentiment has posted only limited improvements. Consumer sentiment very likely benefited from the VAT rate reductions on durable goods and labour demand stimulus such as the reduction of social security contributions by companies.

The demand stimulus, the lira's strong depreciation and measures to stimulate loan growth have also contributed to halt the declining trend in corporate confidence. The expected reduction in political and policy uncertainty this year is foreseen to lead to a broadening recovery of confidence. The impact of which is expected to be most visible in 2018.

All in all, foreign trade and public spending are expected to first drive the Turkish economy this year. This is foreseen to be followed by a recovery in confidence leading to reinvigorated investment and household consumption. Employment growth is foreseen to strengthen over the course of 2018, adding to the positive cyclical developments and further broadening of the recovery. Despite high growth of both loans and non-performing loans, Turkish banks continue to have relatively sound headline risk metrics, a positive factor that should support domestic investment in the period ahead.

Inflation untamed?

Inflation has increased from high single-digits registered over the past five years to low double-digits in the first quarter of 2017 in large part owing to the depreciation of the lira, increased energy prices, temporary factors and entrenched expectations of high inflation. These elements will continue to keep inflation high, although temporary factors are expected to recede later this year. High inflation has already hollowed out in part the real increase of disposable income stemming from nominal wage hikes at the beginning of 2016. At the same time, it has also limited the loss in competitiveness vis-à-vis major foreign competitors.

Solid public finances to act as a buffer

Using part of the fiscal pace available, the government embarked in 2016 on an expansionary path that is set to continue in 2017 and offsets part of the slump in private final demand (excluding inventories). Under the new national accounting methodology the budget deficit will continue to register lower numbers than under the old system of national accounts. The difference between the deficit on an accrual and cash basis amounted to nearly 2% of GDP in 2015 (last year for which government statistics are available). Still, the underlying dynamics are expected to help a further decline in the debt figures. Over the forecast period, fiscal stimulus is expected to become less important as private domestic demand takes over.

Domestic and external financial risks rising

There are both positive and negative risks to the outlook. On the positive side, remaining fiscal space can continue to be used in case of lower than expected developments in private domestic demand. Net foreign trade might get a greater impetus from the depreciation of the lira and tourists could return to the country more quickly than currently foreseen under a more benign geopolitical environment. Reduced domestic uncertainty and a further easing of financial conditions could have higher than foreseen spill overs to confidence and demand growth. The young and growing population could also be absorbed more quickly than currently foreseen with a larger increase in the participation rate than in the current scenario.

Downside risks include high inflation and high unemployment, which would risk bringing Turkey close to stagflation. High increases in non-performing loans and the external vulnerabilities built up over the years would further add to the risk. Finally, the strong build-up of debt by non-financial corporations may raise the concerns over debt sustainability in the corporate sector. Non-financial corporations have seen their liabilities surge from 30% of GDP in 2007 to over 60% in 2015 with about 45% of this borrowing in foreign currency.

Table II.32.1:

Main features of country forecast - TURKEY

		2015			Annual percentage change					
	bn TRY	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		2337.5	100.0	4.3	8.5	5.2	6.1	**2.9**	**3.0**	**3.3**
Private Consumption		1411.9	60.4	4.0	7.9	3.0	5.5	**2.3**	**1.9**	**3.0**
Public Consumption		324.4	13.9	4.8	8.0	3.1	4.1	**7.3**	**5.9**	**5.8**
Gross fixed capital formation		694.7	29.7	6.5	13.8	5.1	9.2	**3.0**	**1.6**	**3.1**
of which: equipment		263.0	11.3	-	8.1	3.9	18.4	**6.3**	**2.2**	**7.6**
Exports (goods and services)		545.4	23.3	7.2	1.1	8.2	4.2	**-2.4**	**4.1**	**4.2**
Imports (goods and services)		606.8	26.0	7.3	8.0	-0.4	1.7	**3.9**	**2.0**	**4.7**
GNI (GDP deflator)		2307.0	98.7	4.4	8.2	5.2	5.7	**3.9**	**3.0**	**3.3**
Contribution to GDP growth:	Domestic demand			4.9	9.9	3.7	6.5	**3.3**	**2.5**	**3.6**
	Inventories			-0.1	0.3	-0.6	-1.1	**1.0**	**0.1**	**0.0**
	Net exports			-0.3	-1.8	1.8	0.5	**-1.4**	**0.4**	**-0.2**
Employment				1.0	2.8	1.6	2.6	**1.0**	**1.1**	**2.7**
Unemployment rate (a)				8.6	8.8	9.9	10.3	**11.8**	**13.6**	**14.1**
Compensation of employees / head				27.5	10.3	14.8	12.8	**20.5**	**13.0**	**9.2**
Unit labour costs whole economy				23.4	4.5	10.9	9.2	**18.3**	**10.9**	**8.5**
Real unit labour cost				-1.8	-1.6	3.2	1.3	**9.7**	**0.7**	**-0.3**
Saving rate of households (b)				-	-	-	-	-	-	-
GDP deflator				25.8	6.3	7.4	7.8	**7.8**	**10.2**	**8.9**
Consumer-price index				27.8	7.5	8.9	7.7	**7.8**	**11.1**	**8.6**
Terms of trade goods				-0.7	4.1	1.3	-0.3	**-0.3**	**-1.3**	**-0.1**
Trade balance (goods) (c)				-6.0	-8.2	-6.5	-7.0	**-7.8**	**-8.5**	**-8.2**
Current-account balance (c)				-3.2	-6.7	-4.7	-3.8	**-4.1**	**-4.4**	**-4.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-6.7	-4.7	-3.8	**-4.1**	**-4.4**	**-4.3**
General government balance (c)				-	0.1	0.1	1.3	**-0.9**	**-1.6**	**-1.4**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	31.3	28.6	27.5	**28.3**	**26.5**	**24.9**

(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.