32. TURKEY

Economic slowdown amidst conflicts and turmoil

Economic activity has suffered from Syria-related conflicts, terrorist attacks, and a military coup attempt. While short-term economic disruptions are projected to fade and growth is expected to pick up moderately, a deteriorating business environment is reducing medium-term growth prospects. In 2017-18, private consumption and, to a lesser extent, public spending will provide the main support to economic activity. The large current account deficit continues to pose a downside risk.

Economy is cooling despite policy measures

The Turkish economy grew by 4% in 2015. In 2016-Q2, real GDP growth was only 0.3% (q-o-q) in seasonally adjusted terms. Monthly data indicate that real GDP may have contracted in the third quarter. To a large extent, the slowdown has been caused by a drop in foreign tourism (-32% y-o-y in the first eight months) in the context of a deteriorating security situation, including large-scale terrorist attacks, and Russia's temporary restrictions on tourist visits to Turkey. The military coup attempt in July has resulted in economic disruptions and is also set to weigh on economic growth in the short term. Annual GDP growth is expected to record a relatively modest 2.7% in 2016.

Partly in response to the challenges facing the country, the fiscal policy stance has become more expansionary. Spending on security and defence has increased. Targeted fiscal measures, including subsidies for charter flights, have been introduced. Public wages have been raised significantly in addition to the 30% hike of the minimum wage that took effect at the beginning of the year. Overall, public consumption is currently surging at a double-digit rate in real terms.

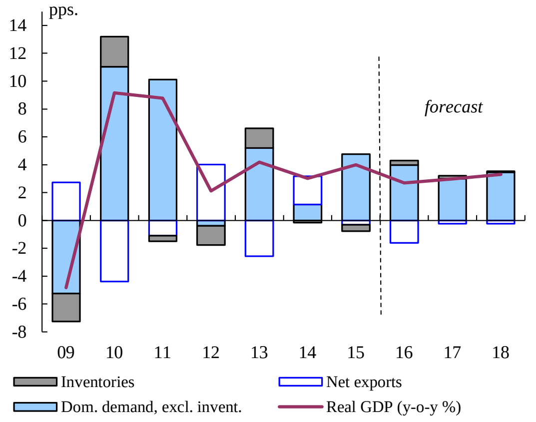
Monetary policy has also been eased. The central bank lowered the overnight lending rate gradually by a total of 250 basis points to 8.25 % between March and September, significantly reducing the average cost of funding. Reserve requirement ratios have been cut, releasing liquidity to financial markets. Macro-prudential rules, especially for credit card borrowing, have been relaxed to stimulate consumer spending.

Net exports and private investment set to remain weak

Looking forward, private consumption is expected to continue benefitting from higher wages, growing employment, and to some extent from the inflow of refugees. Although retail sales have been relatively soft in recent months and consumer loan growth is decelerating, it is projected that private consumption will remain the backbone of GDP growth over the forecasting period. In contrast, private investment is expected to remain weak in the context of a deteriorating business environment due to the government's targeted actions against critical media, business people and political opponents.

Regarding the external sector, the drop in foreign tourist visits is leading to a decline in exports of goods and services in 2016. It is expected that tourism will gradually return to the previous level over 2 - 3 years, resulting in moderately growing exports. Reflecting relatively strong consumption, import growth is projected to remain above export growth. As a result, net exports are set to continue subtracting from GDP growth, albeit much less than in the current year.

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



Current drags expected to moderate, but downside risks to growth remain large

Over the next two years, a lower drag on growth from net exports is projected to more than compensate for decelerating public consumption. Fixed investment is forecast to stabilise and stop subtracting from growth by 2018. As a result, annual GDP growth is projected to strengthen moderately to 3.0% next year and 3.3% in 2018.

This forecast is associated with significant downside risks. First, the security situation may worsen again, domestically and in the near abroad, with negative economic spill-overs as in 2016. Secondly, the large current account deficit, mainly financed with relatively short-term capital inflows, makes the economy vulnerable to worsening investor sentiment towards Turkish assets. A reversal of capital flows could, for instance, occur in the context of further downgrading of Turkey's sovereign debt by rating agencies and require a sharp tightening of macroeconomic policy.

Underlying imbalances remain large

Average inflation amounted to 7.8% in the first three quarters of 2016, slightly higher than last year. The monthly rate has trended downward helped by lower food price inflation and the slowdown in aggregate demand. Going forward, it is projected that the pass-through from this year's surge in wages and currency depreciation will raise average annual inflation to 8% next year.

The current account deficit narrowed in the previous two years, but is now on the rise again as tourism receipts falter. Going forward, rising oil prices (cf. external assumptions) will add to the import bill, resulting in a deficit clearly above 5% of GDP next year in spite of the partial recovery in receipts from tourism.

Employment growth is forecast to remain somewhat below output growth. Since the labour force is projected to outpace the number of available jobs, the annual unemployment rate is projected to remain on an upward trend and surpass 11% in 2017.

Fiscal deficit to rise, but debt to remain stable

This year's surge in public spending is projected to increase the deficit of general government to 2.5% of GDP. The widening of the deficit is kept at bay by strongly rising revenues (14.2% for central government in the first three quarters) based on wage acceleration and some broadening of the tax base. Decelerating public spending is projected to lower the fiscal deficit again as of next year.

As a result of the current fiscal expansion, the downward trend in the general government debt ratio is flattening. However, at the level of 32–33% of GDP, public debt is sustainable.

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		1953.6	100.0	3.9	4.2	3.0	4.0	**2.7**	**3.0**	**3.3**
Private Consumption		1341.2	68.7	3.9	5.1	1.4	4.8	**4.3**	**3.8**	**4.0**
Public Consumption		306.6	15.7	4.3	6.5	4.7	6.7	**12.0**	**6.0**	**5.6**
Gross fixed capital formation		396.6	20.3	4.4	4.4	-1.3	3.6	**-1.1**	**-1.4**	**0.0**
of which: equipment		-	-	-	-	-	-	**-**	**-**	**-**
Exports (goods and services)		546.3	28.0	6.8	-0.3	7.4	-0.8	**-1.3**	**3.5**	**4.3**
Imports (goods and services)		602.1	30.8	6.9	9.0	-0.3	0.3	**5.0**	**4.0**	**4.7**
GNI (GDP deflator)		1917.9	98.2	4.0	4.0	2.9	3.5	**3.0**	**3.1**	**3.4**
Contribution to GDP growth:	Domestic demand			4.3	5.3	1.2	4.8	**4.0**	**3.0**	**3.5**
	Inventories			2.1	1.4	0.1	-0.6	**0.3**	**0.2**	**0.1**
	Net exports			-0.3	-2.5	1.8	-0.3	**-1.6**	**-0.3**	**-0.3**
Employment				1.0	2.8	1.6	2.5	**2.3**	**2.2**	**2.7**
Unemployment rate (a)				8.6	8.9	10.1	10.5	**10.7**	**11.2**	**11.5**
Compensation of employees / head				26.8	10.9	11.2	12.1	**17.2**	**7.1**	**9.3**
Unit labour costs whole economy				23.2	9.4	9.7	10.5	**16.7**	**6.3**	**8.7**
Real unit labour cost				-1.8	3.1	1.3	2.8	**6.1**	**-1.4**	**1.4**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				25.6	6.2	8.3	7.5	**10.0**	**7.8**	**7.2**
Consumer-price index				27.8	7.5	8.9	7.7	**7.8**	**8.0**	**7.6**
Terms of trade goods				-0.7	3.4	1.0	6.1	**3.3**	**-1.0**	**-0.3**
Trade balance (goods) (c)				-6.3	-9.5	-7.7	-6.3	**-5.5**	**-6.4**	**-6.8**
Current-account balance (c)				-3.4	-7.7	-5.5	-4.5	**-4.9**	**-5.4**	**-5.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	-7.7	-5.5	-4.5	**-4.9**	**-5.3**	**-5.6**
General government balance (c)				-	-1.3	-0.9	-1.0	**-2.5**	**-2.0**	**-1.8**
Cyclically-adjusted budget balance (d)				-	-	-	-	**-**	**-**	**-**
Structural budget balance (d)				-	-	-	-	**-**	**-**	**-**
General government gross debt (c)				-	36.1	33.5	32.9	**32.9**	**32.6**	**32.2**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.