2017

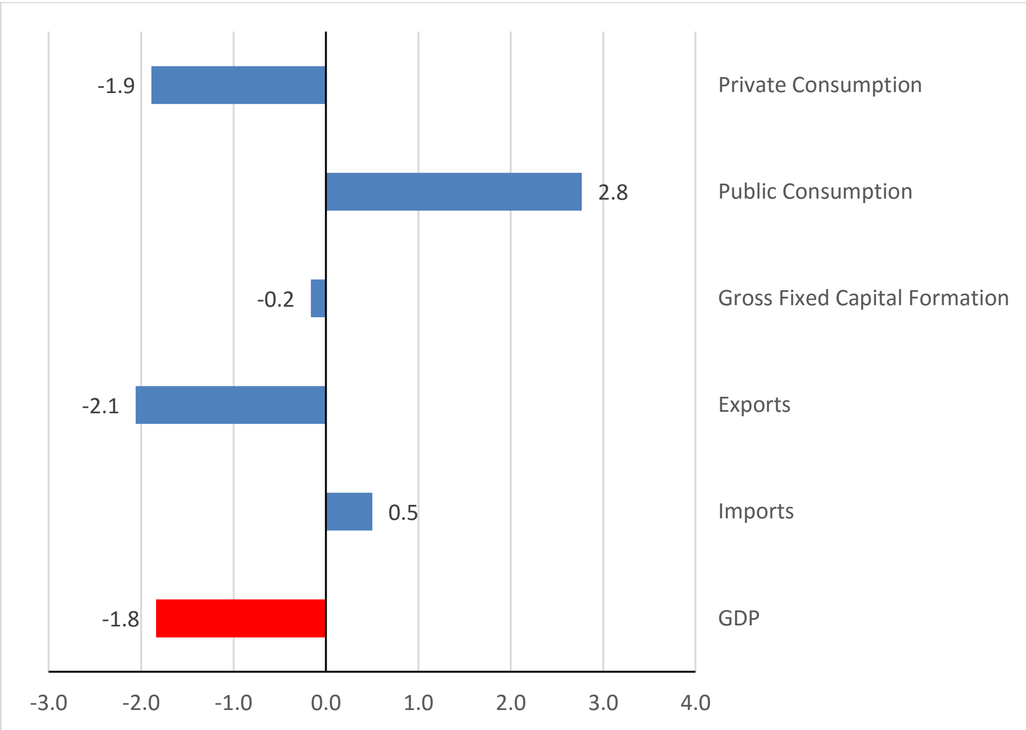
The Economy in Turkey in 2017

Extraordinary Developments and Turkey's Economy

2016 was a difficult year for Turkey. It was a year in which we hoped that we could focus on economic reforms following the November 2015 elections, but instead the agenda was dominated by political developments, including the resignation of the government, an attempted coup, and a proposal to amend the constitution. Furthermore, the continuation of increasingly violent terrorist attacks, the initiation of cross-border military operations in Syria, and domestic repercussions have placed security at the top of the national agenda.

Despite these conditions, the Turkish economy had a relatively good start to the year, growing by 4.5% in the first half of 2016. However, the economy contracted by 1.8% in the third quarter. The growth rate was at 2.2% in the first three quarters. As in previous years, domestic demand continues to fuel growth, while the share of government spending has gradually increased. In fact, the government's consumption expenditures increased 24% in the third quarter, contributing to a 2.8 percentage point increase in growth. Without this contribution, contraction in the third quarter would have been much larger.

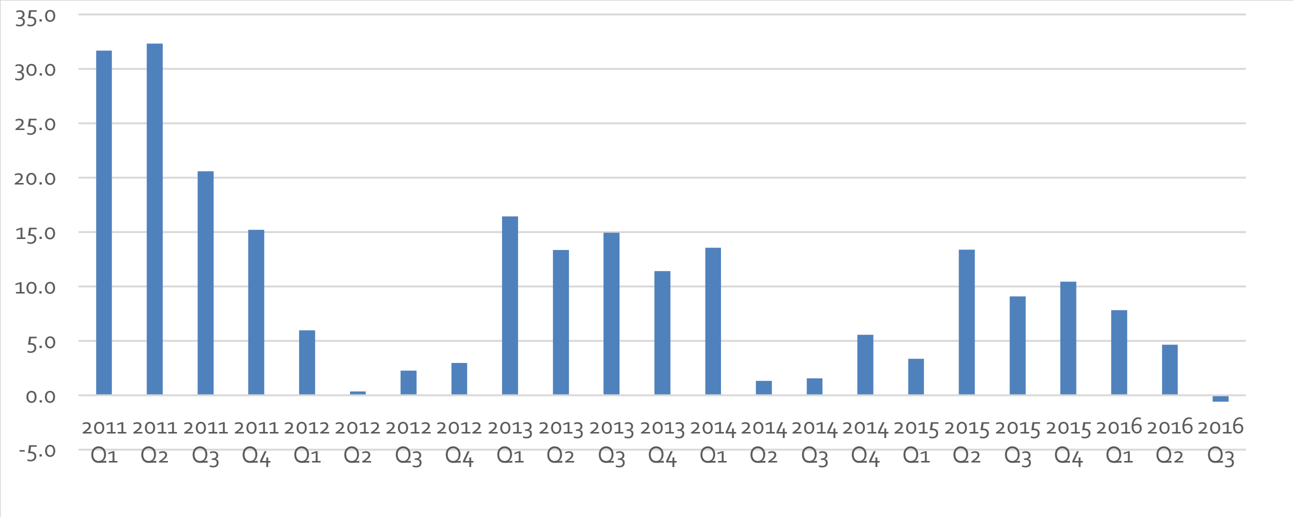
Figure 1: Contributions to Growth (2016 Q3 contribution to annual growth, %)



Source: Turkish Statistical Institute (TÜİK), National Accounts data

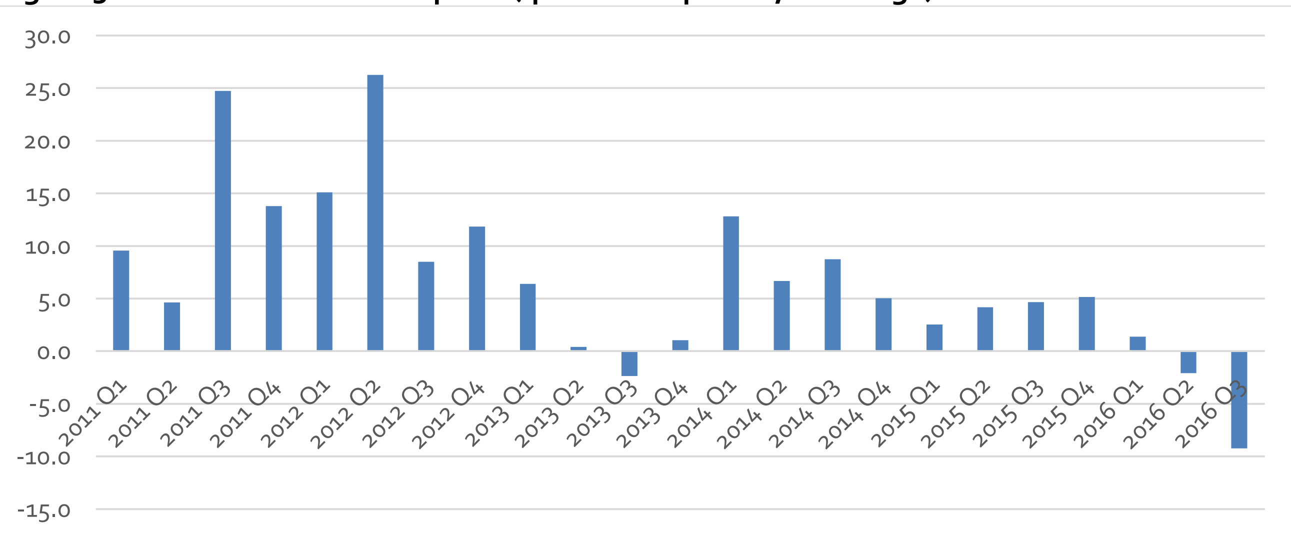
The weakness in investment since 2011 continues. Periodic increases in investments are predominantly in the construction sector. According to Turkish Statistical Institute (TÜİK) officials, the revised GDP series introduced in December 2016 uses administrative records instead of survey data, resulting in important differences in investments, primarily in the construction sector. Additionally, the lack of differentiation between the public and private sectors in revised data sets means that we only have data relating to total investment.

Figure 2: Total Investments (quarter on quarter, % change)



Source: Turkish Statistical Institute (TÜİK), National Accounts data

Figure 3: Goods and Services Exports (quarter on quarter, % change)



There was a significant decline in exports in 2016. Due to the economic crisis in Europe and security concerns in the Middle East, the contribution of exports to growth decreased after 2011. Decreases in exports in the second and third quarters of 2016 are noteworthy.

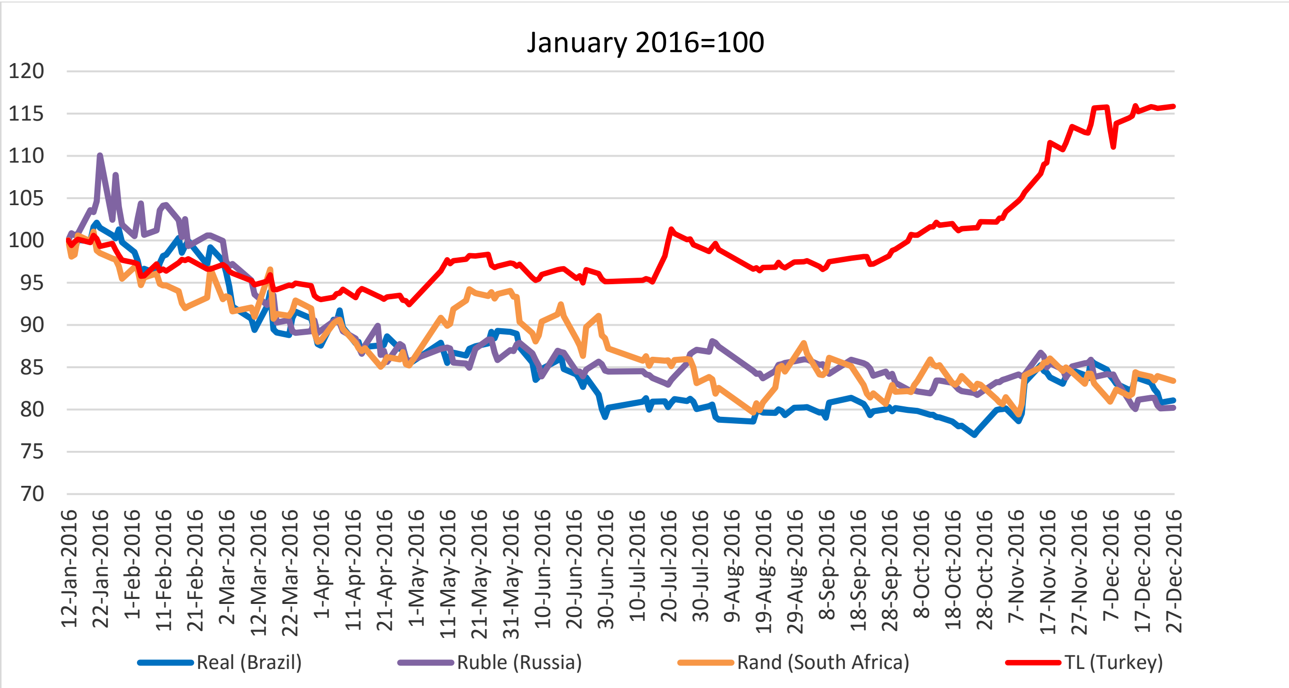
The decrease in exports partially results from losses in tourism. However, in dollar terms, exports of goods have also decreased by 0.8% in 2016, compared to 2015.[1] Decreases in exports and investments continue to raise questions about the quality of growth. Public spending and consumption-led growth is being replaced by economic contraction. If consumption does not continue to strengthen, public spending alone is unlikely to be able to drive growth much longer. In order to stimulate consumption and investments, it is necessary to maintain macroeconomic stability and increase confidence in the economy.

Financial Conditions Tighten

[1] According to initial data from the Customs and Trade Ministry.

While Turkey's economic growth slows, developments in the global economy and the expectation that the Fed will further increase interest rates next year have accelerated capital outflows from emerging markets. Pressures on the Turkish Lira are increasing. Compared to other emerging economies, the lira has been among the highest depreciating currencies since the beginning of this year (Figure 4). Closer examination of fluctuations reveals the clear negative impact of the change of government in May and the attempted coup on July 15, 2016. Nevertheless, these effects were short-lived and the lira initially succeeded in regaining losses. This period was dominated by greater demand for other currencies, as opposed to a decrease in the value of the lira.

Figure 4: Dollar Exchange Rate of the Turkish Lira and Other Emerging Market Currencies



The disparity in currencies appeared to widen during and after the U.S. election cycle. Although external factors contributed to the weakening of the lira, limited fluctuations in other currencies demonstrates that domestic economic factors and political uncertainty is causing the lira to be negatively priced. The depreciation of the lira is also a result of its qualification as a relatively fragile currency. The increasing dependence of the private sector on external financing in the aftermath of the 2009 crisis also plays an important role.

The budgetary discipline and banking reforms from the early 2000s have led to credit growth in both households and the real sector. In the aftermath of the global financial crisis, the increase in foreign capital inflows has made credit growth easier and cheaper. Accordingly, credit growth increased rapidly and the loan-to-deposit ratio approached 120%.

Figure 5: Credit/Deposit Ratio, %

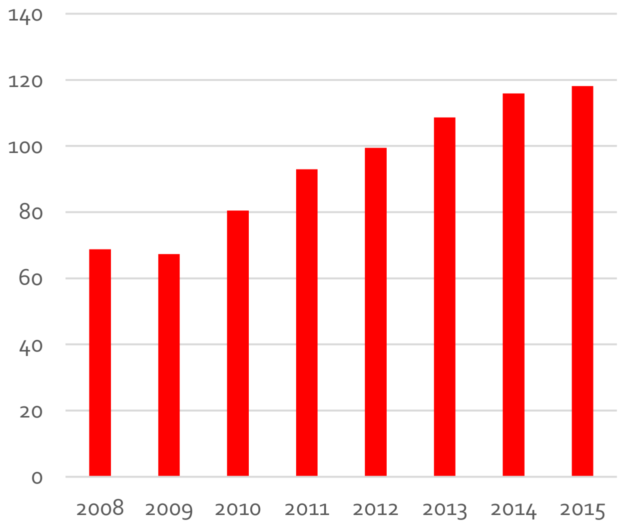
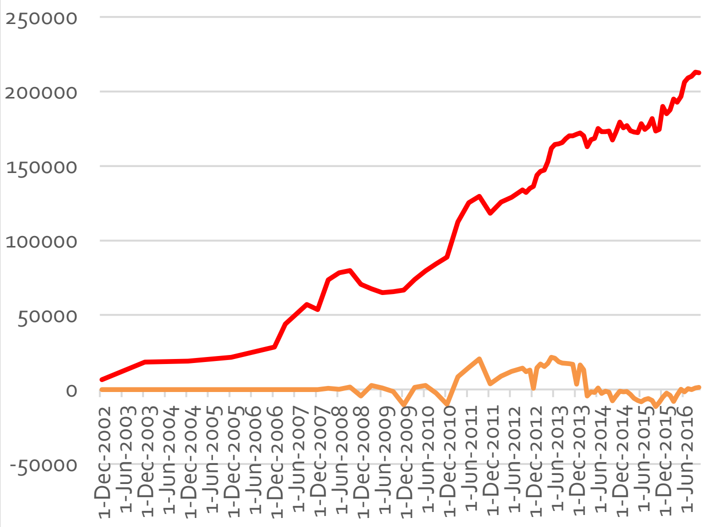


Figure 6: Real Sector Exchange Rate Exposure ($, million)



Therefore, credit growth is currently limited to the growth rate of deposits; and at any rate that exceeds this, external financing becomes necessary.

In the aftermath of the financial crisis, foreign currency denominated debt incurred by businesses increased significantly. As companies without foreign currency income were allowed to incur foreign denominated debt in 2009, the real sector's exposure increased rapidly, exceeding $200 billion. In this period, Turkey's external debt also neared 50% of its GDP.[2] Although this ratio is relatively high compared to other developing countries, Turkey maintains an advantage in terms of low government debt (Table 1).

These figures demonstrate that the private sector in Turkey needs a significant amount of foreign capital to roll over its debt. The necessity of foreign financing, combined with high inflation, the current account deficit, and political uncertainties, leads to the frequent assessment of Turkey as one of the most fragile emerging economies.

[2] This figure is 46% according to revised national income. World Bank data reports 55%.

Figure 7: Foreign Debt as Percent of GDP

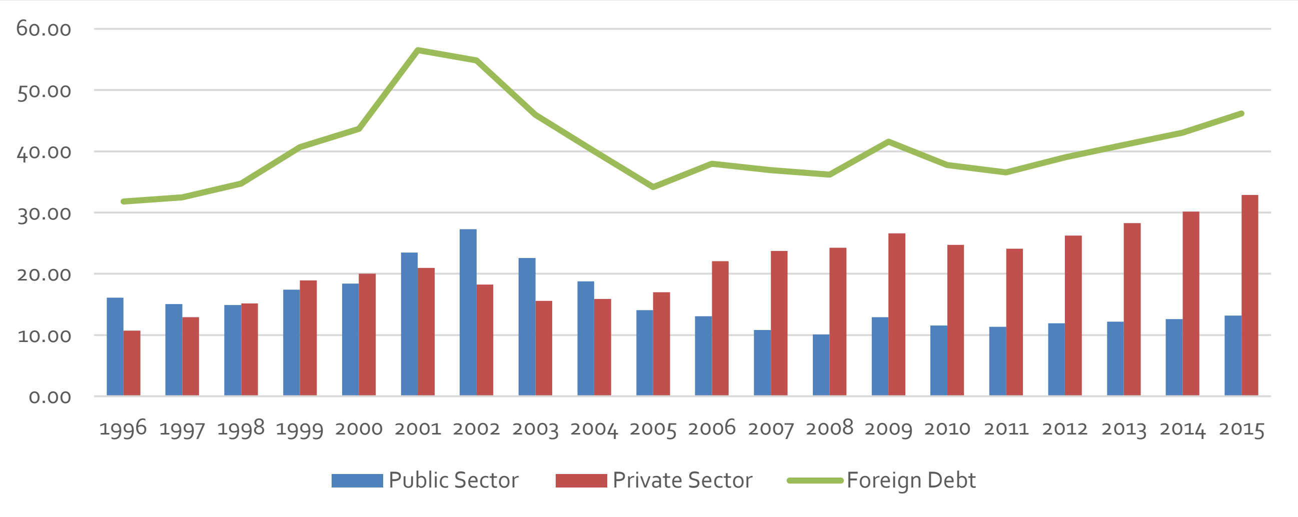


Table 1: Selected Countries Foreign Debt and Public Debt

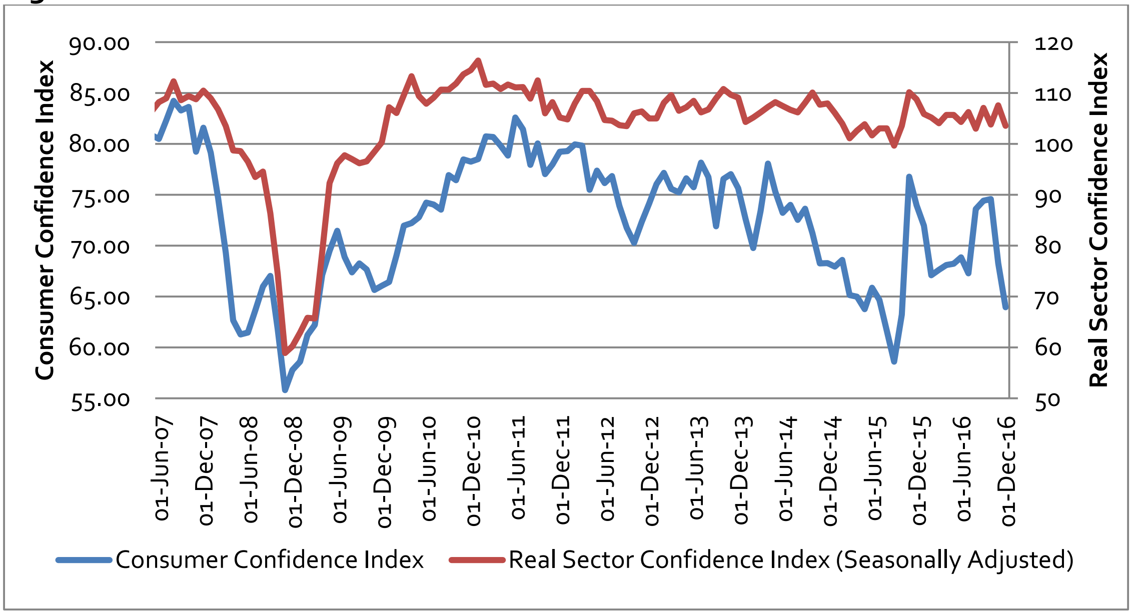
	Foreign Debt/GDP, %	Public Debt/GDP, %
China	12.9	43.9
Brazil	30.6	66.2
Russia	35.1	17.7
Indonesia	35.8	27.0
South Africa	43.8	50.1
Turkey	55.4	32.9

Source: World Bank

Weak Confidence in the Economy in the Last quarter

Following contraction in the third quarter, there have been positive and negative indicators in the last quarter. The real sector and consumer confidence indices had registered a strong increase in the immediate aftermath of the July 15, 2016 coup attempt. However, we see a sharp decline in confidence in the last quarter. Following the significant increase in the exchange rate in November and December, the consumer confidence index fell 4.2%, followed by a decline in the real sector confidence index.

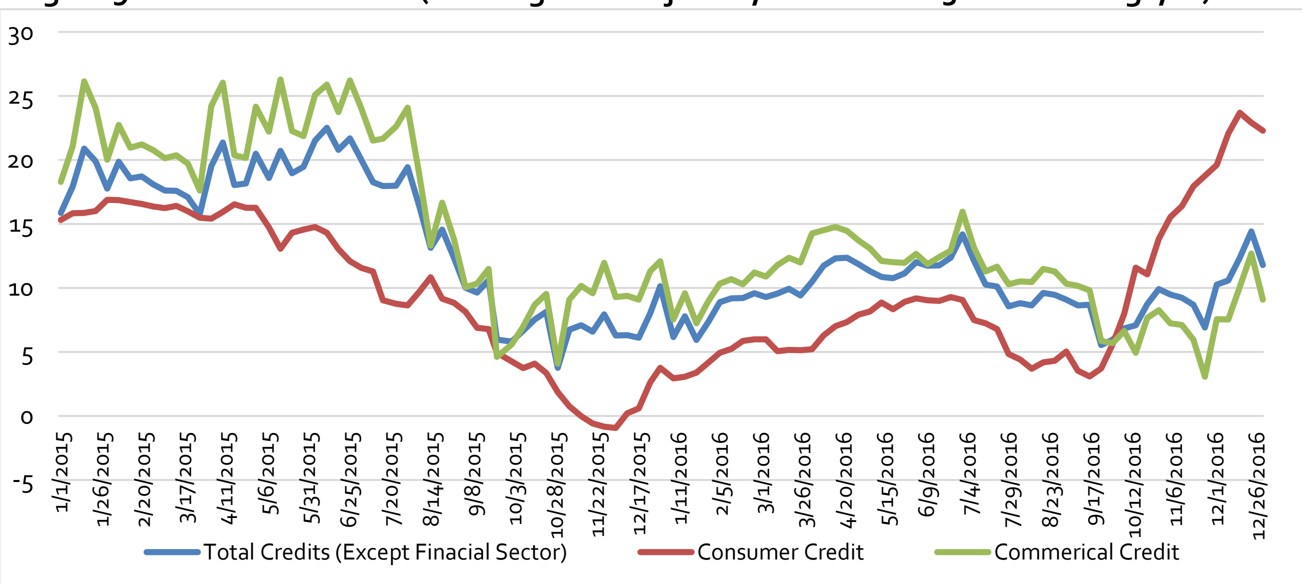
Figure 8: Consumer and Real Sector Confidence Index



Source: Turkish Statistical Institute (TÜİK); Central Bank of the Republic of Turkey, Economic Tendency Survey and Real Sector Confidence Index; Turkey Data Monitor

Unlike consumer confidence, the increase in consumer credit has recovered (Figure 9). The main reason has been the growth in housing and vehicle loans. The decline in mortgage rates and a spike in automobile sales before the increase in the special consumption tax (ÖTV) seem to have increased demand for these types of loans. However, this increase originates in public banks, while commercial credits are still under pressure. The rate of increase in commercial credit is rather low, compared to levels prior to the June 2015 elections. We believe that decreased demand and the increase in financing costs are significant, in addition to the nonperforming loans ratio slowly exceeding 3%.

Figure 9: Credit Growth Rate (exchange rate adjusted, annualized 13-week average, %)



Source: Banking Regulation and Supervision Agency, weekly bulletin; Turkey Data Monitor

On the other hand, industrial production remained strong in the last quarter. In November, the index was able to maintain October levels, largely due to increases in the auto industry. Seasonally adjusted production thereby increased 4% compared to the previous quarter. All items had significant quarterly increases.

Table 2: Industrial Production Index (seasonally adjusted quarterly % change)

	2016			
% change	Q1	Q2	Q3	Q4
Industrial Production Index	1.5	-0.6	-2.8	4.0*
Intermediate Goods Manufacturing	0.6	-0.8	-2.2	2.7*
Capital Goods Manufacturing	-0.4	0.0	-3.9	8.6*
Durable Consumer Goods Manufacturing	-1.4	-1.0	-6.3	3.3*
Nondurable Consumer Goods Manufacturing	5.1	-1.4	-4.4	3.3*

Source: Turkish Statistical Institute (TÜİK), Industrial Production Index
*October -November seasonally adjusted quarterly average percent change

Limited positive growth seems possible in the last quarter, due to increased industrial production and increased demand in real estate and automobiles. We think the possibility of a recession, defined as two quarters of economic contraction, is quite low.

However, the increased cost of financing and inputs caused by the devaluation of the lira will negatively affect the economy beginning in the first quarter of 2017. To the extent that the weakness in consumer confidence translates into lower consumption, the economy is unlikely to rebound significantly. Meanwhile, it is necessary to wait and see whether or not the increase in consumer credit is sustained.

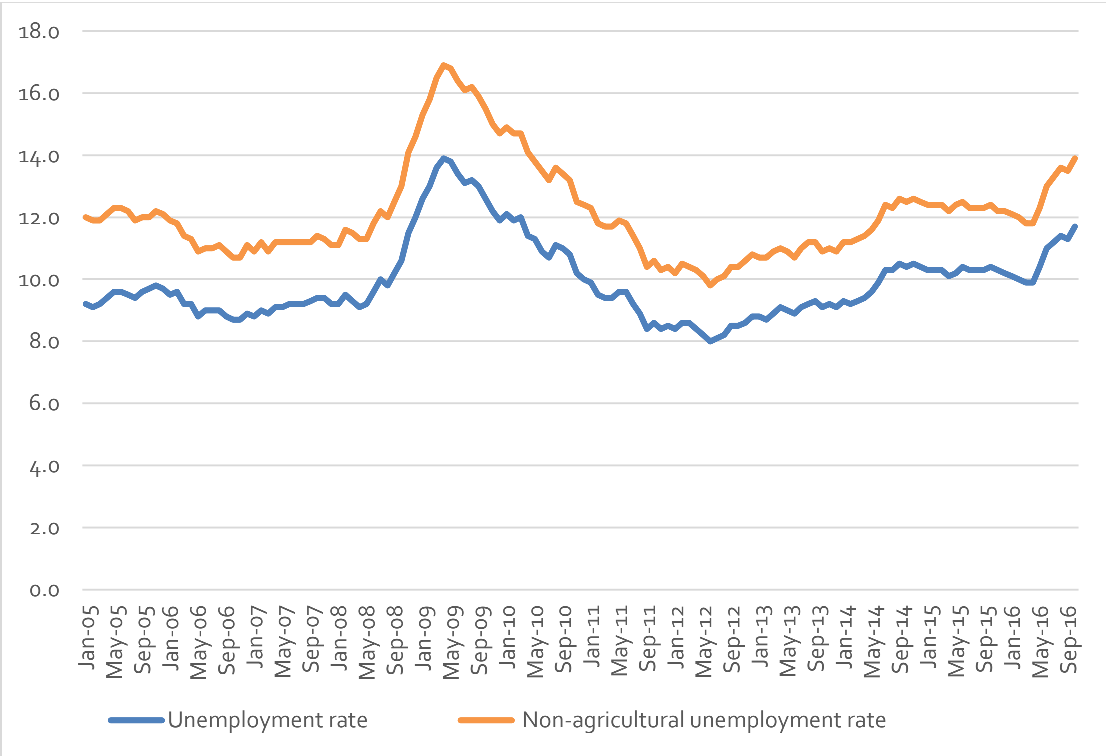
Losses in Tourism and Unemployment

Increased tensions with Russia towards the end of 2015 and factors negatively affecting the flow of European tourists, such as terrorism, caused 2016 to be a "lost year" for the tourism sector. In just the first 10 months of 2016, the number of foreigners visiting Turkey decreased by 31%. Average spending by visitors also decreased from $1,000 to around $700 per capita. We estimate that annual losses will amount to at least $10 billion.

The decline in tourism negatively affected other sectors as well, especially food, retail, dining, and entertainment. The unemployment rate, which was 9.9% in April, increased to 11.3% in August. The increase in unemployment was not limited to services and was felt in all sectors, including industry. Moreover, we cannot ignore the effects of the July 15 coup attempt on these figures. Nevertheless, its impact is hard to distinguish since the attempted coup took place in the third quarter when tourism and agriculture are most heavily weighted.

The increase in unemployment has stopped, indicating that the economy is unlikely to contract in the last quarter, however, a significant rebound is not expected. For the tourism sector, the continuation of terrorist attacks and the extension of the state of emergency declared after July 15, 2016, continue to negatively affect the number of visitors. Although tensions with Russia have declined, the inflow of visitors from Europe is not expected to significantly increase in 2017. As for convention tourism in Istanbul and other major cities, there are indications that companies are struggling with bookings for the next two years.

Figure 10: Unemployment Rate (%)



Source: Turkish Statistical Institute (TÜİK), employment data

TÜSİAD 2016 Macroeconomic Forecast

TÜSİAD Macroeconomic Forecast

	Actual				TÜSİAD Estimate	TÜSİAD Forecast
	2012	2013	2014	2015	2016	2017
Growth	4.8	8.5	5.2	6.1	2.2	2.5
Private Consumption Expenditure Growth	3.2	7.9	3.0	5.5	0.4	2.0
Total Fixed Capital Investment Growth	2.7	13.8	5.1	9.2	3.5	2.4
Inflation	6.2	7.4	8.2	8.8	8.5	9.4
Budget Deficit / GDP, %	-1.8	-1.0	-1.4	-1.0	-1.4	-1.7
Public Debt Stock / GDP, %	33.9	32.4	29.9	29.0	28.2	27.8
Exports, FOB, Billion USD	152.5	151.8	157.6	143.8	142.6	145.0
Imports, CIF, Billion USD	236.5	251.7	242.2	207.2	198.6	210.0
Current Account Deficit / GDP, %	-5.5	-6.7	-4.7	-3.8	-4.0	-4.5
Unemployment, %	8.4	9.0	9.9	10.3	10.6	11.5
Real Effective Exchange Rate Index (CPI Based, CBRT), %	2.4	-1.7	-5.1	-2.7	-0.2	-2.5
Secondary Market Nominal Interest Rate, %	6.2	10.0	8.0	10.8	10.7	11.8

Sources: Ministry of Development of the Republic of Turkey; Turkey Data Monitor; TÜSİAD

Overall in 2017 domestic demand is expected to fuel economic growth in Turkey. Net foreign demand is expected to have zero or a very limited negative effect on growth. The euro/dollar parity, growth in the EU economy, rising oil and raw material prices, and regional geopolitical risks will be the fundamental determinants of net foreign demand.

We predict the rising exchange rate will increase inflation, limit purchasing power, and weaken consumer confidence. Therefore, we expect increases in private consumption will be limited. We anticipate investments will remain weak due to growing political uncertainty, security issues, and pressure on financing costs from global conditions. We assume public spending will adhere to the Mid-term Program and will therefore have a more limited role in growth than in 2016.

Net foreign demand could contribute more to growth, provided the EU's quantitative easing continues to have positive effects, Brexit negotiations create minimal economic damage in the U.K.

and EU, and geopolitical risks are reduced. In this scenario, growth rates could increase 1 percentage point. For our current estimates, another basic assumption is that emerging market economies will not experience a sudden economic slowdown.

Accelerating structural reforms, especially steps to reduce burdens on the workforce, education reform, tax reform, and promoting regulations to improve the investment climate, not only positively affects economic growth but also increases potential growth over the long term.

Similarly, the share of net foreign demand in growth could decline up to 1 percentage point if geopolitical risks from Syria deepen, if the Fed raises interest rates more quickly than expected or if the growth in EU domestic demand is below expectations. **In other words, the basic scenario of 2.5% GDP growth in 2017 is estimated to be within +/- 1 percentage point.**

However, a sudden interruption in emerging markets or larger problems in the European banking sector could create negative outcomes far beyond the estimated margin above. Moreover, a potential trade war sparked by protectionist policies introduced in the U.S. could cause a cycle of economic downturn globally.

There is a high probability that growth will be met with an increasing cost of financing. Especially in light of terrorist attacks and the extension of the state of emergency, a significant increase in tourism revenues should not be expected. As a result of the decline in tourism and rising energy prices the current account deficit is unlikely to improve.

Under all conditions, the ability of structural reforms to effectively stimulate potential growth requires the careful implementation of the reform program. According to TÜSİAD Economic Research, supply side mid-term growth could increase up to 1.0 – 2.0 percentage points if structural reforms are prioritized and implemented.