2018

The Economy in Turkey in 2018

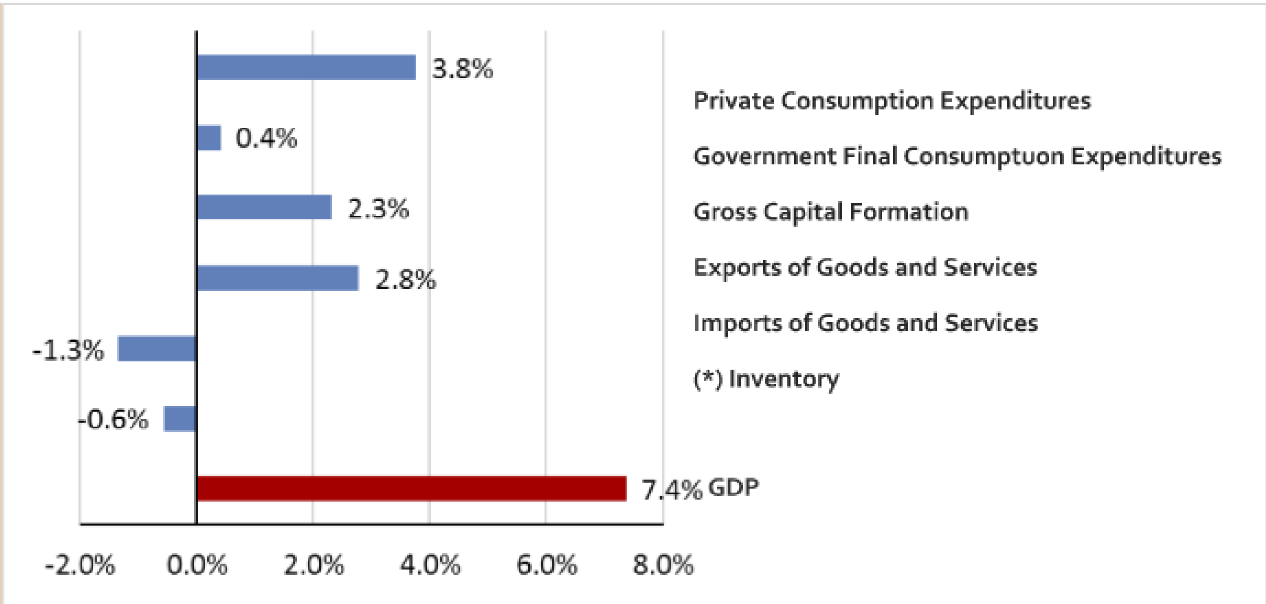
The Turkish Economy

The Turkish economy grew at a rate of 3.2% in 2016, largely due to the attempted coup and terror attacks. The outlook was negative in the beginning of 2017. Expectations for growth were in the range of 2.5-3% and the Turkish lira was losing value against the dollar. The early retreat of risk perceptions in tight market conditions supported growth, as did measures taken by the government to increase domestic demand. In the first 9 months the economy grew at a rate of 7.4%. However, this growth occurred alongside an increase in financial vulnerabilities. Inflation, foreign debt, loan-to-deposit ratios and budget deficits increased. In the first section we briefly analyze the economy in 2017 and in the second we give our expectations and forecasts for 2018.

Dynamics of Growth

We estimate that the Turkish economy grew at a rate of 7% in 2017. In the first three quarters, the largest contributor to the 7.4% rate of growth came from consumption expenditures, at 3.8% percentage points. While the contribution from investment was 2.3 percentage points, contribution from net exports was 1.5 percentage points. Public consumption only contributed 0.4 percentage points. Although the growth in investment, which had long been viewed as weak, is notable in the composition of growth, it is not possible to confirm the source of growth since the public and private sectors cannot be differentiated in the data. After recording weak investments in the first two quarters, we record an increase in the third quarter and a return to growth in machinery and equipment investments, which had declined in the last four quarters. (Figure 1).

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



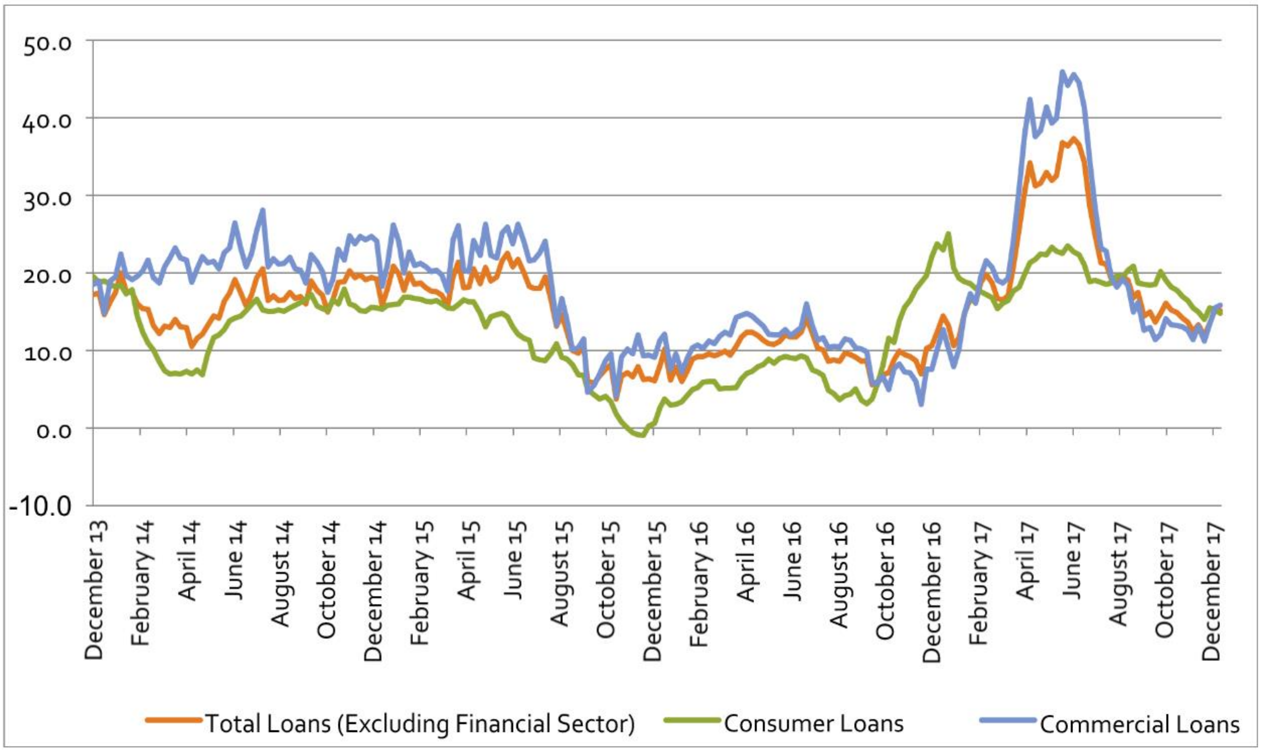
Source: Turkish Statistical Institute (TÜİK), National Accounts data

On the other hand, industrial production which had been growing since the beginning of the year began to slow in the last quarter. According to the averages from October and November, industrial production increased around 1.4% in the fourth quarter. While the production of capital goods increased, there was a decline in durable consumer goods production. But in total industrial production continues to grow robustly. This growth also supports the increase in capacity utilization rates.

While the public sectors contribution to growth decreased in 2017, tax cuts and disbursements from the Credit Guarantee Fund (CGF) were important factors. Although public consumption had less of an impact, fiscal policy was an important component in 2017 growth rates.

The Credit Guarantee Fund extended nearly TL 200 billion in loans in 2017. This credit was directed primarily to SMEs and contributed positively to annual credit growth rates. Figure 2 shows the rising rate of credit due to the CGF. The 13-weekly average of commercial credit growth increased from 10% at the end of 2016 to more than 40% in July 2017. Use of the fund has slowed since the summer months, when the rate of credit growth declined to around 15%. The 2017 rate of credit growth was around 21% (Figure 2).

Figure 2: Rate of Credit Growth (exchange rate adjusted, 13-week average, annualized, %)



Source: Turkish Data Monitor

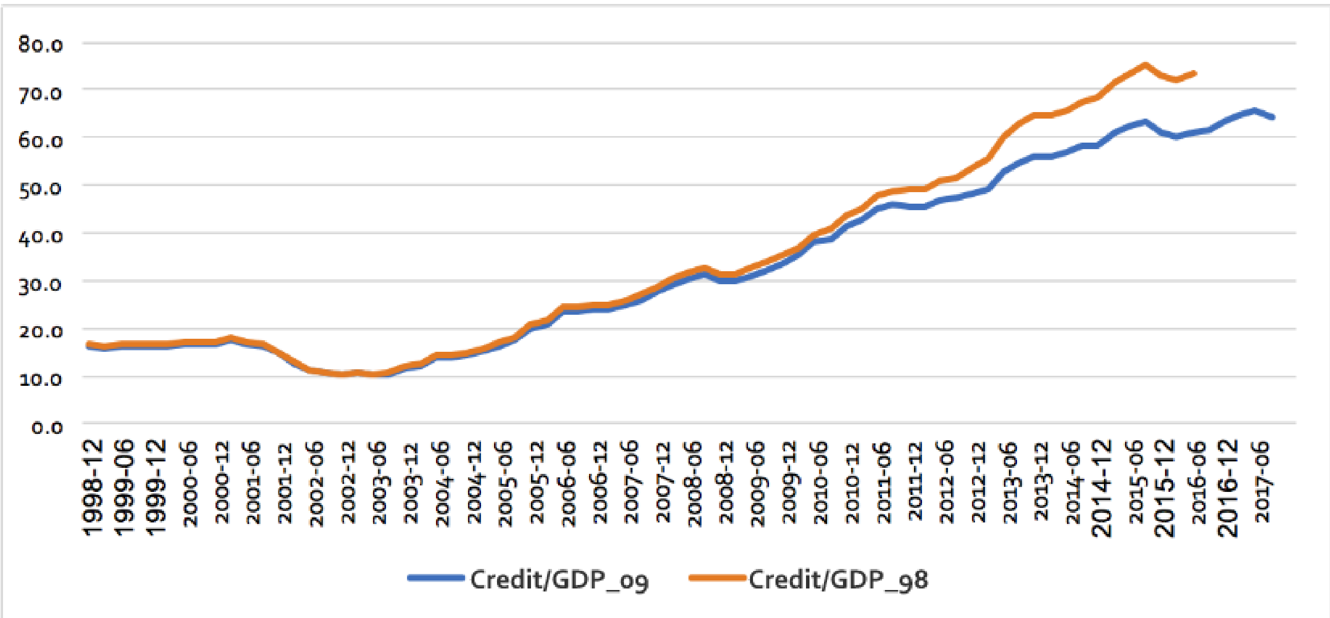
The quality of economic growth is closely related to investments, which has been weak for an extended period of time. In the 3rd quarter both construction and machinery and equipment recorded increases. But it is too early to say whether there was a sustained increase in investment. With an increase in exports, rising capacity utilization rates in industry should contribute to increasing investments. The capacity utilization rates which registered over 75% at the end of the crisis, has been increasing since the final quarter of 2016 and has neared 80%. However, uncertainty related to the economy and especially related to economic policies is an obstacle to improving the investment climate. The high credit/deposit ratio in Turkey's banking sector and rising financing costs made investment financing difficult.

The end of credit fueled growth?

Turkey went through an important financialization process in the 2000's. The banking sector, which primarily focused on financing state borrowing began to turn towards the real sector. As a result, both households and businesses increased their credit. The banking sector's total credit in 2003 was around 10% of GDP. At the end of 2017, it reached 64%. This ratio would have been 74% based on the previous GDP series calculations (Figure 3). Turkey benefited from the positive influence of financialization on increases in growth and productivity, however, as the percentage of credit approaches its natural limit, the rate of credit growth will naturally decrease.

While Turkey's credit to GDP ratio is still below many developed countries, the fact that an important part of credit financing comes from foreign debt creates a distinct vulnerability. The rate of credit to deposits in the third quarter of 2017 was 120%, whereas the credit to deposit ratio in TL has reached 140%. In the period between 2011-2017, Turkey's percentage of foreign debt increased from 35% to 52%. The utilization of the Credit Guarantee Fund increased this percentage considerably. While foreign debt at the end of 2016 was 47%, it had risen to 52% only six months later in June 2017.

Figure 3: Credit/GDP (%)

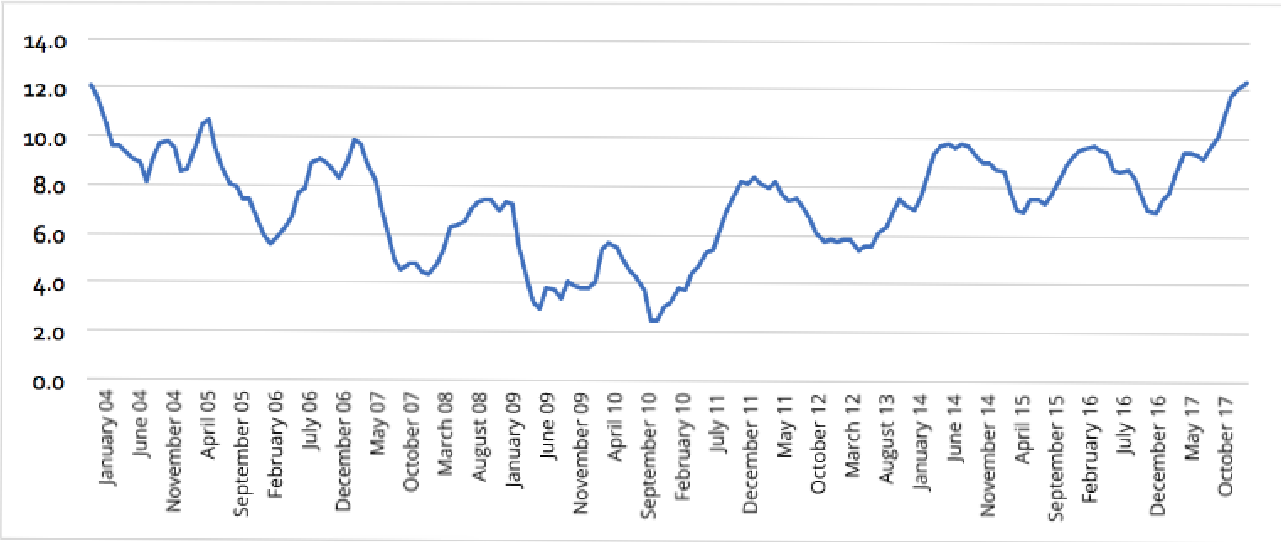


Source: BDDK, TÜIK National Accounts

Is the inflation problem underrated?

Inflation was 11.9% in 2017, the highest it has been since 2004. Loose monetary policy and stimulus programs like the CGF played a role in this increase. Core inflation was 12.3%, also the highest since 2004. Core inflation in the period between 2004-2010 was in a downward trend. In 2010 with the implementation of new monetary policies it again began to increase and spiked in 2017. Core inflation does not include the prices of food or energy. The upward trend in inflation after 2017 can be seen particularly in basic goods and services. In addition to this, inflation remained high despite the fact that input prices have fallen due to decreased energy and commodity prices.

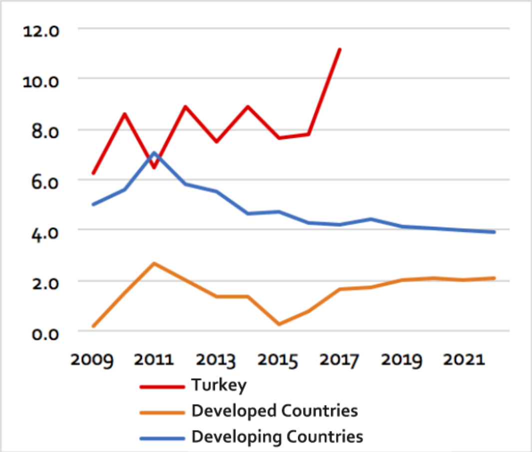
Figure 4. Core inflation (Year-on-year, %)



Source: TÜIK, Consumer Price Index

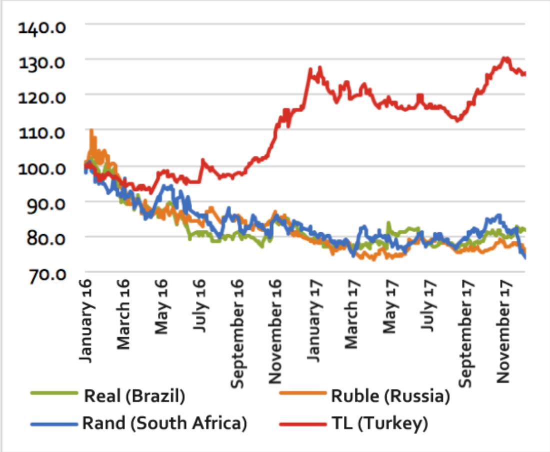
In countries like Brazil, South Africa, and Russia, which have comparable capital inflows, and even in fast-growing Asian countries like India and Indonesia, the rate of inflation has fallen to 3-5%. Inflation in Turkey on the other hand remains in double digits, after Argentina and Venezuela. While the average rate of inflation for developing countries worldwide is approaching 4%, Turkey is increasingly diverging from this trend. While the average rate for a long time was around 8%, inflation climbed to 11.9% in 2017, despite the prevailing global trends (Figure 5). The vulnerability of the Turkish lira has increased since the U.S. elections in 2016, and the FED policy of balance sheet reduction has exasperated the situation. (Figure 6).

Figure 5. Rate of Inflation in the world and in Turkey (12-month average, %)



Source: World Bank

Figure 6. TL and selected foreign currency exchange rates (index 2016= 100)



Source: Turkish Data Monitor

Uncertainty over inflation makes it difficult for the real sector to make investment decisions. The uncertainty also plays a large role in utilizing savings in the short term and causes relatively shorter deposit terms (maturation) in Turkey. High inflation and uncertainty must be overcome so that savings are invested in capital markets, and not in foreign exchange markets and short-term deposits. The cost of inflation to Turkey's economy is too high for short term growth and is gradually increasing.

Exports and Imports Increase

Exports increased 10.2% in 2017 to 157 billion dollars and imports increased 17.9% to 234 billion dollars. The largest share of increase in exports was to Europe, while exports to the Middle East was largely in gold. The largest share of increase in imports was gold and energy.

In 2017 the foreign trade deficit grew from USD 56 billion to USD 77 billion. According to our estimates, the current account deficit also grew to 5.6% at the end of 2017. We expect that in exports in 2018 will continue to increase, at a slower rate, due to the growth of the global economy. In 2017 the Eurozone grew 2.4%, and it is predicted to grow at 2.1% in 2018. The UK is behind in growth due to concerns over Brexit. While the UK economy grew 1.5% in 2017, Turkey's exports to the UK declined by 17.5%. We expect a limited increase in exports to Europe in 2018. As for imports, in the year ahead we expect gold imports will return to normal and the impact of energy prices will remain limited in comparison to 2017.

Table 1. Exports according to country groups (January – November, billion dollars)

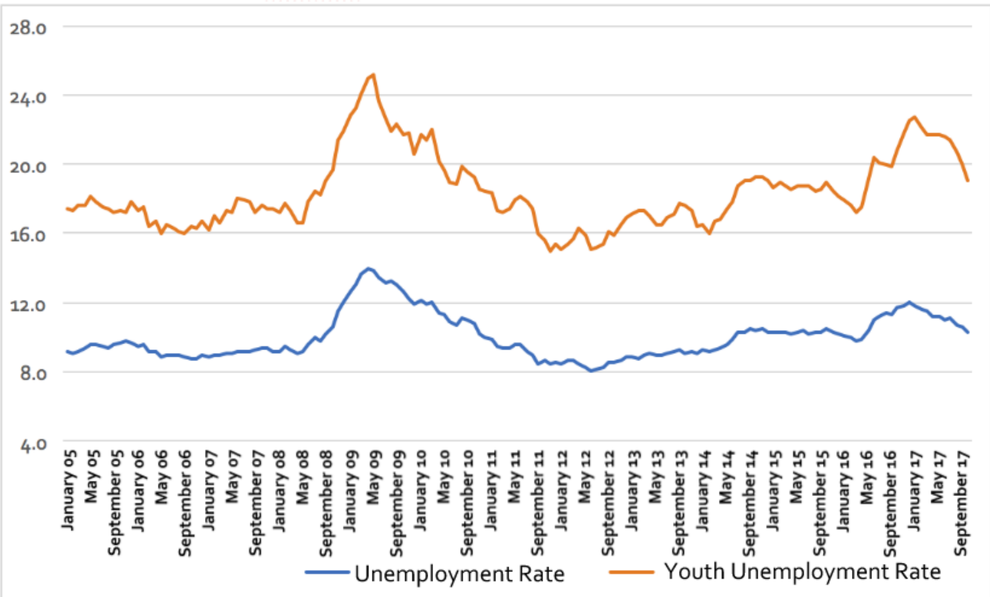
	EU	ME + NA	Other	Total
2017	67,4	32,5	43,3	143,2
2016	62,7	28,1	39,0	129,8
% Change	7,5	15,6 (4,7)*	11,0	10,2

Source: TÜİK, Foreign trade statistics. *Excluding gold. ME + NA (Middle East and North Africa)

High growth leads to lower unemployment

At the beginning of 2017, the unemployment rate, which had increased to 12%, declined to 10.3% due to higher growth. But this decrease was only felt in the final quarter. In parallel to the headline unemployment rate, the rate of youth unemployment also fell from 22.1% to 19%. The industrial and service sectors played an important role in the reduction of unemployment. From the beginning of the year to September, 1 million 76 thousand jobs were created. Of these 701 thousand came from the services sector and 196 thousand came from the industrial sector. The workforce increased by 670 thousand. The rising trend in unemployment seen since 2012 has decreased, however it persists above the 8% level achieved in 2012. We expect that the decrease in the unemployment rate in 2018 will slow and plateau.

Figure 7. Unemployment Rate (seasonally adjusted, %)



Source: TÜİK, Household Workforce Survey

TÜSİAD's 2018 Expectations

The Turkish economy has been growing in recent years as a result of public spending and consumption. In 2017, the net export contribution in the first nine months was positive due to higher domestic demand and an increase in exports. Continued strong growth in industrial production, brought net capacity utilization back to 80%. The expectation that growth will continue worldwide indicates that the contribution of net exports can continue, although it might slow down somewhat.

The growing budget deficit caused the government to implement saving measures and to increase tax rates. The increase of corporate taxes by 2 percentage points, automotive vehicle tax and a new tax on certain consumer goods (special consumption tax) will limit the contribution of public spending to growth. As for rising inflation, if the target rate is to be achieved, tighter monetary policy will be required.

The Credit Guarantee Fund (CGF) limit of TL 50 billion has not yet been used and approximately TL 28 billion have been repaid. In this case, it will be possible to create additional credit of around TL 80 billion this year in addition to the TL 200 billion that was disbursed last year. If the additional credit is disbursed more selectively and spread over time, it's impact on growth will be more limited than last year.

With tighter fiscal and monetary policy and a smaller scaled CGF program, we forecast that 2018 growth will decline to 4.5%.

We believe that the Federal Reserve will implement three rate hikes this year, provided that there is no unexpected slowdown in the American economy. Recent tax cuts and the growing labor market supports this view. We therefore expect that dollar denominated financing costs will increase and that this can have a negative effect on the TL. We expect that in 2018, the inflation rate will reach around 9.5-10%, depending on the exchange rate and the policies of the Central Bank.

Any steps taken by the government in implementing the reforms listed in the Middle Term Program will support growth and investments. Turkey has been categorized as "unfree" by Freedom House and ranks 53rd in the global competitiveness index in 2017 (Turkey ranked 43rd in 2012). According to the global competitiveness report published by the World Economic Forum, political uncertainty is the number one problem in Turkey. According to the report, political uncertainty is followed by access to financing and education of the labor force. In the macroeconomic expectations surveys conducted by TÜSİAD, uncertainty related to the legal system is the most important problem facing the investment environment, while political uncertainty is seen as the second most important problem.

There is no doubt that ending Turkey's state of emergency and strengthening the justice system and fundamental rights and freedoms will have a positive effect on Turkey's economy and will help improve the perception of Turkey abroad. Furthermore, any steps in this direction will be extremely beneficial for progress in European Union accession negotiations and the initiation of negotiations on modernizing the customs union, which is of critical importance to Turkey.

TÜSİAD 2018 Macroeconomic Forecast

TÜSİAD's macroeconomic predictions are carried out quarterly, one week after national income data is officially announced. The report is shared with the public in January, generally during the TÜSİAD General Assembly meeting.

Expectation surveys conducted with TÜSİAD members, evaluations done by the TÜSİAD Macroeconomic Analysis Working Group, and econometric tools developed by the TÜSİAD Economic Research Department are used in the forecasts. The forecast is based on data from public sector forecasts and global and regional forecasts of international institutions. In 2018, the forecasts of government expenditure data from the 2018 Annual Program, the CBRT's monetary policy statements for monetary policy preferences, and external growth, cross-exchange rates and price data from various international institutions were utilized. The scenario prepared in this framework is presented in the following table.

TÜSİAD Macroeconomic Forecast

	Actual				TÜSİAD Estimate	TÜSİAD Forecast
	2013	2014	2015	2016	2017	2018
Growth	8.5	5.2	6.1	3.2	6.9	4.5
Private Consumption Expenditure Growth	7.9	3.0	5.4	3.7	6.0	4.5
Total Fixed Capital Investment Growth	13.8	5.1	9.3	2.2	7.6	4.0
Inflation	7.4	8.2	8.8	8.5	11.9	9.8
Budget Deficit / GDP, %	-1.0	-1.1	-1.0	-1.1	-1.5	-1.9
Public Debt Stock / GDP, %	31.0	28.8	27.6	28.3	28.0	28.5
Exports, FOB, Billion USD	151.8	157.6	143.8	142.5	157	166
Imports, CIF, Billion USD	251.6	242.2	207.2	198.6	234	252
Current Account Deficit / GDP, %	-6.7	-4.7	-3.7	-3.8	-5.6	-5.4
Unemployment, %	9.7	9.9	10.3	10.9	11.1	10.5
Real Effective Exchange Rate Index (CPI Based, CBRT), %	-1.7	-5.1	-2.7	-0.2	-10.3	-4.0
Secondary Market Nominal Interest Rate, %	7.4	9.3	9.7	9.8	11.8	13.8

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

In 2018, we expect that growth in Turkey's economy will be relatively stable between exports and domestic demand. We also predict that there will be limited positive contribution to growth of net foreign demand. Key determinants of net foreign demand will be growth in the EU economy, a rise in the price of oil and other raw materials, and regional geopolitical risks.

We foresee that a rise in the exchange rate will cause the inflation rate to increase and continue to negatively affect consumer confidence. Also, the tax increase may limit consumption. For these reasons, we expect the increase in private consumption to be limited. We also expect that investments will continue to weaken due to growing political uncertainty, security problems, and the pressure of global conditions on financing costs. We assume that public expenditures will occur as determined by the Middle Term Program, thus the contribution to growth from public spending will be limited.

The continuation of the positive effects of the quantitative easing in the EU economy, Brexit negotiations that limits damage to the EU and UK economies, and the mitigation of geopolitical risks could increase net foreign demand in support of growth. One of the assumptions of this scenario is that there will be no sudden slowdown in developing economies.

The acceleration of implementing structural reforms in the economy, especially taking steps to reduce the burden on the workforce, reforms in education, tax reform, and regulations to improve the investment climate, will increase economic growth as well as potential for growth in the long-run. The expansion of the Credit Guarantee Fund may also increase growth. In this case, the growth rate could be approximately 1 percentage point higher.

Also, contribution of net external demand to growth could be 1 percentage point less due to intensifying geopolitical risks, tighter than expected monetary policy by the Federal Reserve, and the weaker domestic demand in the EU. **The forecast band of the 2018 annual GDP growth of 4.5% is predicted to be +/- 1 point.**

Additionally, problems stemming from a sudden slowdown in developing economies or high indebtedness in global financial markets, might have negative consequences far greater than the above stated forecast bands. The new U.S. Administration's focus on protectionist policies and risk of trade wars could cause a global economic slowdown. The economy will likely face growing costs in the financing of growth. The increase in the current account deficit due to higher energy prices, could decrease somewhat due to a slowdown in the economy.

In any case, the important contribution of the structural reform-growth relationship to potential growth depends on the healthy implementation of the reform program. The work of TÜSİAD Economic Research shows that if the structural reforms are implemented with correct prioritization, medium-term growth can rise by 1.0-2.0 points towards supply side.