Turkey Regular Economic Brief

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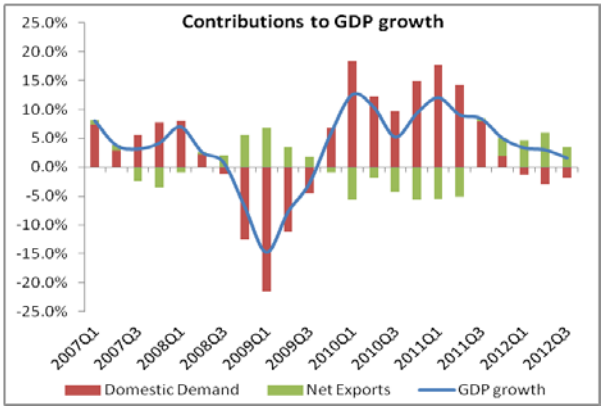
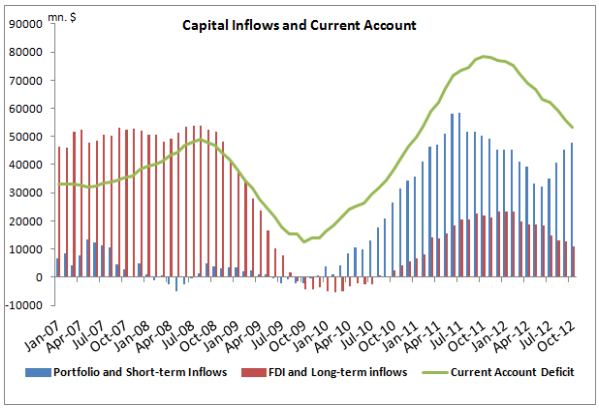
Turkey's economy had a soft landing.

Turkey's economy experienced a soft landing in 2012. Exchange rate depreciation followed by decisive monetary tightening in the fourth quarter of 2011 has led to a significant rebalancing of the economy. In the first nine months of 2012, GDP expanded by 2.6 percent y-o-y, down from 8.5 percent in 2011. The contribution of domestic demand to headline growth turned negative on the back of shrinking private investment partly linked to tighter and "unorthodox" liquidity management by the central bank as well as unfavorable external conditions. Net exports more than offset the slowdown in domestic demand and became the major contributor to headline growth with 4.6 percentage points in the first three quarters. A recent modest recovery in credit growth and VAT revenues suggests domestic demand may pick up in the final quarter of the year. Consequently, we estimate 2012 full-year growth at 2.9 percent, in line with our forecast at the start of the year.



Adjusting for a likely one-off boom in gold exports, export growth stood at 2.5 percent in 2012.

External balances have improved significantly but the current account deficit remains high. Thanks to the slowdown in domestic demand, the deficit has narrowed each month since November 2011 and is expected to reach 6.8 percent of GDP for the full year of 2012. Imports of goods and services declined by 2.5 percent y-o-y in the first ten months of 2012 while exports increased by 12 percent y-o-y on the back of a boom in gold exports. Adjusting for gold sales, export growth stood at 2.5 percent. Despite this significant improvement, the current account deficit is still above the level of end 2010 (6.4 percent) when the central bank first implemented its "unorthodox" policy to curb the deterioration in external imbalances. In addition, the quality of financing remains weak with inflows of FDI and other long term capital accounting only for 20 percent of total financing.



The downward trend in headline inflation corroborates the CBRT's policy stance.

While the jobless rate remains below pre-crisis levels, the growth slowdown is starting to be felt in the labor market. Unemployment has been below the pre-crisis average of 10.3 percent for the last 16 months, with the labor market showing remarkable resilience in the face of declining growth. However, with industrial production depressed during the third quarter, the seasonally adjusted unemployment rate increased from 9 percent in June to 9.4 percent in September 2012.

End-year Inflation remained within the central bank's target interval in 2012. The headline 12-month inflation eased to 6.2 percent in December 2012, down from 10.5 percent at end-2011. The main drivers of this decline were low food price inflation stemming from the deceleration in domestic demand and a favorable harvest. The downward trend in headline inflation helped re-anchor medium-term inflation expectations and increased the credibility of the central bank. Two-year forward looking CPI inflation expectations eased to 5.9 percent in the first half of December 2012 from 6.5 percent at the end of 2011.

Medium-Term Macroeconomic Projections and Targets						
	2012	2013	2014	2015	2016	2017
GDP Growth (%)	2.9	4.0	4.5	5.0	5.1	5.1
CPI Inflation (%) (end-of-period)	6.2	6.1	5.2	5	5	5
Public Sector Primary Balance/GDP, %	1.6	2.1	2.3	2.3	2.4	2.4
Gross Public Debt/GDP[1]	39.8	38.1	37.2	36.6	36.2	35.8
Gross External Debt/GDP	41	41.7	41.5	40.9	40.6	39.9
CAD (billion US$)	55.1	59.1	61.2	62.4	61.8	60.8
CAD/GDP (%)	6.8	7.0	6.8	6.5	6.0	5.6
Reserves (billion US$) (including gold)	120.3	124.3	127.3	129.8	131.4	132.6

Source: World Bank Staff Projections

- **Improving confidence is expected to help private investment recover.**

The authorities allowed the fiscal deficit to widen as growth slowed, cushioning the impact of the domestic demand adjustment. The central government budget deficit is estimated to reach 2.3 percent of GDP in 2012 compared to the target of 1.5 percent and 1.3 percent in 2011. The main reasons behind this deterioration are the rise in personnel expenditures and losses from state owned enterprises (SOEs) as a result of delayed price adjustments. On the other hand, revenues also underperformed in the first three quarters due to the slowdown in private consumption. The rigidity of current expenditures and the increasing cyclical sensitivity of revenues is a fiscal risk going forward.

- **Our growth forecast is 4 percent for 2013.**

With growth slowing markedly, monetary policy has been gradually relaxed since June 2012 with some initial signs of a revival in credit expansion. The average funding cost of the banking sector fell by 325 basis points since June and stood at 5.60 percent as of December. As a result, FX adjusted credit growth rose to 18 percent in November from 15 percent in September signaling a recovery in domestic demand in the final quarter of the year. In addition, the central bank started to narrow the interest rate corridor by cutting the O/N lending rate starting from September. Lower rates and improving confidence are expected to help private investment recover in the coming year.

- **Turkey ranks 71st in the 2013 Doing Business ratings.**

We expect growth to increase moderately in 2013 before returning to trend growth in 2014 and beyond. Our growth forecast for 2013 is 4 percent. While the contribution of net exports is expected to remain slightly positive in 2013, a rebound in domestic demand will limit the improvement in external balances in the short-term. Beyond 2013, growth is forecast to reach 5 percent while the current account deficit is anticipated to ease below 6 percent.

Turkey's dependence on external financing is the main short-term vulnerability. Turkey's current account deficit and the composition of its financing remain of concern. Under a deepened crisis scenario in the Eurozone and a corresponding sudden stop of capital inflows to emerging markets driven by a flight to safety, Turkey could face a sharp GDP contraction similar to the experience during 2008-2009.

Increased capital inflows and a stronger global recovery in 2013 present upside risks to our forecast but would call for prudent macro and financial management to prevent exacerbating existing vulnerabilities. Highlighting the soft-landing in the economy and strong fiscal and financial buffers, Fitch upgraded the country's credit rating to investment grade in November 2012. Following the upgrade, portfolio inflows increased significantly with domestic and external borrowing costs of the government easing to record low levels. While this helps the country finance its current account deficit at relatively favorable terms, it could also reverse the rebalancing process and cause a renewed deterioration in external imbalances. Careful economic management is thus needed in order to safeguard the gains in stability in 2013 and beyond.

The current macroeconomic environment provides a window to deepen structural reforms and boost productivity and competitiveness. Turkey's business environment remains relatively burdensome with the country ranking 71st in the 2013 Doing Business ratings. Improving the investment climate is critical for raising Turkey's low labor productivity and further boosting its export performance (Turkey's trade openness remains below that of many peers). Key reforms include the full implementation of the commercial code and the capital markets law, the adoption of the employment strategy, and improving business regulations. Progress in these areas is critical to increase the country's productivity and competitiveness and to attract more FDI. In addition, boosting domestic savings remains a priority to decrease the country's dependence on external financing. Higher productivity growth and improved export competitiveness would allow Turkey to boost trend growth without excessive external deficits.

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