BBVA | RESEARCH

Turkey Economic Outlook

1ST QUARTER 2017 | TURKEY UNIT

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Global conditions improve but some uncertainties remain

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Turkish economic activity gradually recovers after the slump in the third quarter of 2016

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Closing date: 14 February 2017

1. Editorial

Global GDP economic activity accelerated in the final quarter of last year and is continuing to do so at the start of 2017. Despite the acceleration, the outlook remains uncertain mainly due to concerns regarding the political and economic policies of the new US administration. The size and type of fiscal impulse, deregulation policies and the response to potential impulses and greater inflationary pressures by the Federal Reserve will be crucial. Also, the rebound in energy prices has already driven annual inflation rates closer to the targets of most of the major central banks. In short, the risks of deflation have been replaced by at least temporary inflationary pressures, raising questions as to how global central banks could respond.

The Turkish economy slowed sharply in the third quarter of 2016 as multiple shocks, including heightened uncertainties after the July coup attempt and a sizable contraction in revenue from tourism, hit the economy. The economy has already showed signs of recovery in the last quarter thanks to stronger external demand and a fiscal policy stimulus. Our monthly GDP indicator points to 1.9%YoY growth in the last quarter of 2016.

The sizable exchange rate depreciation, the pass-through to inflation and the resulting higher domestic interest rates led to a tightening of financial conditions, which, together with an impaired confidence channel, is likely to keep weighing on private demand in the first quarter. The intensified fiscal stimulus and the statistical base effect will be especially supportive of economic recovery in the second half of the year. Overall, we expect Turkey's economic activity growth to accelerate modestly from 2.3% in 2016 to 2.5% in 2017.

The incoming data confirm the mounting inflationary pressures amid exchange rate depreciation, tax adjustments and a partial pick-up increase in food prices. These forces will offset the deflationary impact of weak domestic demand on core inflation. We forecast that inflation will recede to 8.5% by year-end.

The Central Bank is facing a crucial dilemma as the slowdown in economic activity is accompanied by higher inflation data and expectations. This is likely to constrain the monetary policy space until there's visible improvement in exchange rate and inflation. To cope with the slowdown in domestic demand, the economy's managers have intensified the use of the fiscal space and the countercyclical macro-prudential toolbox.

Despite strong growth in non-interest public expenditure, overall budget performance remained notably solid in 2016 thanks to expanded one-off revenue generation. We expect the budget deficit to rise to 1.8% of GDP in 2017 (from 1.1% in 2016), mainly linked to the extra fiscal stimulus and some potentially deficit-creating initiatives designed to reflate the economy. Despite some fiscal relaxation, both the expected budget deficit and public indebtedness remain well below international standards, such as the Maastricht criteria. However, the budget figures should be closely monitored and altered once economic recovery reaches its potential.

The overall balance of risks is balanced. On the positive side, the global outlook could boost emerging markets' assets while the local policy stimulus could boost domestic demand more than envisaged. However, important risks remain as uncertainty regarding the new US economic policy and its impact on world growth, inflation and monetary policy response continue. Political and geopolitical risks can also affect Turkey's economic confidence. The referendum on the new constitution could increase the political uncertainty while the country's increasing role in Syria could affect the domestic economy due to security issues.

2. Global outlook

Higher growth and greater uncertainty

While the global economy improved in the closing months of 2016 and continues to do so at the start of 2017, greater uncertainty is shrouding the year to come and a note of caution is advisable when making economic projections.

Global GDP growth accelerated in the last quarter of 2016 by 0.9% QoQ, and suggests slightly higher rates in the first quarter of this year, from 0.8% during most of the year. There is a notable increase in confidence in all areas, and the industrial indicators are rising alongside an incipient improvement in world trade.

Despite this acceleration, the outlook for 2017 and 2018 is plagued with uncertainty. This is mainly related to the economic policy of the new US administration, the shape of which remains largely to be seen. Measures for fiscal stimulus and deregulation in various sectors have been announced with a positive reception following the elections. Since Trump's victory, 10-year interest rates have risen by 63 base points to 2.5%, with a global knock-on effect – both in Europe and emerging markets. The value of share indices has increased globally, and the dollar has strengthened against major currencies, including the euro.

The announcement of protectionist measures could seriously harm international trade in the medium and long term and impinge on confidence in the near future, particularly outside the US. The magnitude of the fiscal impulse remains to be defined; what form it will ultimately take (higher bills for infrastructure or, more than likely, corporate tax reductions); and, above all, to what extent it may stimulate activity or generate greater inflation, given that the US economy may be close to reaching its growth potential. For this reason, since the start of the year, the markets have been showing moderate optimism and their dynamics have corrected slightly. They also remain more cautious as they try to assess the negative impact of protectionist measures in the medium and long term. Looking ahead, disengaging increased uncertainty about economic policy from low volatility at an aggregate level does not appear to be sustainable.

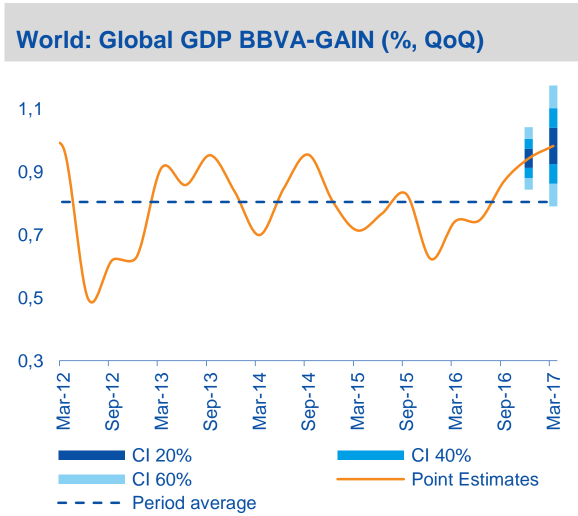
The magnitude of inflationary pressures is another unknown opening up at the global level. The prices of commodities have rebounded in recent months, somewhat more than predicted, following the OPEC agreement and the improvement in activity. The price of Brent crude oil was around 56 USD/barrel at the start of 2017, whereas we had been hoping to see a somewhat slower transition to its long-term equilibrium (60 USD/barrel, which we expect will be reached by the end of 2018). This is coupled with the fact that the underlying effects of energy prices are driving annual inflation to rates closer to the targets of the central banks, raising the expectations of long-term inflation discounted by the markets. After tying this in with the scale of the accumulated balances in recent years due to quantitative easing programmes and the outlook for fiscal stimulus packages, the result is that the deflationary risks of only a few quarters ago have been replaced by inflationary pressures, raising questions as to how monetary policy may respond.

In principle, the Federal Reserve is taking a cautious approach and continues to point towards a relatively slow normalisation of rates (although recently they have revised their interest rate expectations for 2017 slightly upwards, with three increases of 0.25% to 1.50%). In its latest communications it has acknowledged

a slight improvement in the outlook for growth and inflation, based on expected fiscal growth, while maintaining a balanced tone between upward and downward risks. Our forecast is for two interest rate increases to take place this year, with a further two in 2018.

Figure 1.1

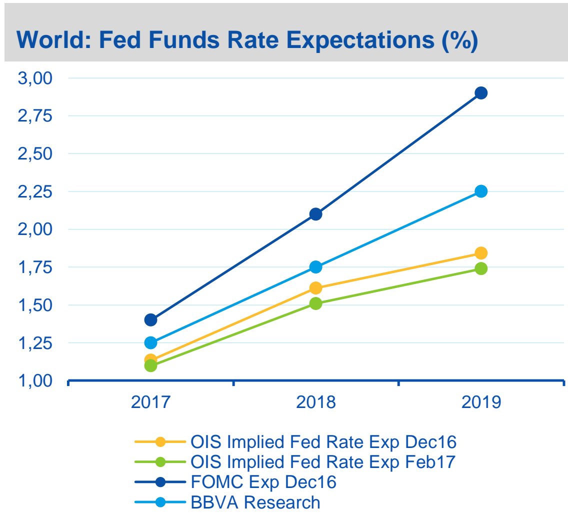
World: Global GDP BBVA-GAIN (%, QoQ)



Source: BBVA Research

Figure 1.2

World: Fed Funds Rate Expectations (%)



Source: IMF and BBVA Research

At the end of 2016, the ECB extended QE until December 2017, while reducing monthly asset purchases from 80bn to 60bn euros from March onward, underlining that it is not tapering. Even so, the pressures to bring forward the normalisation of monetary policy have already begun, with an increase in prices in Germany, and may well intensify in the coming months when inflation in the Eurozone approaches 2% owing to the effects of energy prices. Thus, we expect the ECB to begin the process of withdrawal from QE in early 2018 and decide on the first interest rate increase at the end of that year.

All in all, our growth projections for 2017 have undergone no substantial revision, although they are subject to a higher degree of uncertainty than normal. The base effect of increased growth at the end of 2016 and its inertial effect, together with the fiscal stimulus packages expected in the US, encourage us to moderately revise our forecasts for the US and Europe to the upside, and slightly more for China, while the forecasts for Latin American countries are being revised downward, mainly due to idiosyncratic factors. Global economic growth should therefore increase slightly from 3% in 2016 to 3.2% in 2017 and 3.3% in 2018.

The risks are largely downward and are governed by the above-mentioned uncertainty regarding protectionism in the US, a less friendly attitude toward immigration and the danger that the fiscal stimulus policies will not have any impact on growth and will increase inflation, or that the deregulation announced in various sectors will not be properly managed. In addition, there is the potential reaction of other countries or regions to these protectionist impulses. An unanticipated increase in inflation could lead to a toughening of monetary policy from the major central banks, with global consequences. In the long term, the risks of the accumulation of imbalances in China, together with the lack of structural reforms and the restructuring of public companies, may have an impact on their capital flows and currency and lead to a sudden slow-down in growth. Europe is subject to substantial political risks, in a year that is packed with election dates and with certain increasingly powerful parties proposing going back on structural reforms or measures to leave the euro zone or the European Union. And, in general, geopolitical risks continue to run high.

3. Turkish Economic Outlook

Contraction in 3Q16 due to multiple shocks

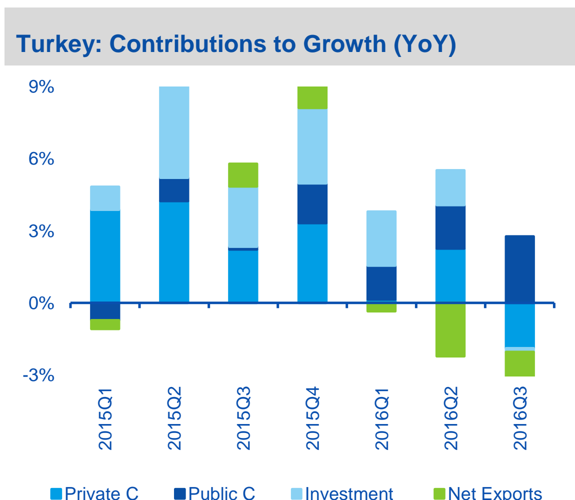
Turkey's economy slowed sharply in the third quarter of 2016 as multiple shocks, including heightened uncertainties after the July coup attempt and a sizable contraction in revenues from tourism, hit the economy. After growing 4.5% in the first half, the Turkish GDP contracted by 1.8% in 3Q16, despite a huge fiscal impulse from the Government. The strong growth of public spending was not enough to offset the sharp contraction in private demand, which was hampered by the confidence channel. A weak tourism sector and an unfavourable calendar impact were other important factors weighing on GDP growth.

TurkStat made some major revisions to the national accounts when revising to ESA-2010. The main driver of the change was the reach and quality of the data sources. In the new methodology, TurkStat relies more on hard data from the Revenue Administration and Social Security System and less on survey-based information. According to the new chain-linked GDP series with 2009 as the reference year, between 1998 and 2015 average growth was 5.1% compared to 3.9% in the old series and 2015 nominal GDP was higher by some 20% (see the box for the effects of the new national accounts on potential output).

The economy has already shown signs of recovery in the final quarter thanks to stronger external demand and brought-forward domestic demand in the automobile and housing sectors. **Our monthly GDP indicator points to 1.9% YoY growth in the final quarter of the year. We are keeping our 2016 full-year growth forecast at 2.3%, with slight downside risks.**

Figure 2.1

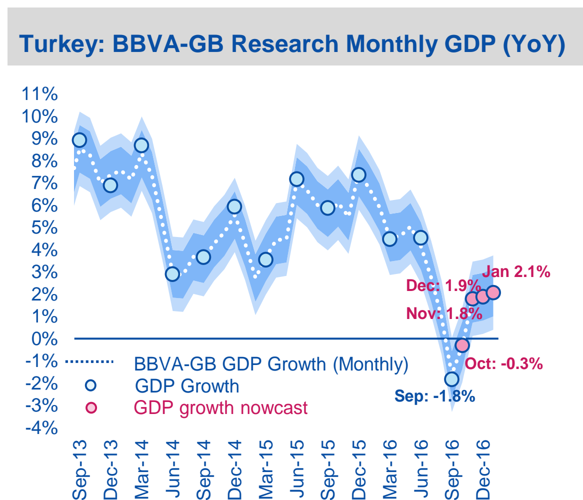
Turkey: Contributions to Growth (YoY)



Source: Turkstat, BBVA Research, Garanti Research

Figure 2.2

Turkey: BBVA-GB Research Monthly GDP (YoY)



Source: BBVA-Garanti Research Monthly GDP Model, Turkstat

Weakness in economic activity caused a sizable increase in the unemployment rate (SA) from 10.2% at end-2015 to 12.1% in January, the highest level since January 2010. Although still low, the steady increase in the participation rate (to 52.6% in October from 51.6% at end-2015) was another driver. Job creation remained weaker than before, adding 390,000 jobs in 2017.

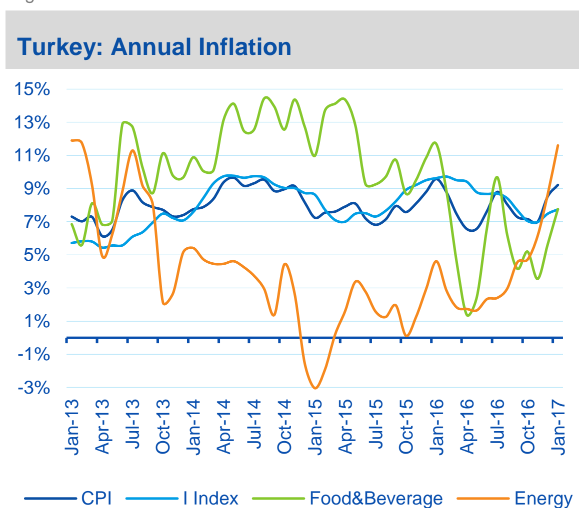
Inflation overshoots CBRT's target and the forecast

Consumer inflation continued to increase and ended 2016 at 8.5%, accelerating in January to 9.2% amid exchange rate depreciation, tax adjustments and a partial pick-up increase in food prices. Year-end inflation breached the Central Bank's 5% target for a sixth consecutive year.

Indirect tax increases, rising energy inflation and a weak exchange rate outweighed the deflationary impact of weak domestic demand. Despite a partial pick-up in December, 2016 food inflation was significantly lower than the average for the last 5 years (5.4% in 2016 vs 10.0% in 2011-2015). This is partially the result of the new structural food committee's containing food price volatility, which helped to reduce the 2016 headline but poses some upside risks to 2017 inflation. Despite the lower output gap, the core inflation trend has started to deteriorate due to the second-round effects of exchange rate depreciation and the failure to contain inflation expectations (at their highest levels since December 2008).

Figure 2.3

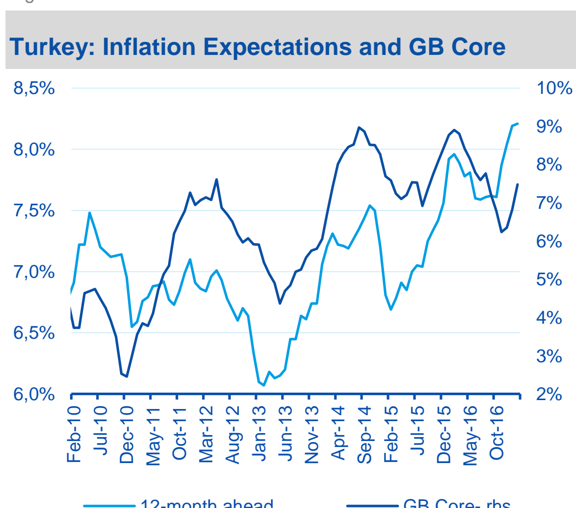
Turkey: Annual Inflation



Source: TURKSTAT, BBVA Research and Garanti Research

Figure 2.4

Turkey: Inflation Expectations and GB Core



Source: BBVA-Garanti Research Monthly GDP Model, Turkstat

A gradual reaction from the CBRT to increased FX and inflationary pressures

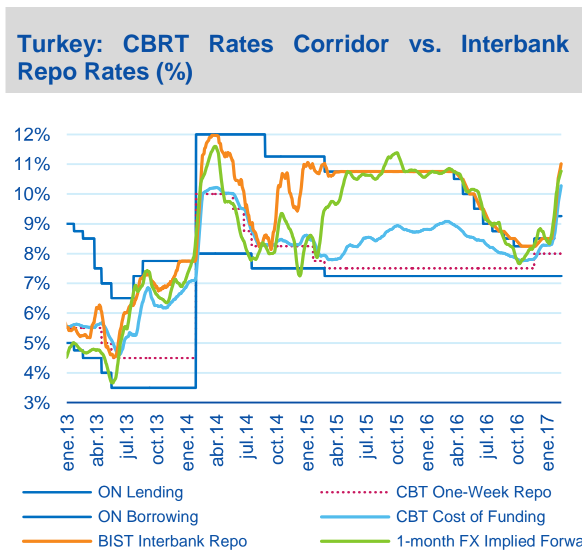
The sharp depreciation of the exchange rate after the summer was the result of higher risk premiums in the Emerging Markets after the US elections, the downgrading of the Turkish sovereign ratings to noninvestment grade and the political and geopolitical uncertainties surrounding the Turkish economy. Once the exchange rate started to depreciate beyond fundamental values, the Central Bank (CBRT) started to react, firstly with a gradual monetary tightening and then with an implicit sharp increase of the average funding cost so as to contain speculative pressures.

The initial increases in the one-week repo rate of 25 and 50 basis points in November were followed by liquidity tightening measures that proved to be insufficient to contain both the depreciation of the lira and

inflation expectations. After the sharp depreciation of the lira in January, the CBRT decided to tighten liquidity and sharply increase its average funding rate. Although it maintained the one-week repo at 8%, the CBRT decided to increase the marginal funding rate and the late liquidity window lending rate by 75 and 100 basis points to 9.25% and 11% respectively on January 24th. With this combined measure, the CBRT has been funding the system through a mix of the O/N lending rate at 9.25% and Late Liquidity Window rate at 11%, at an average rate of around 10.4%. All in all, the increase in the average rate since November neared 250 bp, from 8.0% to the recent 10.4%.

Figure 2.5

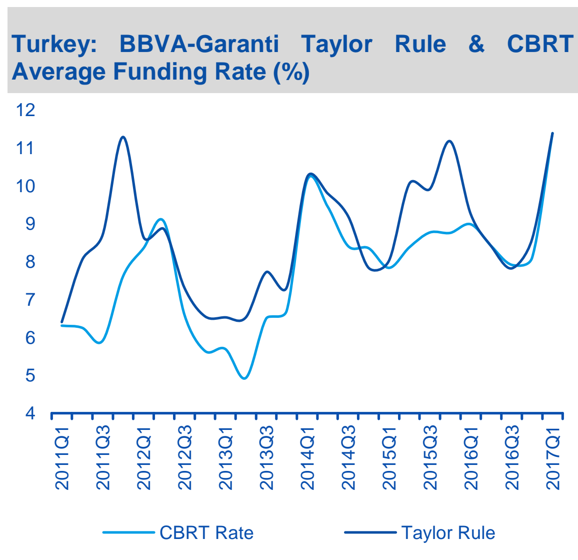
Turkey: CBRT Rates Corridor vs. Interbank Repo Rates (%)



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 2.6

Turkey: BBVA-Garanti Taylor Rule & CBRT Average Funding Rate (%)



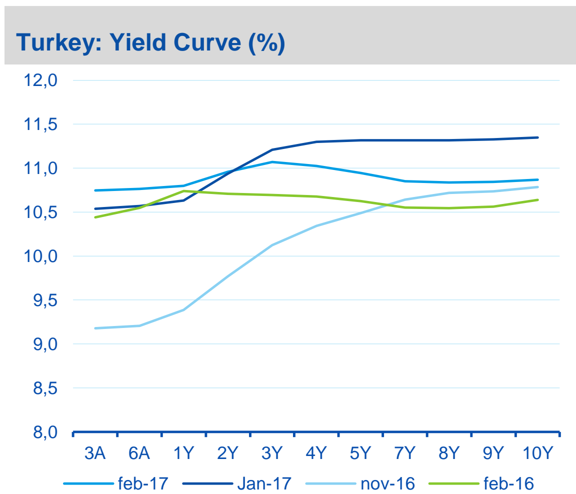
Source: CBRT, BBVA Research and Garanti Research

The lira depreciated by 20% in 4Q16 and up to 31st January due to some initial doubts after the Trump victory and deteriorating local factors, including increasing inflation expectations and risk premiums, security concerns, geopolitical risk and political uncertainty. After the CBRT's tightening, the renewed optimism regarding emerging markets and more dovish expectations of the Federal Reserve supported the stabilization of the exchange rate.

The treasury yield curve shifted upward despite increased risk premiums and inflation expectations. Recently, the yield curve flattened, a reflection of the monetary tightening by the Central Bank.

Figure 2.7

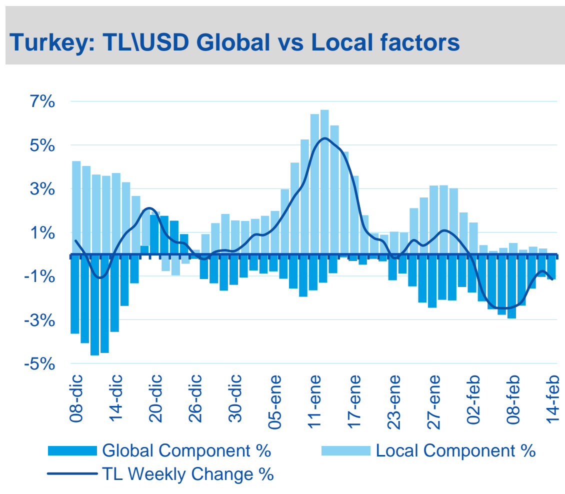
Turkey: Yield Curve (%)



Source: CBRT, BIST, BBVA Research and Garanti Research

Figure 2.8

Turkey: TL\USD Global vs Local factors



Source: CBRT, BBVA Research and Garanti Research

Budget deficit target was met thanks to a Tax Amnesty

Public balance performance deteriorated slightly in 4Q16 due to a significant acceleration in non-interest expenditures, which offset the solid revenues supported by a tax amnesty (particularly effective by November) and some last minute tax adjustments. **According to our calculations, the budget deficit to GDP ratio increased marginally to 1.1% in 2016 from 1.0% in 2015, while the primary surplus to GDP ratio declined to 0.8% from 1.3% in the same period.**

Behind the solid headline performance in 2016, the details of the budget are less pleasant, with primary expenditure growth (18%) continuing to overshoot the target (17%) and tax revenue growth (13%). Increased security spending, a government subsidy for the rise in the minimum wage and increased government employment were the main drivers behind the marked increase in primary expenditures.

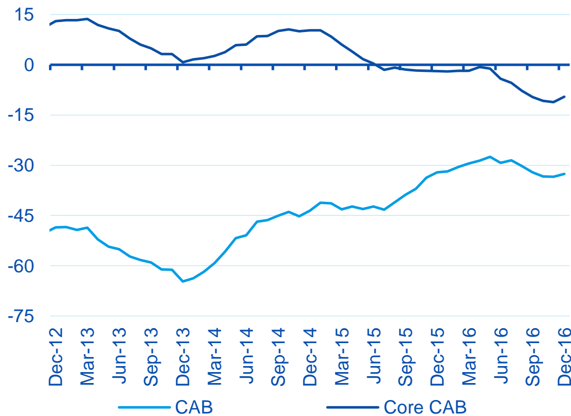
Excluding tax amnesty revenues (a total of TL 13.7bn in 2016), tax revenues were flat in 4Q compared to the previous quarter, implying that private domestic demand continued to be weak towards the end of the year. On the other hand, sizable support from non-tax revenues kept the overall revenues strong. In this period, the growth rate of non-interest expenditures accelerated to 22% from 10% in 3Q, signalling a higher public contribution to GDP growth rate in 4Q.

Stabilization of the Current Account deficit in 4Q

The recovery of exports and the gradual withdrawal of the high negative impact of the tourism sector in 4Q helped the current account balance (CAB) to stabilize around USD33bn despite the rebound in oil prices. During the whole of 2016, the current account deficit deteriorated slightly to USD 32.6bn (3.9% of GDP) from USD 32.1bn (3.7% of GDP) in 2015. On the other hand, the CAB excluding net energy and gold (core CAB) worsened, to a USD 10bn deficit from a USD 2bn deficit, mainly due to contracting tourism revenues (30% annual, by USD 17bn). On the financing side, net FDI, portfolio flows and external credit lines (particularly other investments) were positive (1.1%, 0.8% and 0.7% of GDP, respectively). The rest was mostly financed by net error and omissions (1.3% of GDP) in 2016.

Figure 2.9

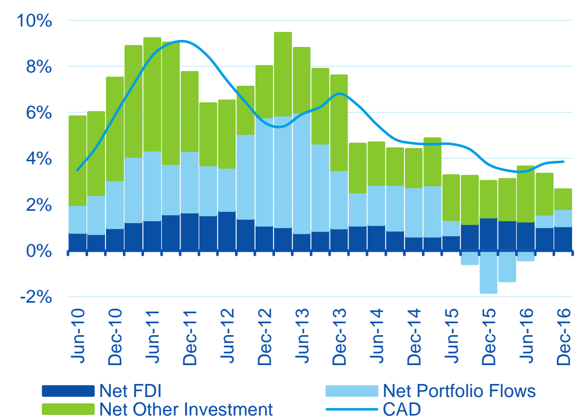
Turkey: Core Current Account Deficit (12 months cumulative, bn USD)



Source: BBVA Research and Garanti Research

Figure 2.10

Turkey: CAB Factor Decomposition (12 months cumulative, % of GDP)



Source: CBRT, BBVA Research and Garanti Research

We reduce our 2017 growth forecast to 2.5%

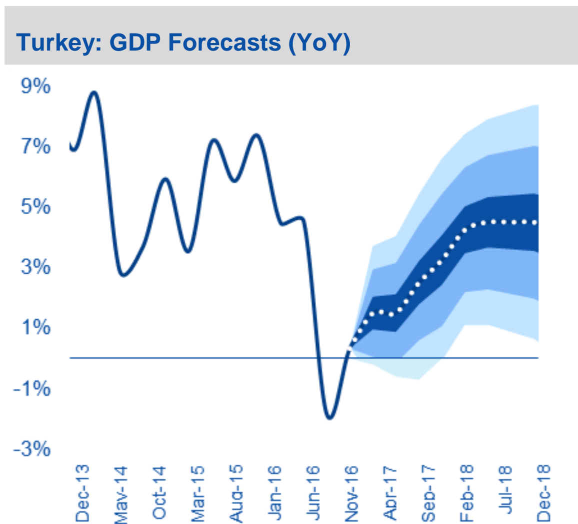
The incoming information for the final quarter of last year points to a modest, uneven recovery in economic activity. Our monthly GDP indicator shows 1.9% YoY growth in 4Q, which adds slight downside risks to our 2.3% 2016 full year growth forecast.

Having finished the last year with a below potential growth rate, we expect economic activity to continue to recover gradually going into 2017. A sharp exchange rate depreciation and resulting increase in domestic interest rates led to a tightening of financial conditions, which, together with the impaired confidence channel, is likely to weigh on private consumption and investment through 1Q17. During the second half of the year the statistical base will become more supportive and an acceleration of GDP growth rates seems more likely.

The level of the exchange rate and higher inflation data and expectations will require a tight monetary policy in the first part of the year. We therefore expect the government to intensify usage of its fiscal room to boost domestic demand. However, a recently announced credit guarantee facility and employment and tax incentives are aimed at bolstering domestic demand. We expect Turkish economic activity growth to accelerate modestly to 2.5% in 2017.

Figure 2.11

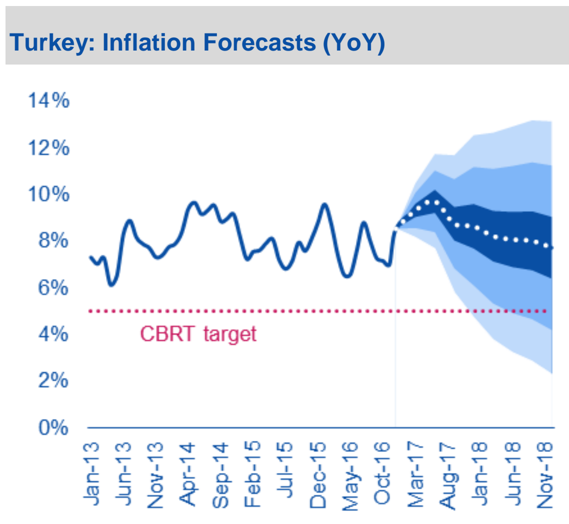
Turkey: GDP Forecasts (YoY)



Source: BBVA Research and Garanti Research

Figure 2.12

Turkey: Inflation Forecasts (YoY)



Source: BBVA Research and Garanti Research

Cost push factors to drive inflation into double digits

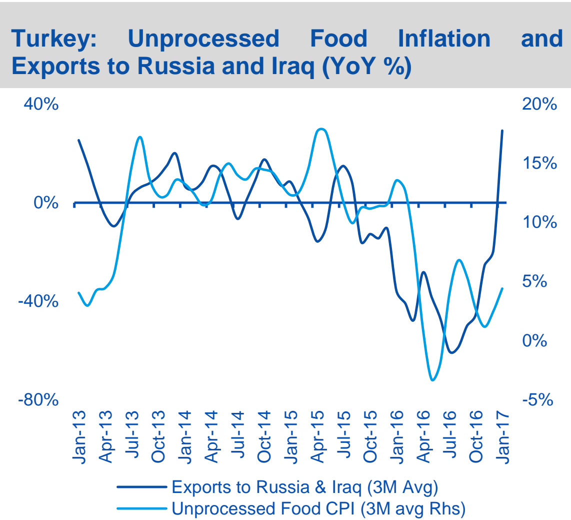
The cost push pressures stemming from first and second order exchange rate and energy pass-through are already visible in producer price inflation, which surged to 13.7% YoY as of January from 2.8% in October. Mounting cost push pressures and the unfavourable base effect of food prices will drive consumer inflation into double digits in the first quarter of the year, according to our calculations. This is despite the disinflationary impact of the recent tax cuts on durable goods & furniture and the negative output gap due to ongoing subdued domestic demand. Our calculations show that the secondary impacts of the exchange rate pass-through will continue during the year unless a major currency appreciation takes place.

In addition, the recent resumption of fruit and vegetable exports to Iraq and Russia adds upward risks of food inflation. This is an important source of upside risk as although food makes up some 22% of the CPI basket, food inflation explains nearly 50% of the volatility over the headline.

We have therefore increased our 2017 year-end inflation forecast to 8.5% from the previous 7.4%. In this respect, potential actions taken by the Food Committee could bring some downside risk while an unexpected tourism-induced increase in food demand is an upside risk to our inflation forecast.

Figure 2.13

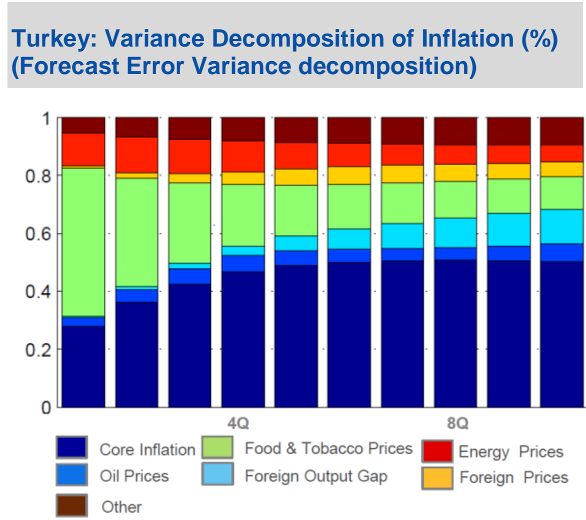
Turkey: Unprocessed Food Inflation and Exports to Russia and Iraq (YoY %)



Source: BBVA Research and Garanti Research

Figure 2.14

Turkey: Variance Decomposition of Inflation (%) (Forecast Error Variance decomposition)



Source: BBVA-GB Research Turkey MPM DSGE Model

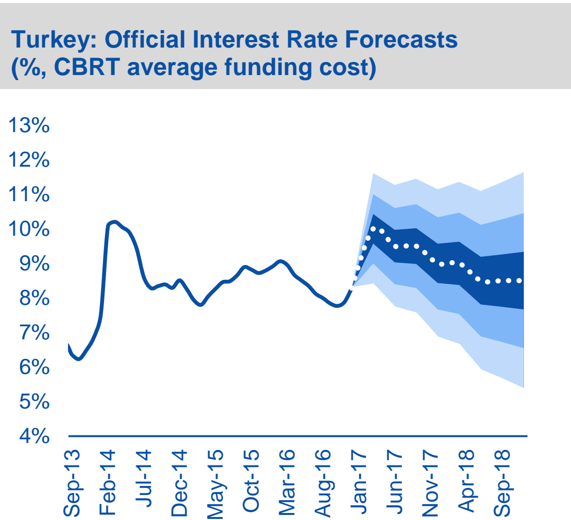
… creating a challenging environment for monetary policy

The Central Bank is faced with a significant dilemma as the slowdown in economic activity has been accompanied by a sharp depreciation in the exchange rate and rising inflation expectations. Our inflation forecasts suggest that even a zero percent ex-post real interest rate policy would require an average funding rate close to 10%. In other words, the CBRT will probably continue to use the extraordinary Late Liquidity Window as a regular policy tool for some time.

So far, the CBRT will have little room for easing until there is a visible improvement in the exchange rate and inflation. In the face of subdued domestic demand, this will lead the economy's managers to intensify the use of the fiscal space and the countercyclical macro-prudential toolbox to stimulate the economy.

Figure 2.15

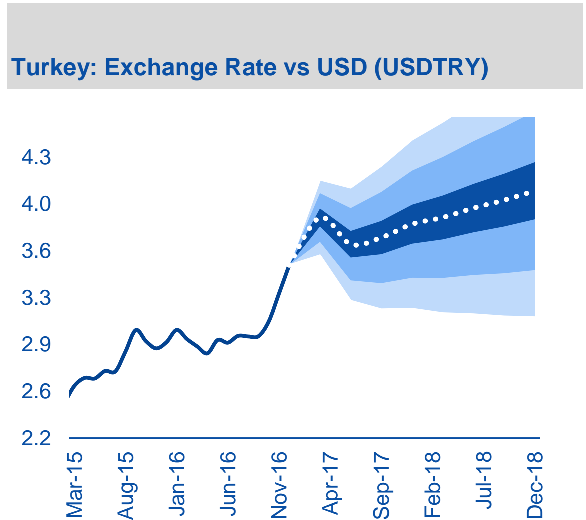
Turkey: Official Interest Rate Forecasts (%, CBRT average funding cost)



Source: BBVA Research and Garanti Research

Figure 2.16

Turkey: Exchange Rate vs USD (USDTRY)



Source: BBVA-GB Research Turkey MPM DSGE Model

Public finances will worsen due to increased fiscal stimulus

After posting a budget deficit of 1.1% of GDP in 2016, our expectation is a rise in the deficit to 1.8% of GDP in 2017. This will lead to a slight increase in the EU defined public sector debt to GDP to 28.2% from 27.6% in 2016, according to our forecasts. Even if we pencil in some deterioration in budget performance, both the expected budget deficit and public indebtedness will remain significantly below international standards, such as the Maastricht criteria. **However, the budget figures will be closely watched as the government's involvement in overall economic activity is on the rise.**

The worsening of the public balance in 2017 will be linked to increased fiscal stimulus and some potentially deficit-creating initiatives, including Private Public Partnership projects (PPPs), the Sovereign Wealth Fund (SWF), the Treasury's guarantee through the Credit Guarantee Fund (CGF) and employment incentives.

Looking inside, the Treasury guarantees for PPPs could amount to some 0.4% of GDP per year for some mega-projects including the 3rd Bosphorus Bridge and the Northern Marmara Motorway Project, Istanbul's 3rd Airport, the Eurasia Tunnel and the Gebze-Orhangazi-İzmir Motorway. The SWF does not create a sizable direct impact on the government budget as the transferred state-owned enterprises pay annual dividends of circa 0.1% of GDP. Additionally, the Treasury-backed collateral facility for SMEs and commercial borrowing with a Treasury guaranteed loan capacity of TL250bn and other short term measures to support employment have the potential to put some pressure on the budget balance in the medium term.

The current account deficit is expected to widen

We forecast that the current account deficit will rise to USD 35bn in 2017 from USD 33bn in 2016. Higher oil prices will widen the gap while potential recovery in tourism revenues will offset it in part. This will translate into a CAD/GDP ratio rising from 3.9% in 2016 to 4.5% in 2017 as the nominal GDP in USD terms will be lower due to sizable exchange rate depreciation.

Table 2.1

Baseline Scenario: Forecast

	2015	2016	2017	2018
GDP (%, y/y)	6.1	2.3	2.5	4.5
Inflation (%, average)	7.7	7.8	9.5	7.6
Inflation (%, end of period)	8.8	8.5	8.5	7.2
Official Interest Rate (%, average)	8.4	8.4	9.5	8.7
Official Interest Rate (%, end of period)	8.8	8.3	9.0	8.5
Exchange Rate vs USD (average)	2.72	3.02	3.75	3.93
Exchange Rate vs USD (end of period)	2.92	3.52	3.80	4.05
Current Account Balance (% of GDP)	-4.5	-3.9	-4.5	-5.1

Source: BBVA Research

4. Balancing Risks

Global market uncertainty remains

Although significant uncertainty remains, a cautious adjustment to our forecasts makes our macroeconomic outlook more balanced. From a domestic point of view, the higher fiscal stimulus could boost domestic demand more than envisaged, especially if the security climate remains calm and political noise wanes after the referendum in April. However, the geopolitical situation remains uncertain and the security risks continue.

On the external front, the main downside risks are governed by the new US economic policy, its impact on world growth, inflation and the accompanying monetary policy response. An unanticipated increase in inflation may lead to a toughening of monetary policy from the major central banks, with global consequences. One such risk could be a further strengthening of the US dollar, causing outflows and abrupt currency depreciation in the emerging markets. Such an episode would add challenges to Turkey's domestic monetary policy, which is already facing a dilemma, with a slowdown in domestic demand and rising inflation. In Europe, the upcoming elections pose some risks, but Russia's normalization of relations with Turkey could have a positive impact.

The cards are reshuffled in the geopolitical realm

Geopolitical risks are on an uncertain track as the regional powers' game plans in the Middle East could escalate until the US new foreign policy has been fully defined (see Geo-World: Conflict & Social Unrest - January 2017 Update). Syria and the fight against ISIS continue to be the hot topics in 2017 while the situation in Iraq could deteriorate and the attitude to and from Iran could change. The cards of the geopolitical realm are being reshuffled, with Turkey directly involved in the Syrian War and the Donald Trump presidency's foreign policy agenda still not crystal clear. The new outlook could be more risky but positive developments could balance the risks:

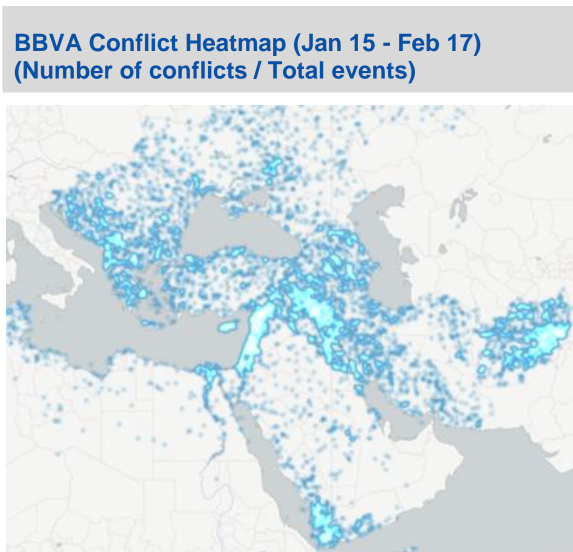
- **The Syrian War will continue to be challenging**. The Syrian theatre involves many actors from the regional to the global level. So far, Turkey, Iran, the Gulf States, including the Kingdom of Saudi Arabia, and Russia are involved and each actor is following its own agenda through a proxy on the ground. So, uncertainty still remains due to the conflicting interests of the actors. In addition, since Washington has not defined a concrete Syria policy so far and has not answered the question of with which regional actor the US will go after ISIS, the uncertainty is heating up. Nonetheless, the war against ISIS has started to make significant progress. In Syria (and in Iraq), ISIS is about to lose its key territories despite its attempts to regain lost cities and towns. Unfortunately, as ISIS loses ground in the region, the risk of retaliatory terrorist attacks against western cities could increase.
- **The regional rivalry between Iran and the Sunni actors is still alive but depends largely on US foreign policy formulation.** The nuclear agreement between the West (P5+1 countries) and Tehran is still active but with the new US administration the stakes could be higher. Due to Iran's regional aspirations and its determination to enlarge its ballistic missile arsenal, new sanctions against Iran have been issued by the White House. On the internal side, Mr. Rouhani and his team should prevent the hardliners from hijacking the diplomatic process between Tehran and Washington and contain the risks.

In the meantime, the Sunni Gulf states are also in “wait and see” mode until a new Middle East policy has been defined by the United States.

- **The Cyprus talks continue but the disagreements on power and territorial sharing are very much alive.** The Cyprus issue is crucial for Turkey’s EU agenda and regional energy politics. The parties to the negotiations are determined to keep the talks going, which is a positive sign for Turkey-EU relations. In 2017, the importance of a solution for Cyprus could increase as the Russian presence in the Middle East grows. In addition, the relationship between Ankara and Brussels seems to be calmer. Both sides tend to uphold a deal on immigration and mutual cooperation.

Figure 4.1

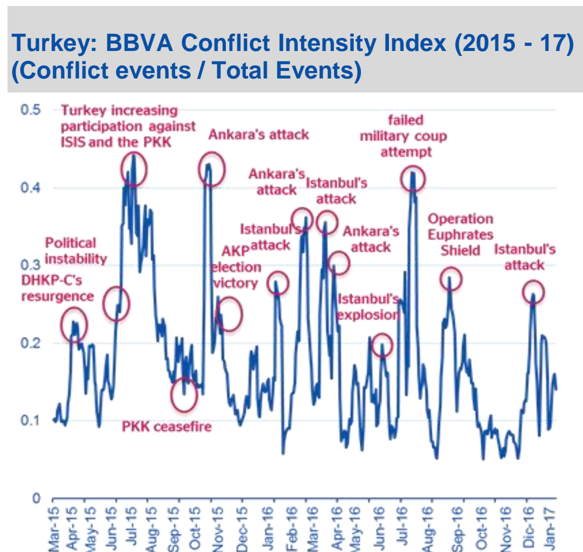
**BBVA Conflict Heatmap (Jan 15 - Feb 17)
(Number of conflicts / Total events)**



Source: www.gdelt.org, BBVA Research and Garanti Research

Figure 4.2

**Turkey: BBVA Conflict Intensity Index (2015 - 17)
(Conflict events / Total Events)**



Source: www.gdelt.org, BBVA Research and Garanti Research

The executive presidency referendum

The Turkish people will vote for “executive” presidency amendments on April 16. Under the new amended system, there would be no longer a Prime Minister and the President would have full authority over the government and serve as the head of state. The President could also declare states of emergency. In addition, the President would select the MPs to serve in Parliament since he/she could be the head of a political party (in Mr. Erdogan’s case, as soon as the amendments were approved in the referendum, he could chair the AK Party at a renewed AK Party congress – possibly in 2018). Under the old system, Presidents were obliged to drop their political party memberships. Under the amended system, it would require the approval of 400 MPs out of 600 to impeach the president.

The polls suggest that the ‘Yes’ vote has increased slightly but there is no margin for complacency in either camp. From November 2016 to February 2017, seven different polls were published. The average of the results indicates that 52.5% of overall voters could say ‘Yes’ and 47.5% of them could say ‘No’ in the referendum. However, these polls have been conducted before the President’s public rallies so there is still margin for change. The polls also missed the opposition’s upcoming rallies. As of mid-February, the impact could be more visible in the poll results. Nonetheless, if the results are still tight close to 16th April, market volatility could heighten.

Uncertainty remains on the spotlight

All in all, the complicated geopolitical atmosphere in the region around Turkey still has the possibility of negative shocks for the market. However, due to positive developments, including the fight against ISIS and the intention of reaching a peaceful solution in the region, these shocks could be contained. The sooner the Trump administration defines its new agenda, the better for the region, as some of the uncertainties could start to be resolved.

Box 1

The New National Accounts Reveal Higher Potential and an Output Gap

Introduction

The new System of National Accounts (NNA) is not just a simple revision, it significantly changes the Turkish economy's past and has implications for the future.

The key difference is that most of the sources of the accounting now come from records rather than surveys. It is therefore assumed that the NNA will measure Turkish economic performance more accurately.

The purpose of this box is not to analyse the main changes in the NNA but rather how the new data change recent economic history and what lessons we can extract for the future:

Higher potential growth...

The changes in economic growth for the period 2010-15 are sizeable. During the post financial crisis period the average growth rate of the Turkish economy was 7.5%. This is a 2 p.p average growth rate higher than we thought and places Turkish economic growth close to that of emerging Asia (EM Asian growth was X.X% while China's economy posted X.X% growth).

This extra growth could have resulted in higher potential output, a bigger output gap or both. To assess this, we will evaluate how the NNA has affected potential output using the Neoclassical Production function. **This is a function of Capital (K), Labour (L) and total factor productivity (A) with α and (1-α) the shares of capital and labour respectively (1):**

$$Y_t = A_t K_t^{\alpha} L_t^{1-\alpha}$$

If we evaluate the production function at potential we can estimate potential output as:

$$Y_t^* = A_t^* K_t^{*\alpha} L_t^{*1-\alpha}$$

Potential output cannot be measured directly and therefore must be estimated. To handle this, we apply the HP[1] filter to capital and labour using the standard value of lambda for annual data of 100[2]. We estimate the capital, labour and TFP series separately. We estimate capital by using productive investment (i.e., machinery investment deducting the amortization rate) as a proxy while we use the labour force, participation rates and structural unemployment to estimate labour at potential.

We include forecasts of Capital and Labour to 2030 in order to avoid the filter end of sample bias. Once we have estimated Capital and Labour at potential, lastly we estimate the total productivity factor or technical progress (the Solow residual).

Figure B.1.1. shows one of the salient results of the NNA. Starting from the beginning of the century, the potential output of the economy starts to accelerate, reaching nearly 5.5% in 2010 and then moderating.

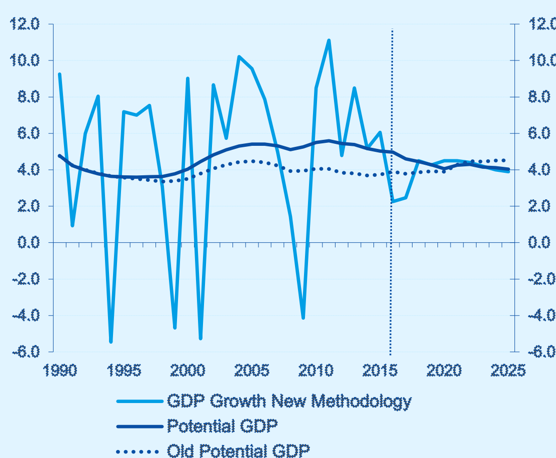
1: In order to avoid the end of sample bias from the HP filter we apply the filter to the time series including the forecasts. We complete the forecasts by making the time series converge with the steady or long run values.
2: Ravn & Uhligh have shown that the 100 lambda parameter should be adjusted in order to make the equivalence to the 1600 quarterly parameter. We opted for 100 for the comparative analysis and the results do not change substantially. Ravn, M. O. and H. Uhlig (2002), On adjusting the Hodrick-Prescott filter for the frequency of observations, Review of Economics and Statistics 84(2), 371-376.

Box 1

This is nearly 1 p.p higher than our previous estimates and sets the latest potential output growth at almost 4.7% (nearly 1 p.p higher than our previous forecast). Looking ahead, in the absence of reforms, the convergence of the drivers to their long run values will moderate potential output to about 4% in 2025.

Figure B.1.1

Turkey: Potential Output with the old and new National Accounts (% YoY)



Source: BBVA Research

Where is this new growth coming from? What were the main drivers of this robust growth rate during 2010-2015? Is moderation in 2025 unavoidable?

The analysis of the production function provides us with some insights. In principle, the statistics office has not released new employment figures (although it has already announced to analysts that there will be some revisions, especially to match the strong revisions to residential investment in the NNA). We think that the employment figures will also be revised and they will recognize a slightly higher participation rate (one of the lowest in the world). However, as we do not expect a strong revision, we think that the labour contribution to the production function will be slightly higher (near 0.2p.p), but not dramatically different. Policies to increase the still low participation rate or decrease structural unemployment could have an important pay-off in terms of potential.

The capital accumulation process has been faster than we assumed. The NNA has provided a significant acceleration of investment not only in residential but also in machinery (our proxy for productive capital). Productive capital grew at an average of 6.7% (nearly 1p.p higher than the 5.8% growth in the old national accounts). Note that in the long run we assume a trend growth of 8.0% for productive investment, slightly lower than the long run average of near 9.5%.

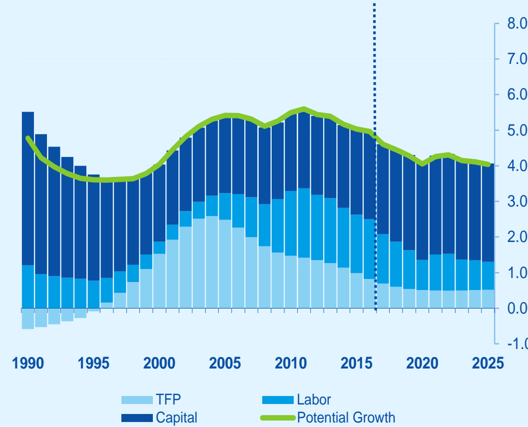
Finally, the NNA and the production function result in higher growth of total factor productivity. Here, there is good news and news of increasing efforts. The first is that the growth of total factor productivity was also higher than initially expected. This is especially true in the period 2010-15 but it has also been higher since 2003 when Turkish reforms accelerated after the Banking crisis. Thus, sticking to the EU-Enlargement process to step up reforms had a higher than previously envisaged pay-off[3]. Furthermore, it will be important to commit to a new generation of reforms to avoid a long-term moderation in technological progress.

3: See Acemoglu and Ucer (2016) The Ups and downs of Turkish Growth 2002-2015. NBER WP 2108.

Box 1

Figure B.1.2

Turkey: Potential Output wih old and new National Accounts (% YoY)



Source: BBVA Research

All in all, the NNA portrays a very different picture of the Turkish economy. The “catch-up” process following the Turkish banking crisis of 2001 and the resilience of the economy after the global financial crisis of 2009 were more impressive than we thought. Beyond this, the sources of growth were more balanced, as shown in the following graph. While labour was slightly higher, the contributions of capital and total productivity have been higher. Looking ahead, the reform momentum has to revive in order to maintain high growth rates of capital and productivity.

and a bigger positive output gap...

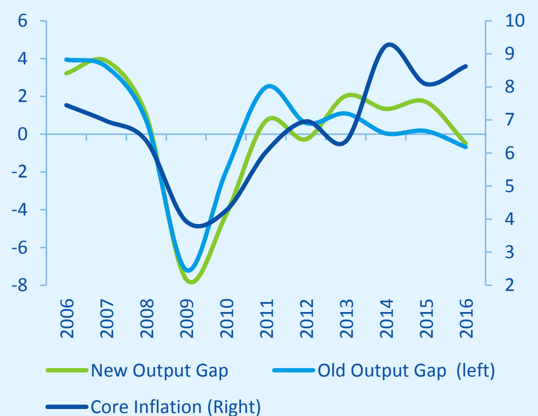
As we mentioned, potential output was between 0.5 and 1 p.p higher during the post financial crisis period. However, this fall shorts of explaining the total upward revision of Turkish GDP. So, unless we assume potential growth rates of almost 6%, the output gap should have been higher too.

To check this, we have relied on the own production function, individual ad hoc filters and multivariate filters[4] to assess the contribution of transitory shocks to Turkish economic activity.

The graph below shows the main result: the old output gap was near zero during the period 2013-2015, but this contrasts with a positive output gap in the same period when we use the NNA. All in all, demand pressures could have played a more important role in explaining core inflation rather than the traditional explanations of supply cost push shocks.

Figure B.1.3

Turkey: Potential Output wih old and new National Accounts (% YoY)



Source: BBVA Research

4: We used a total of 5 models to decompose trend and cycle and built up the output gap measures. We use individual item series filters (Hodrick Prescott , Christiano and Fiztgerald and Baxter and King) , Multivariate filters (Benes) and the production function.

5. Tables

Table 5.1

Baseline Scenario: Forecast	2015	2016	2017	2018
GDP (%, y/y)	6.1	2.3	2.5	4.5
Inflation (%, average)	7.7	7.8	9.5	7.6
Inflation (%, end of period)	8.8	8.5	8.5	7.2
Official Interest Rate (%, average)	8.4	8.4	9.5	8.7
Official Interest Rate (%, end of period)	8.8	8.3	9.0	8.5
Exchange Rate vs USD (average)	2.72	3.02	3.75	3.93
Exchange Rate vs USD (end of period)	2.92	3.52	3.80	4.05
Current Account Balance (% of GDP)	-4.5	-3.9	-4.5	-5.1

Source: BBVA Research

Table 5.2

Macroeconomic Forecasts: Gross Domestic Product

(Annual average, %)	2014	2015	2016	2017	2018
United States	2.4	2.6	1.6	2.3	2.4
Eurozone	1.2	1.9	1.7	1.6	1.6
Germany	1.6	1.5	1.8	1.6	1.6
France	0.7	1.2	1.1	1.3	1.5
Italy	0.2	0.6	1.0	1.0	1.2
Spain	1.4	3.2	3.2	2.7	2.7
United Kingdom	3.1	2.2	2.0	1.2	1.1
Latam *	0.8	-0.3	-1.4	1.0	1.7
Mexico	2.3	2.6	2.0	1.0	1.8
Brazil	0.5	-3.8	-3.5	0.9	1.2
Eagles **	5.4	4.7	4.8	4.7	4.7
Turkey	5.2	6.1	2.3	2.5	4.5
Asia Pacific	5.7	5.6	5.4	5.1	4.8
Japan	0.2	1.2	0.6	0.8	0.9
China	7.3	6.9	6.7	6.0	5.2
Asia (ex. China)	4.3	4.4	4.3	4.2	4.5
World	3.5	3.3	3.0	3.2	3.3

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date 3 February 2017.
Source: BBVA Research and IMF

Table 5.3

Inflation (annual average, %)

	2014	2015	2016	2017	2018
United States	1.6	0.1	1.3	2.3	2.0
Eurozone	0.4	0.0	0.2	1.6	1.6
Germany	0.8	0.1	0.4	1.9	1.8
France	0.6	0.1	0.3	1.3	1.4
Italy	0.2	0.1	-0.1	1.4	1.4
Spain	-0.2	-0.5	-0.2	2.1	1.9
United Kingdom	1.5	0.0	0.7	2.6	2.5
Latam *	12.1	17.4	32.1	60.1	67.5
Mexico	4.0	2.7	2.8	5.7	4.3
Brazil	6.3	9.0	8.8	4.6	4.4
Eagles **	5.1	4.9	4.3	4.6	4.5
Turkey	8.9	7.7	7.8	9.1	7.8
Asia Pacific	3.3	2.2	2.3	2.9	3.2
Japan	2.8	0.8	-0.1	0.8	1.0
China	2.0	1.4	2.0	2.7	3.0
Asia (ex. China)	4.4	2.9	2.6	3.1	3.4
World	3.9	3.7	4.8	7.3	7.7

* Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
** Bangladesh, Brazil, China, India, Indonesia, Iraq, Mexico, Nigeria, Pakistan, Philippines, Russia, Saudi Arabia, Thailand and Turkey.
Forecast closing date 3 February 2017.
Source: BBVA Research and IMF

Table 5.4

Macroeconomic Forecasts: 10-year government bond yield

(Annual Average, %)	2014	2015	2016	2017	2018
United States	2.53	2.13	1.84	2.56	2.81
Germany	1.25	0.54	0.11	0.59	1.21

Forecast closing date 3 February 2017.
Source: BBVA Research and IMF

Table 5.5

Macroeconomic Forecasts: Exchange Rates					
(Annual Average)	2014	2015	2016	2017	2018
USD-EUR	0.75	0.90	0.90	0.95	0.88
EUR-USD	1.33	1.11	1.11	1.06	1.13
GBP-USD	1.65	1.53	1.35	1.20	1.28
USD-JPY	105.82	121.07	108.82	120.50	126.50
USD-CNY	6.14	6.23	6.64	7.04	7.50

Forecast closing date 3 February 2017.
Source: BBVA Research and IMF

Table 5.6

Macroeconomic Forecasts: Official Interest Rates					
(End of period, %)	2014	2015	2016	2017	2018
United States	0.25	0.50	0.75	1.25	1.75
Eurozone	0.05	0.05	0.00	0.00	0.25
China	5.60	4.35	4.35	4.35	4.10

Forecast closing date 3 February 2017.
Source: BBVA Research and IMF

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